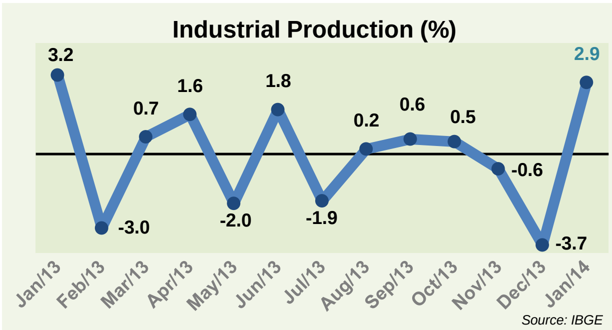
POLICY MONITOR

March 10 – 14, 2014

The Week in Review

On The Economic Front



Monthly industrial production: According to the Geography and Statistics Institute (IBGE), Brazilian industrial production rose 2.9% in January compared to December, when it presented a 3.7% decline. The January indicator reflects the rise of the consumer and capital goods sectors and is above the 2.4% average expected by firms and financial institutions polled by Valor Data, a news service affiliated with newspaper Valor Econômico.

Inflation: Consumer prices rose in February to 0.69% compared to 0.55% in January (IBGE), as education, food and beverage prices kept pressuring inflation. Since President Rousseff took office in 2011, inflation has remained above the 4.5% target, reaching 5.9% in 2013.

Productivity: A report by McKinsey, a management consulting firm, indicates that over the past 25 years Brazil has lagged behind the most dynamic emerging and developed countries in labor productivity. While productivity has grown on average 1% per year in Brazil, South Korea has presented a 4.7% annual increase and Peru 3.3%. In the same period, productivity grew 1.6% annually both in Chile and in the U.S. According to McKinsey the combination of high tax burden, exorbitant payroll costs and a rigid labor framework is what causes Brazil's meager productivity gains.

Petrobras/bribery allegation: The House approved the creation of an external committee responsible for investigating an alleged bribery scheme involving Petrobras employees over the procurement of platforms leased by SBM Offshore, a Dutch company. Although the external committee does not have the power to summon witnesses and lift tax and bank secrecy of individuals or legal entities, it will send Congressmen to both the Netherlands and to the United States to meet with authorities who could help investigate the charges. Petrobras has nine platforms contracted with SBM and is doing an internal audit to be concluded at the end of March. (See also Congressional rebellion below)

S&P: The rating agency met President Rousseff's economic team to assess macroeconomic data. S&P issued a negative credit rating outlook last June citing a "bit-by-bit deterioration" of the country's fundamentals. Brazil currently stands at BBB, a rate two notches above S&P's lowest investment grade level BBB-.

Drought: Despite increasing rainfall, the water levels are still very low in the in the Southeastern and Midwestern regions. On Wednesday, the Cantareira water supply system that provides water for nine million consumers in the metropolitan area of São Paulo reached 15.7% of maximum capacity, the lowest level on record. Following a joint decision of the National Water Agency (ANA) and the São Paulo State water department, Sabesp, the state utility, has reduced the water drained from the Cantareira system by 15.5%. Meanwhile, on the federal level, the Monitoring Committee of the Electricity Sector (CMSE) has changed its outlook from "very low" to "low" for the risk of power cuts.

Electrical Sector Relief: President Rousseff's Administration will allocate BRL$ 12 billion to help power distributors cope with increasing costs of thermal plants, an alternative source of energy generation to hydroelectric dams. According to the Administration, the costs will be partially rolled to consumers both through taxes and energy bill increases starting in 2015. Quote: “Let’s share the burden among the Treasury, consumers and the industry itself," said Finance Minister Guido Mantega.

On The Political Front

Congressional Rebellion: Congress has inflicted important defeats to the Administration this week amid disputes over political appointments, the composition of electoral tickets for the states and municipal races in the October elections and also on the release of pork barrel spending. It has created an external committee to investigate Petrobras and invited CEO Graça Foster to testify on an alleged corruption case involving the oil company. Congress has also summoned four ministers and invited other six to testify on current federal policies. Although Brazil is not facing an institutional crisis, the frictions indicate increasing political challenges for the Administration and President Rousseff herself to keep the governing coalition in good terms during a challenging electoral campaign. Quote: “PMDB only gives me joy”, said President Rousseff before the Congressional defeats articulated by the PMDB party leader in the House, representative Eduardo Cunha (RJ).

Cabinet reshuffle: President Dilma Rousseff continued the cabinet reshuffle started in February to replace ministers who will run for public office in the October general elections and also to accommodate key political allies. PMDB, who has been lobbying for greater representation, decided not to appoint the new Agriculture and Tourism Ministers. The new Ministers, who will step in on Monday, March 17, are:

- Ministry of Agriculture: **Neri Geller**, currently the agriculture policy secretary, replaces Antonio Andrade, who will try re-election as a House Representative for the state of Minas Gerais;
- Ministry of Tourism: **Vinicius Nobre Lages**, currently the Sebrae international advisor, replaces Gastão Vieira (MA), who will likely run for the Senate;
- Ministry of Cities: **Gilberto Occhi**, currently Caixa Econômica Federal Vice-President, replaces Aguinaldo Ribeiro (PB), who will likely run either for the Senate or the Government of Paraíba;
- Ministry of Agricultural Development: **Miguel Rossetto**, currently the president of Petrobras Biofuel, replaces Pepe Vargas (RS), who will run for the House for the State of Rio Grande do Sul;
- Ministry of Science,Technology and Communication: **Clélio Molina**, former Dean at Minas Gerais University, replaces Marco Antônio Raupp;
- Ministry of Fisheries: Representative **Eduardo Lopes** replaces Marcelo Crivella, who will run for the government of Rio de Janeiro.

Forest Code: With the help of the Ministry of Agriculture, representatives of the rural sector have pressed the federal government to allow more flexibility for the new Brazilian Forest Code regulation that is being finalized by the Office of the Presidential Chief of Staff. The Ministry of Environment normative act and the Presidential decree that will implement the Rural Environmental Registry (CRA) and regulate the Environmental Adjustment Program (PRA), respectively, are expected to be published before the end of the first half of the year.

Task Force

Innovation:

- **Internet Framework bill**: At the request of the Administration, the internet framework bill was withdrawn from the House floor agenda until an agreement on the bill’s text is reached. On Tuesday, 20 new amendments were offered to the Internet Framework draft bill presented by Rapporteur Alessandro Mollon (PT/RJ) and supported by the Administration. An amendment offered by Representative Eduardo Cunha (PMDB/RJ), who leads the opposition against the current text, presents a replacement bill aligned with pledges made by the private sector. Highlights include: suppression of article 12 on the requirement of data localization and the relaxation of net neutrality. Article 9 of Cunha’s amendment also proposes Anatel, the telecommunications regulatory body, to regulate Internet related businesses. Next step: If approved by the House, the bill will be sent to Senate committees for discussion, followed by a floor vote.

- **Information Technology Committee**: Ordinance 436/14 creates a Committee on Information Technology under the Comptroller General's Office (CTI – CGU) aimed at promoting governance and strategic use of information technology by prioritizing actions and investments in the sector. The Committee will be responsible for:

  - Drafting a Strategic Plan for IT that corresponds to the Institutional Integrity Plan (PII);
  - Drafting a Director Plan for IT at CGU, which will be used as a goal oriented action plan;

» Prioritizing CGU's IT budgetary allocations;
» Prioritizing training actions that help implement and maintain IT solutions;
» Prioritizing solutions that meet IT demands in accordance to the operational capacity of the Directorate of Information Systems;
» Monitoring project's progress and IT solution performance in comparison to institutional business results.

» **Telecom User's defense code**: Ordinance 632/14 adopts the General Regulation for Consumer Rights on Telecommunications Services (RGC). The Regulation establishes rules that include billing and provision of services such as: Fixed Commuted Telephone Service (STFC); Personal Mobile Service (SMP); Multimedia Communication Service (SCM); and Television Subscription Services. The Regulation will enter into force within 120 days from the March 10 publication date.

Tax and Investment:

» **Tax Reform / MP627**: According to Valor, following a meeting with Finance Minister Guido Mantega and a group of CEOs of Brazilian and foreign companies operating in Brazil, the Administration agreed to make five changes in the draft bill. The main are: increase from five to eight years of the deadline for income tax payments on overseas profits; reduction from 25% to 12.5% of the fraction of payable taxes in the first year of its determination. Another important pledge from the private sector agreed by the administration, is a new formula to determine the taxation on overseas profits. The current version states that the income tax should be calculated through the "adjusted portion of the value of investment", charging companies on the variation of the exchange rate and assets valuation and not only on payable profits. Mantega also signaled that the Administration will likely introduce a new provisional measure aimed at complementing Provisional Measure (MP) 627/13 to prevent the new tax framework to have loopholes that could allow tax avoidance. Next step: The new text is likely to be voted on by the Joint Committee next week, at a meeting scheduled for March 19. If approved, the MP will be sent to the House for a floor vote followed by the Senate Floor vote. The MP is in effect until 04/21/14.

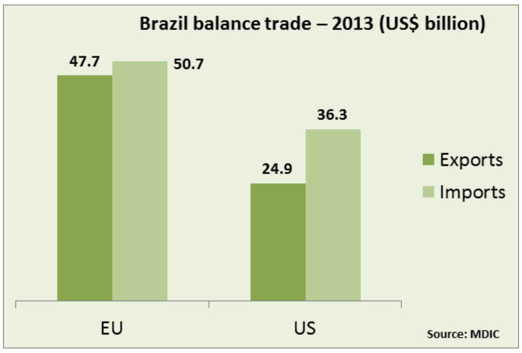
» **Public Procurement**: On Wednesday, Rapporteur Senator Gleisi Hoffmann (PT/PR) read her report on Provisional Measure (MP) 630/13, which facilitates the contracting of public engineering construction projects through the Differentiated Government Procurement Law (RDC), originally created for implementing projects of the World Cup and the Olympics in Rio, and then extended to the Growth Acceleration Program (PAC) and the Public Health System (SUS). The report extends RDC to any public service or construction procured by the three levels of the Administration (federal, states and municipalities) and establishes a 30% performance guarantee of the contract value. Next Step: The MP is likely to be voted on by the Joint Committee next week at a meeting scheduled for March 18. If approved, the MP will be sent to the House for a floor vote followed by the Senate Floor. The MP is in effect until 06/02/14.

The Pulse

Do Brazil-EU Trade Negotiations Signal a Change in Trade Policy? Weighing the costs and benefits for both sides, as well as addressing sensitive industries will be major points of the negotiations

The VII Brazil-European Summit held on 24 February 2014 in Brussels concluded with a wide-ranging Joint Communique that included, among many commitments, a strong reaffirmation of the proposed comprehensive European Union-Mercosur Free Trade Agreement. President Dilma Rousseff said at the end of the summit that there was a "very real will...to complete the agreement." Nonetheless, the news received mixed reviews in Brazil and a key question remains: is Brazil ready for a deep change in trade policy necessary to fulfill this agreement?

Negotiations, which dated back to 1999, were re-launched in 2010. A bi-regional trade accord like this one makes sense for Brazil given the strong mutually beneficial trade relationship. The EU is Brazil's largest trading partner accounting for 20.8% of its total trade and Brazil is the EU's 8th largest foreign market, accounting for 2.2% of total EU trade. Trade between the EU and Brazil has grown by 200% over the past decade to a total of US $97.5 billion in 2013, although falling commodity prices and a decline in imports from Brazil shifted the trade balance to negative for Brazil in 2012 and 2013 for the first time since 1999. New-found support from both manufacturing industry (CNI) and agriculture (CNA) also bodes well.



This agreement would require major changes to Brazilian trade policy, presenting significant challenges. For example the 'challenging interests for the EU are in areas where Brazil and the other Mercosur countries have been most protectionist: manufacturing, investment, public procurement and intellectual property. On the other hand, the problmatic interests for the Mercosur countries are typically in the protected agro-food sector, particularly beef and pork. Weighing the costs and benefits, as well as addressing sensitive industries will be a major point of negotiations.

External challenges could also nudge Brazil toward a trade policy shift. Mercosur has become an increasingly difficult Customs Union to manage and may not serve Brazil's economic interests indefinitely. Economic growth and increased competiveness in Brazil will require a vibrant and more diversified export sector, and the rise of so-called "mega-agreements," particularly the Trans-Atlantic Trade and Investment Partnership (TTIP) between the United States and the EU, could threaten Brazil's global trade position.

Mercosur plans to hold a meeting prior to attending the March 21 EU-Mercosur technical discussions, which may signal whether there is sufficient agreement to proceed with formal offers. No doubt the United States private sector and government will be watching closely to see if these developments point to new opportunities to deepen its trade relationship with Brazil, one of the top policy priorities of the Brazil Council. In addition, President Rousseff's administration has also signaled a rapprochement towards both Mexico and Chile, important Latin American countries that are not part of the bloc. While the move does not suggest a rupture within Mercosur, it does indicate that Brazil could be looking beyond the Customs Union to enhance trade and diplomatic ties within the region.