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Global Finance Crisis and Development in the South

The Brazilian Response

Paulo Paiva

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Global Finance Crisis and Development in the South: the Brazilian Response.

Paulo Paiva[1]

Introduction

There is evidence that the recession that has befallen almost all the economies in the world since the end of 2008 has already been overcome. The most recent forecasts for economic growth for this year and next exceed the most optimistic expectations of a few months ago, although much uncertainty remains about the recovery of industrialized economies. According to estimates published by the IMF[2] this year, the average growth of the world economy is expected to exceed 4% in 2010 and 2011. Even more surprising will be the expected growth of 3.3% for the United States (US) economy[3], the center of the crisis, in 2010. Growth in excess of 1% is expected for the Euro region, and 2.4% for Japan this year.

In turn, the emerging countries will maintain much higher growth rates. For example, for 2010 and 2011, estimates for China point to growth of 10.5% and 9.6 %, for India, of 9.4% and 8.4% and for Brazil, of 7.1% and 4.0 %, respectively. These estimates point towards two unexpected trends, both in relation to expectations on the extension and depth of the crisis, and in regards to the growth trends observed before the crisis: (i) the recovery seems to be quicker than expected, and (ii) the speed of the recovery varies strongly when compared to the average performance of the emerging economies with that of the industrialized economies. The emerging economies will maintain annual growth rates comparable to those of the previous cycle, while the industrialized economies will recover slowly.

Thus, it seems that not only was the crisis overcome, but the post-2009 global economy is poised to be much different than it was before. If the estimates for the next two years are extended into the future, a significant change will be seen in the relative position of several economies. For example, the difference between the sizes of the Gross Domestic Products (GDP) of the industrialized economies and those of the emerging economies will be significantly reduced, breaking a trend that had been occurring for

[1] President of the Development Bank of Minas Gerais S.A. (BDMG). I thank the assistance and comments of Tonyedson Pereira e Lana. The opinions expressed herein do not represent the view of the BDMG, and any errors or omissions are the exclusive responsibility of the author.
[2] See IMF, World Economic Outlook, Update, July, 2010.
[3] By the middle of 2010 US economy has shown signs of lower growth.

more than three decades. A simple example will suffice to show this new trend: considering the sum of the economies of China, India and Brazil and forecasting growth, weighted by the size of each one of them, it can be seen that this “new economy” will double in 10 years. Another indicator that can be seen are the results in the future forecasting current estimated rates for the next two years, which could probably occur. If the industrialized economies continue to grow at around 1.5% a year, while the emerging economies grow at around 6% a year, by the 2020s, the ratio between the Gross Domestic Product of the United States and that of China may reach 1, that is, they will be equivalent in size, while today the ratio between the American economy and the Chinese economy is 2.75; that is, the US economy is almost three times larger than the economy of China.

How did the emerging economies react to the crisis? What are the opportunities and threats to future growth? Can these countries play a more relevant role in the international political and economic context?

This paper tries to address these questions, using the case of Brazil as an example. Brazil is a special case to analyze. Its economy was growing vigorously before the crisis, albeit at relatively lower average levels, when compared to India and China, for example. Within this growth, Brazil was showing significant gains in the reduction of poverty and inequality. Thus, a new standard of development was consolidating itself in Brazil. On the political arena, democracy had been strengthened by stable institutions, and the country had begun to play a relatively greater role in international decision-making forums. The crisis interrupted the growth that was underway. But was the pattern of economic growth with social inclusion also interrupted? Was the growing international political influence of Brazil harmed?

This paper is an attempt to respond to these questions, by analyzing in the coming sections which were the channels for propagation of the crisis, and its impacts in Brazil, what measures were taken to mitigate its negative effects, and what results were obtained, and what are the main opportunities and threats, from both the domestic and international standpoints, that the Brazilian economy will have to face to continue growing with greater social equilibrium. The paper ends with a brief conclusion.

Crisis propagation channels

The crises of the eighties and nineties began in the emerging economies, and spread from there to the other economies, principally through the contagion caused by the risk of default in sovereign debt in foreign currency. These were crises that originate in governments and that affected the financial markets. In some cases, as in the second half of the nineties, the contagion affected economies on all the continents.

This time, the crisis began in the United States, the center of the globalized economy. It was initially a crisis of the financial system, and spread throughout the world. It is interesting to examine the channels through which the crisis spread before we go on to discuss the actions taken by Brazil to mitigate their effects.

The crisis reached emerging economies through a number of channels at both supply and demand sides.

On the supply side, firstly through the financial markets. The stoppage of the American and European money flows eliminated financing mechanisms for export from emerging countries, cut credit facilities for banks from those countries and practically closed operations for banking institutions in industrialized countries that operated in emerging economies.

Whatever credit remained, it has come at a very high price for borrowers.

Secondly, through the stock market. Accompanying the drop in the prices of commodities, the price of stock fell rapid and deeply. The stock exchanges became unstable and in order to meet the needs in their countries of origin and fearing the risks, foreign investors abandoned their assets positions in the stock exchange of emerging countries amplifying the drop in those markets. The drop in the value of the shares on the stock markets affected the assets of many companies and countless investment funds, often reducing the capacity for new productive investments.

Thirdly, through export. The demand for commodities fell, thus affecting export and, as a consequence, the production in emerging economies dropped. In the case of Brazil, the reduction in demand for mineral products and industrialized products, such as iron and steel products, had a significant impact on mineral and manufacturing output.

Internally, credit restriction amplified the effect of the crisis. Banks restricted credit and elevated interest rates in a high risk environment. Inter-bank operations almost stopped totally affecting the solidity of small and medium banks. Finally, total lack of trust ruled.

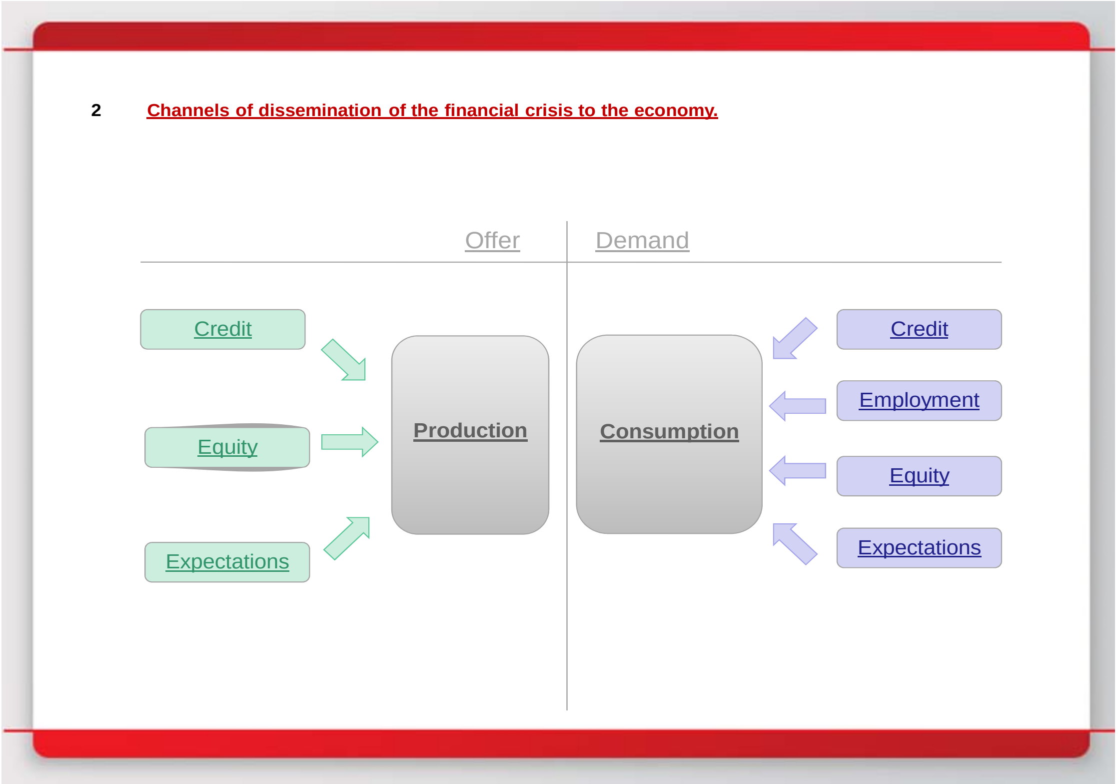
Credit reduction. Many companies with loss of assets due to the fall in the prices of commodities and stock, and still increase of uncertainties with regard to the future constituted factors that determined the fall in the offer of goods and services.

On the demand side, there was also a restriction. High unemployment rates, lack of credit and uncertainties regarding the future were the ingredients for retraction in consumption, especially of durable goods which depend a lot on financing.

Expectations of both producers and consumers are another channel for propagation of the crisis. The first evaluations of the crisis led many consumers to delay purchase decisions, principally for those in the upper middle class who saw significant losses in valuation of their assets.

Chart 1 presents a visual explanation of how the effects of the external crisis affected the Brazilian economy, both in terms of supply and demand, as described above.

Chart 1: Channel of Dissemination of the Financial Crisis to the Economy



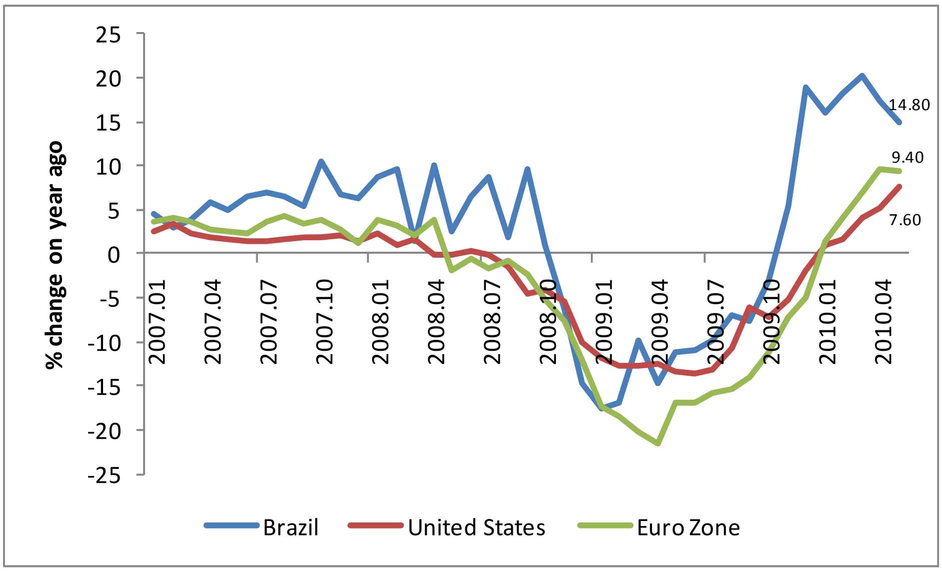
The final result was a drop in GDP, with negative rates lasting for three quarters.

Crisis impact on Brazilian economy

Although at first, it was thought that the crisis would affect the Brazilian financial system more deeply, the result was very different. Even with the credit crisis, the Brazilian banks dealt fairly well with the impacts of the crisis, which were more accentuated on industrial production, and as a result, on GDP. The impacts were also short-lasting, as can be seen in the following data.

Chart 2: Industrial Production

Euro Zone, USA and Brazil: jan.2007-may.2010



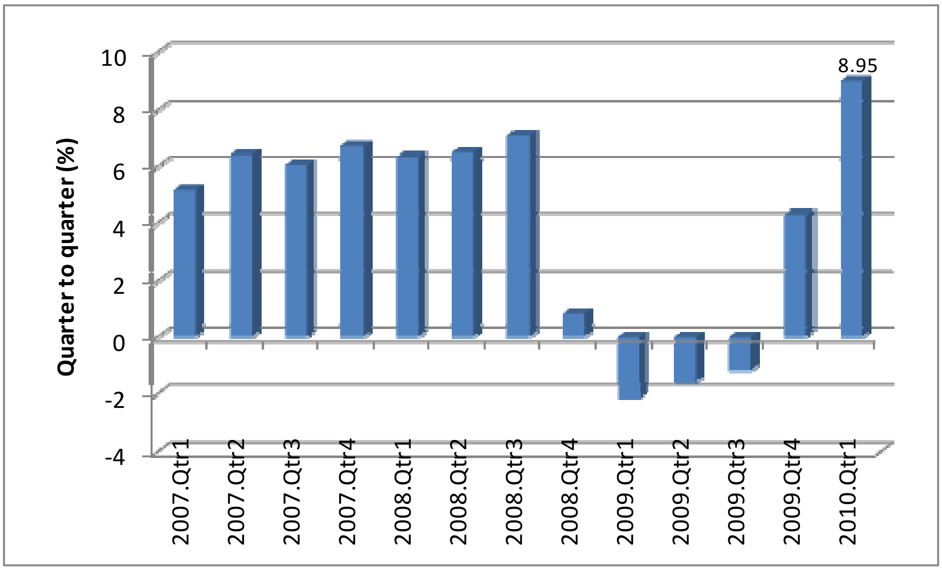
Source: IBGE

Note that industrial production in Brazil followed the same path as in the United States and the Euro zone, falling sharply in the last months of 2008 and recovering in the last quarter of 2009. Because the Brazilian economy had been growing faster, the drop was also steeper. Industrial production in the United States and in the Euro Zone had been slowly falling since the end of 2007. This drop became more pronounced beginning in the last quarter of 2008.

During the recovery phase, Brazilian industrial production reacted more strongly, presenting annual variation in the first quarter of 2010 of around 14%, much higher than the recovery of industrial production in the United States and in the Euro Zone.

Chart 3: GDP Quarterly Growth Rate

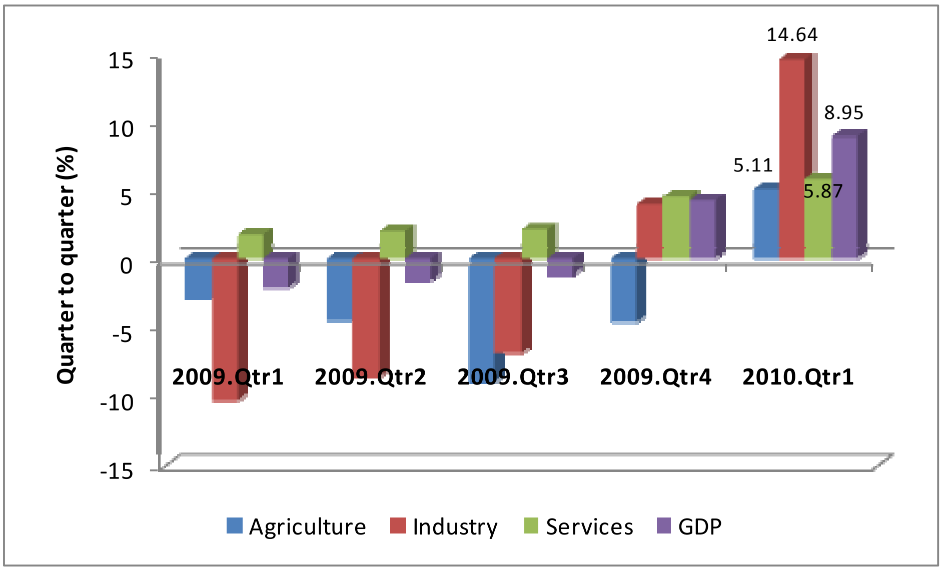
Brazil: GDP Growth Rate - 2007Qtr-2010Qtr



Source: IBGE

The impact on Brazilian economic growth can be seen in Chart 3. The crisis interrupted growth that had reached some 6% annually, and was increasing. In the margin, the Brazilian economy was growing at an annualized rate of 7%. There was an abrupt drop in the last quarter of 2008, with a period of three quarters of negative growth. The recovery began in the last quarter of 2009 and in the first quarter of 2010 the variation compared to the first quarter of 2009 was 8.95%. Not only did the economy recover, but it also returned to the path of expansion it had been on before the crisis. The expectation of both, market and IMF, for 2010 are for growth of around 7%, greater than that in 2008.

Chart 4: GDP Growth Rate by Economic Sectors – 2009/2010



Source: IBGE

As mentioned previously, the fall in Brazilian economic growth was mainly due to the reduction in industrial growth, as can be seen in Chart 4, which presents the performance of the GDP growth rates by industry. Agriculture closely followed the behavior of industry, mainly due to a drop in exports, and services maintained soft growth throughout the crisis period. This sector played an important role in attenuating the social impacts of the crisis, as we will see later on.

How Brazil reacted to the crisis[4]

The crisis seems to have affected Brazil more strongly on the real side of the economy, rather than in the monetary side of it.

Brazil was much better financially prepared than in previous crises. It is worth mentioning the main elements which strengthened Brazilian economy to face crisis, by showing what was the remote responses, that is, reforms and policies which have

[4] This session is an update and an expansion of parts of my paper: Impact of Economic Crisis on Brazilian Economy (2009).

strengthened Brazilian economy, and then the immediate responses to deal directly with crisis impacts.

As the remote responses in addition to a few reforms that since later eighties started the modernization of public management, the implementation of the *Plano Real*, a program for currency stabilization in 1994, established a new standard for Brazilian economy.

Beginning with the *Plano Real*, there were several reforms to modernize the country's economic management. Brazil overcame a long period of hyperinflation and economic instability, promoting in-depth reforms to consolidate the operation of market mechanisms, privatizing important productive sectors, encouraging integration in foreign trade, and maintaining solid economic fundamentals in macroeconomic policy. The most relevant reforms for discussion by this paper will now be presented in a summarized fashion.

In 1995, a Program was implemented to incentive the restructuring of the financial market[5], which provided for a clean and sound financial system in Brazil. Insolvent banks were sold or extinct, there were mergers and acquisitions and commercial banks owned by Brazilian states, with rare exceptions, were liquidated and their good assets were sold to private banks. The rotten assets were segregated and the states themselves attempted their recovery, outside the books of the new banks. After the implementation of that program Brazilian banking institutions became better capitalized and stronger.

The Securities and Exchange Commission (CVM), which had been created in 1976, was modernized and consolidated in 2001, and had a fundamental role in the supervision and control of the capital market. Probably, in regard to governance, regulation and supervision, Brazil has one of the better and more modern stock exchanges among emerging economies[6].

The Central Bank of Brazil kept on performing its functions of supervision and regulation of the financial system with a competent team of professionals. As far as banking supervision is concern, Brazil adopted both the Basel principles I and II. Administration of Brazilian Central Bank has a long history of de facto independence from government.

As a consequence of these reforms and measures, Central Bank supervision was extended to all financial institutions, including investment banks, and the requirements for capital are those established by the Basel agreements, which has contributed to a lower vulnerability of the Brazilian banking system. Thus, risk control in the Brazilian banking system has been shown to be fairly effective.

[5] The program related to private banks was called PROER, other related to public banks was called PROES.
[6] BOVESPA, Brazilian stock exchange, has very modern standards of Corporative Governance.

On the side of public administration, a fiscal responsibility regime was implemented by Law in 2000, which limited indebtedness by the states and municipalities, and instituted principles and rules for fiscal management. This law was instrumental in contributing to fiscal equilibrium, an important factor to ensuring stability of the Brazilian economy during the crisis period. The Law of fiscal responsibility also encouraged a new standard of public management based on the principle of budgetary equilibrium.

In addition a program of privatization was able to take away from government's responsibility steel companies, telecom companies, some companies on the energy sectors to mention a few, contributing towards better governance of these companies, to increase private investment, for greater efficiency in the market, and finally, for fiscal equilibrium.

These reforms made the financial market more solid and fiscal management more balanced.

As policies are concerned, coherent macroeconomic policies, which are based on the foundations of monetary stability and fiscal equilibrium have been adopted in the nineties and persist until today. A mechanism to control prices by means of inflation targeting, associated to a fiscal program which generates enough primary surplus to initially contain and, then, reduce the net public debt to Gross Domestic Product ratio are complemented by a policy of floating exchange rate.

These pillars of macroeconomic policies, which begun under *Itamar Franco* administration, were fully established by *Fernando Henrique Cardoso* government and have been totally maintained under *Luiz Inácio Lula da Sillva* administration, thus consolidating the credibility of the Brazilian economic management, since 1994. Its continuity is one the (if not the one) most important elements perceived by the market, regarding Brazilian public management, when it comes to economic policy.

As a result of both economic policy reforms and management, the country rode the winds of the expansion of international economy and retook its growth trajectory. As a consequence, international reserves grew, currently exceeding US$ 240 billion. The public debt to GDP ratio fell considerably and public debt in foreign currency turned negative, which means that the country went from external debtor to external creditor. In spite of the relatively higher internal costs (difference between the external and internal interest rates) to maintain external reserves, they ended up being an important source of insurance against the crisis.

It is not hard for one to understand that the country received the investment grade, with the Brazilian risk falling to levels way below the “country risk” standards among Latin American countries just before the crisis has begun.

These conditions were essential to alleviate the impacts of the crisis in Brazil.

As soon as the crisis reached Brazil, as immediate responses the federal government took quick measures to minimize its impacts. These were anti-cyclical measures in both monetary policy and fiscal policy.

On one hand, the Central Bank opened credit lines to finance exports. An effort that was more comprehensive with support from the United States’ Federal Reserve (FED), which opened a line of credit for Brazil, which by means of exchange swap operations has been contributing to reduce the fall in the offer of credit in dollars to its exporters.

Exchange auctions undertaken regularly by the Central Bank aimed at maintaining a reasonable level of financing to exports and also for allowing Brazilian companies to renew their credit line in the international market.

Due to the previous monetary instability and specific conditions of the Brazilian financial market the Central Bank has maintained for several years a conservative financial policy, with relatively high levels of compulsory deposits and basic interest rates at high levels. As a consequence, credit as proportion of the GDP in Brazil has been relatively low, reaching an average of 30% in 2007. That policy strategy turns out to be functional at crisis time.

Then, Central Bank has used the large volume of the compulsory stock to supply banks with money, and subsequently has reduced the basic interest rates aimed at assuring liquidity in the banking market. Thanks to the monetary strategy adopted in the past, there was space to use it now with effective results to minimize the negative effects of the crisis[7].

Faced with the crisis, the Central Bank has now counted on efficient instruments to manage the monetary policy. There has been still room for the use of monetary policy, differently from a number of industrialized countries, where the basic interest rate is already around zero.

However, the reduction in the basic interest rate has a few limitations that need to be overcome before they can reach the levels of the more developed economies.

[7] The Central Bank did not hesitate to raise the basic interest rate in 2010 when inflationary pressures could have threatened the medium-term economic growth strategy. The basic interest rate, called the SELIC rate, is applied to one-day financing operations, backed by federal government paper.

On one side, the lack of credibility and increasing risk in banking transactions prevent that the reduction of basic interest rate reaches in its totality to the rates offered to the borrowers. So the decline of the market interest rate is smaller than that of SELIC. There are still restrictions to inter-bank operations with small and medium banks. These banks are currently exposed to pay much higher rates for getting new deposits, whether from bigger banks, whether from the public. Central Bank has offered a deposit guarantee fund for up to 20 million of *Reais* in order to allow medium and small banks be more competitive in getting deposits from the public.

On the other side, the institutional structure of the Brazilian financial market still carries traces of the indexation period. For instance, public bonds are still been carried in the sort-run due to the absence of a long-run market for public bonds; mismatch between liquidity and investment gains (there are some saving accounts with high liquidity earmarked to long-term investment, as in the case of FGTS[8]); and, still, tax burden and administration fee on financial operations, especially on applications in funds whilst there are tax exemptions for deposits in savings accounts linked to the housing system both with the same liquidity time. Those distortions in the financial market may impose a roof for the basic interest rate. The reform of such structure is a challenge that is necessary and urgent, even though complex and of difficult political consensus[9].

Central Bank eased the purchase of small and medium private banks by larger private banks. At the beginning of the crisis, this decision was an indication that, if one bank could get in liquidity or solvency problem, it could be sold instead of go to bankruptcy.

Finally, through specific legislation, public federal banks[10] were authorized to purchase portfolios and banks. That measure had an important impact signaling to the market that no bank in Brazil would be liquidated. Besides, by authorizing federal banks, eventual purchases by them would not affect the fiscal equilibrium because they would not be made with tax resources or government indebtedness. Not directly due to these measures, there was the fusion of Itaú Bank and Unibanco Bank, two of the larger private banks in Brazil, Banco do Brasil, a public bank, bought Banco NossaCaixa[11] and acquired almost 50% of Banco Votorantim`s shares.

On the other hand, the government adopted credit and fiscal measures to stimulate economic activity. Brazil has a tradition of keeping its tax burden relatively high for Latin American standards. Nowadays, the weight of taxes represents approximately 37% of

[8] FGTS stands for Fundo de Garantia por Tempo de Serviço (a fund that in the sixties was created for subsituting employment stability).
[9] Political difficulty comes mainly in the case of special public savings (*caderneta de poupança*), which is addressed to middle and small savers.
[10]Two federal owned commercial banks were authorized: Banco do Brasil and Caixa Economica Federal
[11] Nossa Caixa was owned by the state of São Paulo and one of the remaining state owned banks.

the GDP[12]. The country did not use the period of economic expansion to adopt an anti-cyclical fiscal policy. On the contrary, it allowed ongoing expenses to expand at a rate far above GDP growth. So, with no reduction of public expenses there is not much room for decreasing the tax burden, unfortunately.

Then, in the fiscal area, the government adopted measures of support to some sectors by means of tax exemptions. The automobile sector was one of the first beneficiaries. Then, exemptions went to durables goods, manly the so-called white line, and housing sectors.

Although those measures have actually some positive impact on consumption in the short run, as the crisis is general, support to specific groups may result in privileges, changes into the structure of relative prices, with no guarantee that the incentive to resumption of the economic activity will be permanent.

On the side of public credit expansion, the measure seems to be correct, but the action of public banks may be very limited.

As Brazil has a public development Bank (BNDES)[13], actions to expand credit have been taken. The government increased BNDES capitalization, which started to play a more relevant role in financing the Brazilian economy, also entering the area of credit concession for working capital unrelated to investment projects.

BNDES has limited resources and if it goes to the market searching for funding will get it at higher cost as compared to the cost of it basic fund: tax resources, under the responsibility of the National Treasury[14]. The Brazilian Government adopted an aggressive BNDES capitalization position with Treasury resources, which increased the country's gross debt. BNDES' quasi-fiscal operations have already reached 7.5% of GDP. The Treasury issued public debt, at market cost, and BNDES offers this credit at subsidized interest rates, below the SELIC rate. There was strong growth in public credit, principally focused on industrial activity. For example, the BNDES offered a line of credit with more subsidies for the purchase of equipment manufactured in Brazil[15], created a line of working capital financing, independent of investments, which is an operation that is typical of a commercial bank, and increased its offer of credit in general.

[12] The increase in the tax burden in Brazil was very large. It went from 25% of GDP at the end of the eighties to its current 37%, according to Pinheiro (2010).

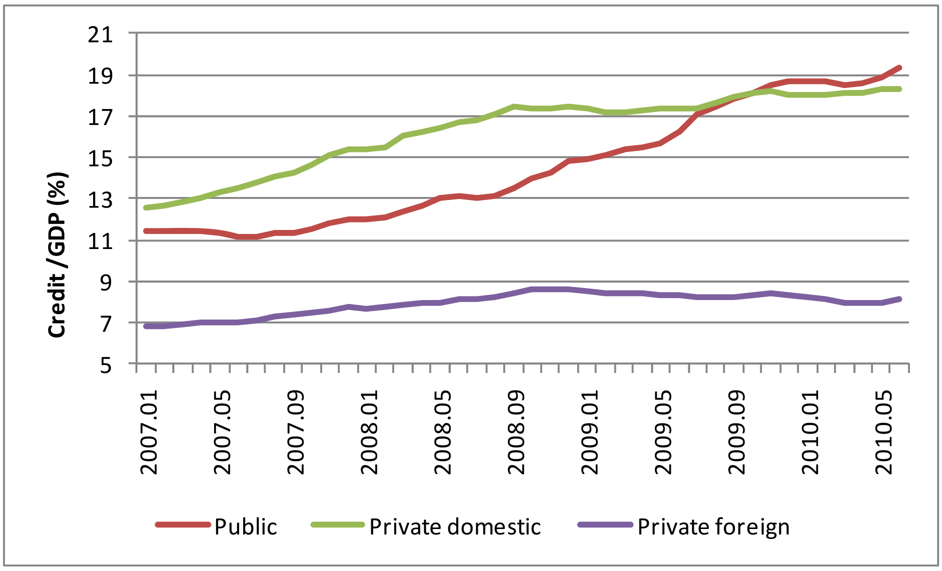
[13] BNDES or Banco Nacional de Desenvolvimento Econômico e Social is the largest national development bank in Latin America

[14] Main BNDES funding is FAT (fund of workers aid), which cost is a special interest rate, so called TJLP, which is lower that SELIC, National Treasury opportunity cost. TJLP is also the basic cost of BNDES loans.

[15] For example, it increased the financing program for acquisition of domestically manufactured machinery and equipment (FINAME) with much lower interest rates.

The role of the BNDES has been highly discussed in Brazil recently. Although its importance is recognized, not only as in anti-cyclical action, but also as an instrument to stimulate investment, given the distortions and limitations of the private long term credit market in Brazil, the impact of its capitalization on government's gross debt, without the clear transparency of its subsidies included in the Federal budget and the possible disincentive of its growth on the strengthening of the capital markets are questions that need to be faced.

Chart 5: Brazil - Credit of financial system/GDP (by origin of capital)



Source: BCB

Chart 5 shows the rapid expansion of credit during the crisis, which was an important factor in softening the negative effects of the recession. It grew by almost 50%, from around 30%, at the start of 2007, to almost 50% in the middle of 2010. Private foreign banks did not participate in the increased supply of credit. In fact, since the total volume of credit grew, the supply of these banks in relation to total credit fell. The main factor behind the expansion was the increase in the public credit supply.

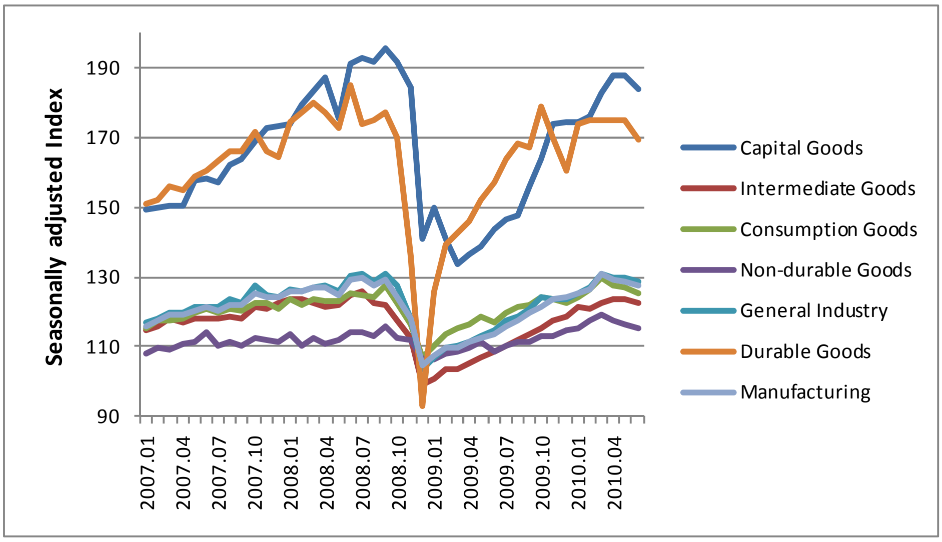
It should also be mentioned that during the last fifteen years, Brazil developed programs that were important in strengthening the country's social bases. In first place, the *Plano Real*, by eliminating hyperinflation and stabilizing the economy, made it possible for workers with lower incomes to maintain their purchasing power. Social programs designed to transfer income, like the *Previdência Social* (Social Security Agency), which offers benefits to a large number of the elderly, the Social Assistance Organic Law, Unemployment Insurance and the *Bolsa Família* (Family Scholarship Program), are responsible for maintaining access to revenues for a large portion of the lower income population in Brazil. Finally, the real growth in the minimum wage has become the bases for remuneration of workers in formal employment sector in the economy, for whom purchasing power has grown over the years. The real increase in the minimum wage has been made possible as a result of low inflation rates and growth in formal employment. All this has ensured access to consumer goods by the lower income population, and thus reduced the impact of the crisis on those industries in which the products are destined for the domestic market. Finally, those industries that produced for the foreign market were the most affected by the recession, while those that meet domestic demand were the least affected.

Results of Brazilian reaction to the crisis

The net result of the crisis and its recover on industrial production, including with the impact of all measures mentioned previously can be seen in Chart 6.

Chart 6: Brazil - Industrial Production by Sectors

(average 2002=100)



Source: IBGE

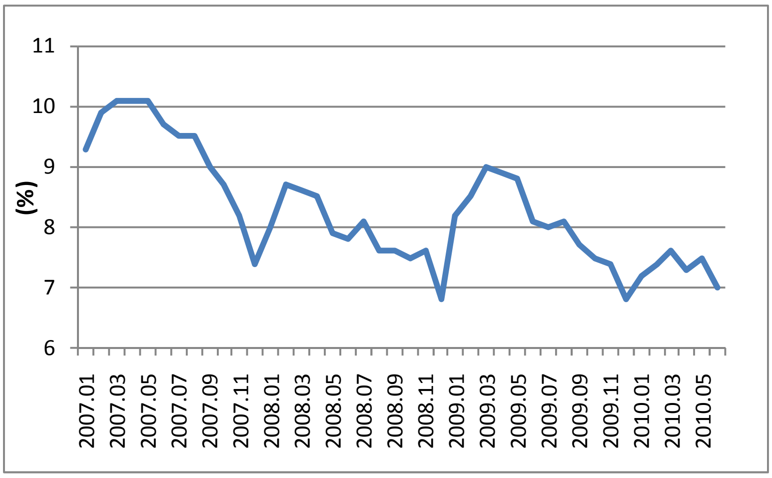
In first place, the areas most affected by the crisis were the capital goods and durable goods industries. The negative effects of the crisis on non-durable goods were much softer, thanks to growth in the domestic market. The restriction on credit mainly affected the automobile industry and the durable goods production industry, in which sales depend to a large degree on consumer financing.

Thanks to the anti-cyclical measures, both with regards to credit growth and to fiscal exemptions on automobiles and durable goods, recovery of the capital goods and durable goods industries was rapid, contributing to a return to industrial production at pre-crisis levels, in the first quarter of 2010.

It is worth mentioning that the increase in foreign demand for commodities, for which prices began to rise in the last quarter of 2009 also played a relevant role in the recovery of the Brazilian economy, although less than the growth in domestic demand.

In the social area, it can be seen in Chart 7 that unemployment rates had already reached their lowest levels in recent years, and their increase during the crisis was relatively moderate.

Chart 7: Brazil – Unemployment Rate (Metropolitan Areas)



Source: IBGE

In summary, the crisis affected the Brazilian economy, the rapid responses with anti-cyclical measures, together with the solid macroeconomic policies, which have been in practice for many years, and the economic and financial reforms of the nineties, helped to mitigate its effects, and the Brazilin economy returned to its pre-crisis growth.

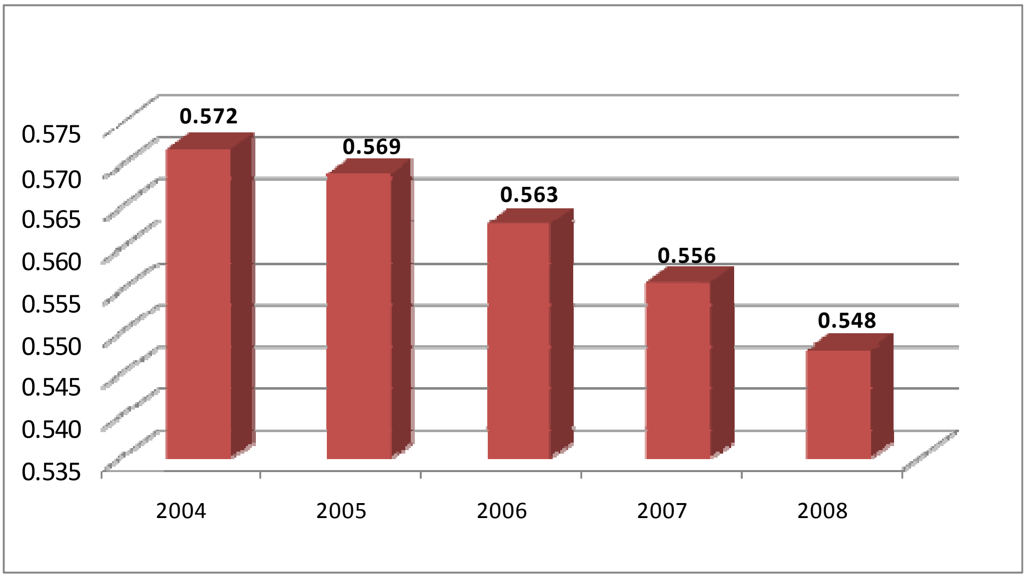
What next?

The Brazilian economy has excellent opportunities to continue to grow in the coming years.

From the domestic standpoint, there is growth in the market, principally in relation to growth in the so-called middle class and in the reduction of poverty and inequality.

Chart 8 shows the significant reduction in income inequalities as indicated by the behavior of the Gini Coefficient.

Chart 8: Gini Coefficient



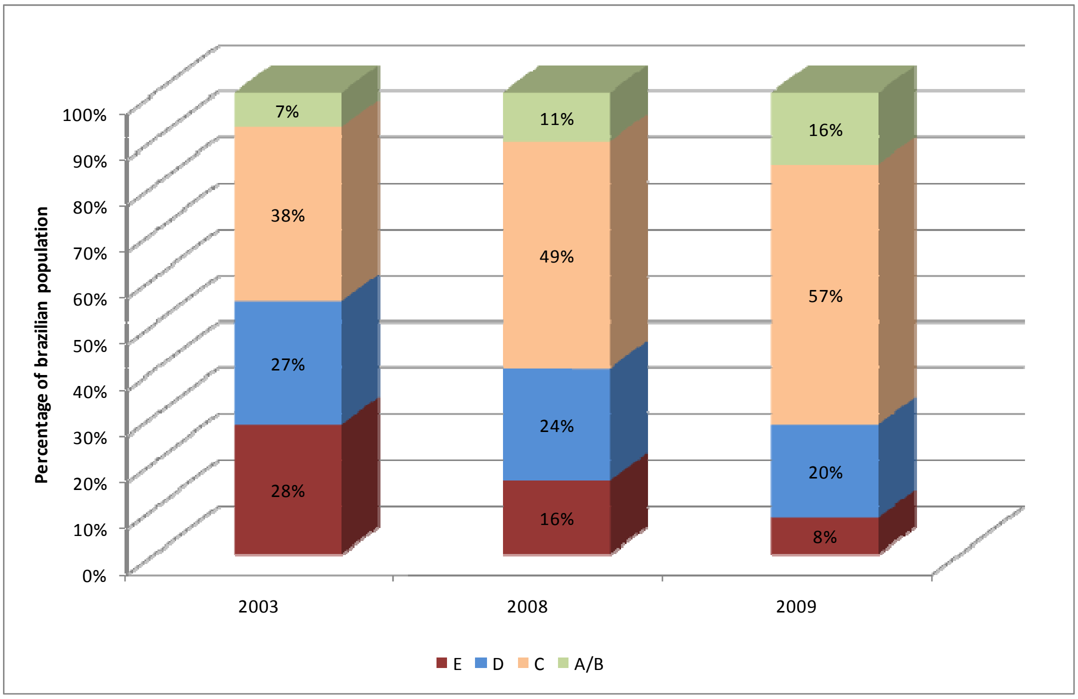
Source: IPEA

Since the implementation of the Plano Real, with the economic reforms and maintenance of economic and social policies, which sustained economic growth, Gini Coefficient has been falling. More recent data show that from 2004 to 2008 it fell from 0.572 to 0.548.

The Gini Coefficient shows the reduction in inequality, but says little about the reduction in poverty.

Chart 9 shows the distribution of the population by classes of income, and indicates actual change in the structure of revenues among the Brazilian population.

Chart 9: Evolution of The Brazilian Population According to Income Class



Source: Exame

Monthly Household Income: A/B: more than US$2,406 / C: from US$558 to US$2,406 / D: from US$384 to US$558 / E: from zero to US$384

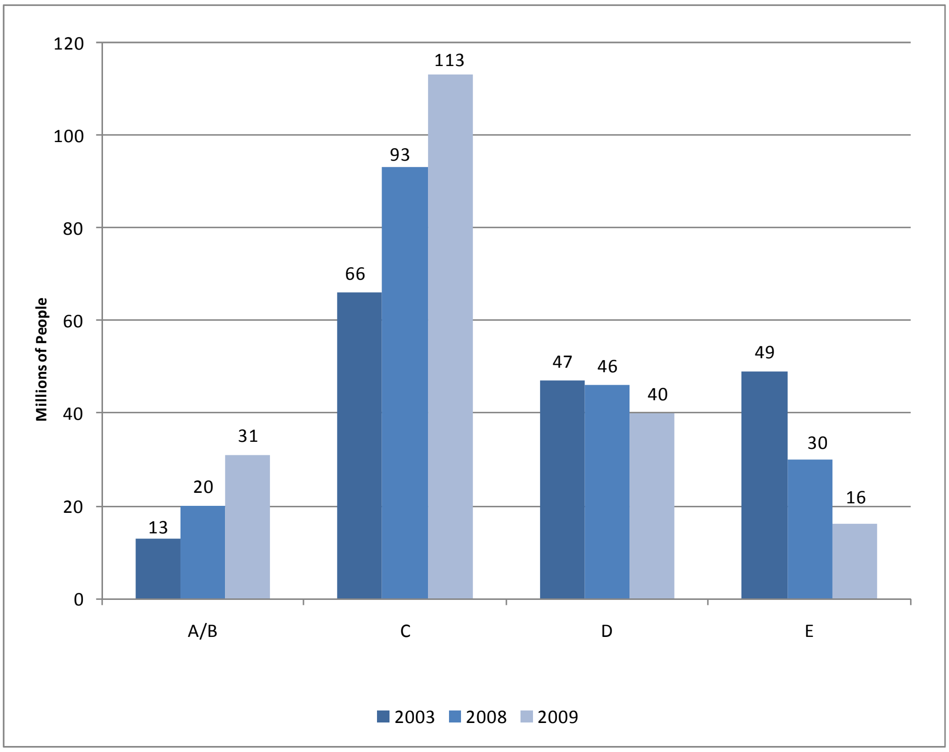
The graph shows the population distribution by income classes, with A/B the highest income class, and which has a standard of consumption similar to that of the industrialized countries, and with class E corresponding to the poorest segment. Between 2003 and 2009, the poorer classes (D and E) reduced their share in the total Brazilian population from 55% to 28%. The largest increase was in class C, the middle class, which today accounts for some 57% of the total population. This segment began to benefit from access to consumer goods, through an increase in its revenues, and through access to credit. Automotive financing became easier, with lower interest rates and longer terms. Financing for major appliances was also made more available. This led to enhanced access to consumer goods from classes with relatively lower income.

Private health care plans have been growing, as has enrollment in private schools. This segment represents the main domestic opportunity for growth of the Brazilian economy.

Chart 10 gives an idea of this growth in absolute numbers. Between 2003 and 2009, the number of people in Class C grew more than 70%, that is, some 47 million people. This number is similar to that of the population of Colombia, or to the sum of the populations of Chile and Peru. Comparatively in terms of the number of consumers, it is as if Colombia or Peru and Chile together had entered the domestic consumer market in Brazil during the last seven years.

This seems to be the greatest transformation in the Brazilian economy, and has been stimulating domestic consumption and changes in the economy.

Chart 10: Brazilian Population According to Income Class



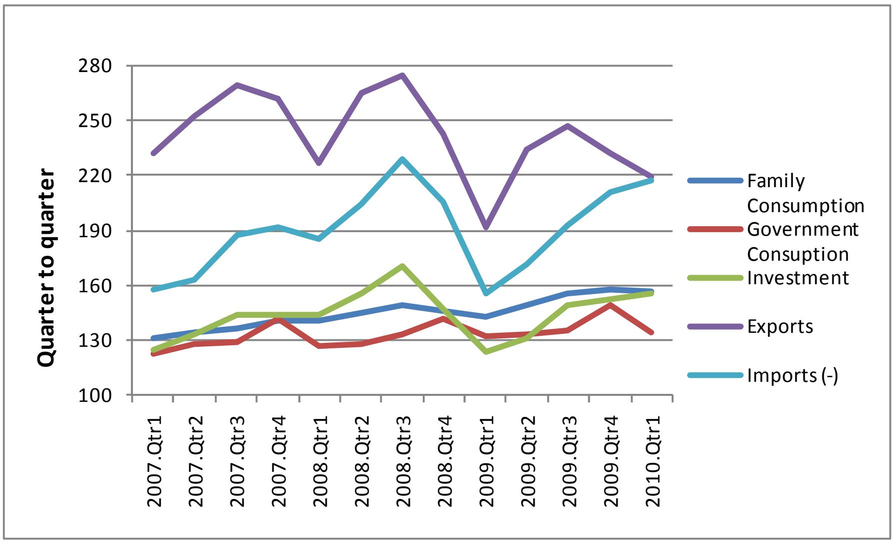
Source: Exame

Monthly Household Income: A/B: more than US$2,406 / C: from US$558 to US$2,406 / D: from US$384 to US$558 / E: from zero to US$384

In fact, when we analyze the evolution of GDP by sector, it can be seen that consumption by families and imports are the main factors responsible for growth in the Brazilian economy. See Chart 11.

Chart 11: Brazil – GDP Index by Sector (Expense)

(Average 1990=100)



Source: IBGE and IPEA

If these are the largest domestic opportunities for economic growth, there are also important threats that could impede sustained economic growth. On the one hand, the tax burden in Brazil, as previously mentioned, is very high, around 37% of the GDP and is more concentrated in indirect taxes, which contributed to economic inefficiency. On the other hand, current government expenses have been growing more quickly than the GDP, which raises the public deficit. Expenses growth due to the fiscal anti-cyclical measures in order to stimulate the economy resulted in a reduction of the primary surplus. Within the scope of these measures, many others with permanent effects, like salary increases, new hiring, etc, will be added to rapid growth in current expenses, and may lead to fiscal imbalances in the near future.[16]

Increasing consumption by families, the high tax burden and current expenses in rapid growth lead to lower savings rates. As a result, there are lower levels of investment to guarantee economic growth. The largest domestic threat to growth is the low level of investment as a proportion of GDP. There are serious deficiencies in infrastructure that must be faced in the near future. Public investment is very low. The alternative of increasing the public debt to guarantee investment, with high domestic consumption, may lead to high inflation. The alternative of substituting domestic savings with foreign savings is unsustainable, whether from the point of view of the balance of payments, or of exchange rate stability.

From the standpoint of productivity, the main threat is from the relatively low education rates among young people (future workers in the coming years). Although almost all the children are in school, high school graduation rates are relatively low.

In summary, the domestic opportunities require changes in fiscal policy and deepening of economic reforms that enable more private investment, principally in infrastructure and in education.

The economic and social policies as well as a new agenda of reforms will be defined in 2011 with the start of the new government administration.

From the external standpoint, there are also great opportunities, principally from the growth in other emerging economies, like China, India and Southeast Asia. The growth in these economies is expected to keep the commodity market strong, and may hold prices at current levels.

External threats come from the behavior of industrialized economies, principally the United States and Europe. The possibility of a new recession in these economies could have more serious effects on the international financial market, and, as a consequence, on the emerging economies, like Brazil. The fiscal imbalance in these economies is a threat to the sustainability of their growth and price stability. Unlike what occurred in 2008 and 2009, when the crisis was in the financial system, now the risk is of sovereign default; that is, of countries, like Greece, Spain, Portugal and Ireland, which would have a significant effect on the relation between currency and market equilibrium. This is the greatest external threat to the growth of the Brazilian economy.

A new world recession, or even of the industrialized countries, could possibly again interrupt the cycle of economic expansion with social inclusion in Brazil. Within this

[16] Fiscal balance has been deteriorated. This matter has not been considered very much in the future perspectives of market evaluation.

context, it is up to the emerging economies, like Brazil, to play a more active and solidary role in the construction of solutions that re-establish commercial balance, strengthen the financial system and allow fiscal re-adaptation of countries at risk. In summary, in a globalized world, everyone is in the same boat, and countries like Brazil, whose relative importance in this context has increased, also have their share of responsibility in this broader search for solutions.

This is not an easy task, but an international agenda, in which Brazil's opinion should be constructive, is already under discussion and considers (i) the creation of a new Bassel agreement (Bassel III), as a proposal discussed within the scope of the G20 at the beginning of this year, with stricter capital requirements for financial institutions, (ii) construction of a new international financial architecture that creates mechanisms for supervision of operations that are not submitted to national central banks; (iii) the review of governance of multi-lateral institutions like the IMF and the World Bank so that countries with economies that are beginning to occupy a greater share of the international economy may have a stronger voice and more responsibility in decisions, obviously with participation compatible with the capital of these institutions, (iv) review of the practices of corporate governance in private sector economies to ensure transparency and rendering of accounts of all stakeholders, and finally (v) greater active participation and solidary responsibility for developing nations in international forums that govern the political balance and the well-being of the global population.

Concluding remarks

Brazil has been a good example of a country that has managed to reconcile economic growth with social inclusion. The country has been implementing important reforms for more than 15 years to ensure economic stability and consolidate democracy. As a result, even with the political alternating in the federal government, so far there is to certain extend continuity in the foundation of the economic and social policies, and in the basic commitment to democracy.

The international crisis that emerged in 2008 interrupted for more than three quarters the economic growth process that had been taking place in Brazil. At the end of 2009, the economy began to grow again, and has already reached pre-crisis levels.

Three sets of reforms and policies were essential for this performance and can be seen as remote responses from Brazilian government. In the first place, there are the economic reforms that began with the implementation of the *Plano Real* in 1994, on the one hand, consolidated the financial system and the institutions that regulate and oversee the market, and on the other hand, the practice of fiscal responsibility. In second place, very important was the continuity in the macroeconomic policy based on three pillars: inflation targeting, floating exchange rates and fiscal responsibility. In third place, as immediate response, there was the adoption of anti-cyclical policies, principally in the areas of tax exemption for the hardest hit sectors and the increase in the offer of credit through public banks. Among these measures, it is also worth mentioning those that maintained credit for Brazilian exporters.

Behind the success of the actions to mitigate the effects of the crisis is a strong process of social inclusion, with reduction in inequality and transfer of some 27% of the population that was below the poverty line to segments with higher purchasing power.

The greatest challenge in the future will be to ensure sustainability of growth with social inclusion, which depends on both domestic policies, and the international context, in which greater Brazilian participation in international forums may contribute towards stability in the global economy.

Beginning in 2011, with the new government, we will know whether Brazil made the right choices to ensure sustained growth with social inclusion and to contribute to global economic stability.

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