

# Brazil Competitive Profile

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## Investors urged to spread net

Study reveals pockets of excellence for business all over the country, reports *Joe Leahy*

São José dos Campos is one of those cities that can lead a foreign visitor to wonder why Brazil, Latin America's largest economy, is classified as a developing country.

The 90km drive from the international airport in São Paulo to São José dos Campos via the modern Ayrton Senna freeway, named after the Brazilian Formula One driver, takes just an hour.

There, the visitor to São José dos Campos will find a sophisticated environment for doing business, as did officials from Thales Alenia Space, the European space telecommunications company, who this month inaugurated a centre in the city's technology park to develop applications for satellites.

"São José dos Campos contains nearly 100 per cent of Brazilian space-related activities," says Carlos Rondina Mateus, aerospace cluster co-ordinator at Cecompi, an industrial promotion agency. The city is also home to Embraer, the world's third-largest commercial aircraft manufacturer after Boeing and Airbus.

But those expecting to see such investment across the rest of Brazil might be disappointed. The city is ranked as one of Brazil's 10 most competitive "micro-regions" for doing business in a study by the FT and FGV Projetos, the consultancy arm of Brazil's Getúlio Vargas Foundation, an



On the road to growth: São José dos Campos

academic institution. Strikingly, five of these 10 micro-regions are in the greater São Paulo metropolitan area or within an hour's drive of the metropolis. The rest are also in the south or southeast.

The study breaks Brazil down into 558 micro-regions consisting of clusters of

municipalities. Brazil has 5,569 municipalities and 26 states plus the federal district of Brasília. There are five macro-regions – the north, consisting mostly of the Amazon; the northeast, dominated by states such as Bahia; the centre-west, the soyabean growing belt;

the southeast, dominated by the industrial powerhouse states of São Paulo and Rio de Janeiro; and the south, which contains more developed areas with strong European immigration.

The further one travels north or north-east of São Paulo, the fewer islands of competitiveness one will see. They do exist, but in a continent-sized country such as Brazil, the challenge for business and government is to identify these more isolated pockets of excellence and to try to exploit them better in the case of investors and to replicate them in the case of policy makers.

"There is a strong polarisation of micro-regions that are very competitive and of those that are least competitive, while only a small number are in between," says the report, *Brazil's Competitiveness Profile*, by the Getúlio Vargas Foundation.

Competitiveness has become one of Brazil's most fundamental challenges. In the first decade of this century, the country rode a commodity supercycle in which seemingly endless Chinese demand for steel and agricultural products pushed up prices of Latin American exports. In turn, stable macroeconomic management allowed ordinary Brazilians to begin to borrow for the first time. More of the workforce also moved from informal jobs to formal jobs with registered companies, lifting productivity.

Today, however, most of these tailwinds have weakened. Commodity prices have softened, households have maxed out their credit cards and finally, unemployment has fallen to record lows.

Meanwhile, the investment that is needed to lay the groundwork for greater competitiveness is lacking. "We

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Brazil Competitive Profile

# Education lags behind regional peers despite investment

**Low marks** Poverty is not the determining factor in student performance, says *Luke McLeod-Roberts*

Conditions at Visconde de Itaboraí have improved radically in recent years. The state primary school, located in a semi-rural part of Nova Iguaçu, a low-income municipality in the Rio de Janeiro conurbation, has installed new water tanks, thus improving basic hygiene for its 200 or so pupils aged 3-11 and staff. It has also acquired televisions and computers and moved from part-time lessons to a full seven-hour school day.

"Things have changed a lot," says Luciene Pereira, the school's headmistress. "Before, all our funding came from the municipality, which had a one-size-fits-all approach. Now, with additional money from the federal government going directly to the school, we have greater autonomy on how to spend it."

The rise in funding reflects the emphasis that has been placed on the education sector in Brazil under President Dilma Rousseff and her predecessor Luiz Inácio Lula da Silva, both of the left-of-centre Workers' party (PT). Overall, education spending increased

from 3.8 per cent of GDP in 2002 to 5.8 per cent in 2010, a level that is above most countries in South America and on par with many developed nations.

As well as investments in equipment and new buildings, one of the biggest changes has been the expansion of student numbers across of the spectrum, whether it is through the likes of the Bolsa Família programme, which provides a monthly stipend to families that ensure their children go to primary school, or FIES, a student finance fund, which provides cheap student loans for those wishing to go to university.

"Never before has so much been invested," says Dilvo Ristoff, director of undergraduate programmes and policies at the ministry of education, who believes that the government is on track to meet its goal of more than doubling the proportion of 18- to 24-year-olds in higher education, in spite of increased fiscal pressures.

But even with the phenomenal injection of resources of the past few years, attainment levels remain below that of many countries that invest a lot less. For

example, while Brazilian secondary school students have made gains in performance in recent years in the Programme for International Student Assessment (Pisa) test, an international student measure, they still fall short of regional peers in Chile and Mexico and are far below those in Russia, all of which spend smaller shares of public money on education.

"Brazil has progressed very slowly in terms of quality," says Denis Mizne, executive director of the Lemann Foundation, a non-governmental organisation.

"The historical reason is that we started very late, but results could be a lot better."

In the case of Visconde de Itaboraí, results actually appear to have deteriorated at the same time as resources have increased. In the final-year class, six out of 30 pupils, do not know how to read and write says Ms Pereira. In 2013 the school scored just 3.7 out of 10 on the Basic Education Development Index (IDEB), a national assessment reported every two years – not only far below the national average of 5.2 that year but also

0.8 percentage points lower than the school's own result in 2011.

Ms Pereira says part of the problem relates to specific social factors. "There are students that need services the school can't provide. I have 19 pupils with a speech impediment; there are students that have serious learning difficulties – it hasn't been medically diagnosed because the parents have no interest in pursuing it."

But Mr Mizne believes that socio-economic factors are only part of the explanation. "There's no doubt that there's a correlation between lower socio-economic levels and greater educational challenges. But what we [have found] is that poverty is not the determining factor in student performance."

Instead, Mr Mizne believes a clear curriculum, better levels of teacher engagement, and training that is more appropriate to classroom needs, are just as important.

A recent study from the OECD club of rich nations revealed that Brazilian teachers spend just 67 per cent of classroom time actually teaching, the lowest rate among any of the countries

surveyed. The rest is spent mainly trying to impose order. "Teachers aren't prepared to deal with discipline issues. Their training is very academic," says Mr Mizne. "They are evaluated on the basis of a test that is 100 per cent theoretical, not on their ability to teach."

It does not help that teacher salaries are low by international standards, in spite of recent rises. It is not uncommon for teachers to moonlight in other jobs to earn extra cash or to go on long-term sick leave. All this filters through to the learning environment and many pupils end up dropping out.

The number of students finishing secondary school fell 1 per cent, from 1.88m in 2012 to 1.86m in 2013, according to data from FT LatAm Confidential, a research and analysis service. Inevitably, this has started to have an impact on higher education, with the total number of higher education freshers falling by about the same amount over the period.

This was during a time when there was unprecedented access to funds. Now that student finance is expected to be cut, the goal of further increasing university enrolments seems remote.

**Lagging behind: the Bolsa Família programme has failed to bring attainment up to the levels of Brazil's rivals**

Houston Chronicle/  
Marcelo Salinas



# Innovations promise much, yet fail to reach their potential

Industry

Economic and political problems threaten to reverse a decade of advances, says *Samantha Pearson*

On January 26, Brazil's state-controlled oil company Petrobras announced that its biodiesel unit planned to triple production of tallow, a form of processed fat from cattle, to 158,000 tons a year, helping establish the country as one of the leaders in the production of fuels from animal fats.

However, the announcement was overshadowed by the corruption scandal that has engulfed the country's most important company over the past few months. The following day, the oil producer dropped a bombshell on investors by admitting it could not calculate the billions of dollars stolen from the company in an alleged bribery and kickback scheme involving Petrobras executives, its suppliers and top politicians.

The company's shares plunged on the announcement and any excitement over beef tallow was quickly forgotten.

Analysts say that Petrobras, which is widely respected in the oil and gas industry for the advances it has made in deepwater drilling technologies, is the perfect example of Brazil's innovation problem.

It has the capacity to become a world leader in several industries, but long-running problems such as corruption, excessive bureaucracy, weak infrastructure, short-termism and misguided public policy mean this potential is rarely fulfilled.

While Brazil last year improved its ranking by three places in the Global Innovation Index, it was still placed 61st worldwide, behind Russia, China and South Africa.

The index, which is prepared by Cornell University, Insead business school and a UN agency, pointed out that Brazil

was largely let down by its institutions and its general business environment.

Cynthia Serva, co-ordinator of the Centre of Entrepreneurship and Innovation at São Paulo's business school Insper, says that innovation in Brazil is often held back by economic instability, poor educational performance and a lack of government incentives.

While consistent economic growth over much of the past decade has allowed for a greater focus on innovation, these advances are now at risk, because of the country's current political and economic problems, she says.

After growing as much as 7.5 per cent in 2010, the economy is facing a technical recession this year for the second year in a row. Meanwhile, the Petrobras scandal threatens to engulf the government of President Dilma Rousseff and her PT party and has even led to calls for her impeachment.

Prof Serva says: "Our fear is that the recent movement [towards greater innovation] ends up being paralysed. . . . The government has much more complex problems to solve right now, so once again we have a scenario of instability that makes companies focus on the short-term."

'Fostering innovation is not really part of the government's agenda'

Brazil's universities are also not in the position to provide enough academic talent to foster innovation in the country's industries, she adds.

"They produce many research papers and studies but these are often not directed towards problems in the real world. . . . federal-funded institutions in particular have little contact with the market and they just operate within their own walls."

Academics blame low salaries for forcing them to opt for consultancy work rather than independent research



Sugarcane: harvesting for ethanol

— one reason the country's universities are not highly ranked internationally.

According to Marco Antonio Zago, president of the University of São Paulo, the region of Latin America and the Caribbean accounts for less than 3 per cent of global investment in research and development, while the US and Europe account for 34 and 25 per cent respectively.

Greater government incentives would also help encourage innovation in Brazil, says Prof Serva. "It seems that fostering innovation is not really part of the government's agenda," she says.

One example of government barriers to innovation is the ethanol industry. The country has developed one of the most advanced biofuel industries in the world, producing vast amounts of ethanol from sugarcane. Almost all cars sold in Brazil today can now run on any combination of ethanol or petrol.

However, government petrol subsidies introduced to curb inflation over the past few years have made it very difficult for ethanol producers to compete, prompting a wave of bankruptcies across what should be one of Brazil's most innovative and successful industries.

There are exceptions to the dismal scenario, says Prof Serva. "Technology industries in Brazil have more space for innovation, because it is a sector that changes so quickly. This means companies have to create products and adapt quickly or they won't survive," she says.

Much of the innovation in Brazilian industry has arisen through necessity. The challenge now, analysts say, is to provide the conditions so that companies innovate, not out of necessity, but out of opportunity.

# Excessive red tape hampers progress and leaves logistics in a tangle

Infrastructure

The government has tried to increase spending, but with limited effect, reports *Luke McLeod-Roberts*

Brazil's infrastructure lags behind that of many of its neighbours, as well as that of global peers. In the World Economic Forum's 2014-15 Global Competitiveness Report, it was ranked 120th out of 144 countries for the state of its infrastructure. That compares with 50th for Chile, 64th for China and 74th for Russia.

These poor standards are in spite of concerted attempts by the government of President Dilma Rousseff to reverse the historical levels of underinvestment in the sector via a mixture of large-scale public spending and subsidised credit for private sector concessionaires. But the impact has been limited.

Investment in logistics increased only slightly from an average of 2.24 per cent of GDP during 2007-2011 to 2.39 per cent in 2012 and 2.47 per cent in 2013, and actually fell in 2014 according to Inter.B, a Rio de Janeiro-based consultancy (Note: investment figures are expected to be altered slightly in accordance with new official methodology). At its recent peak in 2013, it was far below the 3 per cent considered to be the minimum level necessary to replace the depreciation of fixed capital.

José Virgílio Lopes Enei, an infrastructure specialist and partner at Machado Meyer Sendacz Opice, a law firm, believes one reason for the slow rate of progress on this front has been the excessive level of red tape.

Ms Rousseff's government made some moves to speed things up on key projects. These included investments in public transport for World Cup host cities.

In spite of this, a fifth fewer transport projects were developed for the event than planned, according to FT LatAm Confidential, a research and analysis service, as a result of poor local technical capacity as well as frequent interventions by auditors. Mr Enei argues that other

government initiatives have actually increased bureaucracy.

"It's true that bureaucracy is a historical legacy in Brazil," he says, but he thinks the governments of president Luiz Inácio Lula da Silva and his successor Ms Rousseff re-established a statist agenda, averse to privatisation and defensive of the state machinery. He cites the reduction in the autonomy of regulatory agencies and the creation of state-owned companies.

One example is the central role Ms Rousseff's government gave to Valec, the state-owned railway engineering company, in a set of freight railway concessions launched in August 2012. The programme was intended to see

'There was a lack of understanding as to how the private sector operates'

10,000km of freight railways improved or built by 2018, with an investment of R\$91bn (\$28bn) over a 25-year period.

But almost three years later, not one project has gone to market. Regulatory risk, particularly that associated with Valec, has been cited as one of the reasons for the lack of progress.

Another problem has been the tariff policy adopted by the government on certain schemes. In conjunction with the freight railways, the government launched a R\$42bn package of

motorway concessions to be auctioned within a year.

However, its decision to impose a relatively low upper limit on toll charges, resulting in a rate of return of 5.5 per cent, meant it failed to attract any bidders. The government eventually raised the limit and some auctions were carried out, but with considerable delays.

"There was a lack of understanding as to how the private sector operates," says Claudio Frischtak, the head of Inter.B.

He says that the government has been focusing on affordable tariffs but, for a country that invests so little, improving infrastructure should be its priority.

At the beginning of this year, Ms Rousseff said she intended to auction a further 2,625km of motorways in 2015. However, with less public money available as a result of a fiscal adjustment process, much of the funding will have to come from commercial sources.

Mr Frischtak believes that they may not make up the shortfall.

Another aggravating factor is the investigation, dubbed Lava-Jato or Car Wash by the police, into a multibillion-dollar corruption scandal involving the state-owned oil company Petrobras, which has embroiled some of Brazil's biggest construction companies. There are signs that many of these businesses are having difficulties accessing new funding and if they are found to have been involved in wrongdoing they could be banned from government work.

Andre Loes, chief economist at HSBC bank for Latin America, believes that, ultimately, the success of concessions depends upon the rates of return offered. "The perception of Brazil risk has deteriorated. You have part of the businesses which may be paralysed in the short term by the Lava-Jato investigations. But [the most important thing] is having good rates of return."

"The government has already made changes and raised the rates of return. Tenders have already improved. The return has to be realistic for the [current] situation of the country. If they are, [the returns] there will be bidders for the auctions the government intends to resume."

José Virgílio Lopes Enei: there is too much bureaucracy





Brazil Competitive Profile

# Scandal mars efforts to tame bureaucracy

**Corruption**  
The revelations of the Petrobras case have shocked the country, says *Jonathan Wheatley*

There could hardly be a better symbol of a bloated bureaucracy gone haywire than Petrobras, the government-controlled but publicly traded oil company currently at the centre of the biggest corruption scandal in Brazil's history.

In a scheme said to have cost Petrobras \$10bn, senior executives and politicians allegedly colluded to take bribes from construction and engineering companies contracted by the oil company. Even in a country inured to endemic corruption, the scandal has sickened many Brazilians by laying bare the greed, arrogance and sense of impunity apparently permeating the highest levels of the public sector.

But, like the *mensalão* bribes-for-votes scandal that rocked Brazilian politics a decade ago, the Petrobras scandal has

also highlighted the growing power and self-assurance of another branch of the public sector, the judicial system.

In the *mensalão* scandal, the Supreme Court earned the respect of Brazilians by putting senior politicians behind bars — a first in Brazil. As the Petrobras scandal has unfolded, public prosecutors have earned public admiration by pursuing senior figures in business and government and for their success in securing plea-bargaining deals with vital witnesses.

It's a dichotomy seen at many levels of Brazilian public life. On the one hand, an ossified, insular behemoth; on the other, an agile, reformist, modernising technocracy.

As the FGV Projetos study, *Brazil's Competitiveness Profile*, notes, public sector management is critical for ensuring trust in the business environment and determining competitiveness. The authors write: "It crucially influences investment decisions and the organisation of production and plays a key role in the ways in which societies distribute the benefits and bear the costs of development strategies and policies."

In assessing public sector performance, the study uses nine indicators to measure regional standards in the



management of public finances, the performance of the judicial system and conditions of public safety. Perhaps unsurprisingly, the more prosperous states of the country's south score best by these criteria, with the less developed northeast and extreme north doing worst. But there are pockets of high performance in unexpected areas such as the frontier, if not to say wild-west, states of Acre and Rondônia.

The report notes Brazil's poor

**Unrest: the Petrobras revelations have sparked protest** — EFE/Sebastiao Moreira

'[Public sector management] . . . crucially influences investment decisions'

institutional performance in comparison with other countries, citing the latest World Bank Doing Business report, which ranks it 120th out of 189 countries. It takes 102.5 days to open a company in São Paulo, the World bank says, compared with an OECD average of 9.2 days, and 2,600 hours to pay corporate taxes, against 175.4 in the OECD.

Dealing with such stultifying bureaucracy is a daily fact of life. In a recent study on bureaucracy intermediaries, corruption and red tape, Anders Fredriksson, a researcher in economics at the University of São Paulo, examines the phenomenon of the *despachante*, an intermediary hired by companies and individuals who would rather pay a fee than go through the multiple instances of queuing and form-filling needed to secure everyday documents.

Typically, *despachantes* make use of their familiarity with and contacts within the bureaucracy to speed such processes, often sharing their fees with the bureaucrats. One of Mr Fredriksson's conclusions is that, while the *despachante* system makes life easier on a case-by-case basis, it probably entrenches an obstructive bureaucracy.

On a more optimistic note, Mr Fredriksson cites the example of the

*poupatempo* ("timesaver"), a one-stop-shop where citizens can obtain an identity card or vehicle registration, for example, with much greater ease than is normal. Since they were introduced in 1997, *poupatempos* have sprung up around Brazil. The system has been observed and copied by other countries.

As Mariana Mota Prado of the University of Toronto and Ana Carolina da Matta Chasin of the University of São Paulo noted in a 2011 study, a likely reason for the system's success is that it bypasses rather than replaces the existing bureaucracy: citizens still have the option to go the old route, and the old bureaucrats are still at their desks.

In some cases, the new system has been so popular that the old one has ceased to exist; in others, it has driven reform of the old bureaucracy. But while lauding the success of the *poupatempos*, the authors are unable to conclude that it has been of net benefit to Brazil because of its duplication of cost and effort.

And while the system has been a vote-winner for the politicians who promote it, efforts to replicate its success for small and medium-sized businesses — the drivers of economic growth — have so far failed to take off.

## Investors urged to spread net

*Continued from page 1*

have an investment ratio that is the lowest of any emerging country and the lowest among the Brics," says Carlos Langoni, former central bank president and director of FGV's Global Economy Centre, referring to the group of emerging markets that also includes Russia, India, China and South Africa.

"We have had an average investment rate of 17 per cent for many years now and it doesn't go up. It is a paradox because the opportunities are there, but maybe we don't have the right framework for the private sector to lead the investment," he says.

The FT-FGV study gives a broad picture with which most Brazilians are familiar. Brazil's south and southeast regions tend to lead on most indicators, from quality of institutions to quality of life. The north and northeast, meanwhile, fall down on most indicators. While the northeast has traditionally been the poorer part of the country, the north is home to the Amazon, which remains sparsely populated and heavily forested. The study does show, however, that there are pockets of competitiveness in most states.

The study shows that for basic education — measuring primary and secondary schooling — the southeastern state of Minas Gerais accounts for 40 of the top 100 municipalities in terms of school quality.

As an example, the municipality of Tocos do Moji in Minas is 3,784th for per



versity completion rates and quality of housing.

Extreme poverty is worse in the country's north. But the most unequal city is the capital Brasília, where average income for the top 20 per cent is 22 times higher than for the bottom 20 per cent. Life expectancy is very poor in much of the north and northeast, while the top five cities for this ranking are all in the southern state of Santa Catarina.

Logistics and infrastructure are better in the south, although there are pockets of excellence along the coast in the northeast and in parts of the Amazon. Road quality is mostly appalling outside the south and southeast with the exception of some parts of the northeast.

In findings that might be interesting to investors looking to build new markets in Brazil, the study found micro-regions that ranked highly for business sophistication were sprinkled among some of the poorer states, such as Amazonas and Ceará. The same was true of regions with high numbers of employees with information technology skills — Roraima, in the Amazon, scored surprisingly strongly.

Almost every state included pockets with significant markets for goods and services, from Manaus and Pará in the Amazon to every state of the northeast. This means investors should consider Brazil as a series of markets, not just one national market.

"This reflects the substantial populations of large and midsized cities in Brazil's poorest regions, as well as the substantial driving power of agribusiness and mining to make some regions prominent in population and economic importance," the study said.

Overall, the study showed that while most investors are naturally attracted to Brazil's developed regions, such as São José dos Campos, the more intrepid might want to explore less advanced regions. While they might not have the industrial might of Brazil's southeast and south, most states in Brazil offer islands of relative competitiveness accompanied by large, often untapped, markets.

**22x**

How much richer Brasília's richest 20% are than its poorest 20%

**40%**

Minas Gerais's share of top 100 municipalities for school quality

capita income in Brazil but 13th in school quality.

Literacy levels are higher in the south and southeast of the country, but there are strong regions in Mato Grosso, a soyabean belt state; Rondônia, an Amazonian state; and Manaus, the capital of Amazonas state, deep in the Amazonian rainforest. Cocal dos Alves, in the poor state of Piauí, ranks second-last in literacy but sixth in average maths scores.

Households with personal computer and internet access tend to be distributed throughout the country, but Manaus and Roraima, another Amazonian state, have particularly high rankings for domestic information technology access. They also come higher for uni-

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Brazil Competitive Profile



Summit meeting: individual pictures (clockwise from top left) Cesar Cunha Campos; Carlos Langoni; Fernando Naves Blumenschein; and José Augusto Coelho Fernandes. Main picture: Langoni, left, and Cunha

# An agenda for an outward-looking economy

**Round Table** A panel of business observers met to discuss the areas Brazil's leaders must focus on now that the commodity boom has come to an end

**B**razil's economy has slowed sharply. The brakes were applied by the end of the commodity supercycle that occurred in the first decade of the 21st century combined with rapid credit growth. The debate in Brazil has returned to the vexed question of how to make one of the world's most inward-looking economies more competitive. The answer lies in improving education, streamlining taxation, simplifying bureaucracy in general, and fixing infrastructure. But beneath these concepts are complex questions that run as deep as Brazilian politics and culture itself.

The FT and FGV Projetos explored these issues at a round-table discussion at the consultancy's headquarters in Praia de Botafogo, against the backdrop of Rio de Janeiro's Sugarloaf Mountain. The debate was chaired by the FT's Joe Leahy and included Carlos Langoni, former central bank president and director of FGV's Global Economy Centre, Cesar Cunha Campos, director of FGV Projetos, Fernando Naves Blumenschein, co-ordinator of projects at FGV Projetos, and José Augusto Coelho Fernandes, policy and strategy director at Brazil's National Confederation of Industry (CNI). Below are edited extracts of the conversation.

**If you were president what would you would change first to make Brazil more competitive?** The answers ranged from fixing education and infrastructure to formulating a cohesive strategy on the role of the state. **Langoni** The first area I would improve is human capital and education because they are highly correlated with productivity and innovation. Brazil has succeeded in investing in education, but there is a challenge in terms of quality — there are wide disparities, especially at the regional level. The second dimension, which is also extremely important for a country the size of Brazil, is logistics and infrastructure.

**Fernandes** I would reform the national budgetary process and the tax system. *[FT comment: under the Brazilian constitution, large chunks of the budget are earmarked for mandatory expenditure in areas such as education and health, leaving only about 15 per cent of spending to the discretion of the government for investment in areas such as infrastructure.]* The way we formulate the budget is one explanation of our low investment rates. Every country has some areas in which

at the same time. The round table identified this as a key area for change. **Fernandes** The tax system is so inefficient that it is a good excuse for companies to argue against integrating Brazil with the global economy. One illustration is the cost of investment. In Brazil, for instance, the tax burden on investment in a steel plant is 10 per cent, in the UK 0.6 per cent, in Australia 1.6 per cent and in Mexico 1.8 per cent. So you start the investment game already with a big negative differential. There is a bill ready on federal tax reform that the finance minister may be able to present to Congress. But it will require political leadership. Because of vested interests, some sectors might react negatively to tax reform, even though this would be good for the economy as a whole. The thinking [among some large corporations] is that "a good taxation system is the existing one because that's the one I understand".

**Manaus — the Amazon's "not-so-free trade zone"** The panel singled out the jungle city of Manaus as one of the best illustrations of how Brazil's tax system and protectionist model of development stymies competitiveness. This city, in the heart of the Amazon, has almost no road links with the rest of the country but has become one of the Brazil's most important manufacturing bases. To help populate the region, the government created a free-trade zone there for industries, ranging from electronics to motorcycle manufacturing, by giving tax breaks on imported components. The final products have to be assembled in Manaus. To make these products viable, given the huge transport costs of getting goods to and from the middle of the jungle, the government taxes the same items heavily elsewhere in Brazil. **Fernandes** [Holding up a pencil] One of the most important reasons Brazil is one of the world's most protected economies is the existence of Manaus.

'Less government intervention allowed Manaus to grow as a production centre'

If, for instance, I want to invest in a plant to make this pencil in Manaus, first of all, I have to see if pencils are on the list of items that can be produced there. So there is a bureaucrat somewhere who makes this list. Then for this pencil to be viable, because of the huge transport cost, my competitor outside Manaus must be taxed. So it is a



Question time: the FT's Joe Leahy

very government-oriented process. **Blumenschein** Just to play devil's advocate, Manaus, even with its distortions, at least shows one thing: it was able to grow as a productive centre because of diminished import barriers. Less government intervention, at least in terms of import restrictions, allowed that to happen.

**The financial system — an area of partial success** Parts of Brazil's financial system are islands of excellence, with large private sector banks such as Itaú Unibanco and Bradesco considered regional leaders. Yet state participation in the sector remains very high, with the government development bank, BNDES, providing most longer-term lending for companies. The round table concluded Brazil needs to push ahead with financial sector development to remain competitive. **Langoni** Brazil has by far the best financial system of the Brics [the other large emerging economies being Russia, India, China and South Africa]. Compared with China, where shadow banks account for 50 per cent of the

'The decline of informality in the labour market will lead to a more liberal bias among voters'

system, or with Russia and India, Brazil is performing quite well. **Blumenschein** If you compare Brazil 15 years ago with other countries at the time, financial deepening [the penetration of the financial sector in the economy] was quite low. This has changed. Credit to GDP has grown from a marginal amount to 60 per cent. But we still have a repressed and controlled credit system in some areas. The government is the only provider of many lines of credit [such as loans longer than five to seven years]. I'm not saying it is bad, but it is something we should start to discuss again.

**Is Brazilian society ready to begin voting for competitiveness?** Brazil's centre-left president Dilma Rousseff, a champion of big government, was re-elected by a narrow margin last October. The vote was split between the more pro-business south and southeast of the country, which voted generally for the more market-friendly opposition PSDB party candidate, Aécio Neves, and the poorer, more welfare-dependent north and northeast, which voted for Ms Rousseff. The panel concluded that ordinary Brazilians are becoming more conscious of the need for a more efficient state. **Cunha** Last year's election shows the vote for a more pro-business platform versus big government is now about half and half. **Langoni** One of the main structural transformations in Brazil has been the formalisation of the labour market [employees working for formally registered companies]. Once you have a more formal economy, there is a greater understanding among people of the weight of the state in their day-to-day lives. People who have formal employment or formal small businesses become more liberal and start to criticise the government because they see lots of inefficiency. The decline of informality will lead to a more liberal bias among voters, with implications for elections.

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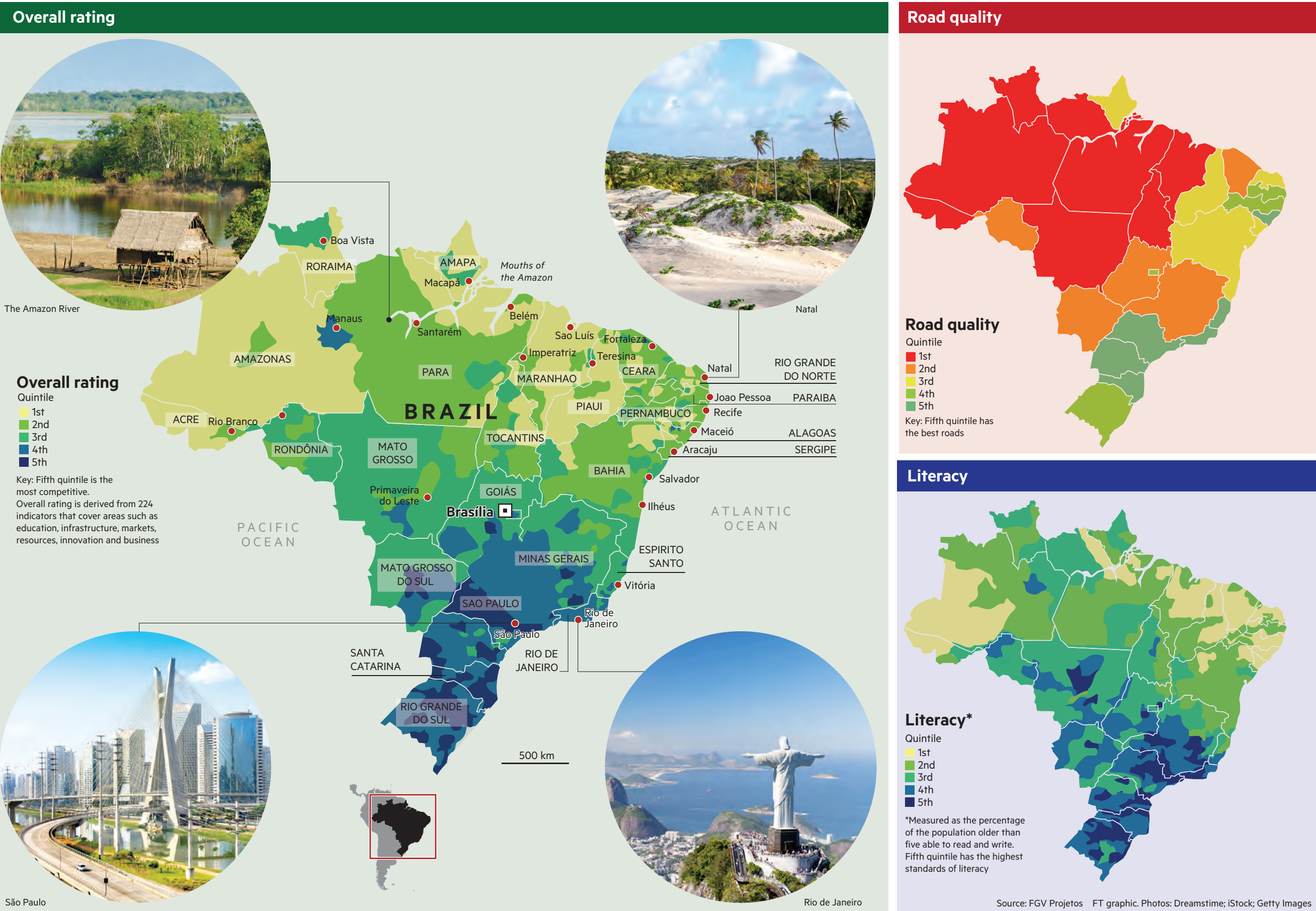
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Brazil Competitive Profile

How the regions rank



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Brazil Competitive Profile

Chronic institutional weakness holds nation back

OPINION

Richard Lapper



Brazil sometimes thinks it is in the first rank of nations but, as economic productivity and competitiveness go, it is still struggling to emerge from the lower leagues.

The picture that emerges from a glance at tables drawn up by the World Bank or the World Economic Forum is of a country hampered by weak infrastructure, complex bureaucracy and an irresponsible political elite.

In the World Bank's latest Doing Business survey, Brazil was ranked 120th of 189 economies, sandwiched between Nicaragua and St Kitts and Nevis. The country is better placed in the Geneva-based WEF's research on competitiveness. But it owes its 57th place (ahead of Cyprus but behind South Africa) in the most recent survey largely to the strength and sophistication of its private sector and

the sheer size of its market. Brazil's institutions are ranked only 94th strongest in the world by the WEF, and in subcategories that measure such things as "public trust in politicians" or the "wastefulness of government spending", it is among the worst international laggards.

The depressing thing is that in many respects the situation has been growing worse. Efforts to increase spending on transport and energy projects have delivered less than promised.

President Dilma Rousseff made some progress in privatising half a dozen big airports ahead of the 2014 World Cup, but plans to develop the railways have been botched. Legal and bureaucratic complexities — often linked to the activities of public accounts bodies and environmental regulators — lead to endless delays, contributing in the energy sector, for example, to shortages and a potential rationing crisis.

Worse, the infrastructure effort now runs the risk of falling victim to economic austerity, as Joaquim Levy, the new finance minister, seeks to restore order to fiscal accounts after several years of mismanagement.

The corruption scandal surrounding the alleged payment of bribes to officers



Trying to restore order: Dilma Rousseff and Joaquim Levy — AP

The private sector is well managed and has been good at adapting and developing technologies

in the state-controlled oil company, Petrobras, and its political allies has shattered credibility in the political elite. According to one opinion poll, 84 per cent of Brazilians think Ms Rousseff knew about the wrongdoing.

But there is a positive side to the story. Macroeconomic management is markedly better than it was when Brazil had its last round of hyperinflation 23 years ago. Unlike some emerging markets, Brazil is beginning to deal with

the corruption, with dogged police investigations bringing the malpractice at Petrobras out into the open. The private sector is generally well managed and has been good at adapting and developing technologies. Brazilian agribusiness is efficient and innovative.

A survey by the Getúlio Vargas Foundation (FGV), a university, and the Financial Times points to wide variations in productivity not only in Brazil, but in its regions. For example, although educational standards are generally lower in the poorer north and northeast than in the southeast, some northeastern states are outperforming — Ceará is the best example.

Many cities and urban regions, especially in the south and centre-west, are doing well, with local administrations working constructively with business colleagues.

That differentiation and private sector strength helps explain why Brazil still attracts significant quantities of foreign direct investment. Fund managers may be disillusioned with its underperforming equity markets but, eyeing longer-term prospects, global consumer, logistics and resource groups continue to commit funds.

Last year, FDI amounted to \$62.5bn,

only a fraction less than in 2013, making Brazil the fifth most popular destination for FDI, according to the UN.

Even in the vexed area of business rules — the focus for the World Bank's assessment — there has been some progress. In 2014, Brazil's ratings improved, partly because the time taken to open a business fell. It still takes more than 100 days in São Paulo, however, so for hard-pressed small businesses the improvement can seem imperceptible.

Perhaps this slow and uneven advance is not surprising. This has generally been the historic pattern in Brazil. In the 19th century the country moved to independence by importing a monarchy from Portugal, its colonial power, and abandoned slavery many years after abolition elsewhere in the west. Even in the late 20th century Brazil lived with high inflation for longer than many of its regional neighbours. Brazil will eventually tackle its institutional difficulties but if the past is a guide, change will take decades rather than years to put into effect.

Richard Lapper is principal of FT Confidential, the FT's growth market investment research service

Falling currency clears path for efficiency gains

Pulp and paper

Industry and government urged to use opportunity to remove trade barriers and boost productivity, reports *Joe Leahy*

There are some industries in which Brazil is so naturally competitive it almost seems unfair to foreign rivals. One such sector is pulp and paper, which took off after the introduction of non-native eucalyptus trees. These thrive in Brazil's tropical and subtropical climate.

Whereas a hectare of forest in Europe produces between 7 and 10 cubic metres of wood a year, and 18 cu m in Chile, in Brazil the same area can yield 50 cu m, according to Ibá, the Brazilian tree industry association.

"No country in the world can deliver wood for various uses, no matter whether it is for pulp and paper, panels or flooring, as fast as Brazil can," says Elizabeth de Carvalhaes, Ibá president.

Brazil's competitiveness in pulp and paper is a combination of nature's bounty and strong investment. Production of pulp, the key ingredient for paper, rose 8.8 per cent last year compared with 2013.

'No country in the world can deliver wood . . . as fast as Brazil can'

The industry has also invested heavily in innovation and research and development, adapting the introduced eucalyptus to Brazilian conditions and building state-of-the-art processing plants in ever bigger sizes to create economies of scale.

The sector is an island of promise that could point the way for Brazil's wider industrial base as it struggles to compete in a world with ever more integrated supply chains.

Brazilian industries that compete in global markets, such as pulp and paper, have one thing in common: they are subject to less government intervention and fewer controls than other sectors, such as telecommunications, oil and gas and mining.

Although the government has invested heavily in pulp and paper through its development bank, BNDES, the main companies are listed on the stock market and operate in an open market. They have been affected by the weaker commodity cycle and declining economic growth in China, but are benefiting from a sharp fall in Brazil's currency, the real, against the dollar.

Ilan Goldfajn, chief economist at Itaú Uni-

banco, the bank, says the fall in the real, which is at near 11-year lows of more than R\$3 against the dollar, makes it a good time for the government and industry to begin trying to reduce trade barriers and protection in Brazil.

With a depreciated real, he notes, domestic industries have a competitive advantage. The weaker currency gives them room to breathe while they improve efficiency. Such a process should result in a more competitive industrial base and cheaper goods and services for Brazilian consumers, helping curb inflation, he adds.

"This is the moment when we should start opening the economy and dismantling the last legs of tariff protection and reducing local content measures," Mr Goldfajn says. "The weaker currency gives us room to do it with less trauma."

Such a move should be accompanied by a push to conclude more trade agreements with other countries, he says. Brazil is trying to reach such a deal with the EU, but this has been held back by its partners in South America's regional trade bloc, Mercosur.

Mr Goldfajn says a more open economy will naturally adapt better to global business cycles. Losses in productivity will be offset by declines in the value of the currency. "The problem of the past 15 years was we had booming commodities and a boom in capital inflows, meaning industry could not get a break from the strong exchange rate," he says. "It looks like this is over and capital flows will continue but not in the same way as in the past."

Mr Goldfajn says the country's complex taxation system needs to be fixed. Companies say that in Brazil they employ more lawyers than elsewhere just to cope with tax compliance. Environmental licensing procedures also need to be speeded up and simplified, he adds. "The issue is not to lower standards but to be able to produce a simple 'yes' or 'no' [to projects] much faster."

A sign of how the free market favours the brave is that pulp and paper companies are attracting attention again, even though times are difficult for Brazil in capital markets.

After a period in which the industry has faced high costs in the form of soaring wages and land prices, as well as overcapacity, analysts are starting to back the sector again. Credit Suisse is upgrading its rating on pulp and paper companies, citing their rising cash flows and the benefits of the weaker real.

"The real has depreciated significantly and should continue to do so; and . . . commodities prices have fallen sharply, reducing exporters' margins," the investment bank said in a note. "Few sectors will benefit from this tough scenario, [but] pulp and paper is definitely one of them."



Pulp and paper: grabbing market share

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