Brazil-U.S. Business Council
Brazil Bulletin

Interview: Sérgio Werlang, Member of the Board of Directors of Banco Itau-Unibanco

--"Interest rate hikes are more effective against inflation than they were 20 years ago."—

Brazil's biggest short-term challenge is bringing down 8.0% inflation. The arsenal of weapons against spiraling prices is well known. The only question is using them effectively, according to Itau banking executive, and former Central Bank director, Sérgio Werlang. Monetary tightening is already doing its work. The next round will require fiscal austerity, especially spending cuts. Werlang recently met with investors, academics and reporters to discuss Brazil's 2015 outlook. Excerpts follow:

- **On monetary policy:** "Credit expanded rapidly during the decade beginning in the year 2000. Credit doubled as a percentage of GDP. This has the effect of making the overall economy more sensitive to interest rate moves. Consequently, interest rate hikes are more effective against inflation than they were 20 years ago. In that sense, the current pattern of high interest rates should be effective against inflation, meaning that the cycle of rate hikes must be near the end."

- **On fiscal policy:** "The next field of action against inflation should be the fiscal field. We have exhausted what we can do against inflation from the monetary side. Of course, it's hard to cut spending and raise taxes. Of the two approaches, cutting spending is the more effective against inflation, but also the more difficult to accomplish politically. That's why we have a higher inflation target, at 4.5%, than other countries adopting inflation-targeting"

- **On employment and productivity:** "Employment has reached its limit. Since 2010, we have effectively been at full employment, meaning that labor, from that point forward, ceased to be a source of economic growth. At full employment, you get wage inflation without productivity gains. Since 2011, real salaries have risen faster than productivity. The rest of the world still has an unemployment problem, while we do not. On the other hand, we have become less competitive because of it."

- **On economic stimulus:** "Meanwhile, the government was offering economic stimulus, in other words, more consumption. That can only lead to inflation. We are seeing this especially in the area of services, which are non-tradeable."

- **On GDP prospects:** "The potential for Brazilian GDP growth is now a mere 1.4%. A big reason is full employment and the resulting wage inflation and stagnant productivity."

Top News of the Week

Central Bank hikes base rate for fifth time in a row to towering 13.25%. The Board of Directors of the Brazilian Central Bank last week voted unanimously to hike the bank's base interest rate by a half percentage point to 13.25%. It was the fifth rate hike in a row and brings Brazil's base rate to its highest level since early 2009. In a brief note, the bank said it was hiking rates in order to counter an increasingly intractable inflation problem. Brazil's inflation rate is currently running at 8.22%, well ahead of the country's inflation targeting range. The range runs from 2.5% to a ceiling of 6.5%. Few economists expect Brazil to close out 2015 with inflation of 6.5% or less even with continued aggressive Central Bank action. Investors and economists expect another rate hike when the Central Bank's board next meets in June.

First quarter budget performance puts question mark around 2015 targets. Brazil's public sector produced a primary budget surplus in the first quarter of 2015 of only R$19 billion, down from R$25.6 billion for the first quarter of 2014 and the worst first quarter performance since the recession year of 2009. On a 12-month basis, Brazil was running a primary deficit as of March equal to some R$39.2 billion, up from R$35.8 billion as of February. The government's goal for 2015 is a primary surplus of R$66.3 billion. Budget performance has proven a disappointment because of flat revenues against 2014, due to an economic slowdown, against rising government costs due to inflation and higher unemployment. Public sector gross debt, consequently, has risen from the equivalent of 58.9% of GDP at the end of 2014 to 62.4% as of March 31.

Congress approves bill expanding access to genetic resources. Congress gave its final approval last week on legislation that expands access to genetic resources found in the country's rich flora and fauna. The bill also cuts tax rates on products developed from such resources and is likely to spur research and development in two industries—pharmaceuticals and cosmetics. President Rousseff is expected to sign the bill into law.

Joint congressional committee approves bill to reduce welfare, unemployment, and retirement benefits. The compromise version should result in annual savings to the Social Security System of about R$15 billion, somewhat lower than the R$18 billion sought by the administration. The bill will now go to both the Chamber of Deputies and the Senate for consideration.

President Rousseff threatens to veto labor outsourcing bill. In comments made on International Labor Day, Rousseff said she would veto the bill if passed by the Senate in its present form. The sweeping legislation, already adopted by the Chamber of Deputies, would allow for a major increase in the use of outsourced labor. Rousseff called for adoption of amendments that would reduce the scope of the legislation.

Business News

Investment News:

Brazil's largest private transportation and logistics company, **Rumo ALL**, last week announced an ambitious R$11.7 billion, five-year investment plan. The capital investment program follows final approval, in February, of the merger of Rumo with ALL. About one-third of the investment total will go toward maintenance and upgrades of existing rail links and other facilities. The rest will go toward bids on new rail concessions and expansion of rolling stock. Money for the program will come from re-invested profits, bank loans and capital markets, the company said.

The **Carlyle Group,** a U.S. private equity fund, last week took an 8.3% stake in Brazil's D'Or hospital chain, paying R$1.75 billion. The money will be invested in expansion rather than reverting to the chain's family and institutional controllers.

Company News:

Shareholders of troubled state-run oil company **Petrobras** last week elected mining executive Murilo Ferreira as the firm's new board chairman. Shareholders acted at their annual meeting. Ferreira was backed by the administration of Brazilian President Dilma

Rousseff. The government holds controlling shares in the company. Ferreira replaces former Finance Minister Guido Mantega. Traditionally, the Petrobras board follows government policy directives and leaves actual management of the company to top executives, now led by company President and CEO Aldemir Bendini. Ferreira will continue as President and CEO of Brazilian mining company Vale. Petrobras has been shaken by a bribery and money laundering scandal that unfolded over the past year.

Brazilian mining giant **Vale**, the world's largest producer and exporter of iron ore, posted first quarter losses of R$9.5 billion, reversing first-quarter 2014 earnings of R$5.9 billion. Losses were due mainly to a sharp decline in world iron ore prices. The company also faced higher debt service costs because of the depreciation of the Brazilian Real against the U.S. dollar. Revenues were also down, at R$18.0 billion against R$22.4 billion for the first quarter a year ago. With revenues in decline, Vale cut back on investments, with first quarter capital spending of R$2.2 billion, down from R$2.6 billion in the first quarter of 2014.

Brazilian Calendar

-Monday, May 4, Development, Industry and Foreign Trade Ministry release of monthly foreign trade figures, Brasília

-Monday, May 4, Feiplastic International Plastics Fair, Anhembi Center, São Paulo

-Wednesday, May 6, Brazilian Census Bureau (IBGE) release of monthly industrial production figures, Rio de Janeiro

-Thursday, May 7, National Motor Vehicle Manufacturers Association release of monthly auto industry data, Hotel Mercuré, São Paulo

-Friday, May 8, Brazilian Census Bureau (IBGE) release of monthly IPCA inflation figures, Rio de Janeiro

Indicators

Foreign exchange rate: **R$3.01 = $1.00**

Tax revenues for March weighed in at a disappointing R$94.1 billion, up a bare 0.48%, in inflation-adjusted terms, from March of 2014, the Federal Tax Authority announced last week. First quarter performance was even more of a disappointment, with revenues reaching only R$309.4 billion, down 2.03% from the first quarter of 2014, in real terms. Revenues have failed to take off so far in 2015 despite recent government-ordered tax hikes, raising questions about the government's ability to meet 2015 fiscal austerity goals. Revenues have been slack in recent months because of an overall economic slowdown.

Brazil's **unemployment rate** rose to 6.2% in March from 5.9% the previous month and just 5.0% in March of 2014, the Brazilian Census Bureau (IBGE) said last week. Meanwhile, average earnings of registered workers plunged, dropping 2.8% from February to R$2,134 per month. Economists said wage losses were a direct result of rising unemployment and the consequent loss of bargaining power by workers.

Unemployment is rising because of a broad economic slowdown worsened by persistent inflation and high interest rates.