Brazil-U.S. Business Council Brazil Bulletin

Interview: José Júlio Senna, Director of Monetary Studies at the Brazilian Economic Research Institute (IBRE); Aloísio Campelo, Coordinator of IBRE Business and Consumer Confidence Surveys; Salomão Quadros, IBRE Economic Analysis Coordinator; and Sílvia Matos, Director of Applied Economics Research at IBRE

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Brazil's government has lost the first round in its battle to restore confidence in economic policy. GDP performance this year will be worse than originally forecast and inflation and interest rates will be higher, according to a group of economists at the Brazilian Economic Research Institute (IBRE). The key is fiscal policy, but so far the administration of President Dilma Rousseff has failed to impose needed austerity measures and will likely miss even modest year-end targets. The economists addressed Brazil's economic dilemma at a recent meeting with investors and reporters. Excerpts follow:

- **José Júlio Senna**: "What we are seeing is a higher real interest rate than anyone expected. The government's original plan was to make most of the needed adjustment via fiscal policy, especially by means of spending cuts. That has proven more difficult than anticipated. There has been resistance from Congress. The Central Bank and the Finance Ministry have lost the confidence battle and they know it."

- **Aloísio Campelo**: "Business and consumer confidence fell faster in the first half of 2015 than in all of 2014. By any historical parameter, confidence is extremely low. There are a number of factors behind this, including perceptions about political turbulence and fears about energy and water rationing. It's not just worries about overall economic conditions."

- **Salomão Quadros**: "Inflation has advanced rapidly this year. It ended 2014 at 6.41% and could top 9%, on a 12-month basis, sometime in the second half. Government-controlled prices are rising faster than the overall inflation rate as the government makes much needed adjustments. We could see government-controlled prices rise by 13.9% to 14.9% this year, depending on gasoline and deisel fuel hikes. Services should stabilize at about 8%, but food prices will rise by about 9%. Brazil will have a bumper crop in grains and oilseeds but dry weather continues to pressure prices of perishables. Consumer goods will likely rise only about 5% this year as retailers respond to lower demand with discounts."

- **Sílvia Matos**: "It's going to be very difficult for the government to meet its 2015 fiscal goals. Revenues have failed to meet expectations. This has caused the government to cut spending but the easiest way to do that is by slashing investments. If prospects for the primary surplus are poor, prospects for the nominal deficit are worse. This is extremely worrisome since interest rates are on the rise, making debt-service payments higher. The gross national debt was 53% of GDP in 2013, 60% in 2014 and could rise to 63% this year. It will only stabilize around 2017."

Top News of the Week

Corruption probe leads to more arrests, arraignments of top executives. Federal Police and prosecutors last week showed no inclination to ease up on arrests and arraignments in a sweeping investigation of alleged corruption at state-run oil company Petrobras and other government-run entities. In one wave of arrests, police took eight executives and former government officials into custody, including ex-Presidential Chief-of-Staff José Dirceu. They charged Dirceu with coordinating portions of the alleged bribery scheme at Petrobras. Dirceu was recently paroled after serving prison time for an earlier bribery scheme. Meanwhile, a federal judge arraigned 26 business executives for their participation in the alleged bribery set-up at Petrobras. Among those charged were presidents of two major contractors, Andrade Gutierrez and Odebrecht.

President's popularity sinks to all-time low in face of corruption, economic woes. President Dilma Rousseff's personal popularity sank to just 8% in a poll released last week by the Datafolha organization. It was the lowest level of support for any Brazilian President since the organization began polling in 1985. Support for the President was 13% in the previous Datafolha poll, released in March. Meanwhile, 71% of respondents said the President's job performance was "poor" or "very poor," up from 62% in March. Some 66% of respondents said they favor opening impeachment proceedings against the President in Congress, up from 63% in March. Rousseff is suffering effects of a sweeping corruption investigation (see item above). Her popularity has also suffered from a series of blows to the economy, including rising inflation, high interest rates and declining job creation.

Auto production, sales bounce back in July after miserable first half. Brazilian motor vehicle production and sales finally bounced back in July on rekindled demand following a long period of doldrums. July saw output of 215,100 and domestic sales of 189,900, up 17.5% and 5.7%, respectively, from June, according to the National Motor Vehicle Manufacturers Association last week. Performance improved after the industry sold down inventories during much of the first half of the year. An aging motor vehicle fleet also helped spark the recovery. But year-on-year performance is still poor. January through July output of 1.49 million was down 14.9% from the same period in 2014 while seven-month sales of 1.23 million were off 20%. Only exports showed durable performance, rising 10.7% from last year to 225,300 for the first seven months of 2015.

Business News

Investment News:

Brazil may be suffering from a deep malaise when it comes to overall growth, jobs and investment but there was one bright spot last week when a U.S. survey pointed to São Paulo as a leading hub for hi-tech start-ups. The **Global Start-up Ecosystem Ranking** for 2015, released by U.S. software company Compass, showed Brazil's biggest city as number 12 in the world for hi-tech start-up ventures, up one notch from the company's first survey in 2012. Compass lists only 20 cities worldwide in its survey. São Paulo was the only Latin American in the rankings. The survey pointed to capital availability and solid market opportunities as São Paulo's major advantages over other cities in the region.

The **Brazilian Real** fell to its lowest point in 12 years last week, closing at R$3.51 against the U.S. dollar. The Real has lost 9% over the past month and 35% over the past year. The main reason for the decline of the Brazilian currency is increased political risk, according to market analysts. Failure to meet 2015 fiscal goals could cause Brazil to lose its investment grade sovereign rating. That, in turn, would force many institutional investors to pull up stakes in Brazil. The weaker currency is having one favorable effects. It is boosting exports. But, on the downside, it is also fueling inflation.

Company News:

Brazil's number four-ranked retail bank, **Bradesco**, last week announced its purchase of the Brazilian assets of international banking giant **HSBC** for $5.2 billion. The HSBC unit is Brazil's sixth largest retail bank. By making the purchase, Bradesco will challenge number three-ranked CEF, the federal mortgage bank, and number two-ranked Itau. Federal government-run Banco do Brasil will continue as Brazil's largest bank. By adding HSBC's five million account holders, Bradesco will have some 30 million clients and control assets of nearly R$1.2 trillion.

State-run oil company **Petrobras** last week released its second quarter earnings report, showing profits of R$531 million, a decline of 89% against the second quarter of 2014. Earnings were down because of payment of tax arrears and additional write-downs due to depreciating assets. The company took a huge write-down on assets in 2014 because of alleged overbilling and other abuses by contractors at Petrobras projects. The company also lost revenue on declining international prices for its oil-product exports and continued high debt-service costs.

Brazilian Calendar

-**Wednesday**, August 12, Brazilian Census Bureau (IBGE) release of monthly retail sales data, Rio de Janeiro

Indicators

Foreign exchange rate: **R$3.43 = $1.00**

Brazilian **industrial production** took another downturn in June, following a slight gain in May, falling 0.3% against the previous month and 3.2% against June of 2014, the Brazilian Census Bureau (IBGE) said last week. Capital goods took a dive during the month, reflecting reluctance of manufacturers to invest in the long term. Consumer goods were stagnant. Brazilian industrial output hit a dry patch as of last year, reflecting problems such as rising consumer debt, inflation and stagnant wages. Problems were exacerbated this year by higher interest rates and rising unemployment.

Brazil posted a July **foreign trade surplus** of $2.4 billion, down from $4.5 billion in June on declining international commodities prices. But the country managed an overall January through July surplus of $4.6 billion, reversing a $952 million deficit for the same period in 2014. Brazil's trade bottom line has improved since last year but only because of a sharp decline in imports caused by a weaker Brazilian Real and faltering consumer and business demand.

Brazilian monthly **inflation** weighed in at 0.62% in July, down from 0.79% in June, but that was not enough to halt the advance of the 12-month inflation figure, which rose to an astonishing 9.56% as of July from 8.89% as of June. July inflation was led by soaring costs for electric power, with food prices only slightly behind. The government is committed to a 2015 inflation goal of 4.5%, but even government economists say it will be impossible to hit that target. The Central Bank is aiming to bring inflation down to 4.5% by the end of 2016.