Brazil Bulletin

Interview: Armando Castelar, Coordinator of Applied Economics Studies, Getúlio Vargas Foundation

--"Brazil's overseas accounts have deteriorated at a rate of 0.6% of GDP per year since 2003. That can't last forever."—

Brazil faces enormous challenges on several fronts—a burgeoning current account deficit, rising inflation, and out-of-control government spending. Initial efforts by the country's new economic team this year are promising, but the hurdles are probably higher than anyone supposed, according to Getúlio Vargas Foundation economist Armando Castelar. The economist discussed challenges for 2015 and 2016 at a recent meeting in São Paulo with investors and reporters. Excerpts follow:

- **On the current account deficit:** "Brazil's overseas accounts have deteriorated at a rate of 0.6% of GDP per year since 2003. That can't last forever. It has already led to some depreciation of the currency and could eventually result in a certain amount of capital flight and a steeper depreciation. Unfortunately, the depreciation we've seen to date is not helping much to reverse the trend toward trade and current account deficits**.** This is due to the fact that, while the Brazilian Real has depreciated, global commodities prices have declined. Meanwhile, inflation and high wages are making our non-tradable goods uncompetitive in world markets."

- **On the challenge posed by inflation:** "There is continued pressure on inflation from government-controlled utilities rates, many of which still need to be adjusted. The key to pulling down inflation is the services sector, but that's especially difficult. It will take lower wages and higher unemployment to do the job."

- **On the trend for interest rates:** "Historically, higher U.S. interest rates have meant higher Brazilian interest rates. But that, in turn, means higher debt service costs and brings pressure on the fiscal side, making it harder to pull down the debt-to-GDP ratio."

- **On fiscal challenges:** "The government has been increasing spending faster than it has been able to increase revenues. This needs to be reversed. The fiscal challenge for 2015 is huge. Last year, Brazil produced a primary *deficit* equal to 1.6% of GDP. This year, the government is aiming at a *surplus* of 1.2%. That's a distance of 2.8% of GDP. We don't think they can do it. Brazil's government had one-off revenues last year equal to 1.0% of GDP. That's an unusually high level, unlikely to be repeated this year. We're predicting a primary surplus in 2015 equal to 0.7% of GDP, including one-off revenues equal to 0.6%."

Top News of the Week

Rousseff trip to U.S. yields climate agreement, Global Entry, and other gains. President Dilma Rousseff spent four days in the United States last week, capped by White House meetings with U.S.

counterpart Barack Obama. She also met with investors in New York and Washington and visited hi-tech businesses and research centers in California. Much of the effort was aimed at getting investors interested in a sweeping Brazilian program of concession auctions for infrastructure projects. Another aspect was clearing the way for increased trade. President Rousseff told reporters she believes bilateral trade can double over the next few years from the 2014 level of $62 billion. The centerpiece accord came in the area of global warming. Brazil agreed to end all illegal de-forestation, while pledging to recover 12 million hectares of rainforest by 2030. The two countries agreed to a goal of 20% for use of alternative fuels in electric power generation by 2030. More specific agreements will allow Brazil to participate in the U.S. Global Entry program, which allows frequent travelers faster processing at U.S. points of entry. The U.S. agreed to resume acceptance of Brazilian fresh, chilled, and frozen beef from 14 Brazilian states following a 15-year ban. The two countries agreed to speed up consideration of measures designed to streamline customs procedures, standardize product classifications, and beef up patent protection. They also agreed to end double payments of social security taxes for citizens of one country who work in the other.

Petrobras to slash investments, sell assets in order to pay down debt. State-run oil giant Petrobras last week made a long-awaited announcement of its investment plans for the period 2015 through 2019. The company slashed planned investments by 37% from its previous 2014-2018 plan to $130.3 billion. The company also announced plans to sell assets worth $15 billion almost immediately, with more asset sales set for 2016 through 2019. Altogether, the company expects to sell $57 billion in assets through 2019. The company's main focus will be debt reduction, Petrobras executives said. Petrobras currently carries domestic and foreign debts totaling the equivalent of nearly R$400 billion, considered the highest level of any oil company, private or public, in the world.

Government accounts remain in deficit, putting 2015 goal in check. Brazil's public sector slipped back into deficit in May, after posting a robust surplus in April, putting Brazil's 2015 fiscal goals into check. May saw a combined public sector deficit of R$6.9 billion, reversing an April primary surplus of R$13.5 billion. The 12-month primary deficit as of May was R$38.5 billion. Brazil's goal for calendar 2015 is a primary surplus of R$66.3 billion. May saw a major decline in revenues to R$91.5 billion from R$109.2 billion in April. April revenues are typically outsized because of annual income tax payments. More generally, revenues are down because of a broad economic slowdown. On the other side of the ledger, government spending continues pressured by heavy, fixed transfer payments. Expected increases in revenue have been delayed by sluggish congressional consideration of government-proposed austerity measures.

President Rousseff's approval rating sinks to lowest in history of Ibope poll. After administration officials predicted in March that President Rousseff's approval rating couldn't go any lower, it declined in a poll released last week by the Public Opinion Research Institute (Ibope). The poll showed only 9% of voting-age Brazilians approving of the President's performance, down from 12% in March. It was the lowest approval level for any President since Ibope began the measure in 1986. Those characterizing the administration as "poor" or "very poor" rose to 68% from 64% in March. Ibope conducted the poll for the National Confederation of Industry, interviewing 2,002 voting-age Brazilians nationwide. Poll-takers noted that support for the administration was sinking across the board, including all age and income groups and all regions of the country. Voters cited a number of reasons for their dismay, including a sweeping corruption scandal at state-owned oil company Petrobras as well as 8.5% inflation, high interest rates, and rising unemployment.

Business News

Investment News:

The Brazilian subsidiary of **Volkswagen** last week announced a R$460 million investment in its sprawling São Carlos engine plant in São Paulo state. The investment will be used to introduce new technology making Volkswagen engines more fuel-efficient. The money will be invested between 2015 and 2018. The plant manufactures ten million engines per year

Brazilian protein giant **JBS**, the world's largest meatpacker, last week announced the acquisition of another U.S. assets. JBS will pay $1.45 billion to purchase **Cargill Pork**, the hogs and pork division of Cargill. JBS will pay for the acquisition with cash and issuance of new debt.

Company News:

Brazilian airline **Azul** last week announced a new code-sharing agreement with U.S. carrier **United**. The agreement included the purchase, by United, of a 5% stake in Azul for $100 million. The agreement will give United greater access to Brazilian destinations while Azul will be able to book its customers on United flights in the U.S.

Brazilian Calendar

-Tuesday, July 7, National Motor Vehicle Manufacturers Association (Anfavea) release of monthly motor vehicle production, sales and export data, Hotel Mercuré, São Paulo

-Wednesday, July 8, Brazilian Census Bureau (IBGE) release of monthly IPCA inflation data, Rio de Janeiro

-Thursday, July 9, State holiday in São Paulo

Indicators

Foreign exchange rate: **R$3.12 = $1.00**

Consumer confidence as measured by the Getúlio Vargas Foundation's **ICC** index fell to one of its lowest levels ever in June. At just 83.9 points, the index declined by 1.4% from the previous month. Any level below 100 points represents a net negative scenario from the viewpoint of consumers. Issues include rapidly rising prices and interest rates that are rising even faster. Consumers are also worried about job security and existing debts.

Industrial production posted an uptick in May against the previous month, the first after three months of steady decline, the Brazilian Census Bureau (IBGE) said last week. Output was up 0.6% against April, led by consumer goods. Even capital goods managed to post a modest 0.2% month-on-month gain. But industry still has a long way to go to catch up against Brazil's economic slowdown. May production was down 8.8% against May of 2014 in the face of high interest rates and heavy consumer debt.

Brazil posted a hefty June **trade surplus** of $4.5 billion, up from $2.8 billion in May for a first-half surplus of $2.2 billion. By contrast, Brazil posted a $2.5 billion trade deficit in the first half of 2014. Trade performance has been enhanced by a burgeoning grains and oilseeds harvest this year and by a weaker Brazilian Real. But the trade bottom line has also improved because of declining imports in a sluggish economy. According to the Trade and Development Ministry, export revenues fell 14.7% during the first half of 2015, on declining commodities prices, but spending on imports fell even faster at 18.5%.