

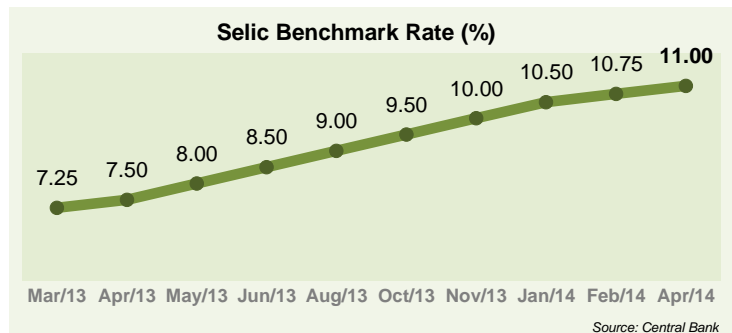
**POLICY
MONITOR**

March 31 – April 4, 2014

The Week in Review

On The Economic Front

Interest Rate Hike: The Central Bank (CB) raised the benchmark Selic rate by 0.25 percentage points to 11.0%, the ninth consecutive hike since April 2013. It is now above the 10.75% rate that existed at the time of President Dilma Rousseff's January 1, 2011 inauguration.



Trade Surplus: After two consecutive months of deficit, Brazil posted a trade surplus of US\$ 112 million in March, but it is still the lowest surplus on record for March for the last 13 years. The trade balance was hurt by a fall in demand, and prices for Brazilian commodities combined with increasingly higher fuel imports. The March current account gap rose to 3.69% from February's 2.82% of GDP, reflecting the merchandise trade balance, a large deficit in services trade, and increased remittances of payments and profits abroad.

Confidence Index: A Datafolha poll released on April 1st indicates that Brazilians are less optimistic about both their own economic situation and that of their country. The share of those who consider themselves optimistic dropped from 56% in November to 49% in April. On the other hand, the share of those who considered themselves pessimistic grew from 9% to 13% over the period, while those who think the situation will remain stable decreased from 36% to 31%.

Industrial Output: According to Brazilian Institute of Geography and Statistics (IBGE), Brazilian industrial output rose 0.4% in February following 3.8% growth in January. Analysts had forecast a 0.5% growth. On a year-over-year basis, output increased by 5%, slightly above a projected growth of 4.9%.

Drought: Projections made by the National Grid Operator (ONS) for water levels of the Southeast and Midwest dams have been overly optimistic. ONS predicted that reservoirs in both regions would rise to 41.3% of maximum capacity by the end of the March, but in fact they topped out at only 36.2%. Meanwhile, given the continuing decline in water levels of the Cantareira Reservoir System, which supply the São Paulo metropolitan area, the state government expanded the water saving program from 11 to 31 cities. Businesses and households that reduce consumption by 20% will receive a 30% discount rate on their bills starting April 1st. Municipalities not managed by the state controlled utility, Sabesp - including Guarulhos, Mogi das Cruzes, Maua, Santo André, and São Caetano, are not part of the program.

FACTA Agreement: According to Valor Econômico, Brazil and the U.S. have reached an agreement on the Foreign Account Tax Compliance Act (FATCA). Brazilian financial institutions that serve U.S. citizens and U.S. companies would not be considered liable of tax evasion by the U.S. from July on. Also according to Valor, the bilateral agreement is subject to Brazilian congressional approval and also needs to be regulated by a presidential decree. Only the ratification will ensure that Brazilian financial institutions would not be assessed penalties from January 2015 on.

On The Political Front

Bilateral Relations: The Senate Committee on Foreign Relations (CRE) held a public hearing on Thursday, April 3rd to discuss the current status and the future of the Brazil-US relationship. Invited



speakers included Brazil's General- Undersecretary of Policy for the Ministry of Foreign Relations, Ambassador Carlos Antonio da Rocha Paranhos; the President of the American Chamber of Commerce Brazil (AMCHAM), Gabriel Ricco; and the director of the Brazil Institute at the Woodrow Wilson International Center, Paulo Sotero. The hearing focused on issues such as the need for rebuilding of mutual trust following the NSA affair and the World Trade Organization Cotton Case. Quotes: "The Brazil-US relationship is unique in that it places Brazil in the global value chain. Of all exports to the United States, 72% are manufactured goods." - Gabriel Rico, CEO of AmCham. "Dilma has expressed discontentment with the episode of espionage. It's time to put the episode behind us and reorganize the bilateral agenda to develop affinities and common interests." - Senator Ricardo Ferraço. "The United States is the largest foreign investor in Brazil with investments of \$ 135 billion." - Ambassador Carlos Antonio Paranhos.

Democracy support: As the country recalls the April 1, 1964 military coup that led to a 21-year dictatorship, Brazilians are expressing strong support for democracy. A Datafolha poll indicates that 62% of Brazilians believe that democracy is better than any other form of government, unchanged from a 2008 poll. 16% of those surveyed believe that it does not matter if the government is a democracy or a dictatorship, while 14% defended dictatorship under certain circumstances.

Petrobras: The Administration was able to postpone a Senate investigative probe (CPI) into Petrobras activities. President of the Senate Renan Calheiros (PMDB/AL) announced that the decision to create the CPI will be made by the Committee of Constitution and Justice (CCJ) next week. The opposition has pushed for a separate CPI, but the Administration countered by threatening to create a joint (Senate and House) CPI to investigate alleged bribery schemes involving subway contracts in states ruled by the PSDB, the main opposition party, such as São Paulo. The CPI could also look into contracts made for the construction of the Suape, ruled by PSB, the party of presidential candidate Eduardo Campos. Meanwhile, in their own internal audits, both Petrobras and SBM Offshore, a Dutch platform supplier company, said that they did not find any evidence of improper payments made by SBM to Petrobras' employees. The alleged bribery scheme is also being investigated by the Federal Audit Court (TCU) and the Federal Police (PF).

Cabinet Reshuffle: President Dilma Rousseff named three more Ministers: Representative Ricardo Berzoini as Minister of Institutional Relations, Ideli Salvatti as Minister for the Human Rights Office, and Nefi Cordeiro as Minister of the Justice Supreme Court. Berzoini has already proven to be a critical factor in the Administration's attempt to derail the Petrobras Senate probe.

Task Forces

Energy and Green Technology:

- » **Belo Monte:** The National Electric Energy Agency (Aneel) released the outcome of the Belo Monte transmission line auction held on February 7. The concession includes construction, operation, and maintenance of transmission facilities that will transport energy to the Southeast produced by the Belo Monte dam. The consortium IE Belo Monte formed by Furnas, State Grid, and Eletronorte won with a bid of BRL\$ 434.6 million, 38% below the maximum value set by the government. The runner up, Abengoa, had submitted a proposal for BRL \$ 620.4 million.

Innovation:

- » **Internet Framework Bill:** The Internet Framework Bill (PLC) 21/14 was introduced in the Senate and is being considered under the constitutional urgency provision, which means it must be voted on within 45 days or other legislation will be blocked on the Senate floor. The bill is being simultaneously analyzed by three committees: Constitution and Justice (CCJ), Science, Technology, Innovation, Communication and IT (CCT), and Environment, Consumer Protection, and Surveillance and Control (CMA). Senator Vital do Rêgo (PMDB/PB), president of CCJ, named himself rapporteur of the bill in the committee and Senator Luiz Henrique (PMDB/SC) was nominated rapporteur in CMA. Next step: If approved by the Senate as is, it will proceed to the Planalto for President Rousseff's consideration. If the Senate amends the bill, it must be returned to the House for a second vote.
- » **Platform for consumer complaints:** The National Consumer Services Secretariat (Senacon) established a new online website for consumer complaints (Consumidor.gov.br), although it is still not up and running. According to the National Information for Consumer Defense System (SINDEC), the business signup rate to the new site is high, including firms from the telecommunications, retail, e-commerce, finance and electronic sectors. The site launch date has not been released. Terms of use:
 - » Companies interested in joining the platform will have to do so through a membership form and commitment term, which will be evaluated by Senacon;



- » Consumers may only register complaints against registered companies;
- » Participating companies are obligated to analyze, solve, and respond to consumer complaints within a ten day period.

Tax and Investment:

- » **Tax Hikes:** The Administration hiked the payroll tax (PIS/Cofins) on cold beverages (beer, refreshments, and sport drinks) by 1.5% effective April 1st in an effort to bolster tax receipts by BRL\$ 200 million in 2014. According to the Finance Ministry, the inflationary impact would be 0.4% if the hike is fully passed on to consumers (see more in The Pulse below).
- » **Tax Reform:** Provisional Measure (MP) 627/13, which alters important provisions of the taxation system, was approved by the House on Wednesday. The House-passed MP is a friendlier version to Brazilian multinationals operating overseas. It would enable them to refinance tax liabilities generated up to December 2013. Another change would provide additional tax incentives for Brazilian construction companies' overseas profits. They would be exempt from paying taxes on contracts closed until the new tax law is enacted. Correction: Last week, we incorrectly noted that MP 627 would expire if President Rousseff does not approve it by April 21st. In fact, it requires the approval of Congress.
- » **BNDES additional funding:** The joint committee approved Provisional Measure (MP) 628/13, which establishes an additional source of funding of up to BRL\$ 24 billion to the Brazilian Development Bank (BNDES). An amendment that had been included by rapporteur Ricardo Ferraço (PMDB/ES), which proposed extending the draw back regime (REINTEGRA) until December 31, 2017, was not considered in the final version of the text. The bill will expire if it is not voted on by May 8th in both the House and the Senate.

Trade and Regulation:

- » **Visa Process Facilitation:** The Senate Committee on Foreign Relations and National Defense (CRE) approved draft bill (PLC) 04/14. It would allow for an international agreement permitting reciprocal waivers for tourist visas, temporary visas for business trips, and visas for artists or athletes. The bill is intended to reduce bureaucratic inconveniences for select travelers. Next Step: The bill must still be passed by the Senate and signed by President Rousseff.
- » **2014 General Elections:** The deadline for public servants to resign from public office in order to campaign for elections is Saturday, April 5th. Among others, seven governors have already left their positions: Eduardo Campos (PSB/PE), Sérgio Cabral (PMDB/RJ), Antonio Anastasia (PSDB/MG), André Puccinelli (MS), Omar Aziz (PSD/AM), José Anchieta (PSDB/RR), and Wilson Martins (PI).
- » **Mercosul:** On Wednesday, the Brazilian delegation to the Mercosul Parliament (Parlasur) announced its chairs and members of the 10 standing Mercosul committees. Brazil will hold the chair or vice chair of the following committees:
 - » Representative Renato Molling (PP / RS) Vice Chairman of the Committee on Economic, Financial, Business, Fiscal and Monetary Affairs;
 - » Representative Benedetta da Silva (PT / RJ) Vice Chairman of the Committee on Education, Culture, Science, Technology and Sports;
 - » Representative Vieira da Cunha (PDT / RS) Chairman of the Committee on Labor, Employment Policy, Social Security and Economics;
 - » Representative João Ananias (PCdoB / CE) Chairman of the Committee on Sustainable Regional Development, Planning, Housing, Health, Environment, and Tourism.
- » **ANTAQ:** Adalberto Tokarski was appointed Director of the National Waterway Transportation Agency (ANTAQ). The Administration's nomination was approved in a confirmation hearing at the Senate's Infrastructure and Services Committee. The nomination must still be approved by a floor vote before he can be confirmed, along with last week's nominations of Mario Povia and Fernanco Fonseca who were appointed director and interim director, respectively. The agency is responsible for regulating, supervising, and monitoring water transportation services, port operations, and waterway infrastructure activities carried out by third parties.
- » **Cotton Case:** Roberto Azevedo, World Trade Organization (WTO) Director, stated last week that Brazil has announced it would open an implementation panel to discuss the cotton case between Brazil and the U.S.. Quote: "However "it has not yet officially arrived to us (WTO)," said Azevedo.



The Pulse

New tax hikes indicate that Brazil may have initiated a moderate fiscal adjustment. While the Administration is counting on additional one-time receipts from concessions such as the 4G auction, it will likely need to consider more permanent forms of revenue, as well as possible budget cuts

As many anticipated, this week the Rousseff Administration moved toward greater fiscal consolidation in traditional Brazilian style: by raising taxes. The government increased taxes on cold beverages (beer, refreshments, and sports drinks) and signaled that future hikes could also come soon for cosmetics, perfumery, and hygiene products. Focusing on the so-called “superfluous” goods whose sales have skyrocketed over the last decade, the current policy could also be expanded to include higher tariffs on imports. The new steps follow in the wake of Standard & Poor’s recent sovereign rating downgrade and suggest that Brazil is scrambling to fill a budgetary gap that could range from BRL\$ 4 billion to BRL\$ 8 billion in 2014. The Administration also counts on extraordinary receipts to come from the 4G concession bid that could raise as much as BRL\$ 8 billion in the second half of the year.

Brazil’s fiscal picture is becoming increasingly difficult for many reasons. A root cause of Brazil’s structural fiscal vulnerability is the distribution of public spending. In 2013, almost 74% of the overall federal spending went to payments to individuals. Of this share, almost 50% covered pensions and 13% went to the public sector payroll. Social programs accounted for another 11% of total spending. The structural fiscal shortfall has been exacerbated by higher energy (thermal power) prices (and subsidies) caused by the drought’s impact on hydroelectric output. On Wednesday, the Administration established a special BRL\$ 8 billion account to cover all or part of the extra costs faced by energy distribution companies. The Treasury had previously allocated BRL\$ 4 billion to fund the electricity sector in 2014. In addition, income from foreign transactions has been reduced by the fall in trade.

Another source of concern comes from the Congressional fiscal agenda, which includes proposals with negative fiscal impact. One example is bill (PL 99/13), which would lower retroactively the interest rate index used for both states and municipalities to roll over their debts with the federal government. Passed by the House, PL 99/13, it is now being considered in the Senate. If approved, the bill would not only decrease the states and municipalities overall debt, it would also allow them to borrow more, threatening the current 1.9% fiscal surplus target. “We are asking for a vote on the bill to be delayed,” Finance Minister Guido Mantega said in an interview to the state owned radio EBC, adding that he would also try to postpone the vote on other bills with negative fiscal impact.

A stronger fiscal remedy is unlikely before the October elections. A modest fiscal adjustment may be sufficient to increase the primary surplus to 3.5% of GDP for the next five years and perhaps help reduce the current 6% annual inflation rate. Current popular dissatisfaction with inflation and high interest rates may compel the next administration to produce more robust fiscal indicators, but given the hardship implicit in such a move, it would seem that it is unlikely to materialize in the near term.

