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BRAZIL ECONOMIC FOCUS: OCTOBER 2014 - ELECTION ISSUE

Summary

[Economic Context and Political Uncertainties](#)

The election is the closest in recent memory. Voters divide between the economically poorer who support President Dilma because of her strong record in creating jobs and lowering inequality, and the wealthier who, critical of the Government's weak record on economic growth and inflation, support Senator Aécio Neves. In between, the lower middle class will decide this election. Who will serve them best? They must choose between two quite sharply defined economic models that translate into more nuanced differences in policy.

[In Focus : Dilma and Aécio – Economic Models and Policies](#)

Local commentators define the differences between the two candidates as follows. President Dilma supports state intervention to develop key economic sectors and to maintain real wage growth and employment levels. She believes in Mercosur and doing a trade deal with the EU. Her vision is more protectionist and South-South leaning. Aécio trusts more in private sector initiative and profit-led growth. He will seek tighter inflation control and deeper linkage with developed countries. Either will have to make a fiscal adjustment. Both will attempt some tax reforms, support policies to reduce poverty, increase education and develop infrastructure.

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Source: Reuters (Ueslei Marcelino)

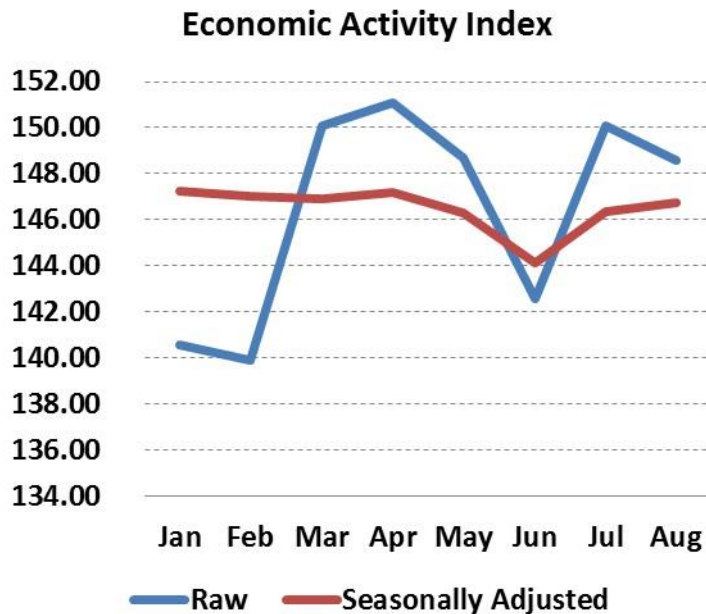
Economic Context and Political Uncertainties

1. The economy is showing some modest signs of growth. The Central Bank's leading

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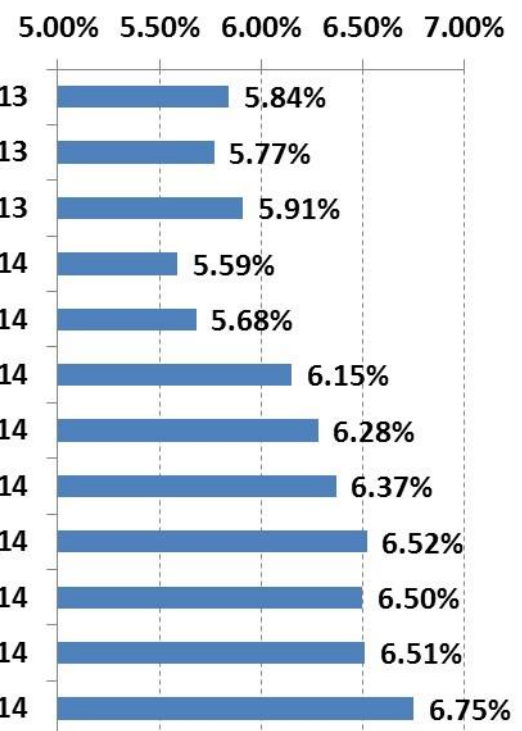
economic indicator (IBC - Br) increased 1.5% in July and 0.27% in August. Industrial Production grew 1.4% over the same period after four months of decline. Overall GDP growth expectations

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r the year are very modest, with private market analysts surveyed by the Central bank predicting 0.28%. These are signs that Brazil will not end the year in recession.

Inflation remains above the 6.5% target band upper limit despite the slow economy. Flight ticket (17.9%) and beef (3.2%) inflation in September led to a 6.75% 12-month figure. Beef prices rose due to booming exports to Russia. Lower international oil prices (down 23% since June due to tepid European and Asian demand and plentiful US and Libyan supply) should help ease inflation. Petrol prices in Brazil are now on a par with international prices, and diesel prices just 5% lower. This brings relief for Petrobras who lost about £0.5bn this year importing fuel and selling it the lower domestic price. There is now less pressure on the Government to increase regulated domestic oil prices. **Private market analysts expect inflation to end the year within the target band at 6.38%.**

IPCA 12-month inflation



3. Brazil is still creating formal jobs albeit at a lower rate. Monthly job creation was

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124,000 in September. This was lowest September figure in 13 years. Formal job creation is 31.6% lower in the year to date compared to the same period last year. Lower formal job creation is helping to reduce wage inflation.

- 4. Economic uncertainty predominates as Brazil awaits the Presidential election outcome on October 26th and the composition of a new economic team. The Senator and the President are running neck and neck (51% to 49%).** If President Dilma Rousseff wins reelection, the eyes of the market will be on her Finance Minister and Head of Treasury Secretariat picks and on her plans for fiscal adjustment. The risk of a debt downgrade, at least by Standard & Poors, is present. If Senator Aécio Neves wins, the same challenges await, but Brazil will likely benefit from a honeymoon period at least until the end of the first quarter in 2015.
- 5. The economy stupid?** Voters who are economically poorer appreciate the jobs and lower inequality the Workers Party has delivered and in large majority support President Dilma. Voters who are wealthier are critical of President Dilma's economic management – low economic growth and high inflation – and, in large majority, support the Senator. (See our September Focus on President Dilma's comparative performance on the economy.) The contest is for those in between, the lower middle classes (in UK terms, monthly family incomes of £770 -£1160). Who will they believe can best help them climb the ladder of economic opportunity?

In Focus: Dilma and Aécio - Economic Models and Policies

Economic Models

- 7. A tripod of economic policies was the economic legacy of Aécio's political party (PSDB) and his political patron, former President Fernando Henrique Cardoso.** These are inflation control, free floating exchange rates, and primary surplus consistent with public debt stability. President Dilma has not so much broken with these policies as tested their limits citing it as a response to the global financial crisis. Inflation has been kept under control but near the top of the permitted band of 6.5%, rather than the 4.5% target. The Real is floating but its movements are heavily managed. The primary fiscal surplus has been reduced; there will be no recurring primary surplus in 2014 and public debt is rising.
- 8. Aécio concedes that pushing the limits on the tripod was appropriate in 2009 and 2010 when Brazil was affected by the global crisis, but not in 2011, 2012 and 2013 when, in his view, the crisis for Brazil had passed.** The Brazilian Central Bank's (BCB) decomposition of growth suggests that drag due to the external sector was less during President Dilma's first term than during President Lula's second term. The main cause of reduced growth has been the slowdown in the domestic economy, as the IMF has recently suggested. 2014 will look much like 2009.

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9. **Behind the campaigns and arguments are two competing economic points of view.** Dilma's government is seen as starting from a developmentalist and wage-led growth model. Her government believes in intervening to stimulate national development, protect employment and sustain real wage increases. Aécio's team follows a more free market and profit-led growth model. He favours a stricter adherence to the tripod of economic policies and more space for free market initiative in investment and price setting. Observers consider that either approach is liable to be, at times, considerably blurred or blocked in the struggle to get changes through Congress.

Economic Policies

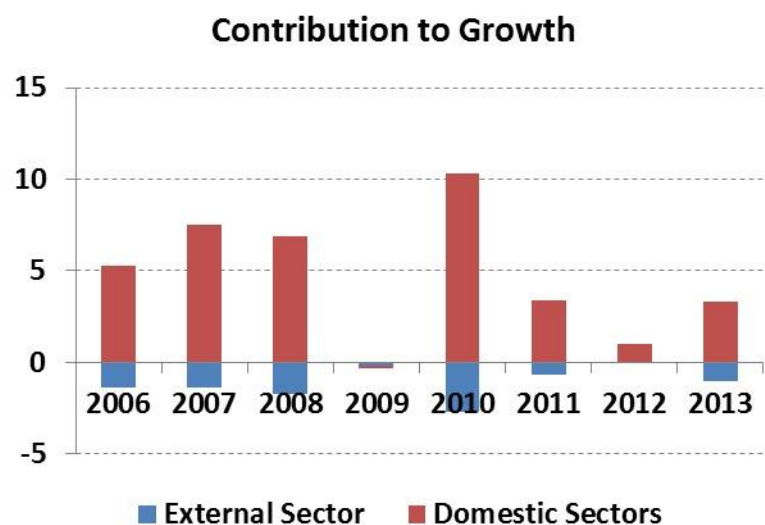
10. **Aécio has said he supports greater "de facto" autonomy for the Central Bank while Dilma supports the status quo where monetary policy is shaped by the Government Economic Team.** Both want to bring down inflation to 4.5% in the next two or three years. Aécio however, proposes then to reduce the target to 3% and narrow the permitted variation band from 2% to 1.5%. This would bring Brazil's inflation targeting regime into line with best practice in other Latin American countries such as Chile and Mexico. Both Aécio and Dilma will seek to adjust regulated prices which have been held down to control inflation, with Aécio favouring less regulation of prices.

11. **2015 will be marked by fiscal restraint to avoid a debt downgrade.**

The current Government acknowledges that, if re-elected it will have to increase the primary surplus but will attempt this gradually so as to support employment and consumption. Aécio wants a better quality, and larger, primary fiscal surplus to strengthen Brazil's fiscal credibility. Over two years he would increase it to 3% of GDP.

Dilma argues that this could cause recession and unemployment. Aécio will be more willing to use fiscal policy to reduce inflation and promises to limit growth in public spending to the level of GDP growth; it has exceeded it under Dilma's Presidency.

12. **Both candidates will try to reform Brazil's onerous tax system.** The States control indirect tax on goods (ICMS tax) while the Municipalities control indirect tax on services (ISS tax), so both candidates know that tax reform will require great skill. Aécio wants to reduce the number of indirect taxes converting them into a modern VAT tax system. He would seek



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to speed up payment of tax credits (often never paid), and introduce a single tax registration process (rather than 27 - one in each state). Dilma attempted indirect ICMS tax reform, made some progress, but met resistance from the States. She supports a tax reform proposal before Congress. In mid October, she also offered to reform domestic transactions taxes (PIS and Cofins) which add greatly both to the complexity and burden of the system.

- 13. Trade policy - look more North or South.** 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 prioritises South American and South-South integration. Aécio looks to new trade deals with developed countries, not only EU-Mercosur, but also with the US and with Brazil's other main markets. He wants to engage with Mercosur based on economic criteria and not political-ideological affinities. He suggests that Brazil should lead the creation of a free trade area encompassing Mexico and all of South America, including infrastructure integration.

Policies to Improve Productivity

- 14. Productivity growth is the main challenge for Brazil's next President .** The country is currently 116th in the World Bank's Doing Business Index and **products produced nationally are, on average, 24% more expensive** than those produced in other emerging markets. Industrial production and sales have fallen this year and investment is just 16.2% of GDP.
- 15. Improving the qualification of the workforce is essential to increase efficiency and foster innovation.** Dilma has implemented significant further education initiatives. 31% of all higher education students benefit from scholarships and/or cheap loans. 8 million students have taken a PRONATEC skills training course. 100,000 students have gone abroad to study under Science without Borders (SwB). **214 new technical schools and 126 new university campuses** have opened their doors. Dilma proposes a "Skills without Borders" programme for technical training overseas. Aécio wants longer PRONATEC courses, closer integration of universities with industry and a two-way international researcher exchange programme. Both want to move towards a full school day for all primary and secondary students. This is an objective for Aécio, while for Dilma it is a medium term goal. Either will depend on the 27 States and 5,570 municipalities who run their school systems. Many schools simply lack the buildings to run a full school day.
- 16. Infrastructure investments will continue whatever the election outcome. If Aécio is elected, there will probably be more of a shift to PPPs and private sector financing.** Dilma will continue to finance infrastructure through the public capital programme (PAC) and subsidised public credit provided by state development bank BNDES. The PAC has improved under Dilma, but still many projects are delayed or abandoned. She used major private sector concessions to increase road and airport investment and, for the

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first time, permitted private ports to compete with public ports. Aécio says he will seek deeper involvement of private banks and capital markets in infrastructure finance and expand the use of PPPs. He wants to streamline the infrastructure macro-regulatory framework by creating one Infrastructure Ministry from the many ministries and agencies. BNDES would help plan more high quality projects so as to reduce delays and budget overruns.

17. Dilma's developmentalist approach to industrial policy contrasts with Aécio's commitment to let private initiative hold sway. Both favour greater insertion of Brazilian companies in global value chains through trade agreements. Aécio would reach out more to developed countries, seeking modern double taxation agreements and increasing confidence so as to attract more foreign investment. He wants to simplify processes to open and close businesses, extending what Dilma's government is introducing for small businesses. Aécio is against R&D subsidies for specific sectors, believing they should be for all. Dilma's has focused more on fostering national champions but shows signs of acting more cross-sectorally on tax concessions. Dilma favours broad local content policies but Aécio wants to focus them on integration with specific links in global value chains.

18. Aécio or Dilma will develop Brazil's extensive fossil fuels. The key challenge for either will be a successful pre-salt (offshore) oil auction next year. Aécio is conscious of complaints about high costs and delays due to current local content policies. Petrobras will see change whoever wins the election; either is likely to appoint a new Petrobras CEO and clear out officials enmeshed in the current corruption scandal. Dilma views Petrobras as the national oil company, developing the nation's oil for the nation's people and serving the national interest, even when it comes to controlling inflation. Aécio would be likely to let Petrobras operate more like a private company, an approach that the stock market prefers.

Key Macroeconomic Indicators					
	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14
Inflation (accum.)	5.86	5.91	6.15	6.52	6.75
Benchmark Interest Rate	9.5	10.5	10.75	11	11
Unemployment (%)	5.4	4.3	5	4.8	-
Trade Balance (US\$ bn)	2.1	2.6	0.1	2.3	0.9
Exports (US\$ bn)	21	20.8	17.6	20.4	16.6
Imports (US\$ bn)	18.8	18.2	17.5	18.1	20.5
	Q3/2013	Q4/2013	Q1/2014	Q2/2014	Q3/2014
GDP (% var. QoQ)	-0.6	0.5	-0.2	-0.6	-

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Unemployment PNAD (%)	6.9	6.2	7.1	-	-
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