POLICY
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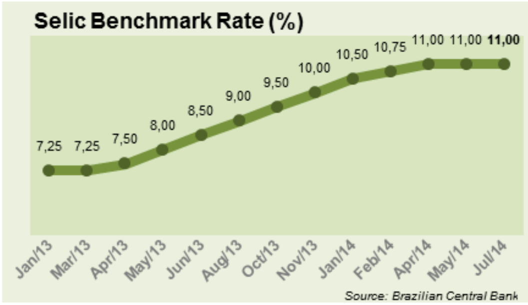
The Week in Review

On The Economic Front



Interest Rate

On Wednesday, the Central Bank (CB) maintained the Selic benchmark interest rate at 11% for the second consecutive month. The Monetary Policy Committee halted the Selic hikes in May after nine consecutive increases.

World Cup Effect on Politics and the Economy Still Ambiguous

According to the "Financial Times", the FIFA World Cup provided some stimulus to the Brazilian economy, and Apex, the Brazilian trade and investment promotion agency, suggests that the largest sporting event in the world increased foreign business travel resulting in deals worth $6 billion. It is estimated that over the past four years, the World Cup contributed, directly and indirectly, an additional $50 billion to national output. Notwithstanding these gains, national economic growth has continued to decline over the same period, and certain sectors have suffered, in part from lost time to World Cup games. Automobile production, for example, continued a downward trend, decreasing 33% in June.

At the same time, consumer and business confidence has hit new lows, while the stock market has responded positively following Brazil's last two lopsided defeats. The market's upward trend continues to coincide with President Rousseff's fall in popularity over the last year, reflecting investors' increased hopes that she will not be reelected. In addition, investors consider President Rousseff's interventionist economic policies as responsible for exacerbating Brazil's weak economic performance and believe a new president with more market-friendly policies could turn the economic decline around in 2015.

On The Political Front

World Cup Evaluation

According to a Datafolha poll released on Tuesday, the FIFA World Cup left foreigners who came to the country to watch the matches with a surprisingly positive image of Brazil. The approval ratings were extremely high in some areas: 92% of visitors praised both comfort and safety in the World Cup stadiums, and 86% also found transportation to be excellent or good. Communication systems (phone and Internet) and prices in general (food, hotels, and flights) received negative reviews. The cost of living was considered bad/terrible by 29% of those interviewed, with the same rating given to hotels by 27% of respondents. Communication systems were given approval by a minority of 41%. The survey polled 2,209 foreigners from more than 60 countries in the São Paulo, Rio, and Brasília airports, as well as in Fan Fests and venues with large concentrations of fans in Belo Horizonte, Salvador, Fortaleza, São Paulo, Rio, and Brasília between July 1st and July 11th.

Presidential Poll

A new *Datafolha* poll on voter intentions released on Thursday shows President Rousseff (PT) received support from 36% of respondents, followed by Aécio Neves (PSDB) with 20%, and Eduardo Campos (PSB) with 8%. The change of preferences was very small compared to the previous poll, and they indicate

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a strong possibility of a second round runoff occurring. The major news from this poll is that, in a simulation of a runoff, for the first time Rousseff and Aécio Neves appear in a technical tie with 44% and 40% of voter preferences, respectively. This poll is the first to be held after the official start of the election campaign on July 6th. Since then, candidates have authorization from the Electoral Court to, among other campaign activities, hold political rallies and begin street and Internet advertising. Free Airtime on radio and TV begins on August 19th.

BRICS Summit

Brazil hosted the sixth BRICS summit in Fortaleza this week. Leaders established a framework for a New Development Bank (NDB), a body envisioned to finance development projects for member states and potentially other countries. It is intended to serve as an alternative or supplement to the World Bank. The BRICS agreed to an initial capital contribution of $50 billion, evenly divided among the five countries, and the bank is expected to begin operations in 2016, once ratified by the member parliaments. Headquarters are planned for Shanghai, and the first President is to be appointed by India. The BRICS also announced the creation of a $100 billion currency exchange reserve to be used by its members in case of balance of payment crises, and which will serve as an alternative to the International Monetary Fund (IMF). The bank and the reserve will be mostly symbolic at first, according to an UNCTAD study, and will have a limited lending capacity of $3.4 billion per year in the first decade, about 5% of what the World Bank will likely lend in 2014.

Brazil-Russia Relations

On Monday, President Rousseff met Russian President Vladimir Putin, and signed a number of bilateral agreements on the economy, defense, technology, energy, and vaccine production. One of the main agreements would encourage increased trade between the two countries perhaps in the order of US$ 10 billion per year. Rousseff and Putin also signed an agreement on air defense: the Brazilian military will participate in Russian military exercises using their system. Quote: “Our common strategy and partnership are getting stronger and moving to a higher level, which implies development of new projects. We cannot limit ourselves to what we have at the moment. The recent events show that scientific and technological cooperation is extremely significant,” said Rousseff.

Brazil-China Relations

President Rousseff also met with China’s President, Xi Jinping to sign various bilateral agreements on civil aviation, energy, financial relations, infrastructure, education, mining, technology, construction and agriculture. One agreement details the potential purchase 60 Embraer aircraft by Chinese companies Tianjin Airlines and ICBC Leasing. Rousseff and Xi Jinping also signed a protocol on information technology and remote sensing to enhance the security system of the Amazon. China is Brazil’s largest trading partner, according to the Foreign Ministry, the country is the main destination for Brazilian exports and, in 2013, trade between the two countries exceeded US$ 83 billion. "The balance [of business between Brazil and China] could not be more positive, and the future could not be brighter. Our relationships which shape a truly strategic partnership, develop with unprecedented speed in various areas of cooperation,” said Rousseff.

Petrobras

The Joint Parliamentary Committee of Inquiry (CPMI) responsible for oversight of the state-owned oil company Petrobras inquiry authorized an investigation into the breach of banking, tax, telephone, and electronic communications of money changer Alberto Youssef and former head of supply and refining at Petrobras Paulo Roberto Costa. Both were charged with financial crimes including money laundering and illegal exchange rate operations in the so-called Operação Lava Jato (Car Wash Operation). The CPMI also authorized investigation into the breach of confidentiality of several companies accused of being involved in the operation in which Costa and Youssef are alleged to have moved more than BRL$ 10 billion.

Congress

Political party leaders suspended deliberative sessions for the next two weeks. The Constitution determines that an official parliamentary recess must take place between July 18th and July 31st, but conditions it on the approval of the budgetary guidelines law. As Congress did not approve such law in time, members of Congress will have an informal recess instead, as has been done in the past.

Task Forces

Innovation

Access to Genetic Patrimony: The House Select Committee (CESP) that will analyze and present a report on bill (PL) 7735/14, which would establish a new framework to clarify regulatory control over access to "genetic patrimony", is awaiting nomination of members. Among other things, the bill establishes that the base rate proposal for distribution of benefits would be 1% (one percent) of the net revenue (sales less taxes paid) of the product. This is slightly less than the 1.1% rate adopted by TIRFAA (International Treaty on Plant Genetic Resources for Food and Agriculture). On Wednesday, July 16th, an amendment was offered by the coalition of companies proposing that the percentage of the benefit distribution be 0.2% of annual net revenue. The bill was sent to Congress by the executive branch under the Constitutional Urgency provision, which means Congress will have 90 days to vote on the bill. There is very little time for deliberation on the genetic patrimony bill between now and the October general elections for two reasons. First, there is a parliamentary recess that runs from July 18th through July 31st, and second, there is only one week of congressional work scheduled for the months of August and September because of campaigning for the coming elections.

700MHz Spectrum: On Monday, the National Telecommunications Agency (ANATEL) published ordinance 640/14, which establishes technical criteria for mitigating any possible interference between digital television services and 4G, including rules that provide for the installation of certain structures so that no transmission problems occur on either platforms (TV and 4G). This is the first preparatory step prior to the auction of 700 MHz spectrum for mobile Internet companies, which should happen by the first week of September. For months, the government has discussed the possibility of signal interference between the 4G and digital broadcast television, as the two services will share the 700 MHz frequency. Since last year, several studies were conducted to test whether there is in fact a problem of coexistence.

Tax and Investment

Stimulus Package: A joint Committee was installed this week to analyze Provisional Measure (MP) 651/14, which establishes tax cuts on foreign sales and subsidized credit lines and permanently extends the payroll tax exemption policy for companies that are already receiving the benefit. The MP also alters the tax installment plan (Refis) and restores the Special Regime of Tax Incentives (Reintegra) to exporting companies. A public hearing on the MP is scheduled for August 5th. If not approved in time, the MP will expire as of November 11th.

Super Simples: On Wednesday, the Senate approved bill PLC 60/14, which improves the Simples Nacional or Super Simples federal program of tax incentives for micro and small businesses. The system involves monthly tax and social security payments being collected using a single document, thus reducing bureaucracy in order to simplify the process for businesses. The approved text changes the criteria for service companies to be included in the system. The criteria is no longer by category but by revenue. The change allows any company that provides services and makes up to BRL$ 3.6 million per year, to join the special tax regime after their project is approved and sanctioned by President Rousseff. Companies that fit into the new system will be taxed according to a scale ranging from 16.93% to 22.45% of the monthly revenue. Also, an amendment made to the bill includes, among others, soft drink manufacturers in the program. The bill was approved without changes made to the text approved in the House and must now be signed into law by President Rousseff.

Manaus Free-trade Zone: On Wednesday, the Senate approved a proposed constitutional amendment (PEC) 20/14 extending tax exemptions for 50 years for firms operating within the Manaus Free-Trade Zone. It covers Industrialized Products (IPI), imported industrialized products (II), income tax (IR), and payroll taxes (PIS/COFINS). The Senate also approved bill (PLC) 61/14, which extends the benefits to the so-called IT Law (8.248/91). It would also grant tax deductions to companies that develop technology products. The bill must now be signed into law by President Rousseff.

The Pulse

The Rousseff Administration has adopted one-time fiscal measures to boost federal revenue, postponing hard choices to address structural impediments in the Brazilian economy until after the elections

The Brazilian Central Bank's Focus Bulletin has been consistently downgrading its economic expectations for months. On December 27th of last year, it forecast 2.0% GDP growth for 2014; on June 27th, its revised estimate had fallen to 1.1%. Over the same period, industrial growth forecasts fell from 2.23% to 0.14%. Other key economic indicators including inflation, unemployment, and the current account balance are also deteriorating over the longer term.

Inflation has settled for the moment at the top of the government's target rate band and shows little sign of abating. The most recent survey, carried out by the Federation of Industries of São Paulo (FIESP) and released this Wednesday, shows that 69% of Brazilians polled said that prices had increased more than their wages. As a result, confidence indicators from several sources have consistently shown that there is a credibility problem with government.

Lower economic growth implies a reduction in fiscal resources, which is what Brazil is experiencing. Reducing fiscal outlays is a standard response to rising inflation, but the Rousseff Administration has chosen to do the opposite, preferring to find alternative revenue and defer an unpopular fiscal adjustment until after the October elections. To continue financing its budget, including the politically popular tax cuts and transfer programs like the *Bolsa Familia*, the Administration is relying increasingly on one-time fiscal measures.

For instance, the decision to have Petrobras pay in advance for rights to develop select pre-salt reserves under the 2010 transfer framework gives the government the opportunity to cash in on US$ 2 billion in 2014, a strong boost to managing its accounts and perhaps attaining its fiscal-surplus target for this year. Similarly, the administration has decided to relinquish most of the investment requirements that would be imposed to the winners of the 700MHz 4G auction, with the purpose of ensuring a fiscal windfall from licensing fees. The federal government also plans to use the revamped Refis tax program, offering discounts for paying old tax debts in installments, to bring in BRL$15 billion to the Treasury.

These and other measures may allow the government to meet its fiscal targets, without any negative short-term repercussions to the electorate. However, they will not change the need for serious and unpopular macroeconomic policy changes beginning in 2015.

In a sense, many Brazilians have already seen this happen before. In 1998, the presidential race that reelected Fernando Henrique Cardoso also witnessed several macroeconomic measures taken with the sole purpose of delaying tougher ones required to put the country in order. Such measures were eventually adopted, but with a much higher cost to the population because they came later than they should have. Either President Rousseff or one of her contenders, whoever is elected, will likely have to face reality soon after the elections, an unpleasant prospect for the next president of Brazil.

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