POLICY MONITOR

March 24 – 28, 2014

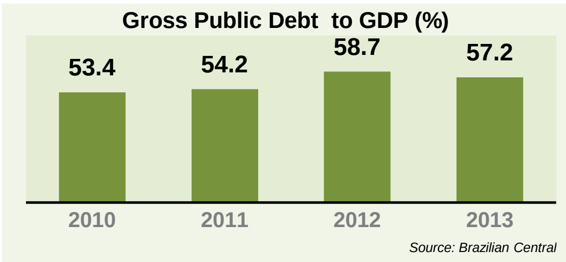
# The Week in Review

## On The Economic Front

**S&P Downgrade:** As many expected, Standard & Poor’s cut Brazil´s long term credit rating to BBB-, the lowest investment-grade level. According to the sovereign rating agency, “the downgrade reflects the combination of fiscal slippage, the prospect that fiscal execution will remain weak amid subdued growth in the coming years, a constrained ability to adjust policy ahead of the October presidential elections, and some weakening in Brazil's external accounts.” The Rousseff Administration responded in a statement by Finance Minister Guido Mantega by saying, “The announced change is inconsistent with the solidity and the fundamentals of Brazil…Assumptions regarding trajectory of investments in Brazil aren’t justified.” See more in *The Pulse*, below.

**Corporate Downgrades:** Following the sovereign downgrade, S&P also cut the ratings of state owned energy companies Petrobras (oil and gas), Eletrobras (electricity), and 13 banks, including Banco do Brasil, Itaú, Unibanco, Bradesco, Santander Brasil, HSBC Brasil, and Citibank Brasil from BBB to BBB- with a stable outlook. BNDES’, the national development bank, foreign currency rating was cut to BBB- and the local currency to BBB+. S&P has also placed another 27 banks on a negative outlook.

**Public Debt:** According to the Brazilian Ministry of Treasury, the federal gross public debt, which includes domestic and foreign indebtedness, grew 1.03% in February to BRL$ 2.1 trillion. The rise resulted from the combination of increased net sovereign debt issuances and higher yields. Market analysts surveyed by the Central Bank now project that the public debt will likely increase, standing at 58.5% of GDP at year end.




**Current Account:** Central Bank data indicate that Brazil posted a current account deficit of US$ 7.5 billion in February, a decrease from US$ 11.6 billion in January. The latest data reflect a record deficit for February and 12% above the previous record set for that month in 2013, causing the bank to revise its annual estimate of the current account deficit from US$ 78 billion to US$ 80 billion.

**Drought:** The National Grid Operator (ONS) again lowered its estimate of the water supply in the Southeastern and Midwestern region dams from 38.5% to 37.3% of their maximum capacity at the end of March. These dams account for 70% of water storage in the country. ONS projections indicate that for sufficient hydroelectric generation to be assured until 2015, water levels will have to increase to 43% of maximum capacity by the start of the dry season at the end of April. Although the Administration keeps dismissing the risks of power rationing, in an interview to the Wall Street Journal, Minister of Mines and Energy Edison Lobão said that the Administration may launch a campaign to encourage Brazilians to save electricity to mitigate risks of power disruptions during the World Cup. Meanwhile, in the state of São Paulo, which has been heavily affected by the drought, Governor Geraldo Alckmin announced that both utilities and companies will start to pay for the costs of water diverted from the Tietê river. The state administration expects to raise BRL$ 24 million in 2014 and BRL$ 40 million in 2016 in water revenue.

## On The Political Front

**President Rousseff Approval:** According to an Ibope poll commissioned by the National Confederation of Industry (CNI), President Rousseff´s approval rating fell 7 percentage points from the previous poll in November and now stands at 36%. She is considered to be doing a “great” job by 6% of respondents and a “good” job by 30%, while 36% of respondents think she is doing a “fair job. For 12% of respondents she is doing a “poor” job, and “really poor” for the remaining 15%. Dissatisfaction with the government’s handling of nine policy areas fell across the board but was particularly noticeable for economic policies.The data presents the first decline in presidential popularity since September, when her approval rating stood at 37%.

Petrobras: In a surprising move, the opposition managed to gather enough votes to create a Senate probe (CPI) to investigate Petrobras. As of Friday, March 28, a total of 29 Senators, two more than the minimum required, had signed the CPI application. However, the probe could still be cancelled up until Tuesday, April 1 if at least three Senators change their votes. Congress has also approved the invitation for both Minister Mantega, Minister Lobão, and Petrobras CEO Graça Foster to attend public hearings about Petrobras. Foster has also announced the creation of a new internal audit committee to probe Petrobras’ US$ 1.2 billion acquisition of Pasadena Refinery System (PSI) in Texas, a sum 28 times greater than the price paid by its former owner, Belgium group Astra Trading Oil. The committee’s report is due in 45 days. Last week, President Rousseff acknowledged that the transaction turned out to be a “bad deal” but that her 2006 vote supporting it as president of Petrobras’ board was based on “incomplete information” and a “technically and legally flawed” report. The deal is now being investigated by the Federal Audit Courts (TCU). See more in *The Pulse* below.

Congressional Ceasefire: Although critical electoral disputes remain unresolved within the governing coalition, the Administration has managed to diffuse most of the recent tension by releasing BRL$ 400 million of pork barrel spending and granting political appointments to key allies. Another important factor was a softer stance adopted by President Rousseff in the Congressional negotiation of important bills, such as the Internet Framework Bill and Provisional Measure 627 (Tax Legislation). The administration has signaled that it will appoint Ricardo Berzoini to head the Institutional Relations Secretariat, a presidential body in charge of congressional negotiations. See more in *Task Forces*, below.

Bilateral Relations: According to Folha de São Paulo, Vice-President Joe Biden will likely visit Brazil during the World Cup and will also meet with President Rousseff. If confirmed, the meeting will mark a bilateral rapprochement.

CNI Legislative Agenda: CNI published its 2014 Legislative Agenda, listing 134 Congressional bills of interest to the Brazilian industrial sector. CNI highlights the following 14 themes as top priority (either supporting or opposing the current draft bills): 1) New public procurement law, 2) Working hours reduction, 3) Termination of the FGTS additional penalty of 10%, 4) Standardization of administrative procedure rules 5) Outsourcing,6) Tax substitution regime for small and medium enterprises, 7) Subsidiary and affiliates taxation regime, 8) Excise tax credits, 9) Reintegra (elimination of residual taxation on exports), 10) New mining code, 11) Internet Framework bill, 12) Environmental licensing, 13) Prohibition of labor dismissal without due cause, and 14) Disregard of the corporate veil. Quote: “Despite the current pessimistic mood, all impacting legislative proposals are worth the industry’s engagement,” said Robson Andrade, president of CNI during the Agenda’s presentation event.

Subway Cartel: The São Paulo State Public Attorney’s Office has requested that the Judicial branch indict 30 executives from 12 companies on criminal acts of fraud and cartel practices related to the BRL$ 2.8 billion subway and train state companies’ procurement bids from 1998 through 2008. Among the companies allegedly involved in the scheme are Siemens, Alstom, CAF, Bombardier, and Hyundai. According to Public Office estimates, the fraud amounted to BRL$ 850 million. Next step: The SP Distric will decide whether to accept or reject the indictments. If tried and convicted, the executives could spend from two to 15 years in prison.

# Task Forces

## Energy and Green Technology:

- **Biosafety:** Edivaldo Domingues Velini and Maria Lúcia Zaidan Dagli were appointed President and Alternate President, respectively, of Brazil's National Technical Committee on Biosafety. The Committee is a multidisciplinary collegiate body that provides technical advisory support to the Federal Government in the formulation of safety standards and related activities involving the construction, testing, cultivation, handling, transporting, marketing, consumption, and storage of genetically modified organisms (OGM) and their derivatives.

## Innovation:

- **Internet Framework Bill**: After six weeks of negotiations, on Tuesday the House approved the Internet Framework Bill (PL) 2126/11. Highlights: 1) Data localization: The requirement was removed from the text, but tech companies may still be subject to Brazilian rules in legal cases disputing data — even if stored in servers abroad; 2) Net neutrality: Although the telecoms did not oppose the approved version of the text, internet providers will not be allowed to charge more or to reduce the conection speed for sites or applications based on content, easing access to videos and streaming; 3) Data privacy: The storage and availability of personal information should preserve privacy, honor, and the images of those involved; 4) Third party content: Internet providers are not liable for damage caused by third party generated content; 5) Citizenship: Ensures Internet access as an essential element of citizenship. Next step: The bill will be sent to Senate committees for discussion, followed by a floor vote.

## Tax and Investment:

- **Tax Reform**: On Wednesday the Joint Committee approved Rapporteur Eduardo Cunha's (PMDB) report on Provisional Measure (MP) 627/13, which alters important provisions of the Brazilian taxation system. The administration considered the approval of the text as a win. Highlights: 1) Tax Recovery Program (REFIS): Multinationals, banks, and insurance companies can renegotiate debts made until December 2013; 2) Overseas profits: Companies will only have to pay 12.5% tax on income obtained abroad in the first year. The remaining balance may be paid in up to eight years but will accrue interest; 3) Special treatment: Brazilian food and beverages multinationals will receive a 9% tax break on income earned abroad, paying less tax than the original MP text established. The new tax treatment will be valid until 2022. New changes can still be negotiated and added to another Provisional Measure, such as the MP 634/14. Next Step: The report will be put to a vote by both the House and Senate. For the MP not to expire, it must be approved by President Rousseff by April 21st.

## Trade and Regulation:

- **Senate Hearing with WTO Director:** Roberto Azevêdo told senators that he asked President Rousseff to support talks to advance the Doha Round, without getting into specifics.

- **Farm Bill:** The National Confederation of Agriculture (CNA) published a report claiming that U.S. Farm Bill subsidies will cause a loss of as much as US$ 4.34 billion to Brazilian cotton, corn, and soybean producer exports in the next five years. CNA has estimated the loss based on projected price declines for the three commodities. According to newspaper *O Estado de S. Paulo*, Brazil could open new WTO dispute against the U.S. over corn and soybean policies.

- **Mercosur-EU:** In the wake of the Mercosur - EU meeting held on Friday to assess the state of negotiations for a trade agreement, no date was set for the exchange of tariff reduction proposals, which is central to moving the discussions forward. Argentina's protectionist policies and Brazil's insistence that Argentina be included as an essential strategic partner continue to hamper the negotiations. Argentina has shown willingness to reach an agreement with Mercosur partners for a trade proposal with the EU.

- **Energy Bids:** The Ministry of Mines and Energy (MME) published Ordinance 118/14, which establishes guidelines for the Electricity bid scheduled for April 25th. The measure ensures the implementation of the Administration's BRL$ 8 billion financial package to support energy distributors burdened by skyrocketing energy prices caused by the increased use of thermal generator plants. Also published on the same day was Provisional Measure (MP) 641/14 and decree 8213, which alter respectively Law 10.848/04 and Decree 5.163/04. They require auctioned energy to be delivered in the same year as the bidding and also enable energy trading contracts to be negotiated in the regulated market (CCEAR) with a 68-month term running from May 1,2014 through December 31, 2019.

- **Brazilian Satellite Bid**: The National Telecommunications Agency (ANATEL) announced bidding for the rights to use the Brazilian Geostationary Telecommunications Satellite. The concession will be for a 15-year renewable term.

- **2014 Election Rules** : The Superior Electoral Court (TSE) approved three resolutions on rules for the next general elections. First, in the case of a resignation or ineligibility, the replacement candidate must be chosen at least 20 days before the vote. Second, there is a ban on electoral advertising through telemarketing, and Brazilian Sign Language (Libras) must be used for any discussions during the period of free TV electoral campaign advertising (8/19-10/4 and 10/6-10/24). Third, candidates financing their campaign with their own resources are limited to an amount equal to 50% of their personal assets. Minister Dias Toffoli removed the prohibition of electoral donations made "by private entities that are controlled, subsidiaries, affiliated, or are part of a consortium with foreign companies."

» **ANTAQ:** Mario Povia and Fernanco Fonseca were appointed Director and Interim Director, respectively, of the National Waterway Transportation Agency (ANTAQ). Both nominations made by the administration were approved in the Confirmation hearing at the Senate's Infrastructure and Services Committee. The nominations must still be approved by a floor vote before being confirmed. The agency is responsible for regulating, supervising, and monitoring water transportation services, port operations, and waterway infrastructure activities carried out by third parties

# The Pulse

## President Rousseff's approval ratings fall, S&P downgrades sovereign debt, and Petrobras' misfortunes expand. New challenges to the Administration will likely resonate in the electoral campaign and impact the next presidential term

President Dilma Rousseff completed a difficult week, with a new poll showing a significant decline in support for her job approval ratings. There has been increasing concern over the credibility of her policies in light of S&P's downgrade of the sovereign debt rating, diminishing water and energy resources in the face of a major drought, and multiple problems with Petrobras, the state's flagship oil and gas company. The timing is challeging for the Administration because the country is increasingly turning its attention to the October national elections. On the macroeconomic front, economists have continued to emphasize Brazil's slow growth, nagging inflation, rising interest rates, and deteriorating public finances as cries for deeper policy adjustment, politically difficult in the pre-election period. Although Brazil is not facing an economic crisis, these negative trends are being felt by firms and households alike through higher prices for basic goods such as food and energy, increased borrowing costs, and a general rise in uncertainty over the country's economic future, as reflected in this week's Ibope poll.

It is perhaps no coincidence that President Rousseff's approval rating would fall 7 percentage points at the same time as it faces two new important hurdles: recent developments of alleged corruption schemes involving Petrobras and the S&P downgrade. As different as they are, Petrobras' misfortunes and the country's fiscal vulnerabilities are a source of personal uneasiness for the President, an economist regarded as a tough technocrat and an oil and gas expert. Although both themes are complex and seem distant from the lives of ordinary Brazilians, they likely influenced the presidential approval ratings.

In 2010, President Rousseff's campaign featured Petrobras as a source of pride in a way not seen since the 1940s by promoting the slogan "the oil is ours." According to former President Luiz Inácio Lula da Silva, the newly discovered offshore pre-salt reserves were a "winning lottery ticket," a jackpot handed to President Rousseff. She was key in shaping the country's new oil and gas (energy) legal framework, adding clauses such as the production sharing agreement (PSA) and the promotion of Petrobras as the deep oil field's "sole operator." Since then, the oil company has kicked off a US$ 225 billion investment plan that includes an extensive local content requirement clause, which has burdened it operationally and financially. Another source of stress is the government's fuel subsidies policy which cost Petrobras US $ 21.6 billion in 2013.

Besides the accusations surrounding the Pasadena refinery deal, there is also an alleged scheme of US$ 139 million involving SBM Offshore, a Dutch platform leasing company. Petrobras is also under increasing public scrutiny over the construction of the Abreu e Lima refinery, a project in Pernambuco state started in 2005 as a partnership between Brazil and Venezuela. While Venezuela never invested in the plant, Brazil has developed the project with a budget that has skyrocketed from BRL$ 2 billion to BRL$ 18 billion. All these missteps have affected Petrobras, a publicly traded company, hurting its share price which has fallen over 70% since 2008. As the murky deals and inefficiencies come to light, in the years ahead the largest Brazilian company will be pressured to become more transparent and regain profitability.

On the fiscal front, S&P's decision to cut Brazil's sovereign rating reflects an outlook marked by inconsistent (if not competing) macroeconomic policies and weaker trade and current account balances. Among the inconsistencies detected, there is an estimated budgetary gap ranging from BRL$ 4 billion to BRL$ 8 billion, aggravated by the drought which has caused the Administration's fiscal package to include a hefty sum for energy distributors to cope with soaring energy prices. To fill the gap, the Administration is scrambling for extra tax receipts, signaling tax hikes on products such as beverages and cosmetics.

Each of these issues is manageable, and Brazil still maintains an investment grade rating, high levels of international reserves (US$ 380 billion), and a stable economy. In this sense, the downgrade works as a straitjacket, providing incentives for the country to pursue slight fiscal policy adjustments. A stronger adjustment is more likely in 2015, after the elections.