

**POLICY  
MONITOR**

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# The Week in Review

## On The Economic Front

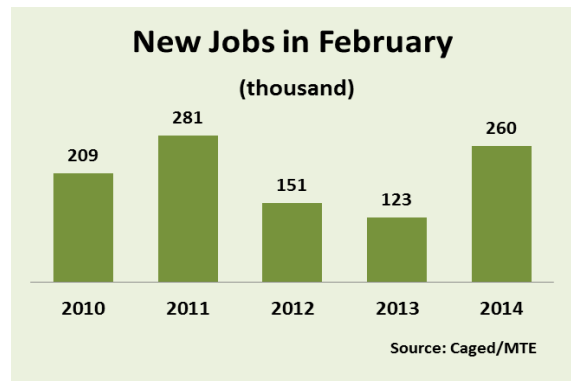
**Jobs:** According to the Ministry of Labor and Employment (MTE), the economy added a net 260,823 payroll jobs in February, an indication of the labor market's resilience despite an outlook marked by slow growth and high inflation.

**Inflation:** Focus Bulletin, a Central Bank weekly poll with market analysts, indicates that inflation is expected to increase this year to 6.11%, the highest Focus forecast this year. Quote: "A significant part of price response to the current cycle of monetary tightening is still to be seen," said Alexandre Tombini, the head of the Central Bank Tuesday during a Senate hearing.

**Primary Surplus:** The Administration has signaled it could raise taxes as early as April on products such as cold beverages, imported goods, and cosmetics to bolster the fiscal account. During a recent hearing, Finance Minister Guido Mantega said the industrial products tax (IPI) and payroll taxes (PIS/Cofins) could have been increased in October but were postponed following business complaints. Given increasing challenges in meeting the targeted primary surplus of 1.9% of GDP, the Administration is scrambling to generate additional tax revenues.

**Bilateral relations:** During his first visit to Brazil, Treasury Secretary Jacob Lew met both Minister Guido Mantega and Central Bank president Alexandre Tombini to talk about new opportunities for the bilateral partnership in trade, investment, and infrastructure, and reform of the International Monetary Fund. In addition, State Department Assistant Secretary for Western Hemisphere Affairs Roberta Jacobson visited Brasilia and Belo Horizonte (MG) to meet with government, business, and civil society members to discuss issues of mutual interest, including bilateral cooperation and regional concerns. Both meetings signal a bilateral rapprochement since President Rousseff's decision to cancel her state visit last year. Quote: "Both countries recognize the great potential benefit from working together to meet the challenges of generating jobs, sustaining growth, and helping support macroeconomic stability," said Lew after the meeting.

**Drought:** As Brazil approaches the end of the wet season in most of the country, water levels are critically low in both hydroelectric dams and water reservoirs. The National Grid Operator (ONS) projects that the dams in the Southeast and Midwest regions should end March at 38.2% of maximum capacity. Also, the Cantareira System, which provides water for nine million consumers in the metropolitan area of São Paulo, fell to 14.9% of maximum capacity on Tuesday, the lowest level on record. President Dilma Rousseff met governor of São Paulo Geraldo Alckmin to discuss policies to mitigate scarcity in the state (see more in *The Pulse* below).



# On The Political Front

**Presidential Poll:** The first Ibope/Estadão poll of 2014 presents President Dilma Rousseff as the favorite candidate to win the October election in the first round. If the election were held today, she would get 43% of the vote – the same results as the previous October poll – while her potential contenders Senator Aécio Neves (PSDB/MG) and Governor of Pernambuco Eduardo Campos (PSB) would get, respectively, 15% and 7%. In the event of a second round, President Rousseff would also get elected, with 47% of the vote either against Neves, who would get 20%, or against Campos, who would get 16%.

**Congressional Rebellion:** Although the conflicts between the Rousseff Administration and its governing coalition led by PMDB have not been solved, the political temperature has diminished in Brasília. While the Administration has appointed new ministers close to PMDB and shown flexibility in releasing pork barrel funding and negotiating critical divergences related to the Internet Framework Bill and Provisional Measure 627/13, which alters important provisions of the Brazilian taxation system, the coalition has agreed to postpone the vote on presidential vetoes with fiscal impact, such as the creation of new municipalities (see more below). The current ceasefire will be put to a test next week, with new legislative developments.

**Petrobras:** Following a statement by President Dilma Rousseff saying that in 2006 she voted in favor of Petrobras' purchase of the Pasadena Refining System in Texas based on "incomplete information" and "a technically and legally flawed" report, and acknowledging that the transaction turned out to be a "bad deal" for the Brazilian state oil company, the press reported that Petrobras' board, including its head, then Minister of Mines and Energy Dilma Rousseff, had access to all due diligence data. The deal, which cost Petrobras US\$ 1.8 billion, is now being investigated by the Federal Audit Courts (TCU) and has been criticized by Senator Aécio Neves (PSDB/MG), a presidential contender. The company is also being investigated about an alleged bribery scheme also involving SBM Offshore, a Dutch oil platform supplier.

**Campaign trail:** In a rebuttal to former President Lula, Governor of Pernambuco Eduardo Campos (PSB) said that "whenever the country clamors for change, some politicians try to put fear in people's hearts. But this time, as in 2002, hope will beat fear." During a meeting with business leaders last week, without mentioning Campos, Lula compared him to former President Fernando Collor, "an unknown handsome and young [figure]... and we saw the outcome." Collor resigned in 1992 in a failed attempt to stop his Senate impeachment trial on corruption charges.

## Task Forces

### Innovation:

- » **Internet Framework bill:** On Wednesday, Minister of Justice José Eduardo Cardoso signaled that the Administration will alter the net neutrality provision of the Internet Framework Bill (PL) 2126/11. Pressured by PMDB leader Eduardo Cunha, the Administration has agreed to include both the Telecommunications regulator body (ANATEL) and Brazil Internet Management Committee (CGI) in the elaboration of a decree that would regulate net neutrality. However, PMDB is still pushing for a different framework that would make ANATEL the regulator of the IT sector without the need for a decree. Following negotiations between Cunha and the Administration, the data localization requirement provision will likely not be included in the final draft bill. The president of the House, Henrique Eduardo Alves, scheduled the vote for Tuesday, March 25.
- » **700 MHZ Band:** The House of Representative's Media Council created a Committee to report on the bid of the 700MHz spectrum for 4G LTE, which is expected to occur in August 2014. Currently the 700MHz spectrum is used by television and radio broadcast services. Different studies are being conducted by the government, broadcasters, and telecom companies to assess the impact of technological interference caused mainly by TV signal repeaters as they digitalize their operations. The report is expected to be presented to the Council at their next meeting, scheduled for April 4th.
- » **Manaus Free-trade Zone:** In the first round of voting, the House approved a proposed constitutional amendment (PEC) 103/11 extending tax exemptions for 50 years for firms operating within the Manaus Free-Trade Zone covering Industrialized Products (IPI), imported industrialized products (II), income tax (IR), and payroll taxes (PIS/COFINS). **Next step:** The second round of voting is subject to negotiations with the Federal Administration to approve other bills that extend the benefits to the so-called IT Law, which would also grant tax deductions for companies that develop technology products.



## Tax and Investment:

- » **Tax Reform / MP 627/13:** On Wednesday, Rapporteur Eduardo Cunha (PMDB/RJ) released a preliminary report on [MP 627/13](#), which alters important provisions of the Brazilian taxation system. Cunha's report, which is more business friendly than the original bill, has 71 articles, including changes to the tax legislation and Transitional Tax Regime RTT. Given ongoing talks between Cunha and the Finance Ministry, the introduction of a completed draft bill was rescheduled for March 25th.

## Trade and Regulation:

- » **Government Publicity:** The Secretariat of Social Communication published [Ordinance 06/14](#) on Monday, at which time it also became effective. It defines the date on which government advertising for the 2014 elections will be legally suspended. The time frame for political advertising will run from May 7th until October 5th. In the event of a presidential runoff, the suspension date will be extended to October 26th. Each government body or entity must take the necessary measures to suspend advertising aired on the radio, television, internet, in newspapers, magazines, and any other means of dissemination. Advertisements subject to the electoral control provision are: institutional advertising, public utility advertising, and advertising on products and services that have no competition in the market.

# The Pulse

Brazil is in the worst drought in decades and now appears to face increasing chances of water and energy supply disruptions, which are beginning to affect the economy and may also spill over into the presidential campaign

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Since January, unusual weather conditions not seen since 1931 have caused a major drought affecting most of Brazil. The last major drought occurred in 2001-2002, during the end of the second term of former President Fernando Henrique Cardoso (PSDB), resulting in blackouts and power rationing. Then-presidential candidate Luiz Inácio Lula da Silva (PT) did not hesitate to make it a political issue, blaming the Cardoso administration for poor planning and over-reliance on hydroelectric energy.

Once elected, Lula appointed President Dilma Rousseff, an unknown technocrat in the electricity sector, as Minister of Mines and Energy. Since then, Brazil has built thermal plants and invested in new hydroelectric dams in the Amazon region to cope with increasing energy demand. However, the critically low water levels and a continuing negative weather outlook again present significant risks of power and water supply disruptions, the latter particularly in the highly populous state of São Paulo. "Unfortunately we haven't seen any evidence of increased rainfall coming in the next few months until the next El Niño, which is expected to arrive at year's end," said meteorologist Patrícia Diehl Madeira of Climatempo Consultancy during a recent interview with cable TV channel *Globonews*.

Nevertheless, the Rousseff administration has downplayed the possibility of power cuts. During a Senate hearing on Wednesday, Márcio Zimmermann, Executive Secretary of Mines and Energy, said: "Has the yellow light turned on? Yes, but we are looking into it step by step." Zimmermann added that there will be no energy rationing "unless the drought becomes worse than what I anticipate." Market analysts, however, paint a different picture. According to PSR, an energy sector consultancy that has run computing models based on official data collected since the 1930s, there is a "substantial risk of [power] rationing" in 2014 and 2015. Also according to PSR, higher energy spot prices and federal subsidies will raise energy costs by as much as BRL\$ 47.6 billion in 2013 and 2014.

Such a price tag is likely to further strain the country's fiscal account. Brazil is under increased scrutiny by sovereign ratings agencies such as Standard & Poors, which in 2013 placed a negative outlook on its BBB rating (two notches above investment grade), raising the possibility that the country could be downgraded as early as this year. Last week, the Administration unveiled a BRL\$ 8 billion package to support energy distributors, signaling that part of the bill will be passed on to consumers starting in 2015, after the October elections. Water and energy restrictions could also hurt industrial output, further eroding the country's fiscal and trade balances. Finally, the drought is already punishing the agriculture sector, reducing export crops such as coffee and sugar and increasing domestic foodstuff prices, adding to inflationary pressures.



From the policy-making perspective, the situation requires a coordinated response from all levels of government. A good start would be public awareness campaigns to inform the public about the real risks of supply disruption and to encourage disciplined use of water and energy. Also, all levels of government could negotiate planned water and energy reductions with industrial sectors to reduce energy demand. Since these steps could be interpreted as the equivalent of "rationing" – a taboo word in Brazil – incumbents seeking re-election such as President Rousseff and São Paulo Governor Geraldo Alckmin (PSDB) still insist on downplaying the risk of shortages.

On Tuesday, Folha de S. Paulo reported that Alckmin met Rousseff to ask her permission to develop a new pumping system to drain water from the Paraíba do Sul, a federal river that flows through the states of São Paulo and Rio de Janeiro. If approved, the new system, which faces opposition from the state of Rio de Janeiro and would supply the Cantareira reservoirs in the São Paulo metropolitan area, would take at least 18 months to build at a cost of BRL \$500 billion. Although a small step, the meeting suggests that Brazilian policymakers from different parties may be able to develop mitigation strategies together, which would be an important outcome because waiting until October will be too late.

