POLICY MONITOR

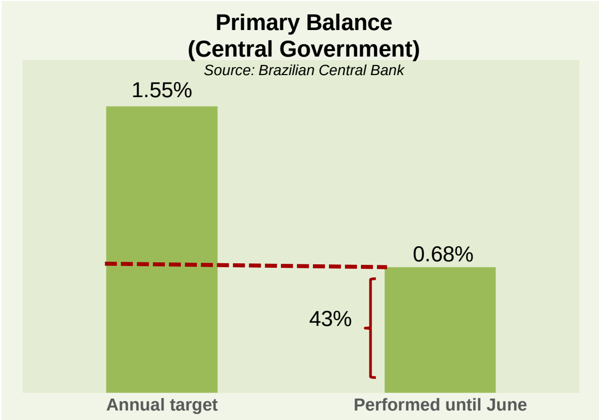
Week of July 28-August 1, 2014

The Week in Review

On The Economic Front

Primary Deficit

For the second month in a row, the Brazilian consolidated government (federal, state, and local) reported a primary budget deficit, the worst showing for June since the Central Bank's index began in 2002. For the first half of the year, the consolidated primary surplus was 1.17% of GDP, or only 61% of the full-year fiscal target of 1.9%. The large federal or central government deficit (Treasury, Social Security and the Central Bank) was the main culprit, coming in at only 43% of its target goal of 1.55% of GDP (see graph).



The falling primary surplus points to expenditures rising faster (12.3%) than revenues (5.9%). This reflects a combination of large tax breaks to industry and a slowing economy that has reduced revenue, raising questions about the Rousseff Administration's ability to meet year-end fiscal targets.

Industry Confidence Index

The Industry Confidence Index (ICI) published on Tuesday by the *Getúlio Vargas* Foundation decreased from 87.2 to 84.4 points, or 3.2%, from June to July 2014. After the seventh consecutive monthly decline, the index dropped to the lowest level since April 2009 (82.2 points). The decrease reflects a 4.8% decline in the Present Situation Index (PSI) to 85.8 points, and a 1.8% decline in the Expectations Index (EI) to 82.9 points. According to Aloisio Campelo Jr., Assistant Superintendent of Business Cycles for FGV/IBRE, "The July outcome flashes a yellow light compared to the third quarter. Although the decrease in the number of holidays may favorably influence production, demand continues to be a limiting factor to this growth."

Electrical Sector / Drought

According to a Reuter's report on Tuesday, Brazilian power regulator Aneel extended by one month the deadline for the country's electricity distributors to pay for power purchased in the May spot market. The extension to August 28th, required because the previous one-month extension expired on July 31st, provides time to negotiate nearly $3 billion in emergency loans from a consortium of financial institutions under the direction of Brazil's National Bank for Social and Economic Development (BNDES). The electricity distributors face a cash flow problem because spot electricity prices have skyrocketed, but distributors cannot immediately pass on the additional cost. Romeu Rufino, Aneel's director-general said that he expects the loan negotiation to be completed before the new deadline, and if that happens, payments could be made before the cut-off on August 28th."

On The Political Front

The Campaign Trail and Industry Proposals

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On Wednesday, the National Confederation of Industry (CNI) promoted a dialogue the three main candidates for president, President Dilma Rousseff (PT), Aécio Neves (PSDB), and Eduardo Campos (PSB). During the event, CNI presented a document entitled "Industry Proposals for the 2014 Elections," which brings together 42 studies made by CNI with suggestions in ten areas. The document prioritizes tax, labor, and infrastructure issues. On the proposed bilateral agenda with the United States, CNI proposes the initiation of negotiations for a preferential trade agreement with the United States. Among the priorities, CNI advocates for change in the adjustment of the minimum wage policy, whose earnings should be linked to increased productivity in the industry.

During the debate, **President Rousseff** used most of her time making a general assessment of her first term in office, highlighting exemption policies, subsidized credits through BNDES, and tax robustness. On the proposals made by CNI, Rousseff signaled that collective labor negotiations could be adopted as a principle, her administration is not against outsourcing of labor, and that she advocated in favor of simplifying labor relations through tripartite dialogue (workers, entrepreneurs, and government). At the end, Rousseff emphasized that there should be no precarious employment and labor guarantees such as a 13th salary, and overtime should not be affected.

Aécio Neves mentioned, countless times, his commitment to bringing back competitiveness to the industry, the importance of being able to predict the rules and having clear regulations, equality between sectors of the economy, a more attractive macroeconomic environment for private investment, and the strengthening and the improvement of regulatory agencies. According to Neves, there are six policies that can promote the recovery of competitiveness: quality education, investment in infrastructure, lower interest rates, a competitive exchange rate, simplification of the tax system and increased trade integration with the world.

Eduardo Campos criticized the lack of industrial competitiveness and stated that he will personally engage himself with tax reform and promised to be the first president to not raise taxes. He also said that if a coalition government is maintained, it will surely slow down the country.

Banco Santander

Banco Santander SA circulated a client note on July 25th saying that the re-election of President Dilma Rousseff could push asset prices lower. In a monthly column to high-income clients, the bank said a drop in President Rousseff's popularity had helped a recent rally in the Brazilian stock market, a view held by many analysts, economists, and investors who believe the Rousseff Administration's policies have contributed to Brazil's current economic decline. Hours after the report was made public on a local website, the president of the leftist Workers' Party accused Santander of "electoral terrorism," sparking a media frenzy that dominated the political pages of Brazilian newspapers over the weekend. Reportedly, following the strong criticism from the Workers Party (PT) apparatus and concerns expressed by President Rousseff, Santader bank management fired a number of employees associated with the report. According to Santander, the note "does not reflect the position of the institution." It violated an internal directive that economic analysis sent to clients should not contain "political or partisan bias."

Task Forces

Trade and Regulation

Patent Concession: According to a report presented to the Supreme Court by the Attorney General's Office (PGR), a ruling on the Industrial Property Law that allows extending the validity of patents when management takes too long to review concession applications is unconstitutional. Although Article 40 of Law 9.279/1996 stipulates that patent inventions have a 20-year term, it may leave a loophole for legislators to consider giving a longer term if there is administrative delay. According to PGR, if the administrative process in the National Institute of Industrial Property (INPI) takes more than eight to ten years to be completed, the Patent term will start counting from the moment the concession is made, allowing the patent protection term to exceed the 15 and 20 year limits. Therefore, according to the PGR report, the patent term must always start counting from the date of the concession application, and not the concession itself.

Tax and Investment

Regional Airports: The executive branch published Provisional Measure (MP) 652/14, which creates a Development Program for Regional Aviation (Pdar) and allows the federal government to subsidize airport and air navigation fees, including additional costs established by Law 7.920/89. For companies to have part of their costs reimbursed with funds from the National Civil Aviation, allocated from the federal budget, they must adhere to Pdar by signing a contract with the federal government. The Pdar aims to increase access to air transportation. By bankrolling part of business costs, the Administration believes it can increase the number of municipalities and airplane routes as well as the frequency of regional routes operated regularly. Pdar will assist approximately 270 regional airports in the country. The proposal's announcement to improve the infrastructure of regional terminals was first made in 2012 as part of the government's *Investment in Logistics Program: Airports*.

Fiscal War: The National Fiscal Policy Council (Confaz), which convenes the finance secretaries from the 26 states and the federal district, held a meeting on Wednesday to elaborate a report to end the so-called tax war. Through ICMS Agreement no. 70, 21 states committed to removing over the next few years the tax benefits granted without the council's approval, as well as granting tax amnesty to all taxpayers that took advantage of the benefits or were fined by states that did not agree with such benefits. Despite the high number of states that signed the agreement, it does not have a practical effect, because six have not signed it, and Confaz acts require unanimity. However, the proposal will serve as a guideline for lawmakers to conclude an extensive debate on bill (PLS) 130/14, which addresses the BRL$ 55 billion in tax incentives granted yearly by the states and is currently waiting to be approved by the Senate Committee on Economic Affairs (CAE). It is also important because it signals to taxpayers that the states intend to end the tax war and that tax incentives will not be removed overnight. Companies will have key information to study in which state it is still worth maintaining a unit.

The Pulse

For the first time since June 2012, when Venezuela was finally admitted into Mercosur, all five presidents attended the summit in Caracas, but politics and Argentina's debt crisis overshadowed substantive work on trade

Although overshadowed by politics and particularly Argentine President Cristina Fernández's plea for support during the current debt crisis, which she received, the Mercosur (Southern Common Market) Summit gathered all five presidents to discuss economic and trade issues. This is the first time a meeting with all five Mercosur presidents has occurred since Paraguay was suspended and Venezuela was admitted to the bloc in 2012.

In her main address, President Dilma Rousseff argued in favor of a South American free trade zone that would encompass an agreement with Chile, Colombia, and Peru, which along with Mexico constitute the Pacific Alliance. Brazil suggested that a zero-tariff agreement could be concluded before the end of this year. Bilateral trade between Brazil and those three Pacific Alliance countries has been increasing dramatically in the last couple of years (389% with Peru, 300% with Colombia, and 200% with Chile), but there is no agreement within Mercosur on how to conclude the proposed accord. The Brazilian position was weakened by the absence of President Michelle Bachelet of Chile, an associate member of Mercosur and full member of the Pacific Alliance, who was expected to endorse Brazil's initiative, and the presence of President Evo Morales of Ecuador, another Mercosur associate member, who focused on his political agenda.

The trade agenda debate has been growing in Brazil, especially within the business community, over the need for Brazil to better position itself in the international arena. Examples of Chile, Peru, and other countries with more open trade postures are frequently cited. The National Confederation of Industry (CNI), for instance, stressed this week that Brazil's trade agreements provide the country with access to only

10.2% of world trade, whereas Chilean and Peruvian agreements cover 82.2% and 73.7% of global trade, respectively.

Some opposition candidates in the presidential race have also been critical of Brazil's dependence on Mercosur, which as a customs union, restricts its members from entering into reciprocal trade agreements with other countries. Some have gone so far as to suggest that Mercosur should remove its common external tariff and revert from a customs union to a free trade agreement. So far, however, the two main opposition candidates have not adopted such a position because Mercosur is still widely supported by Brazilian citizens.

Since its inception in 1991, the Mercosur bloc has only signed free trade agreements with Egypt, the Palestinian Authority, and Israel. Curiously, Israel was the target of severe criticism by all of Mercosur's presidents during the Caracas summit. In Brazil, there is a growing movement among political parties that support asking President Rousseff to consider revoking this agreement.

Beyond these problems with other countries, trade among Mercosur's members has been decreasing significantly over the last few years, as noted by Brazilian Foreign Minister Luiz Alberto Figueiredo. He asked his colleagues during the summit to engage more forcefully in the process of making the bloc’s internal commerce flow more easily, but he received little support.

President Rousseff also mentioned the ongoing Mercosur-European Union free trade negotiations, which began 15 years ago, but have stalled on more than one occasion. Despite her optimistic tone towards the negotiations, it seems unlikely that an agreement between the two blocs may be reached soon because both sides have several problems to overcome before an agreement can be signed. Venezuelan President Nicolas Maduro proposed another initiative, seeking to gain the support of his colleagues to formalize a poorly defined "zone of economic development" between Mercosur and several Caribbean countries, but it did not advance in the meeting.

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