Brazil-U.S. Business Council

Brazil Bulletin

Interview: Mansueto Almeida, Economist at the Applied Economics Research Institute (IPEA)

--"You won't reverse chronic government deficits just by telling Cabinet members they can't fly first class."--

Brazil's number one macroeconomic problem is chronic government deficits. It's also the most difficult problem to solve, according to economist Mansueto Almeida. He should know. Almeida is a long-time analyst at Brazil's Applied Economics Research Institute (IPEA), the organization that advises the Federal Planning Ministry. Almeida recently reviewed the budget conundrum, along with other economic challenges, at a meeting of investors and reporters in São Paulo. Excerpts follow:

- **On the government's fiscal dilemma:** "The new administration is starting right off from a weak fiscal position, confronting chronic deficits. But most government spending goes to salaries, debt-service, transfer payments and retirement and other benefits. These are mainly entitlements and are notoriously difficult to cut. So, how do you reduce spending? By cutting back on paper clips? That's not enough. You won't reverse chronic government deficits just by telling Cabinet members they can't fly first class."

- **On taxes, investments and the fiscal crisis:** "Brazil's tax burden is equal to 35% of GDP. That's very high for a country at our stage of development. In the 1990s, we could confront the fiscal dilemma by raising taxes but we have now reached the limit for how much we can take from our already strained economy. That leaves only one alternative—reduce government spending on infrastructure projects. Of course, if we do that, we will be stunting our economic growth."

- **On longer-term fiscal challenges:** "If we have slow growth over the next few years, government spending will continue to rise, in real terms. There are also other pressures on spending and investment. Population growth is slowing and our population is slowly aging. That is going to result in a gradual rise in government spending on entitlements and a gradual decline in the domestic savings rate. The government already represents a net drain on overall investment. In the 1970s, the government invested the equivalent of 6% of GDP every year in infrastructure projects. In 2013, government demand for money from capital markets drained a net 2.0% of GDP."

- **On government subsidies and energy:** "Government energy subsidies have emerged as another source of pressure on spending. I expect the energy sector to need about R$10 billion per year in subsidies over the next two to three years. That's going to take away from health and education spending."

- **On Brazil and competition:** "The bottom line is that all of this makes Brazil less competitive in global markets. Our investment rate is about 18% of GDP. Korea's is 30%. China's has sometimes reached as high as 50%. This makes us highly dependent on foreign investment to remain competitive."

Top News of the Week

Power failures hit southeast states, Federal District as demand rises in heat wave. Millions of Brazilians in at least eight states and the Federal District experienced temporary power failures last week on rising demand for electricity in the face of a persistent heat wave. The problem was exacerbated by glitches in the system that shifts power from low population regions, such as the Amazon, to the big cities of southern Brazil. The National Power Grid (ONS), which administers nationwide supplies, said it ordered temporary cuts in power distribution in order to avoid a broader and lengthier blackout. In most cases, the power failures lasted only about one hour. But that was enough to disrupt the São Paulo subway system and key industrial and office sites in São Paulo, Rio de Janeiro and Brasília. The power grid has become vulnerable partly because of heavy demand but also because of dwindling supplies of hydroelectric power due to a drought. The situation has led many experts to predict power rationing later this year. Brazil experienced a period of power rationing in 2001 and 2002.

Central Bank orders third hike in a row as base interest rate reaches 12.25%. The Brazilian Central Bank last week ordered its third base rate hike in a row. In a unanimous decision, the bank's Monetary Policy Committee hiked the base rate by a half percentage point to 12.25%, its highest level since mid-2011. The base rate stood at 11.0% before the current tightening cycle began late last year. The committee cited persistent inflation worries for the decision. More rate hikes are possible in the coming months. Brazilian inflation is currently running at 6.4%. Recent hikes in public transportation fares and expected increases in public utilities rates could further pressure inflation in the first quarter, according to economists. Brazil is committed to inflation of no more than 6.5% this year.

Business News

Investment News:

Brazil posted a record year for **mergers and acquisitions** in 2014, despite distractions such as the soccer World Cup and a presidential election, according to a PricewaterhouseCoopers annual report on the subject. The report cited 879 transactions last year, up more than 8% from 2013. Total financial volume was the equivalent of $108 billion. Mergers and acquisitions came, in great part, because of Brazil's economic slowdown, with many companies seeking to shed assets and key industries experiencing further consolidation. M&A activity focused on construction contractors, electric power utilities, oil and gas companies and telecommunications providers. The coming year could see more M&A activity as a weaker Brazilian Real attracts foreign investors.

Only 69.3% of Brazilian manufacturers intend to undertake investments in 2015, the lowest level of **investment intentions** in five years, according to the National Confederation of Industries (CNI) annual investment report, released last week. The similar figure at the start of 2014 was 78.1%. But not all manufacturers followed through with their investment plans last year. In fact, according to the report, only 41.4% met their investment schedules in 2014. Issues cited by manufacturers include economic policy uncertainties, soft consumer demand and scarce credit. Such problems are expected to persist in 2015.

Company News:

Brazil's Justice Ministry last week levied heavy fines against **six major retailers** for alleged violations of consumer laws. Fines totaled R$29 million. The ministry said the retailers systematically included insurance premiums in final prices of big-ticket items sold through their stores. The chains specialize in major home appliances. Premiums covered everything from extended product warranties to life insurance and long-term savings plans. The retailers have ten days to present a defense to the ministry's Consumer Protection Division. They may also challenge the fines in court.

One of Brazil's Big Four telecommunications companies, **Oi**, last week completed action on the sale of its Portugal Telecom division to France's Altice. The deal must still be approved by European regulatory agencies, expected in the next few months. Oi will receive 7.4 billion euros for the sale. The money will help capitalize the struggling Brazilian company, which has debts of some R$47.8 billion. The sale also makes Oi a more attractive partner in a potential merger. Of the other three big Brazilian telecommunications companies, TIM is seen as the most likely partner in an eventual merger.

Brazilian Calendar

Tuesday, January 27, Central Bank release of monthly banking data, Brasília

Thursday, January 29, Brazilian Census Bureau (IBGE) release of monthly unemployment data, Rio de Janeiro

Friday, January 30, Central Bank release of monthly primary budget surplus data, Brasília

Indicators

Foreign exchange rate: **R$2.58 = $1.00**

Brazil closed out 2014 with a **current account deficit** of $90.9 billion, the biggest such gap since 2001, the Central Bank said last week. The deficit was equal to a worrisome 4.17% of GDP. December alone produced a deficit of $10.3 billion. The overall 2013 deficit was $81.1 billion. The gap grew in 2014 because of a trade deficit of $3.9 billion, rising overseas travel expenditure by Brazilians and increased profit and dividend remittances by multinational companies. The trade deficit was the first since the year 2000. Once again, net foreign direct investment did not cover the current account deficit. FDI in 2014 was $62.5 billion, down marginally from $64.0 billion in 2013 as multinational companies pulled back on plant and equipment expansion in the face of a sluggish Brazilian economy.