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A PORTRAIT OF THE BRAZILIAN MOMENT AND ITS SCENARIOS



The marriage of politics
and economy

Sao Paulo, april 2017



To say that this text explains the Brazil of today would be too pretentious for anyone. Brazil does not fit into pages or even compendia. It is not enough to read about Brazil. You have to read between the lines and understand that the most important messages are not written anywhere. Brazil is not one of those stereotypes so well known abroad, such as samba or soccer. We are hard to understand—and that is the secret—with a first glance at Copacabana beach, a more unaware observer may think he already knows everything he needs to know. He is mistaken. The best option is **to take a snapshot, a portrait of the Brazilian moment and its scenarios**, but in 3D; developing it using the old ways, in a dark room bringing forth colors of understanding as the images become clearer by the moment.

Let us look at the questions that come from outside the Country: What can be said about the Brazilian political world? That everyone is purposefully involved in the internationally known Operation Lava Jato, which revealed misappropriations at Petrobras? And that everyone should be incarcerated in a prison the size of Maracanã?

What can be said about the economic scenario? That the crisis has taken over the Country, that we have lost the investment grade and that growth will be slow, with risks and more risks than certainties?

The answer to these questions is “no”. Let us take it one step at a time.

First, we must understand that there has been an **unprecedented attempt to displace all that of economic nature from the political**. Companies and the main street economy no longer let themselves be guided by bad political news, which happens just as quickly as the news portals update their headlines. The economy has begun to want to ignore politics in order to survive.

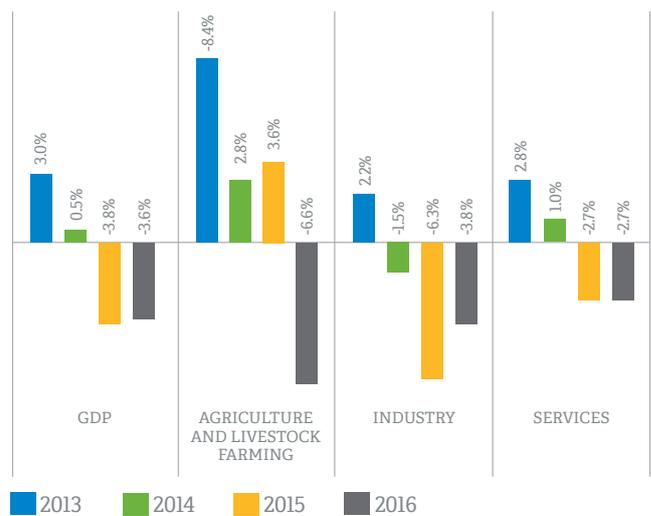
Furthermore: as of today Brazil is experiencing a prodigal moment of credibility towards the economic team and the correct measures are deemed to being taken. The team is first-rate and respected by the international market: under the command of Henrique

Meirelles, there are names like Ilan Goldfajn, Jorge Rachid and even Pedro Parente, at Petrobras, and Maria Silvia Bastos Marques, at BNDES. With a team like that on the field, we are game ready, however difficult it may be, even with an adverse results on the scoreboard. Let them skin the National Congress officials. If they do not mess up, that is already good enough.

The challenge is not small. Brazil has already accumulated a 9 percent reduction in GDP over the last 33 months. That is, we have returned to the same base as 2010. Signs of this unprecedented recession are found in the lives of Brazilians: unemployment, declining quality of life and purchasing power, and even the public safety crisis. It is with this scenario that the economic team has coexisted in recent months. We have hit the bottom and even dug at the pit to get lower.

The minister of Finance, Henrique Meirelles, already speaks of these satanic numbers as an image in a rearview mirror. Speaking with due caution and with no over-optimism. The **economic astral has changed** and every Brazilian sees this reflected in his daily life. Consumer confidence has finally resumed growth, in addition to that of the industry, when purchasing raw material. Industrial production has also risen. After 3

Figure 1. Evolution of GDP and variation of activity by sector (in %).



Source: IBGE

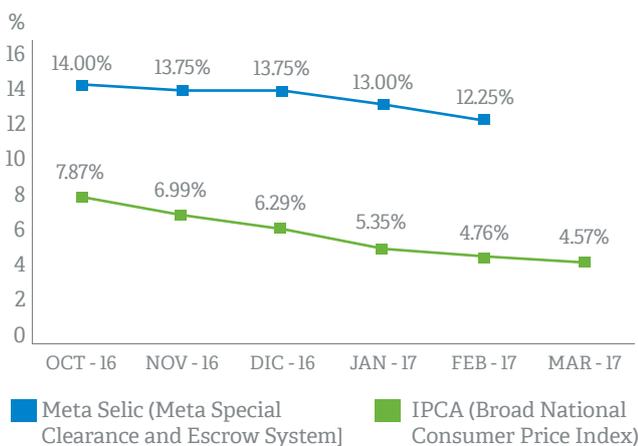
years of red numbers, in January, the number is finally positive at 1.4 percent. Only by a little bit, but the curve now points upward.

Two other positive and direct indicators are the growth of the packaging industry in recent weeks and the increase in electricity consumption. Favorable winds came from the inner parts of the Country with news of a record harvest. Inflation, the worst of taxes, has finally been controlled and is at an acceptable level, ranging a 4.25 percent, with the prospect of an even larger drop by the end of the year, which has led to a steady decline in interest rates by the Banco Central. The dream is to reach a single digit number, if only to have less shame in the international playground, since the Brazilian interest rate of a 12.25 percent per year, is still the highest in the world.

Economists are unanimous in assessing that we have reached the turning point. The economic team has now a clear and well-defined policy, quite different from the one that threatened businesses. This translates into further confidence here in Brazil, with the Stock Exchange rising, and abroad with the timid return of investors. Those who were here and survived the political avalanche and the economic tidal wave

The economy has begun to want to ignore politics in order to survive

Figure 2. National price index and basic interest rate (in %).



Source: IBGE e Banco Central do Brasil

have an additional advantage. They have learned from the mistakes and know how to read the economic and political weather maps.

Let us not forget that the house was a total mess and even with everything starting to be put back into drawers and onto hangers, there is still a lot of scattered stuff. We must keep pace and practice patience. We cannot let ourselves set the table with insurmountable pessimism or deceptive optimism. We still have a long way to go and deal with the risk factors. Those that come from the outside: the low growth of the Chinese economy, the humors of Donald Trump and the protectionism that can come from the victory of nationalist candidates in many of the major countries in Europe. In addition to the risks that come from the Praça dos Três Poderes, in Brasilia, where decisions are made in Brazil. After all, **the economy may want to divorce itself from politics**, but such a marriage does not fall apart easily.

All the positive indicators of the economy will only keep up this improvement, if the reforms proposed by the government **pass in Congress**. And yes, when talking about Congress, we are talking about conspiracies, dubious agreements, aging leaders (even if some are relatively young), and mainly **Operation Lava Jato** and the lists of Minister Edson Fachin of the Supreme Court (STF). This document called for the start of a police investigation against the various crimes, such as active and passive corruption of eight of the current president's—Michel Temer—ministers, the presidents of the Chamber of Deputies and the Senate and three of the state governors; a total sum of over 200 state workers, executives and businessmen. Not mentioning the cases that must be solved during first instance proceedings, not reaching the Supreme Court of Justice in Brasilia (STF), and being taken care of by the juries of the Federation States—the basil level of Justice in Brazil. We are talking about the **imponderable**, which could flow out on to the streets and popular or activist demonstrations, willing to disturb the Country. Not to mention the **Lula factor** (ex-president between 2003 and 2010), for whom, the worse the better, always with an eye on the 2018 elections—Lula who still, as of today, faces prison charges.

The 28 parties, between the Chamber of Deputies and the Senate, crawl around in a true ideological jelly, or rather the vast majority without any ideology... are more about pure physiology. Three parties dominate the scene: PMDB (center-right), PSDB (center-left) and PT (left), the three largest parties in Brazil. The PMDB is the balance, as a partner of the PT, such as in the governments of former presidents Lula and Dilma Rousseff, or alongside the PSDB, as of today under the government of President Michel Temer. We must not forget the “rest”, smaller parties that form a block eager for positions and favors in exchange for support in each important vote.

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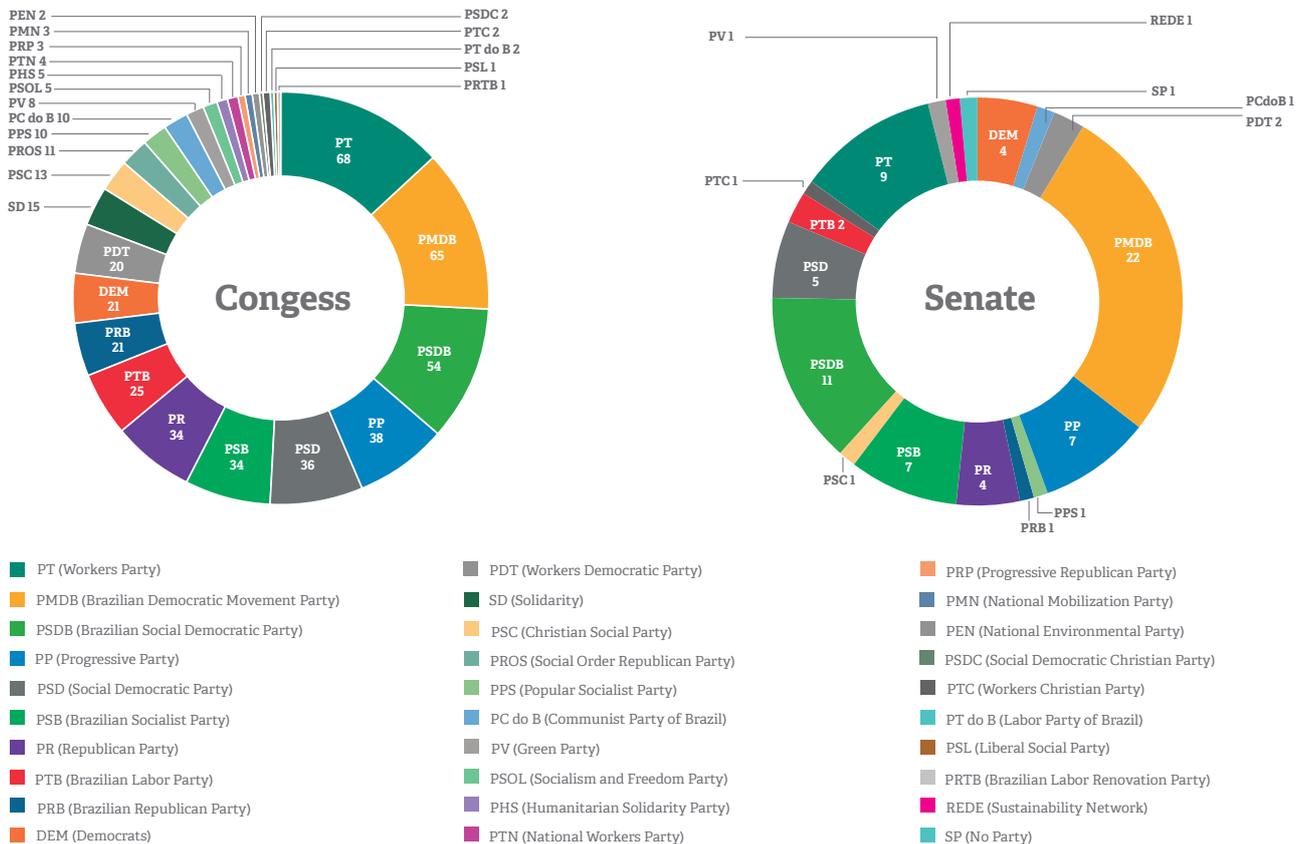
It is in their hands that the reforms that Brazil needs lay: pensions, labor and taxes. So, if politics and economics do not share the same roof, we cannot expect to have good prospects. You can segregate

the politicians from the economic team, because in essence they are like water and oil, but life is “real and biased”, as Caetano Veloso sung, and the couple will have to go hand in hand, if only for appearances' sake.

The first reform to be voted on should be **the social security reform**. Without it, the country will not save itself from a tremendous fiscal crisis. As unions, trade unions and landless/homeless movements mobilize for shutdowns and protests, political analysts, for the most part, are betting on an

endorsement of the pension reform in the first half of the year. It may not be the one the government has dreamed of, but important points in the original text must be kept. However, these favorable winds towards the Palácio do Planalto may bring a bit of rain and cloud the vision of the government, perhaps

Figure 3. Diagram of seat distribution in the congress / senate.



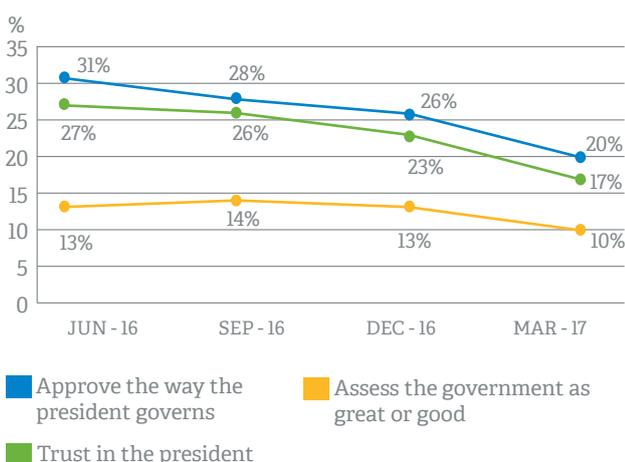
Source: Chamber of Deputies and the Federal Senate.

a little too optimistic about the approval of these reforms. Contrary to what they imagine, it will not be easy. Each of the approvals may cost President Temer dearly, and he has no margin of popularity to risk. Currently in the 10 percent range, Temer is even more poorly rated than former President Dilma Rousseff before impeachment. In fact, the government's option was to make such reforms, even against public opinion, by betting that the country will have improved by the October 2018 elections and that the economic agenda, full of good news, would change the mind of voters. This is the strategy of the government's communication team, which has not worked so far.

The **labor reform**, though highly unpopular, must bring a "modernization" of employment in Brazil. Businessmen who make the Economic and Social Development Council, a "Conselhão", that brings ideas to the Presidency of the Republic, left, the last meeting with Temer, certain that the labor reform would take Brazil out of the salary agenda and onto the employment agenda, with collective bargaining prevailing over any other rule, including the approval of labor outsourcing and flexible working hours.

The emergence of a positive environment for the reforms indicates improved operation of institutions

Figure 4. Popularity of the Michel Temer government.



Source: CNI-Ibope

Regarding the **tax reform**, the strategy is to divide approval of the main measures, with the government gradually sending the Congress several proposals for changes. The expectation is to revise the **ICMS** (our tax for goods and services) and approach having a national **VAT**, to make the system more **transparent and less complicated** to understand (the tax departments of companies suffer trying to understand the rules of the purposely unintelligible Brazilian tax system).

It is paramount that the electoral reform becomes a reality. Basically to solve a problem of the parliamentarians face themselves: the issue of funding political campaigns, including the 2018 campaign—even if it is only a provisional change.

Openly, the market—mainly the projections of the largest banks—is still worried about the unstable times of 2017. It expects GDP growth of only a 0.5 percent this year. Not more than that. In 2018, after the reforms are over, the sun may begin to push away the fog: we could see a growth of 1 to 2 percent. And within a three-year period (19-21), a possible growth of about 2 to 3 percent, for everyone to put on their sunscreen, with the sun almost directly overhead.

The forecast is expected to be confirmed by the end of this year, with controlled inflation and one-digit interest rates—Moody's risk rating agency, by the way, has already advanced and improved the outlook for Brazil's credit rating, from negative to stable. Technical justifications are not lacking, as we have seen above. "The emergence of a **positive environment for the reforms** indicates improved operation of institutions, which will support the implementation of the reforms," says the agency's report released in March.

Yes, investors' moods begin to change. And opportunities are not lacking. Also in the first half of this year, port, airport and highway concessions are anticipated, totaling US\$6.1 billion. By the second half of the year, a broad railway concession program could mean another US\$8 billion. In the field of oil

and gas, eroded by the fall of the indebted Petrobras (in full process of restructuring), there will be another almost US\$2 billion put out to tender; to end with US\$7 billion in auctions of electric power transmission lines. Conducting a quick count we can observe over **US\$15 billion** in business opportunities for this year. What other country in the world, still bruised by the biggest economic crisis in its history, offers so many opportunities for those who want to invest?

The good mood of the market is almost a virtual entity... despite voters on the streets looking down their noses.

If the government can show that the president has done his homework, even in the midst of a serious political crisis, if they value the **positive agenda** of the economy, the electoral scenario may change and Temer may think about **re-election** (though very unlikely) or, even more certain, an official candidate could gain strength, such as Minister of Finance Henrique Meirelles.

President Temer also depends on the decision of the Superior Electoral Court, which can annul his political rights and dismiss him. It all depends on the promptness of the proceedings investigating the illegal collection of funds for the Dilma/Temer presidential ticket in 2014. There is no lawyer who does not see an attempt to postpone this decision until after the current term ends, after 2018, when the ruling would no longer matter.

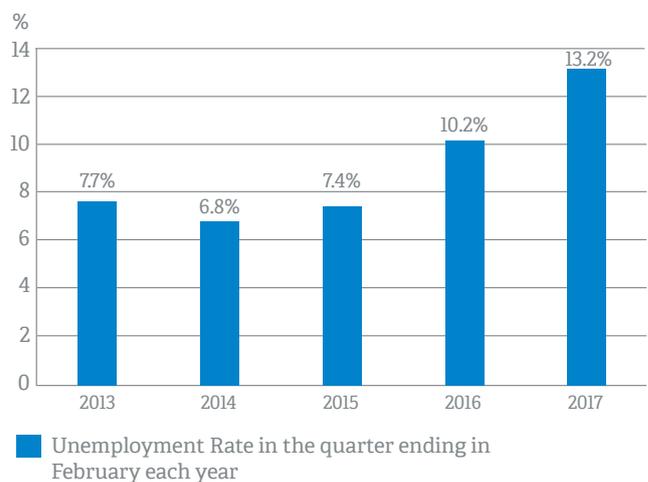
In any case, to confirm a candidacy from within the government, unemployment, one of the most sensitive indicators in people's lives, would have to decrease substantially. The official unemployment rate indicated 13.2 percent, but a study by Credit Suisse bank revealed that the so-called **broad unemployment** is much higher, almost double. The term means the sum of the unemployed, plus workers who do some kind of temporary and informal work, as they lack any

other options, and those who have given up looking for work. By this criterion, considering the third quarter of 2016, Brazil's broad unemployment rate hit 21.2 percent, or about 23 million Brazilians. It is here that the **Lula factor** comes in.

The former president bets on his "you were happy and did not know" speech. He tries to pose as a victim of the Public Prosecutor's Office and the Ministry of Justice. It is defined as a **political persecution** within the Country itself. He is still able to bring crowds to the streets, larger or smaller groups, depending on the press agenda. But his presence on the 2018 ballot is still a mystery. Lula may be barred from being a candidate leaving the leftists orphaned.

As can be seen, the political framework is not so far removed from the economic one, however great the efforts of entrepreneurs to believe the contrary and move on. Brazil **needs a duet in tune**. If one sneezes, the other gets a cold... or pneumonia.

Figure 5. Unemployment Rate.



Source: IBGE



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