

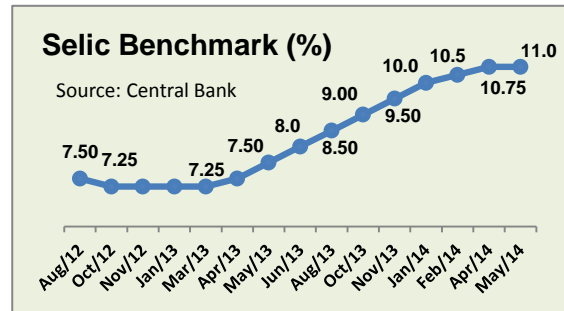
05/30/2014

The Week in Review

On The Economic Front

Interest Rate Hike:

Expectations of significant deceleration in economic growth led the Central Bank to keep the benchmark Selic interest rate at 11%, the first pause in the current monetary tightening cycle since it began in April 2013 (see graph). According to *Focus*, the Central Bank's weekly poll of leading market analysts, GDP is expected to slow to 1.63% in 2014, from 2.28% in 2013. The Monetary Policy Committee (Copom) signaled that as it continues to evaluate the outlook for inflation and economic output, it could raise the Selic in the future.



GDP and IBGE Strike:

On Monday May 26th, data collectors and analysts at the Brazilian Statistics Agency (IBGE) went on strike over increases in wages and benefits. However, according to IBGE leadership, the strike did not affect the first quarter GDP reporting released on Thursday May 29th. GDP grew 0.2% indicating that economic activity has slowed dramatically over the last twelve months. The economy grew 1.9% in the first quarter year over year (see more in Strikes below).

Primary Surplus:

The National Secretary of the Treasury announced that the central government – comprising the National Treasury, Social Security, and Central Bank – posted a primary surplus of BRL\$ 16.6 billion in April. From January through April, the federal government surplus amounted to BRL\$ 29.7 billion, 1.8% of GDP, the same level as in 2013. In January, the Rousseff Administration pledged to meet a consolidated target of 1.9% of GDP, which includes budgets from the states, municipalities, and state-owned enterprises. Since March, when Standard & Poor's downgraded Brazil's sovereign credit rating to BBB-, one notch above investment grade, the Rousseff Administration has been under pressure to improve its fiscal position.

Tax Cut Renewal:

During a meeting with business leaders of 35 trade associations on Tuesday May 28th, President Dilma Rousseff announced that her Administration will support the renewal of tax cuts established by Law 12.844/13, which is scheduled to expire on December 31, 2014. The law replaces a 20% payroll tax (PIS-Cofins) with a 1% or 2% tax on domestic sales for [56 labor-intensive sectors](#), such as home appliances, machinery, and information technology. However, given fiscal constraints, the current tax benefits, which will cost BRL\$ 21.6 billion in 2014, will not be extended to other industries. Quote: "Over the next few years, more sectors will be incorporated [in order] to increase competitiveness of the Brazilian economy," said Finance Minister Guido Mantega.

Correction: Last week's PM incorrectly stated that the retail sector would not be included in the tax cuts. In fact, the sector is already benefiting from the current policy.

STF on Savings Accounts Case:

The Supreme Court decided to delay for the second time a ruling on a landmark case in which depositors are suing lenders over losses to savings accounts because of government policies enacted in the 1980s to combat inflation. A ruling is not expected until 2015. The plaintiffs claim that economic plans aimed at

BRASÍLIA
SAF Sul Quadra 02, Lote 04,
Edifício Via Esplanada
Salas 103 a 106

CEP 70070-600
Fone: (61) 3327-2606
Fax: (61) 3327-1619

SÃO PAULO
Rua Olimpíadas, 134, 5º andar, Cj 52.
Condomínio Alpha Tower
Vila Olímpia

CEP 04551-000
Fone: (11) 3079-4533
Fax: (11) 3079-2202

WASHINGTON, DC
1101 17th St.
NW Suite 1010

Phone: (202) 822-6420
Fax: (202) 822-6423
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controlling inflation from 1987 through 1992 imposed unfair losses to their savings. Last week, the Federal Superior Court (STJ), Brazil's second highest court, ruled in favor of depositors. The banking industry says that it will fight any decision contrary to their interests. According to the National Federation of Banks (Febraban), should lenders lose the case, the compensation could cost the banks as much as BRL\$ 341 billion (US\$ 148 billion).

On The Political Front

Protests and Strikes Ahead of the World Cup:

As the June 12th soccer World Cup kickoff game approaches, three types of public protests have spread throughout Brazil: public sector strikes, civil society rallies against the World Cup over extensive state spending on stadiums, and partisan and union politically motivated movements aimed at influencing voters in the October elections. This week, the first two types of protesters took to the streets of major Brazilian cities. On May 27th at the Mané Garrincha arena in **Brasilia**, where the World Cup trophy was on public display, a march against the World Cup resulted in police clashing with protesters, and demonstrators from indigenous groups demanding land reforms. On the same day, in **São Paulo**, in the aftermath of walkouts by teachers and bus drivers, police officers and traffic inspectors went on strike for better pay and benefits, affecting the already congested public transportation system. In **Rio de Janeiro**, bus drivers organized another 24-hour stoppage on May 28th, while in **Salvador** bus drivers crossed their arms, leaving 1.5 million commuters without service. Following this week's protests, the Rousseff Administration decided that Army troops will be responsible for enforcing security at airports, hotels, and streets to protect the 32 national teams, foreign delegations, and FIFA leadership. Also, during a meeting with business leaders on Tuesday, President Rousseff assured that her Administration would not tolerate riots during the World Cup. Quote: "Brazil's image is at stake...We are taking all necessary steps to prevent [the riots] that happened in the Confederations Cup during the World Cup."

Itamaraty Hacked:

According to *Folha de S. Paulo*, the Ministry of Foreign Affairs' e-mail and data system services were targeted by hackers in Brazil and abroad. Among documents leaked were memos on Vice President Joseph Biden's upcoming trip to Brazil for the World Cup and a summary of Brazilian participation in a nuclear security summit in the Netherlands. Asked about the extent of the attacks, Itamaraty replied that "although small," "confidential information has been leaked." The Federal Police and the Institutional Security Office (GSI), a Presidential body, are investigating the case.

Supreme Court Chief Judge:

Supreme Court Chief Judge Joaquim Barbosa announced that he would step down at the end of June. Although his two-year term at the Court runs until November, Barbosa, the first Afro-descendant to rise to the Court's bench, has been signaling he wants to retire before the next Chief Justice, Ricardo Lewandowski, steps in. It is worth mentioning that according to the Supreme Court Ministers Marco Aurélio Mello and Gilmar Mendes, Barbosa cannot run for public office this election year. To do so, he would have had to retire on April 4th from the Brazilian Supreme Court six months before the October elections.

Campaign Trail:

During a dinner with the PMDB leadership on Tuesday, President Dilma Rousseff (PT) charmed key allies such as House speaker Representative Henrique Eduardo Alves (PMDB/RN), Senate speaker Renan Calheiros (PMDB/AL) and House party leader Eduardo Cunha (PMDB/RJ), stressing the PT-PMDB alliance favors them in the October elections. President Rousseff also took the occasion to blast the opposition. Quote: "There isn't any other alliance in this country today that presents the potential of transformation that we have...We know that one of the alliances means recession, unemployment, and wage crunch. These are the so-called 'unpopular steps'," she said in reference to her main contender, Senator Aécio Neves (PSDB/MG).

A bill introduced by Senator Aécio Neves to amend the *Bolsa Família* (a monthly cash aid program) and one of the PT's main income distribution policies, was approved by a tight margin of 10 to 9 votes in the Social Affairs Committee (CAS). The bill extends the timeframe for collecting the benefit for at least an additional six months to families whose parents obtain formal jobs. The Administration opposes the bill, saying it has been introduced only for electoral gains. The bill has yet to be analyzed by the Human Rights

BRASÍLIA
SAF Sul Quadra 02, Lote 04.
Edifício Via Esplanada
Salas 103 a 106

CEP 70070-600
Fone: (61) 3327-2606
Fax: (61) 3327-1619

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Fax: (202) 822-6423
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Committee (CDH) before it goes to the House. Quote: "Currently, the workers who get jobs are no longer eligible and [if they lose their jobs] in a few months might have to apply to the program again," said Neves.

Former Pernambuco state governor Eduardo Campos (PSB/PE) met with pharmaceutical company leaders on Tuesday and said that the PT Administrations have used the income distribution programs as "electoral terrorism." Although he says that if elected, he would keep the current policies such as *Bolsa Família* and *Minha Casa Minha Vida* (a housing program), he called them "insufficient" to fight inequality and promote growth. Quote: "President Dilma [Rousseff] lost her way: the one who was the mother of the PAC [Growth Acceleration Program] became the godmother of inflation, low growth, [and of] what is happening in Petrobras."

Petrobras:

The Senate probe (CPI) investigating alleged corruption practices by Petrobras summoned former Supply Director Paulo Roberto Costa to testify at a public hearing. He is one of the main targets of the Federal Police for participating in alleged financial crimes, including money laundering and illegal exchange rate operations in the so-called *Operação Lava Jato* (Car Wash Operation). The hearing will likely be scheduled for next week. During a May 27th meeting. CEO Graça Foster said that if talks on the acquisition of the Pasadena Refinery System Inc. (PSRI) had happened today, Petrobras would not close the deal, which turned out to be detrimental to the state oil company. Quote: "In light of the current outlook, the figures show that acquisition of the American refining company was not a good deal...it would not be closed again with the current projections and strategies." Supported by the opposition, a second Joint Congressional Probe (CPMI) also created to investigate Petrobras was installed on Wednesday. Senator Vital do Rêgo (PMDB/PB), who already presides over the Senate probe, was also elected President of the CPMI. Representative Marco Maia (PT/RS) was appointed as the rapporteur.

Task Forces

Tax and Investment

Tax Installment Program: On May 28th the House approved Provisional Measure (MP) 638/13, which extends the tax installments program (REFIS) for federal taxes. Those interested must enter the program by August 2014. The refis will be valid for tax debts due by December 31, 2013. Interested parties should anticipate, upon joining the program, 10% of the debt when the amount is less than BRL\$ 1 million and 20% for amounts over BRL\$ 1 million. The MP awaits Rousseff's approval before it can become law.

Trade and Regulation

Congress During the Soccer World Cup: Congress is deciding whether to hold a special working session during the World Cup period. Apart from not working on the days the Brazilian team plays and on days when there will be a match in Brasilia, Congress will likely have voting sessions only on six of the 32 days of the tournament. The Senate has no voting session scheduled for June, given that the World Cup will coincide with the electoral party conventions, where the candidates for presidency will be officially defined for the October elections. Four days are reserved for voting in July. As for the House, President Henrique Eduardo Alves (PMDB/RN) suggested six days of voting, two in June and four in July. Also, the Supreme Court Judge, Joaquim Barbosa decided that the court will not work on June 26th or 30th, when soccer matches will be held in Brasilia. On days Brazil plays, the workday will end at 12:30 pm.

Foreign Exchange Operations: Congress approved bill (PL) 4458/12, which allows for an increase in foreign exchange contracts in amounts of US\$ 3,000 to US\$ 10,000. The law intends to boost tourism and reduce bureaucracy for non-residents in Brazil to buy Reals. The bill is waiting to be signed by Rousseff.

Biodiesel Blend: On May 29th the Administration published Provisional Measure (MP) 647/14, which starting in July requires that the mandatory blending of biodiesel with diesel, sold to final consumers, be increased from 5% to 6%. In November, the blend will increase to 7%. The MP also states that the National Energy Policy Council may, at any time for reasons of public interest, reduce the percentage to 5%. In 2008 the Biodiesel Program established a mandatory blend of 2%, and in 2010, increased it to 5%. No changes have been made since. According to projections made by the Ministry of Finance, the MP will not have a significant impact on inflation if the present economic scenario stays the same. Also the increased use of biodiesel will have a positive impact on Petrobras. For every one percentage point increase in the biodiesel fuel blend, the amount of diesel fuel Brazil needs to import falls by 600 million

BRASÍLIA
SAF Sul Quadra 02, Lote 04,
Edifício Via Esplanada
Salas 103 a 106

CEP 70070-600
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liters per year. With the 7% blend requirement, Brazil could see its imports of diesel fuel decline by an estimated 1.2 billion liters per year.

BNDES Additional Funding: On Wednesday, President Rousseff signed into law Provisional Measure (MP) 628/13, which establishes an additional source of funding of up to BRL\$ 24 billion for the Brazilian Development Bank (BNDES). According to Guido Mantega, Minister of Finance, the MP will ensure compliance with long-term commitments such as the administration's investment in the Logistics Program (PIL), Growth Acceleration Program (PAC), and BNDES Investment Program (PSI).

The Pulse

Last week, Congress rejected a substitute bill that would have eased public procurement restrictions. Given Brazil's need for infrastructure improvements, legislative action should emphasize technical expertise, urgency and transparency

As the June 12th soccer World Cup kickoff approaches, Brazilian public opinion seems increasingly concerned with delays and cost overruns of the soccer arenas and other construction projects related to the preparation of the championship. According to Bloomberg, the latest cost estimate for 12 new and refurbished soccer stadiums is approximately BRL\$ 8 billion (US\$ 3.6 billion), BRL\$ 2.7 billion more than the first detailed estimate issued in 2010 and almost four times the amount Brazil told soccer's governing body the stadiums would cost in its 2007 hosting profile. The Brasilia arena, Mané Garrincha, had the highest cost at US\$ 900 million, almost three times the original estimate. It is now the second most expensive soccer stadium behind England's US\$ 1.2 billion Wembley Stadium. It is worth noting that the World Cup construction projects have been planned, procured, and built under the Differentiated Government Procurement Law (RDC), a public procurement model created in 2011 to expedite the World Cup and the Rio 2016 Olympic Games projects by easing some restrictions applied to the rigid General Procurement Law 8666/93. Later, the new regimen was extended to the Growth Acceleration Program (PAC) projects and the construction of hospitals. Under the RDC, the low-cost bidder can be superseded by a technical expertise standard. Companies that win public procurement contracts for construction work are also responsible for the basic and executive projects, having more leeway on cost decisions, thus making the inspection more difficult for the Office of the Comptroller General (CGU) and the Federal Auditors Court (TCU).

Last week the Rousseff Administration suffered an important defeat in Congress, as the House and the Senate approved the original Provisional Measure (MP) 630/13, which facilitates the contracting of public engineering construction only for prison projects. The alternative presented by Senate Rapporteur Gleisi Hoffmann (PT/PR), a former Chief of State, was rejected. It would have extended RDC to any public service or construction project procured by federal, state, or municipal levels of government. The main rationale in favor of the RDC expansion is that it expedites the procurement phase, which in turn accelerates construction, reducing labor and other costs. However, according to the Institute of Architects of Brazil (IAB), this argument is flawed. In a *Valor* op-ed piece, IAB's director Pedro Moreira highlighted that there is no guarantee of cost savings based on the supposed agility offered by the RDC. Costs for the renovation of the airports of Cuiabá (MT), Porto Alegre (RS), and Belo Horizonte (MG) – all contracted under the RDC – have ballooned from BRL\$ 379.6 million to BRL\$ 537, reflecting a 30% price increase. Of the 20 urban mobility and airport projects procured under the RDC, only four were delivered on time.

Members of Congress also agreed to accelerate consideration of draft bill (PLS) 559/13, which revokes the RDC and establishes new rules for public procurement based on recommendations made by experts in public governance, representatives of the Administration, and the private sector. The bill will likely be approved in the Senate this year, going to the House in 2015. Following the October general elections and amid an increasingly challenging outlook, the current BRL\$ 240 billion package of planned investments in logistics – roads, railroads, ports, airports, subways, and urban mobility – will be key to stimulating a lagging economy. It is clear that the outdated Law 8.666/93, a framework still used to contract office supplies and roads, needs to be urgently reformed. The new law should not only contemplate speed, transparency, and technical expertise, but also follow the best practices required by both CGU and TCU.

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Edifício Via Esplanada
Salas 103 a 106

CEP 70070-600
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