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British Embassy
Brasilia

BRAZIL ECONOMIC FOCUS: SEPTEMBER 2014 ELECTION SPECIAL

Summary

Legacy and its Challenges

The present Government, under President Dilma Rousseff has a mixed economic record. Her government has made considerable progress in improving the human capital in Brazil, both by reducing inequality and by increasing education provision. Unemployment is low though rising a little. Despite these significant gains, growth has been disappointing, with the country now in a technical recession, inflation has risen further above the 4.5% central target, and the public finances are in a weaker position than four years ago.

In Focus : Candidate Economic Platforms - What to expect in 2015

If Marina Silva becomes Brazil's President we can expect some form of independent fiscal oversight, central bank independence, less protectionism in industrial policy and more private-sector financing for infrastructure. She will give greater attention to integration with advanced economies in trade and focus more on clean energy sources. If President Dilma is re-elected she will maintain political control/accountability of regulators, she will continue to pick winning sectors in industrial policy. She believes in Mercosur and has more protectionist instincts on trade. Either Dilma or Marina will have to make a fiscal adjustment, both will attempt some tax reforms but success for either is far from certain. Both will support policies to reduce poverty, increase education and develop infrastructure. If Aecio Neves goes through to the second round we will issue a supplement on his economic proposals.

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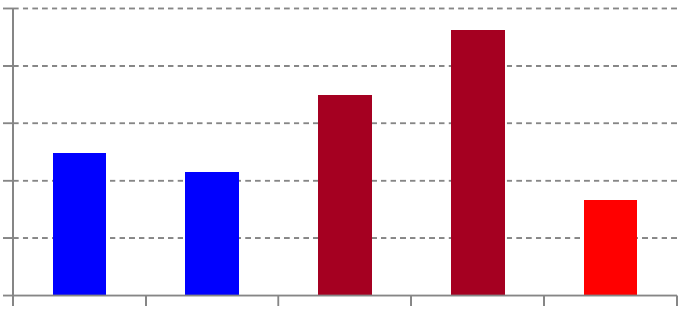
Source: Reuters (Ueslei Marcelino)

Source: Canadian News

Legacy and its Challenges

1. **Economic growth, low inflation, stable public finances, low unemployment and a socially acceptable level of inequality are conventional economic goals.** President Dilma's government has a strong record on unemployment and inequality when compared to her predecessors, but less so on growth, inflation and the public finances.

2. **Economic growth during Dilma's term will be no more than 1.7%,** lower than the previous four Presidential terms.



* 0.5% 2014 growth estimate.

3. **Inflation moved further away from the 4.5% target under Dilma**

Average of Annual Inflation %

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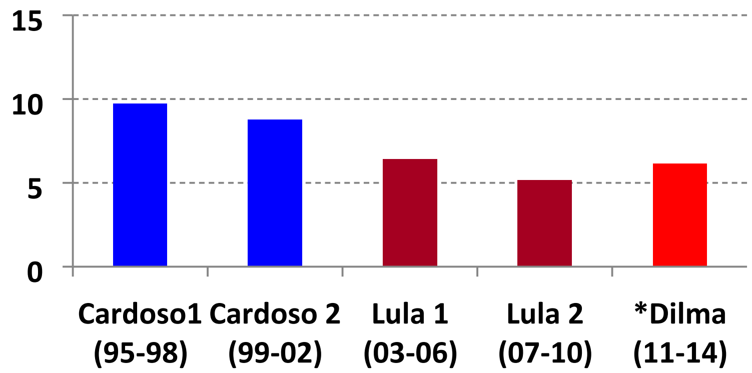
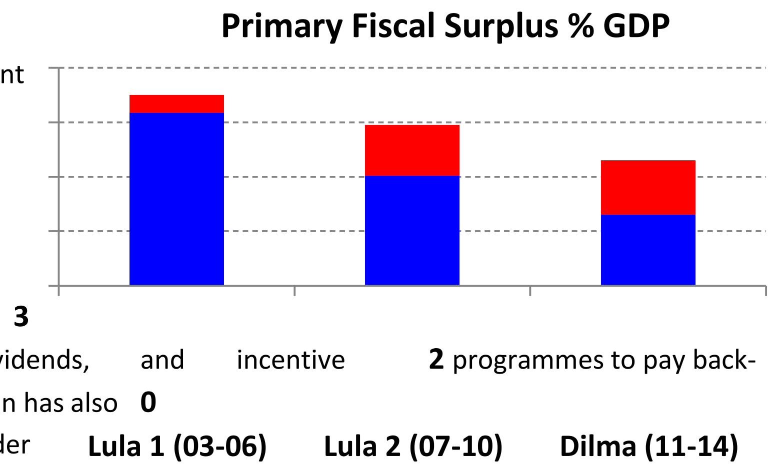


* 6.4% inflation assumed for 2014

due to monetary and fiscal stimulus. Inflation has been below the upper limit of 6.5% overall, but breached it frequently on a monthly basis in 2013 and 2014. The base interest rate was reduced from 12.5% in Aug. 2011 to 7.5% in Aug. 2012, while, on average, nominal government spending grew 11%. Dilma acknowledges that inflation control needs to improve.

4. **The primary surplus fell under Dilma** and became more reliant on once-off revenues, anticipated public company dividends, and incentive programmes to pay back-taxes. The interest burden has also fallen from over 7% GDP from under the previous Government, to just over 5% under Dilma. Brazil needs a 2% recurring surplus to keep public debt from rising.



*BNP Paribas data following Fundação Getulio Vargas methodology.

5. **Reduction in inequality has been a consistent success for the Lula and Dilma governments.** The Bolsa Familia and Brazil Sem Miseria programmes were important causes though rising employment had a bigger impact. The

Gini coefficient - per capita improvement is not only in quality of life, **household income** but also in human capital over time through

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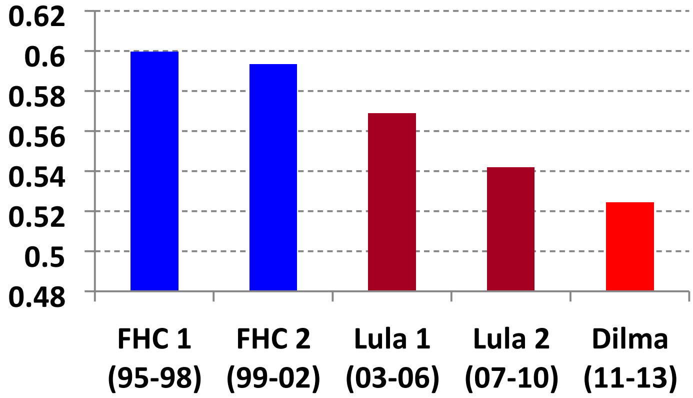
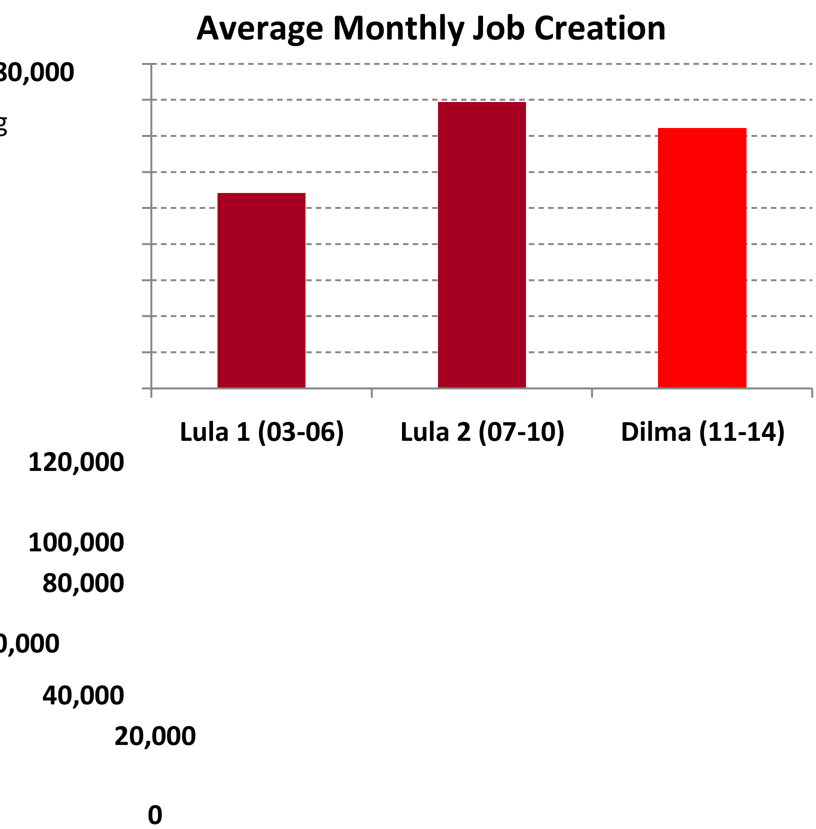


more schooling years of Brazilians (an important side benefit of Bolsa Familia). 8.4 million people left extreme poverty between 2002 and 2012, 6.5 million remain extremely poor.

6. **Monthly job creation has fallen under Dilma's government but has been sufficient to keep unemployment low.** The sharpest fall has come this year to 92,000. 2013 national unemployment was 6.5%, up from 6.1% in 2012. The "five city" unemployment measure still remains low at 5% for August, but layoffs are happening especially in civil construction.



7. **President Dilma knows some change is needed and she faces opposition candidates who propose such changes.** Brazil needs to regain the market's trust by making a fiscal adjustment and controlling inflation more tightly. It also needs productivity enhancing supply-side economic changes such as a simpler tax system and more trade integration.

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In Focus: Candidate Economic Platforms – What to expect in 2015

8. **One week to go.** The decision about Brazil's next president is getting closer (October 5th) and the electoral scenario seems more stable. After Eduardo Campos' death, Marina Silva has emerged as a strong candidate and is running close second to Dilma in opinion polls for the second round (October 26th). It is very likely that the run-off will be between the two. For that reason we do not consider Aecio Neves (PSDB) economic policies here. **If Aecio Neves beats Marina Silva to the second round we will issue a supplement about his economic policy proposals**

9. **Irrespective of the winner, some change is on the way.** Both candidates understand that 2015 will be a tough year. Brazil faces structural constraints on growth, needs macroeconomic correction, and must improve productivity to boost growth. The candidates promise to address those challenges but differ on how.

Macroeconomic Policies

10. **Central Bank institutional independence, proposed by Marina, but opposed by Dilma, is the key monetary policy debate**. Marina argues that independence, with fixed-term mandates approved by Congress, would free the Central Bank (BCB) to conduct a more credible, long-term, monetary policy. Dilma supports the status quo of BCB operational autonomy in setting the base interest rate with monetary policy decided by the broader Government Economic Team. Independence would undermine political accountability, Dilma argues, and, according to some economists close to her campaign, might risk capture of the BCB by private interests. Both teams acknowledge that regulated prices (petrol, electricity) need to increase over time. Marina wants to implement clear rules for regulated price adjustment increasing transparency and predictability.

11. **2015 will be marked by fiscal constraint**. Finance Minister Mantega acknowledges, that, if reelected the Government will have to control spending and increase the primary surplus. This would help inflation moderate and allow the Central Bank to reduce the base interest rate and let the Real weaken. The BCB has been supporting the Real in part to smooth volatility and in part to reduce inflationary pressures. Marina proposes stricter adherence to the "macroeconomic tripod" established in the 1990s, floating exchange rates, bringing inflation to the centre of the inflation target band, and fiscal responsibility. She wants to create a Council for Fiscal Responsibility (powers unclear as yet) to analyse the annual budget and the quality of fiscal spending and restore the credibility of the primary surplus number.

12. **The first year of any government is usually the best to launch a tax reform.** Marina's promises to send a reform proposal to Congress immediately. This would merge and simplify indirect taxes, eliminate tax on investments, and change the distribution of revenue between federal government, states and municipalities. A fund would be created to support states that lose out. Dilma already tried

some indirect tax reform in her first term, and made some progress, but met resistance from the states, who demanded high levels of compensation. She supports the tax reform proposal already in Congress and is now promising to do more. Given that the states control indirect tax on goods while municipalities control indirect tax on services, indirect tax reform is difficult for any President.

13. **Trade policy look North or South.** Marina wants to strengthen trading relationships with the US, the EU (EU-Mercosur FTA) and China even considering bilateral arrangements if Mercosur cannot act. Marina argues that Mercosur lacks flexibility and should integrate more with the Pacific Alliance. Different implementation timetables would allow for disparities between member economies. Dilma has championed progress on the EU Mercosur FTA and wants to speed up implementation of FTAs with Pacific Alliance members. Her vision of trade and development places a higher importance on South American and South-South integration than Marina's.

Policies to Improve Productivity

14. **Productivity growth is the main challenge for Brazil.** The country is currently 116th in the World Bank's Doing Business Index and the products produced nationally are, on average, 24% more expensive than the ones produced in other emerging markets. Industrial production and sales have fallen this year and investment is just 16.2% of GDP. The next President will have to offer solutions since the years of demand-led growth fuelled by rising employment and rapid extension of credit, are pretty much over.

15. **Improving the qualification of the workforce is essential.** The quality of the workforce is still below the level desired to increase efficiency and foster innovation. Just over half have completed secondary school and fewer than one in five has further education. Dilma implemented a range of large scale initiatives in further education. PROUNI student scholarships and FIES cheap loans now assist 31% of all higher education students. PRONATEC training courses have given 8 million students a professional skill. Science without Borders (SwB) has sent 100,000 students abroad and will be extended. 214 new technical schools and 126 new university campuses have opened. She would create a "Skills without Borders" programme for technical training overseas. Marina guarantees she will keep the existing programmes, but would target SwB more towards lower income students. She also wants to deliver a full school day nationally (competence of municipalities, the Federal Government can only set rules and incentives), change the high school curriculum and accelerate the implementation of National Plan of Education.

16. **Infrastructure investments will continue; if Marina is elected, there might be a major shift of financing from public to the private sector.** Dilma wants to continue to develop infrastructure through the public capital programme (PAC) and subsidised public credit through state development bank BNDES. The implementation of PAC improved, but it still has many projects delayed and others abandoned. However, her government has increased investment in roads and airports through concessions and PPPs. Marina's proposal is to increase infrastructure investment to between 3.5%

and 5% of the GDP by expanding the role of the private sector in financing. The role of BNDES would shift to less financing and more planning assistance and would no longer favour specific companies or sectors.

17. **On industrial policy, Dilma's developmentalist vision confronts Marina's commitment to openness and insertion into global value chains.** Marina seeks to foster innovation by attracting foreign investment and internationalising Brazilian companies. Marina wants to make industrial policy cross-sectoral and end Dilma's policy of fostering national champions. Local content rules, promoted by the current Government , would not be broadened and, where existing, would have a definite start and end date, with progress evaluated. Dilma's government shows some signs of acting more cross-sectorally on tax concessions, but it still remains firmly committed to local content strategies and backing the big Brazilian multinationals.

18. **A Marina government would focus more on clean energy and less on fossil fuels, though pre-salt investment will continue.** She intends to increase the competitiveness of ethanol and foster innovation and investment in alternative sources, such as wind and solar. Hydro would have to abide by stricter environmental requirements and minimize impacts on local populations. Despite worries that Marina would diminish the focus on oil, she has already acknowledged that it is a "necessary evil". Dilma will continue to focus on increasing oil and gas output.

Key Macroeconomic Indicators					
	Sep-13	Dec-13	Jun-14	Jul-14	Aug-14
Inflation (accum.)	5.86	5.91	6.52	6.50	6.51
Benchmark Interest Rate	9.5	10.5	11.00	11.00	11.00
Unemployment (%)	5.4	4.3	4.8	4.9	5.0
Trade Balance (US$ bn)	2.1	2.6	2.4	1.6	1.2
Exports (US$ bn)	21	20.8	20.5	23.0	20.5
Imports (US$ bn)	18.8	18.2	18.1	21.4	19.3
	Q3/2013	Q4/2013	Q1/2014	Q2/2014	Q3/2014
GDP (% var. QoQ)	-0.6	0.5	-0.2	-0.6	-
Unemployment PNAD (%)	6.9	6.2	7.1	-	-