Interview: Affonso Celso Pastore, Partner A.C.Pastore and Associates; Mario Mesquita, Partner Banco Brasil Plural; and Rodrigo Azevedo, Partner Ibiuna Investimentos

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Brazil will pay for a number of past mistakes in 2015, a year likely to be remembered for fiscal austerity, political conflict and frustrated expectations about inflation and growth, according to three noted economists. Former Central Bank President (1983-1985) Affonso Celso Pastore, Banco Brasil Plural Partner Mario Mesquita and Ibiuna Investimentos Partner Rodrigo Azevedo met recently with investors, academics and reporters under the aegis of the Getúlio Vargas Foundation to discuss vexing issues including the rapid depreciation of the Brazilian Real, stubborn inflation, sky-high interest rates and many others. Excerpts follow:

- **Affonso Celso Pastore:** "Brazil risk is already higher than Mexico risk or Turkey risk. During the years immediately after the 2008 global financial crisis, those risk levels were about equal. The market perceives the current administration in Brazil as politically weak. Investors trust Finance Minister Joaquim Levy to propose a significant fiscal adjustment but they don't believe the administration has the political strength to see it through."

- **Mario Mesquita:** "In 2007, Brazil made an historic error when the CMN (National Monetary Council) decided to keep the inflation target at 4.5% even though actual inflation was 3.1% and inflation expectations were below 4.5%. We are still paying for that mistake today. The decision not to reduce the inflation target undermined the credibility of the inflation-targeting system. Brazil got through the international crisis but without defeating inflation. On the contrary, inflation rose, and it's still rising."

- **Rodrigo Azevedo:** "Today, the credibility of inflation-targeting in Brazil is in tatters. No one expects 2015 inflation to come in below the 6.5% ceiling. What economic actors are asking is this—if 6.5% is not credible, what is? If inflation expectations are no longer anchored, then neither are interest rate expectations."

- **Pastore:** "We have fallen into a liquidity trap. Real salaries cannot rise faster than productivity without provoking inflation."

- **Mesquita:** "The real challenge is how to coordinate strategy for meeting the inflation target. Can we coordinate fiscal and monetary policy? There are political obstacles. It's hard to cut government spending so, in practice, we rely on monetary policy. The Central Bank is the one primarily responsible for meeting the target but it often needs an assist from the fiscal side."

- **Azevedo:** "If you read the textbook, it will tell you to cut government spending. This will help boost credibility and pull down market interest rates. That, in turn, will help restore business and consumer confidence and kick start the economy. Monetary policy should be aimed exclusively at pulling down inflation. That too will help boost market confidence. In the short term, these policies will produce a slowdown but, after six to 12 months, the economy will return to balanced growth."

Top News of the Week

Chamber of Deputies passes first of government-backed austerity measures. After weeks of political wrangling, the Chamber of Deputies last week passed the first in a series of government-backed fiscal austerity measures. The bill will restrict access to certain unemployment and salary benefits. The government's original proposal would have produced an annual savings to the Treasury of some R$16 billion. The compromise version passed by the Chamber of Deputies will result in annuals savings of about R$13.5 billion. The bill must still be passed by the Senate. The bill passed the Chamber of Deputies by a narrow margin, with a number of nominal pro-government members voting against it. Spokesmen for President Dilma Rousseff said defectors will suffer a government boycott when it comes to legislation, appropriations and nominations for federal jobs. In the coming weeks, the Chamber of Deputies will consider other government-sponsored austerity measures, including a bill to reduce access to certain retirement benefits and legislation raising certain tax rates.

Petrobras plunges in annual *Forbes* list of world's biggest companies. The decline and fall of Brazilian state-run oil giant Petrobras has finally been noted by U.S. business magazine *Forbes*. Petrobras appears on this year's list of the world's largest companies as number 416, a tumble of nearly 300 rankings from last year's 30th place. As recently as 2012, Petrobras was ranked tenth in the world. The company's ranking plunged for a number of reasons, the chief being steep losses from a sprawling bribery and money laundering scandal. The company has also lost ground because of declining global oil prices and rising debt-service costs.

April proves 'cruelest month' for beleaguered Brazilian auto industry. Poor April sales and production figures, released last week, confirmed fears among many in Brazil's battered auto industry that 2015 performance will fail to match even the disappointing 2014 numbers. April output of 217,100 motor vehicles represented a 14.5% decline over March and 21.7% against April of 2014. January through April output of 881,770 was down 17.5% from the same period a year ago, burying any hope for an improvement over 2014. April sales were only 183,753, down 6.7% against March and 24.6% against April, 2014. January through April sales of 743,678 were off 17.8% against the same period a year earlier. The industry has suffered from a number of problems, including inflation, higher interest rates and the end of consumer tax breaks that helped buoy sales in 2014. In releasing the figures, however, National Motor Vehicle Manufacturers Association President Luiz Moan said, "the worst is over." He predicted improved second-half sales as Brazil pulls out of a period of economic doldrums.

Business News

Investment News:

April was a banner month for foreign investors in Brazil's sprawling financial market. According to the **BM&FBovespa**, which combines trading in stocks, commodities and futures, net foreign investment inflows in April reached the equivalent of R$7.6 billion, the highest monthly total since combined trading began in 2000. January through April saw net inflows of R$17.5 billion, also a record. Money is flowing in because of monetary loosening by the European Central Bank and continued low U.S. interest rates. Meanwhile, investors are picking up bargains among Brazilian equities. According to

analysts, stock prices of blue chips such as Petrobras and Vale are unusually low following a long season in the doldrums.

Company News:

Argentina's **Corporación Américas** last week bought out its Brazilian partner **Engevix** at two key Brazilian airport concessions, Brasília and Natal. The Argentine company will now own 100% of the Natal concession and will control the Brasília concession with a 51% share. Brazilian state-run airport management firm Infraero will continue to hold a 49% stake in the Brasília airport. Engevix will receive some R$400 million from the Argentine company. It will apply the money toward payment of an estimated R$1.5 billion in debt. Engevix has been implicated in the sweeping Petrobras bribery and money laundering scandal and has been largely unable to raise money from capital markets.

Brazilian Calendar

-Thursday, May 14, Central Bank release of monthly Economic Activity Index, Brasília

Indicators

Foreign exchange rate: **R$2.99 = $1.00**

Domestic **air traffic** increased by 5.6% in the first quarter of 2015 against the same period a year earlier, the fifth quarter in a row for rising demand, the Civil Aviation Authority (Anac) said last week. March alone saw 7.8 million passengers accommodated on the nation's airlines. Upstarts Azul and Avianca advanced the most, Anac said. In the first quarter, Brazil's airlines provided 4% more seats, lagging slightly against the rise in demand and contributing to higher and more profitable load factors.

Overall billing by Brazilian manufacturers fell by 6% in the first quarter against the first quarter of 2014, in inflation-adjusted terms, the National Confederation of Industries (CNI) said last week. **Utilization of industrial capacity** fell less sharply to 80.5% from 80.8% in the first quarter of 2014 as manufacturers attempted to maintain production and employment levels in hopes of a second-half recovery. Total workforce dropped only slightly while real wages remained stagnant.

Brazil managed to eke out a respectable R$490 million **trade surplus** in April, up slightly from $460 million in March, despite a 23% month-on-month decline in exports, the Trade and Development Ministry said last week. Exports plunged because of shipping delays caused by a truckers strike and an oil depot fire at the Port of Santos. Imports were also down due to Brazil's overall sluggish economy. The first quarter showed a trade deficit of $5.07 billion, down from $5.57 billion for the first quarter of 2014.

Brazilian **industrial production** declined for the 13th month in a row in March, falling 0.8% against February and 3.5% against March of 2014, the Brazilian Census Bureau (IBGE) said last week. Capital goods took the biggest hit, falling 4.4% month-on-month and 12.4% year-on-year. The decline underscores reluctance of manufacturers to invest in expansion. Industrial production for the first quarter of 2015 was down 5.9% against the first quarter of 2014, reflecting low consumer confidence and problems such as inflation and rising interest rates.

Monthly **inflation** for April weighed in at 0.71%, down from 1.32% the previous month but not enough to stem widespread concerns about out-of-control prices. The 12-month inflation rate through April rose slightly to 8.17% from 8.13% as of March, the Brazilian Census Bureau (IBGE) said last week. Food prices continued to rise faster than overall inflation, while fuel prices seemed to stabilize. Brazil's government is committed to 2015 inflation of no more than 6.5%.