Foreign & Commonwealth Office

Brazil: Monthly Economic Report

British Embassy Brasilia
May 2014

Summary

“Trust us, we will win!” says manager Rousseff

Brazil’s manager Dilma Rousseff has acknowledged some underperformance by her team in recent years. She is hoping, however, that her economic tactics will still be enough to deliver a win in the October elections. Her pre-election team recently tested a media attack strategy, and defensive economic measures are being implemented such as seeking to boost fiscal revenues through tax increases and shoring up economic growth through credit subsidies. She faces a real challenge: her opponents, candidates Eduardo Campos and Aécio Neves, are picking on her team’s poor scoring on measures, such as inflation at 6.1% and a growth average of 2%. Either way, the winner will inherit problems that will have to be addressed when the final whistle blows on the Cup and the Election, such as liberalising administered prices and cutting government spending or raising taxes so as to re-establish fiscal credibility.

World Cup 2014: Glory, Draw or Own Goal?

Off to a slow start, the World Cup 2014 is still raising many questions in Brazil: will the remaining stadia be ready on time? How much of the planned infrastructure will be working when the fans arrive next month? What will be the direct economic benefits to the country? These are a few questions we address in this month’s report. Brazilians have been struggling to show the value for money in hosting such a major sporting event. Overspend on stadia, a smaller than promised infrastructure legacy, and expectation of only a small boost to the overall economy from the event leave them relying more on football success and the World Cup feel good factor to deliver. One thing is certain: Brazilians would have liked to see more results off-field from this “Copa”.

For further information contact:

Tax and Trade: Primrose.Lovett@fco.gov.uk
Brazil’s Domestic Economy: Thomas.Giblin@fco.gov.uk
Financial Markets and System: Andre.Assumpcao@fco.gov.uk

Access FCO economic political publications on Brazil on the UKTI website here

Improving performance or tactics to win

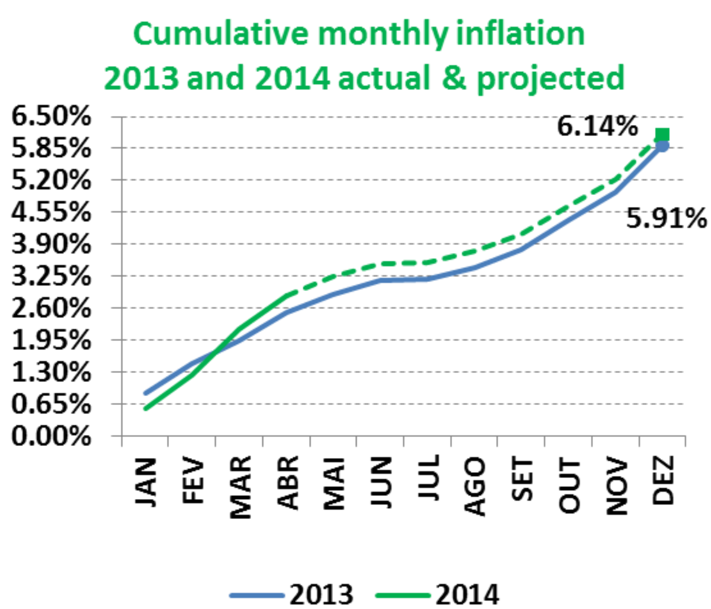
Confidence in team performance is shaken and manager Dilma is seeking to restore morale. On 7 May, President Dilma declared that "inflation will come within target, but that does not mean everything is fine". Inflation is rising again. The 12-month measure reached 6.28% close to the 6.5% upper boundary of the target range. Trade performance has not helped increase confidence either. In Q1 2014, Brazil posted the largest current account deficit since 1970, at US$ 25.2bn. Even with a weaker Real, the rise in imports is holding strong since 2013, reflecting a growing demand by Brazilians for foreign services and goods, both intermediate inputs in production and final goods for consumption. Internationally, Brazil appears increasingly economically uncompetitive.

Defensive tactics on the economy are not likely to inspire better performance. The government has increased the scale of its largest social transfer programme, Bolsa Família, by US$ 600m. This should help political support but increases fiscal spending. The fiscal accounts are under pressure as disappointing rains hit hydroelectric output increasing spending on thermoelectric energy by US$ 1.8bn in 2014.

Market players and analysts want greater fiscal discipline and fear a debt downgrade. Finance Minister Mantega proposed raising taxes on beer and spirits but then, under pressure, agreed to delay introducing the measure until after the World Cup. A programme to reduce penalties on payment of back taxes due if 20% of the total due is paid up front has been extended to cover the period up to 2008 for Federal taxes in order to boost fiscal revenue as the government struggles to meet the 1.9% of GDP 2014 primary fiscal surplus target.

The government is also seeking to give a temporary boost to 2014 growth. New credit incentives for the auto sector, focusing on getting more loans approved for car purchasers have been proposed. Details are not out yet, but the rationale is to take advantage of the sector's strong linkages to other industries to boost economic growth.

Opponents are turning up the heat on the Government's economic performance as they seek victory in October 2014. Eduardo Campos and Aécio Neves highlight that they would reduce fiscal spending, and deliver lower inflation and higher growth. Their tactic is to point out the missed opportunities for growth, and attack the size and inefficiency of government. The lowest growth average in 25 years (2%) and higher interest rates than when Dilma took office (11% vs 10.75%) support their claims.



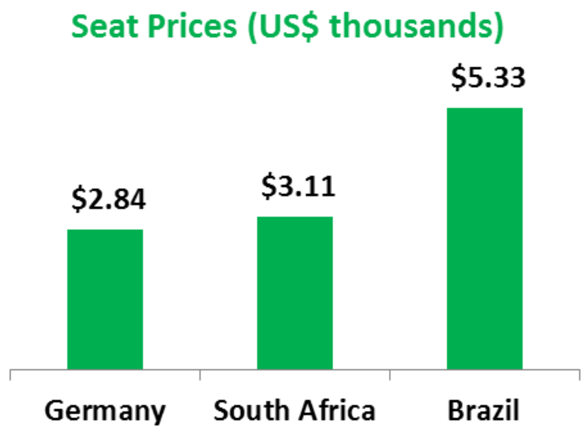
Harder times are expected after the October elections than in the run-up. Regulated prices, held down to fight inflation during Dilma's first mandate, are already being increased and need to rise further. This will maintain inflationary pressure in 2015 and therefore high interest rates. One-off payments for concessions of new oil fields, as in 2013, are not expected in the near future, making it more difficult for the government to keep fiscal balance in 2015. There will also be fiscal pressure resulting from the 4.5% increase in income tax brackets (updated yearly to reflect inflation) and social benefits which will cost US$ 3.5bn in 2015. "Every billion counts", says one well-known analyst. Significant fiscal restructuring or debt downgrade seem the alternatives for 2015.

World Cup 2014: Glory, Draw or Own Goal?

In October 2007, when then President Lula da Silva won the right to host the World Cup Brazil both the world and Brazil were different places. Average GDP growth in Brazil for the three years prior was 4.7%; since 2011 it has averaged 2%.

Now, on the eve of the World Cup, when the focus shifts to football, Brazil is nervous about its performance both on and off the field. The 2-1 defeat to Uruguay in the Maracana Stadium in 1950 stilll resonates as a kind of national bereavement. Off-field performance for the 2014 Cup has been very mixed and leads to anxiety about the logistics of the event.

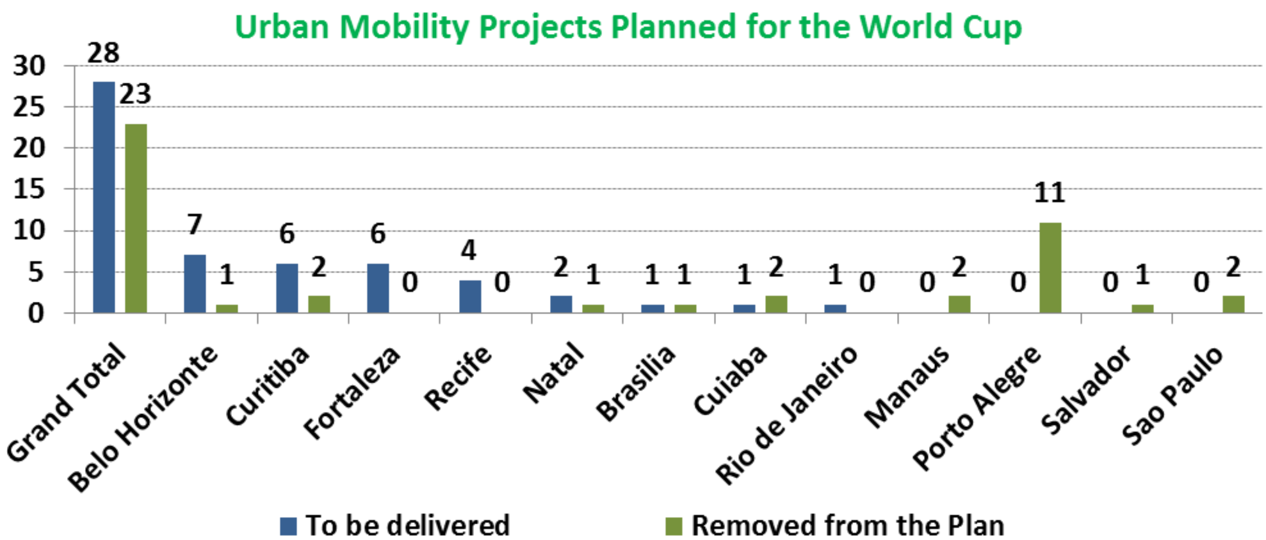
Both the exorbitant cost and last gasp delivery of the Stadia point to failures in Brazilian project planning capacity. When the first whistle blows, TV will show the stadia with paint still drying but open on time for the matches. Some will still lack the full facilities promised to FIFA for fans and press. Brazil spent almost twice as much (US$3.7bn) as either South Africa (US$1.8bn) or Germany (US$1.9bn) in constructing the World Cup stadia. The cost per seat shows similar divergence (see graph).



Brazil lacks a strong value for money public procurement regime which contributed to these cost over-runs. The standard current public procurement law is based on lowest price alone and is suitable for buying standard supplies. It is not suitable for complex engineering contracts. The government therefore created a "fast-track" public procurement regime for the World Cup as it has done for many other sectors e.g. Petrobras. This allowed contracting on the basis of a pre-project proposal and removed the limits to upward revisions of the budget (25% for new and 50% for renewal projects in the standard law). Both facilitated cost overruns in the World Cup stadia particularly where the watchful eye of state development bank BNDES was not involved, as was the case in the most expensive stadium of all in Brasilia.

Off-field, State and Municipal governments failed to complete the full range of urban mobility projects promised in the host cities. Plans were clear: complete 51 projects in urban mobility in the 12 host cities. 45% were dropped due to delays and difficulties in getting approvals and licenses. The 55% that remained became the new target and will deliver legacy benefits in some places. Some are still in progress even one month ahead of the kick-off and of these some will finish only after the Cup. Disappointingly, Manaus, Porto Alegre, Salvador and Sao Paulo will not be left with a single urban mobility legacy from the Cup.

Airports will come under particular scrutiny during the World Cup. 75% of Brazilian airports



already operate beyond capacity and is still difficult to picture how the flow of visitors will be handled. Works in important airports are delayed but some will be partially ready to help with the World Cup. Seven airports still have construction ongoing. Fortaleza airport will use a temporary expansion, because the planned airport expansion could not be finished in time. The World Cup however, has delivered a push to improve airports in Brazil which, even if it arrives too late for the tournament, will provide a significant legacy.

The Cup will not boost 2014 growth appreciably. Tourism gains will be offset by lower production. The expected 3.6 million tourists that will travel during the 32-day tournament will boost the food, drink, hotel and car hire spending in the host cities and generate some multiplier effects. But the majority at matches will be Brazilians. Many will be from the host cities; so more spending on the Cup will mean less spending on other things in the city, rather than an injection of new spending. The airlines are expecting more passengers but, with higher fares, other customers, such as business travellers, have been crowded out. Air fares have begun to fall as the airlines try to fill spare remaining capacity but will likely rise again especially on key routes to key matches.

Production during the month of the World Cup will likely fall as Cup fever builds. Immediate impact will depend on the number of holidays given for Brazil matches in the host cities, and the length of the Brazil team's run in the competition. For the rest of the year, any further effect of the Cup on inflation may count more by encouraging higher interest rates.

There will be no large impact on increasing private investment. 63% of small businesses surveyed in host cities are not going to expand operations for the World Cup. 42% of them claim that the increase in demand does not justify expansion, burned by their experience of the Confederations Cup. Their caution is also linked to the risk of new demonstrations in June, expected by 61% of businesses. Smaller protests continue to rumble on.

The overall macroeconomic effects of the World Cup will be low. Moody's evaluates the overall economic benefits to Brazil will amount to just 0.4% of GDP over 10 years. Brazil is too big, the World Cup lasts too short a time, and planned infrastructure spending for the event was only 0.7% of total infrastructure planned spending between 2010 and 2014.

The government has recently excised any references to the physical legacy of the World Cup. Referring to the event as the Cup of Cups, Dilma declared that "no one who comes here will take away in the suitcase airports, ports, urban mobility projects and stadia". The legacy will be intangible, the positive atmosphere, the party atmosphere, and hoped for victory. The government is focusing resolutely on what is likely to work out to balance out criticism and frustration from the crowds over the costs of the "Copa".

Key Macroeconomic Indicators					
	Jun-13	Sep-13	Dec-13	Mar-14	Apr-14
Inflation	6.7	5.86	5.91	6.15	6.28
Benchmark Interest Rate	8	9.5	10.5	10.75	11
Unemployment (%)	6	5.4	4.3	5	-
Trade Balance (US$ bn)	2.3	2.1	2.6	0.1	0.5
Exports (US$ bn)	21.1	21	20.8	17.6	19.7
Imports (US$ bn)	18.8	18.8	18.2	17.5	19.2
	Q2/2013	Q3/2013	Q4/2013	Q1/2014	Q2/2014
GDP (% var. QoQ)	1.5	-0.5	0.7	-	-

Disclaimer