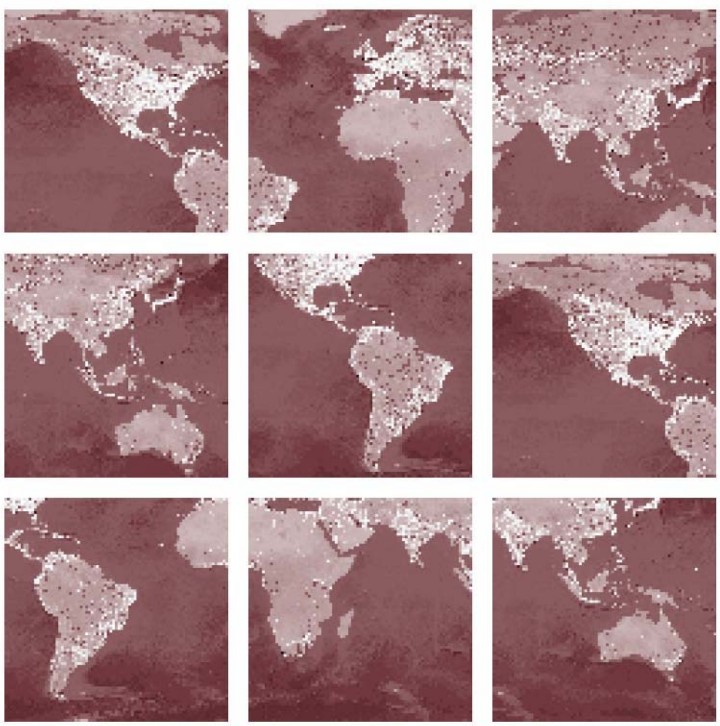
CHAPTER FIVE

THE 'B' IN BRICS: UNLOCKING BRAZIL'S GROWTH POTENTIAL

December 2006



THE 'B' IN BRICS: UNLOCKING BRAZIL'S GROWTH POTENTIAL

While campaigning for his second term, which begins in January 2007, Brazil's President Lula da Silva promised to implement economic policies that would boost GDP growth rates to 5.0%. This growth target sounds ambitious given that, since we published our first BRICs studies in 2003, Brazil has grown only at a disappointing 2.7% a year on average, compared with the 3.7% that we had estimated its long-term growth potential to be.

Brazil has underperformed not only relative to our expectations but also compared with all the other BRICs. Since 2003, real GDP growth rates in China, India and Russia have averaged 10.2%, 8.0% and 6.9%, in each case far exceeding our estimates of their long-term potential (4.9%, 5.8% and 3.5%, respectively).

The disparity in terms of growth performance between Brazil and the other BRICs raises three legitimate questions: (1) Were we wrong about our initial assessment of the growth prospects for Brazil? (2) Should Brazil still be part of the BRICs? (3) Can Brazil boost and sustain higher growth rates in the long term, say at or above a secular average of 5.0% a year?

We remain confident about Brazil's growth potential, at least in terms of what we have envisaged in our BRICs studies. The main reason for Brazil's underperformance is that, until now, the government had been in the process of implementing a stabilisation programme, with a view to achieving macroeconomic stability. This is a key precondition for growth. Thanks to these adjustment efforts, macroeconomic conditions are more favourable now than they have been for decades. The large balance of payments surpluses have been used to prepay external debt and accumulate reserves, while a credible central bank (BACEN) has reduced inflation to 3.0% in 2006.

We believe that the Lula II administration will sustain sound macroeconomic policies and make some progress on structural reforms. Stability should allow real GDP growth rates to move gradually towards Brazil's potential rate of about 3.5%, which is near our BRICs potential growth rate of 3.7%.

We also believe that Brazil could grow much faster, perhaps at a secular growth rate of about 5.0%. For this to happen, the government will have to tackle four difficult structural problems:

- Brazil saves and invests too little. To address this issue, the government will have to deepen and improve the quality of the fiscal adjustment.
- The economy should be opened to trade.
- The government must improve the overall quality of education.
- The government should implement structural reforms to improve institutions, with a view to increasing total factor productivity.

We do not believe that the Lula II administration and Congress will be ambitious enough to implement this politically difficult agenda. Therefore, while Brazil has the potential to grow at or above 5.0%, this is unlikely to happen during the next four years.

Nevertheless, Brazil will remain a valuable ‘out of the money’ option on growth. In the meantime, it will be an important destination for fixed income and equity inflows, given the high carry trade, the embedded growth option for equities and the reassurance of stable macro policies and sound external credit fundamentals.

How Brazil Stacks Up Against the Other BRICs

One way to measure Brazil’s progress is through the prism of our Growth Environment Scores (GES). Among the BRICs, Brazil showed the largest gain in our 2006 GES scores, moving up seven places, to an overall score of 4.15. However, the increase was not large enough to enable Brazil to catch up with its peers in the BRICs, with China and Russia posting increases to 4.9 and 4.35, respectively.

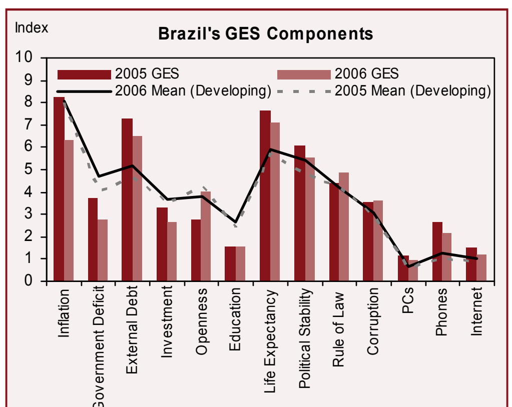
While Brazil’s growth has lagged, the other BRICs have outperformed our estimates of their potential growth rates. We think Brazil falls short relative to the other BRICs in four areas: savings and investments are low; the economy is too closed to trade; the quality of education must improve; and institutional reforms are needed.

Since 2003, Brazil has made progress towards putting in place the foundations for growth, with particular emphasis on achieving macroeconomic stability. Stabilisation has paid off: inflation has fallen, the external accounts are less vulnerable to external shocks and some progress has been made on reducing the public debt. However, stabilisation has come at a high price. Real GDP growth has averaged only 2.7% since 2003, with the adjustment explaining in part why actual growth rates were lower than the rate of 3.7% used in our BRICs studies. Since 2003, inflation has averaged 7.8%. With inflation declining to 3.0% in 2006, a strong and credible central bank should continue to help Brazil reduce the level and variance of inflation. The success of the inflation-targeting regime should gradually reduce nominal interest rates and develop credit markets; over time, this should stimulate growth.

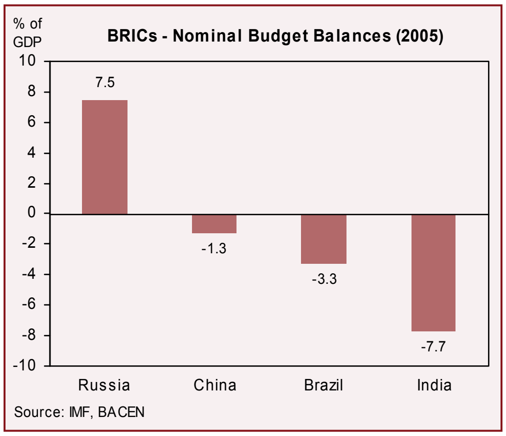
Brazil has also strengthened its external accounts significantly, using its large balance of payments surpluses to reduce its stock of total external debt by one-third, to 18.1% of GDP in 2006, and to bolster its net international reserves almost sevenfold, to US$83bn.

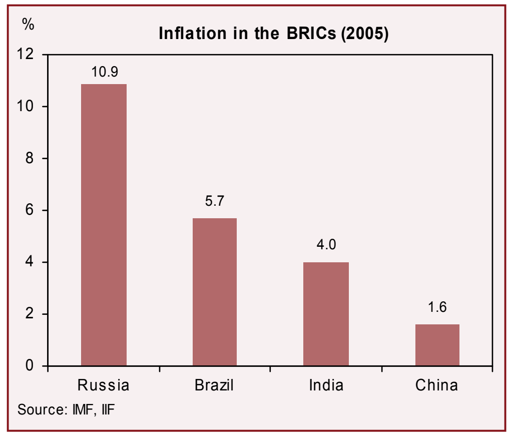
In contrast, progress on the fiscal front has been disappointing. Although the Lula administration raised the primary fiscal surplus to 4.25% of GDP, Brazil still has the second-highest nominal fiscal deficit among the BRICs, and the largest stock of total public debt. The bulk of the fiscal adjustment has been achieved by raising taxes, making the tax burden much higher than elsewhere in the BRICs.

As the indicators of macroeconomic conditions for growth in Brazil are directly linked to its fiscal performance, they are not as favourable as for the other BRICs. In



Source: Goldman Sachs





particular, we note that the investment and savings ratios are extremely low when compared with those in China and India. Although the labour force may continue to grow faster in Brazil than in China and Russia, the secular trend is declining and thus is no longer a strong source of growth for the country.

Brazil has broadened its trade platform since the late 1990s. But with its trade share amounting to just under 25% of GDP, the country is far more closed than China (where trade is almost two-thirds of GDP) or Russia (41% of GDP).

Labour productivity has lagged markedly, largely owing to the deficiencies in the quality of education. If we proxy education by the average number of years of secondary education, Brazil ranks below China and Russia. Brazil has fared relatively better on the technological capabilities front, particularly by increasing internet access and PC access faster than most BRICs other than Russia, and by rapidly expanding telephone access.

Brazil has made important progress in developing its political institutions, due to a great extent to its remarkable stability. Even so, political institutions and the nascent democracy are still evolving, and the atomisation of power inherent in the complex multi-party political system is a large obstacle to rapid implementation of structural reforms. Corruption has also been a problem, draining budgetary resources, undermining the quality of public services and leading to frequent stalemates in Congress, which in turn often stalls progress on the reform front. Brazil's overall legal framework and judicial system compare reasonably well with its BRICs peers, but we believe that they should be modernised and made more efficient, so as to better suit the needs of an open and free-market-oriented economy.

The conclusions from this brief cross-country comparison are clear. In order for Brazil to raise its growth rates and converge towards its peers in the BRICs, the Lula II administration will have to focus on fiscal policy, trade policy, education and modernising institutions.

What Derailed Brazil From Its Path of High Growth Rates?

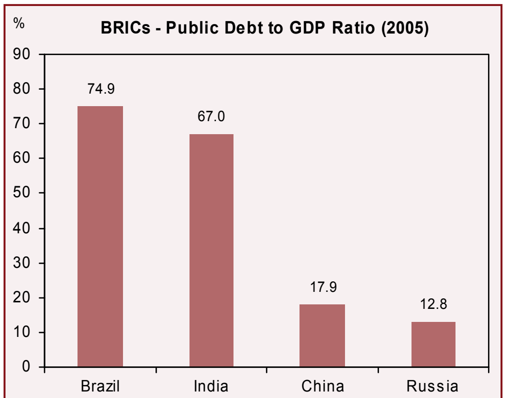
The next step towards assessing Brazil's growth potential is to understand its past. Trend growth has declined since the 1980s. The decline resulted from the macroeconomic instability stemming from a sequence of financial crises, a slowdown in population growth, a drop in domestic savings and investment and an economy that closed itself to international trade.

Over the course of the 20th century, Brazil’s secular growth rate averaged 4.9%. This is why the 5.0% growth rate is such an important reference in the growth debate. Brazil sustained a secular acceleration of growth until the mid-1960s, followed by a spectacular ‘take-off’ period lasting one decade, until the mid-1970s. Following the two oil shocks and the LDC debt crisis of 1982, Brazil entered the ‘lost decade’, marked by financial crises, hyperinflation and economic stagnation. Following the Real stabilisation plan in 1994, Brazil reorganised its finances, eradicated hyperinflation and started to grow again. But the country only managed a fraction of the growth it had achieved up until 1975.

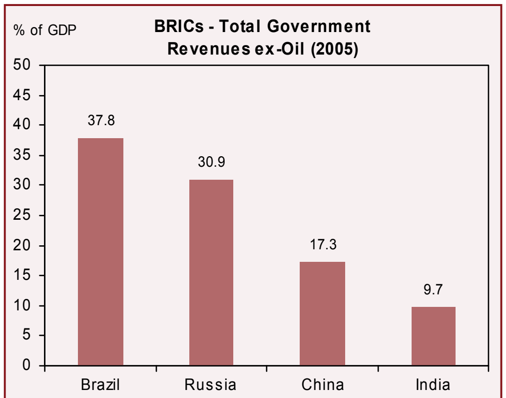
The contributions to growth from capital accumulation, population growth and total factor productivity (TFP) have changed markedly over time. From the early 20th century until the growth take-off period, these three factors contributed almost equally to growth. But as population growth rates have declined since the 1980s, growth has become increasingly more dependent on capital accumulation and TFP. Since the Real plan, growth has primarily come from capital accumulation and improvements in the conditions affecting TFP. TFP currently ranges between 1.3 and 2.0, depending on the quality of economic policies.

If Brazil is to boost growth by relying on savings, investments and productivity, then the data give us reasons for concern.

- The **savings** ratio has fallen considerably since the 1980s, only recovering somewhat since 2002, to about 22% of GDP. Most of the recent recovery has come from the private sector.
- Brazil invests much less than any fast-growing economy does. Indeed, the **investment** ratio to GDP has declined since the 1980s, recovering modestly since 2003, to about 20.5% of GDP. Again, the recovery came almost entirely from the private sector.
- Average **labour** productivity has declined since the 1980s but has recovered somewhat since the Real plan. This is in part because Brazil is inefficient at spending on education and because its labour laws are outdated. Brazil spends almost twice as much (4.1% of GDP a year) on education as China, but even so, it ranks poorly in terms of the average number of years spent in school.
- **Trade** liberalisation has exerted a strong positive influence on TFP, and thus has been a key driver of growth. Although Brazil has recently reduced trade barriers and opened up



Source: BACEN, IIF



Source: IMF, IIF

the economy to trade, it remains too closed to trade when compared with other fast-growing emerging markets. In fact, the share of Brazilian exports and imports in total world trade has plunged to less than 2.0% from a peak of 4.3% in the 1950s. Since the 1990s, as macroeconomic policies have improved, Brazil has gradually reopened its economy to trade and lifted trade barriers. The large devaluations of 1999 and 2002 also helped to make the BRL more competitive. Together with the boom in the global demand for raw materials, this has increased the degree of openness, with the sum of exports and imports reaching 24.2% of GDP in 2006 from 11.1% in 1990.

In all, we believe it is unrealistic to expect that Brazil will once again grow as quickly as it did during its 'miracle' years, or at the same rate as the Asian economies. This is simply because this phase of rapid growth—propelled by a high level of investment, rapid population growth and easy jumps in growth rates resulting from the elimination of stifling economic distortions—is over.

It *is* reasonable to expect Brazil to grow once again at its secular growth rate of about 5.0%. To this end, the government will have to implement policies that would raise savings and investment, by improving the quality of fiscal policy, and increase the contributions to growth from TFP, through better education, trade openness, investment in technology and institutional reforms.

Fiscal Policy Is Key to Unlocking Brazil's Growth Potential

Fiscal policy is a key reason why investment, savings and growth have declined in Brazil. This is because the government has built an onerous welfare state, which has led to ballooning total spending, an increased tax burden and public indebtedness. Fiscal largesse and its associated inefficiencies have crowded out the private sector, ultimately stifling growth.

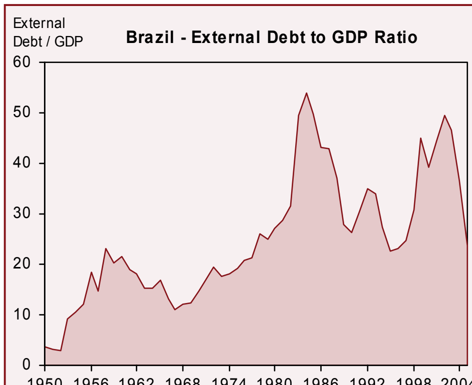
Over the past seven years, Brazil has tightened fiscal policy to rein in inflation and reduce the stock of public debt. Since 1999, the government has raised the primary surplus of the consolidated public sector to a peak of 5.0% of GDP in 2005, though it reduced the target to 4.25% in 2006. The adjustment has reduced the nominal fiscal deficit to 3.5% of GDP, from almost 7% in 2003, and reduced the stock of net public-sector debt to 49.5% of GDP in 2006 from a peak of 65.5% in 2002.

Although Brazil has tightened fiscal policy and improved its debt dynamics, fiscal policy has two big problems.

- The primary fiscal surplus is not high enough to reduce the debt ratio more quickly.

- The fiscal adjustment has been achieved solely by raising taxes, while real primary public spending continues to grow at double-digit rates.

Brazil - External Debt to GDP Ratio



Source: BACEN and Goldman Sachs

Rather than attacking the roots of the structural fiscal problems, the fiscal adjustment has only mitigated their effects on macroeconomic stability and debt dynamics. The main casualty of this approach has been growth.

The structural fiscal problem has five main causes: the generous welfare state, which in aggregate is in deficit to the tune of 4.5% of GDP; the system of revenue earmarking, which makes fiscal policy highly pro-cyclical and resistant to spending cuts; the loss of the (regressive) tool of using high inflation to balance the budget; ongoing growth in the civil service, resulting in federal wage costs averaging 5.1% of GDP in 2001-2006; and higher current spending to combat poverty, with social assistance spending currently rising by 20% per year in real terms.

In all, since 1990, primary government spending has increased by almost 11 percentage points of GDP, raising total nominal and primary government spending to 42% of GDP and 34% of GDP, respectively. In order to finance such high levels of spending, during the same period, the government raised the tax burden by roughly the same amount, to 38% of GDP in 2006—higher than in the US and close behind France and Italy.

As a result, the tax system is complex and highly distortionary; it has crowded out the private sector; and it increases informality by encouraging firms and labour to move underground. Informality reduces TFP, because it influences a firm's decisions about size and markets, precluding them from fully benefiting from returns to scale.

In order to finance higher current spending, the government has also cut public investments, reducing the effective ratio of public investment to 0.5% of GDP from 1.0% since 2002. This has accelerated the depreciation of infrastructure, which has also weighed on TFP.

The fiscal imbalances also help to explain why real interest rates are so high: (1) the stock of public debt is large relative to a small stock of private financial wealth; (2) the markets demand a high risk premium because of contractual uncertainty; and (3) heavy taxation and high reserve requirements on sight and time deposits discourage financial intermediation.

Expansionary fiscal and wage policies have increased the risk that the central bank may not meet its inflation target of 4.5%, preventing it from cutting real interest rates faster. Moreover, high real interest rates have attracted large capital inflows, forcing the central bank to continue to buy international reserves to avoid a further appreciation of the BRL.

A Policy Agenda to Boost Growth to 5%

Brazil has made so much progress on macroeconomic stability and has such unquestionable potential that the government should be more ambitious about its growth objectives for the future. With stronger economic policies and comprehensive structural reforms, Brazil could boost real GDP growth rates back to—or above—its secular growth rate of about 5%. Policies designed to improve Brazil's GES score could help make this a reality.

We believe that the Lula II administration would be well advised to implement a growth agenda aimed at boosting real GDP growth to 5.0% a year. We see a desirable growth agenda as including:

- **Raising the savings and investment ratios** to 25% of GDP. The main instrument would be a multi-year fiscal adjustment programme aimed at increasing the primary fiscal surplus to 5.25% of GDP (from 4.25%) solely by cutting current spending. This would increase gross national savings by reducing the fiscal distortions that discourage private savings. Doing so over a decade would reduce the stock of net public debt to about 28% of GDP, from just under 50% today. This would release resources to the private sector in credit markets, help Brazil to achieve an investment grade rating, reduce sovereign bond yields and allow BACEN to cut real interest rates. These developments would attract the private sector into credit markets and bolster private investment and growth.

- **Undertaking social security reforms**, with two objectives in mind. First, reducing the ratio of social security benefits to GDP for both private workers and civil servants. Among other steps, this would involve increasing the retirement age and de-linking social security benefits from the minimum wage. Second, broadening the pool of domestic pension funds by further encouraging private retirement savings. This would deepen the pool of private savings, helping the Treasury to lengthen the average maturity and duration of the domestic public debt.

- **Reforming the fiscal earmarking problem**. The existing adjustor, which is designed to reduce the effective degree of revenue earmarking, should be raised from 20% to 35%, and its life should be extended by a decade. This would allow the budgetary flexibility to cut current spending substantially.

- **Implementing a comprehensive revenue-reducing tax reform** that would lower the tax burden and reduce the allocational inefficiencies of the current system. We would like to see a simpler and more effective federal value-added tax system that would eliminate the existing cascading taxes and the tax wars among states. Reducing taxes on capital gains and eliminating taxes on financial intermediation reform would encourage private savings and investments.

- **Investing in infrastructure**, which would be made possible by the reduction in current spending and which would bolster competitiveness and productivity.

- **Reducing inflation more rapidly**, through tighter fiscal policy and a rebalancing of the macro policy mix. The target might fall from 4.5% today to perhaps 3.0% in four years. Lower debt financing needs by the government and a longer liquid benchmark for the Treasury would allow the local corporate bond markets to develop, helping the private sector to finance its capital spending programmes.

- **Deepening financial intermediation** by reducing the high level of reserve requirements and taxes on the sector, de-emphasising directed credits and relaxing the compulsory savings mechanisms. At only 33% of GDP, total financial system credit to the private sector in Brazil is just one-half to one-third of the credit ratios for fast-growing emerging economies, particularly in Asia. Financial deepening and credit availability are crucial ingredients for an efficient inter-temporal shift of resources and to leverage private investment and growth.

- **Approving the constitutional reform** guaranteeing the *de jure* operational autonomy of BACEN. Until now, the government has allowed only *de facto* autonomy, conducting monetary policy on technical rather than political criteria. Stronger monetary institutions would likely reduce the risk premia embedded in the term structure of interest rates.

- **Trade liberalisation and trade agreements** should be an important part of the programme. Brazil could use its large trade surpluses to reduce the effective rate of protection and the dispersion of import duties, and particularly to cheapen the imports of capital goods. Reducing trade and current account surpluses would lessen the appreciation pressures on the BRL, which would reduce the high quasi-fiscal costs stemming from FX intervention and reserve accumulation.

- **Pursuing multilateral trade agreements** with large trading blocs such as the FTAA and the EU. Such trade- and growth-enhancing agreements would be much more effective than bilateral and trade-diverting agreements, such as with the Mercosur and Latin American countries. New trade agreements would foster competition, lower domestic prices and expand investments and aggregate supply.

- **Implementing a comprehensive labour reform**, providing the economy with more suitable labour laws and institutions to suit a more dynamic and competitive, services-oriented economy. Labour reforms would reduce the unit cost of labour, increase labour mobility, discourage informality, diminish frictional unemployment and bolster TFP.

TFP is the magical number that explains how to extract more output from the same stock of capital and labour. The TFP is particularly elastic to measures that increase economic efficiency and build or strengthen institutions. Brazil could bolster TFP by investing in technology and by modernising its institutions, through political reform and reform of the judicial system. In this context, the government should implement six specific measures aimed at boosting TFP:

- Improving the quality and increasing the efficiency of the public provision of educational services.

- Improving the regulatory framework and strengthening regulatory agencies, increasing the transparency and dependability of contracts, while enhancing the technical autonomy and governance of the agencies.

- Privatising public services, which would increase efficiency and supply, reduce costs and increase competitiveness. Electricity generation is a key sector.

- Implementing measures to foster economic competition and deregulation.

- Reforming the judicial system to increase the dependability and enforceability of contracts and the rule of law. This should include depoliticising the courts and expediting the judicial process.

- Pursuing political reforms to improve the efficiency and reduce the costs (including corruption) associated with the complex multi-party system. This would expedite the approval of structural reforms to modernise the economy and institutions. It would include reducing the number of political parties, strengthening legislation regulating campaign financing, and altering the systems of checks and balances to reduce the serious corruption practices associated with the legislative process.

The Lula II Administration May Fall Short of the 5% Growth Target

The main economic objective of the Lula II administration is to boost real GDP growth to 5% a year. At the same time, the government plans to maintain fiscal and monetary discipline to preserve price and exchange rate stability. Although macroeconomic stability should lift growth towards the economy’s potential of about 3.5% a year, we believe there are two reasons why the Lula II administration will fall short of its 5.0% target. First, the government will not be ambitious enough to address the deep-rooted fiscal problems. Second, politicians may be unwilling to pay the political price needed to approve the more ambitious agenda of fiscal adjustment and reforms needed to boost growth.

President Lula has stated that he believes the foundations for faster growth are already in place. Therefore, he is planning to keep the primary fiscal surplus target at 4.25% of GDP. According to the government, this fiscal stance would be sufficient to reduce the net public-sector debt to about 40% of GDP in ten years. In order to preserve the 4.25% target, the government plans to implement three simple fiscal reforms: (1) reduce current spending gradually, perhaps at the rate of 0.1% or 0.2% of GDP a year; (2) renew the financial transactions tax (CPMF) for a few more years; and (3) renew the revenue-earmarking adjustor at the current rate of 20% for a few years.

The government plans to increase gross fixed investments, particularly in infrastructure. The public sector would finance such investments through a mild compression of current spending; and the private sector would be encouraged to invest by a combination of tax breaks, public-private partnership programmes (PPPs) and lower real interest rates.

The government will maintain the current IPCA inflation target at 4.5% ± 2/0%. Given that actual and expected inflation for the next 12 months are lower than the central inflation target of 4.5%, the government trusts that it will be able to slash interest rates aggressively. President Lula has no plans to approve the central bank autonomy law, but he would maintain the *de facto* operational autonomy of BACEN.

There are unlikely to be changes to the managed floating exchange rate system. The nominal exchange rate will likely continue to adjust to changes in fundamentals, but the government will maintain its preference to avoid a further appreciation of the BRL.

President Lula sees no need for social security reform, believing the social security deficit will be contained by higher social security contributions resulting from faster growth and reduced informality, along with increased administrative efficiency. He supports a gradual tax reform.

President Lula plans a major structural political reform for 2007. However, there is no consensus for such political reform, which would prioritise party loyalty (impeding frequent shifts from one party to another), impose stricter rules on campaign financing and end re-election. President Lula has significant political capital—he was re-elected with two-thirds of the votes cast, and his party roughly maintained its share of seats in the House and in the Senate. Nonetheless, to govern effectively in Brazil’s complex multi-party political system, President Lula will need to negotiate with larger parties and offer them some senior cabinet posts. This means it will not be easy to maintain fiscal discipline. Past alliances have been neither stable nor dependable, especially in securing approval for Constitutional reforms, which must be approved by both houses in two rounds and by a two-thirds majority.

In theory, therefore, President Lula will enjoy reasonably favourable initial political conditions to improve the quality of economic policies. However, in practice, the main political obstacle is that politicians do not seem convinced they need to pay the political price that the difficult pro-growth agenda would entail. To be fair, it is early days to be precise about, let alone judge, the economic programme of the Lula II administration. Although indications from the government to investors suggest that the Lula II administration will preserve macroeconomic stability, their policy intentions are modest when compared with the extensive agenda of policies and reforms that we deem necessary for Brazil to raise growth to 5.0% a year.

This means that over the next four years, real GDP growth is likely to range between 3.0% and 4.0%. This would be consistent with most estimates of potential growth rates, which range from 3.0% to BACEN’s optimistic 3.3%-4.5%. This would also be in line with the long-term growth rate of 3.7% that we have deemed feasible for Brazil in our BRICs reports. For these reasons, we are comfortable enough to confirm Brazil’s BRICs membership.

Conclusions and Investment Implications

Although Brazil’s growth performance has been disappointing, we remain comfortable in expecting it to achieve the BRICs dream. The government has made progress in establishing one of the pre-conditions for higher growth—macroeconomic stability. However, progress has been modest in some areas, particularly on fiscal and trade policies, while the public debt, the tax burden and the overall quality of fiscal policy have remained a major drag on growth.

We believe the Lula II administration will be marked by policy continuity, with some progress on the structural reform front. However, we believe that the Lula II administration will neither be ambitious enough nor have the time to implement the demanding agenda of more growth-oriented macroeconomic policies and the structural reforms required to eliminate the obstacles for faster growth. This notwithstanding, the Lula II administration will likely make enough progress on both fronts to raise real GDP growth towards the potential rate of 3.5%.

A more ambitious programme aimed at rebalancing the macroeconomic policy mix and structural reforms could raise Brazil’s growth rate to 5.0%. We therefore believe that Brazil is a valuable ‘out of the money’ option on growth, making the country particularly attractive for equity and long-term corporate investors. This upside scenario is unlikely to materialise during President Lula’s second term, due to governance problems and a lack of Congressional commitment to growth-oriented reforms.

In the meantime, Brazil will remain an important destination for fixed income, equities and direct foreign investment inflows, because of the high carry trade, the value of the embedded option on growth, and its sound macroeconomic policies and external credit fundamentals. Hard currency debt spreads are likely to continue to tighten, as the Treasury buys back global bonds, while rating agencies are likely to upgrade the sovereign to just one notch below investment grade. Modest reforms and not-so stellar growth rates will likely preclude Brazil from becoming full investment grade during the Lula II administration.

Paulo Leme
December 4, 2006