The Economist Intelligence Unit

Brazil's political and economic outlook under Dilma 2.0

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Contents

Executive Summary

Brazil continues to struggle to emerge from a period of below-average growth that has lasted since 2011, amid stubbornly high inflation and widespread social discontent over poor government efficiency and public governance standards. If less favourable external conditions (including a softer economic outlook for China and tighter international liquidity) are to blame, so are the increasingly erratic macroeconomic policy management and government intervention observed in recent years, which have soured investor confidence and heightened uncertainty. Major competitiveness shortcomings (including poor government effectiveness, a burdensome tax system, rickety infrastructure, deficiencies in factor markets and skills shortages) have remained unaddressed, hindering productivity gains, and stronger and sustained growth.

After winning the presidential election by a small margin on October 26th, the incumbent president, Dilma Rousseff of the the Partido dos Trabalhadores (PT) will be confronted with her second term, with the challenge of restoring growth, as well as trust in institutions and macroeconomic policy management. This is against a backdrop of Brazil's entrenched system of coalition politics, which limits governability and has so far hindered major progress on structural reforms needed to reinforce the country's competitiveness fundamentals and ensure long-term growth.

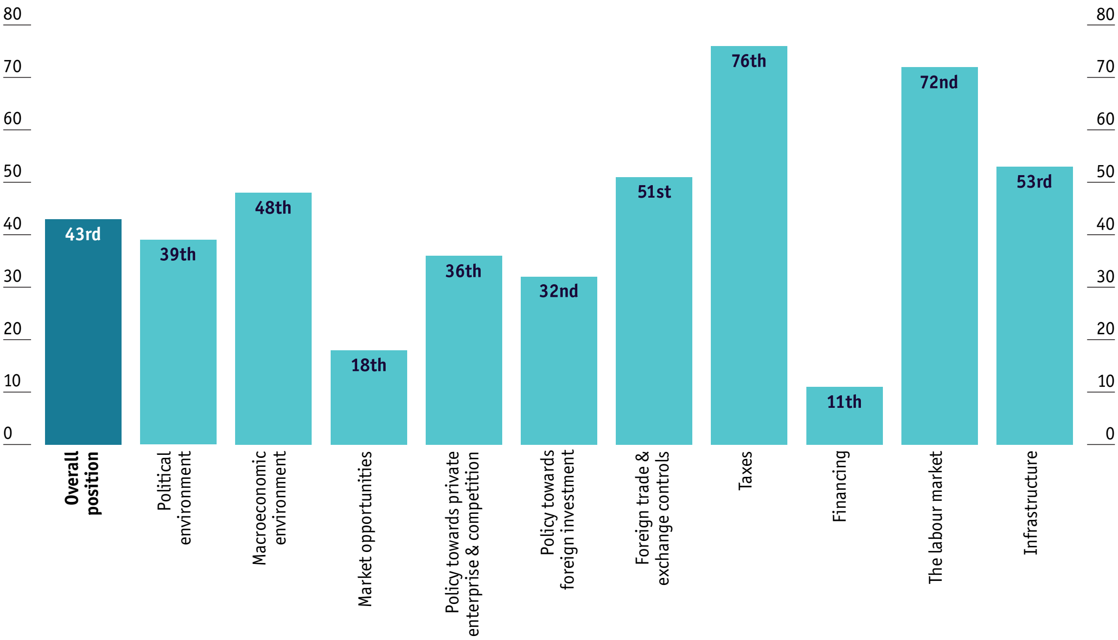
After looking at the current challenges in Brazil's business environment through the lens of The Economist Intelligence Unit's business environment rankings (BER), this paper will focus on the outlook for reforms and growth-enhancing policies in Ms Rousseff's second term, with a view to providing businesses operating in the country with unique insight into what to expect over the next four years.

Assessing Brazil's business environment

Brazil ranks 43rd of 82 economies in the BER for the period 2010-14, supported by its large and growing domestic market, diversified economy and fairly stable political environment, which makes it attractive to businesses as an investment destination[1]. However, poor government effectiveness, a burdensome tax system, rickety infrastructure, deficiencies in the factors market and skills shortages continue to have a negative impact on businesses.

Chart 1 shows Brazil's performance in the ten pillars of the BER, highlighting tax (76th), labour market (72nd), infrastructure (73rd), foreign trade & exchange controls (51th) and macroeconomic environment (48th) as most problematic areas for investors when they do business in the country. On the upside, financing (11th), market opportunities (18th) and, to a lesser extent, policy towards foreign investment (32nd), and policy towards private enterprise and competition (36th) are elements of relative strength.

Chart 1: Brazil in the BER
(ranking out of 82 economies)

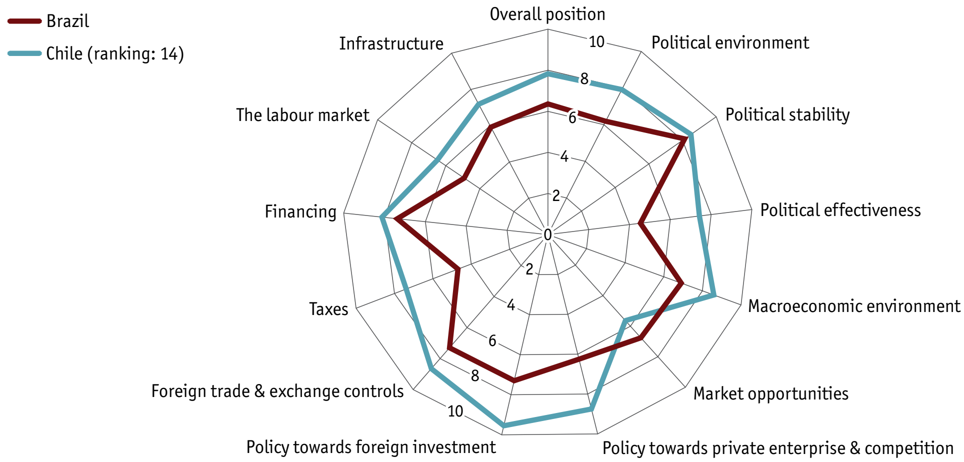


Source: The Economist Intelligence Unit.

In turn, chart 2 plots Brazil's performance in the ten pillars of the BER, compared with Chile, which, at 14th, is assessed as the most attractive economy in Latin America for investors. The comparison highlights the extent of the challenges that the country faces in matching regional and international best practices, most notably in its political environment (a score gap of 1.73), macroeconomic environment (1.68), labour market (1.58) and infrastructure (1.27). The only area in which Brazil scores better than Chile is unsurprisingly market opportunities.

[1] The Economist Intelligence Unit's BER model gauges the attractiveness of the business environment in 82 of the world's major economies. It provides cross-country comparisons of the main aspects of a country's business climate, supporting companies in designing their global business strategies and making their investment location decisions. The assessment of the business environment—based on the opportunities and challenges for doing business—allows countries to be ranked on the basis of the overall quality of their business environment, as well as in each of the ten categories comprising the index, on both a global and a regional basis. The ten categories composing the BER are as follows: political environment; macroeconomic environment; market opportunities; policy towards private enterprise & competition; policy towards foreign investment, foreign trade & exchange controls; taxes; financing; labour market; and infrastructure. The model ranks countries over the historical period (2010-14), as well as according to our projections of how business conditions will evolve over the forecast period (2015-19).

Chart 2: Brazil vs. top ranked in Latin America
(scores on a 0-10 scale)



Source: The Economist Intelligence Unit.

Political environment

Notwithstanding growing discontent over poor public services and corruption, which erupted into mass street protests in 2013—the largest since the demonstrations and the subsequent impeachment of the president at that time, Fernando Collor de Mello, in 1992—Brazil ranks relatively high for its political stability and the consolidation of its democracy (17th). However political effectiveness remains one of the country's main weaknesses (it ranks 52nd), owing to poor ethical standards and a fragmentation of political parties, which leads to obstructionism in Congress and has hindered the passage of major structural reforms needed to reinforce the country's competitiveness fundamentals.

Little progress has been made to enhance the level of political effectiveness in the wake of the 2013 unrest. Demonstrators initially took to the streets to complain about the misuse of public money, as well as corruption and the state of public services. Ms Rousseff's immediate response was a pledge to hold a referendum to reform the constitution in order to introduce political reforms, but her proposal found little support among ordinary Brazilians or in Congress. The end of secret voting in Congress (which was often synonymous with granting impunity for corrupt lawmakers) was the only clear advance. Previously, deputies and senators would insist that secret ballots be held on issues that they considered confidential—notably, voting on the impeachment of a colleague facing corruption charges. Several political reforms (including changes to the electoral system, a ban on consecutive re-election for presidents, governors and mayors, and a campaign financing reform) are still being considered. A lower house commission has drafted a constitutional amendment proposal, but the measures seem to fall short of correcting the current woes of the political system. Political reforms that could effectively boost political effectiveness should allow governments to form a more stable majority, strengthen party loyalty, and put an end to deeply entrenched "pork barrel" politics and practices. In order to achieve this, a radical shake-up of the electoral system that would favour the

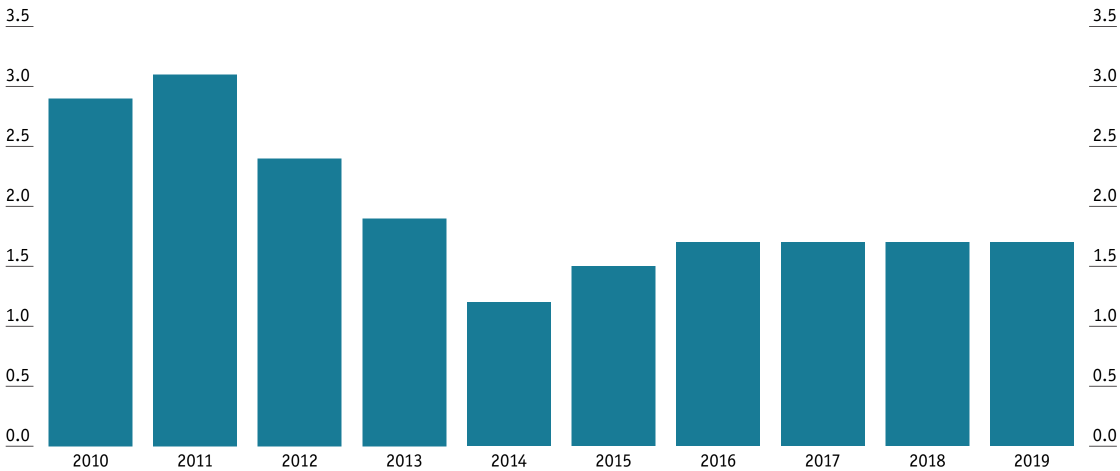
emergence of solid majorities or strong government coalitions would have to be endorsed by voters and then by Congress, which is unlikely to happen.

Following the October 5th first-round election, Congress is comprised of a total 28 parties—six more than previously. In the lower house of Congress, no single party holds more than 70 of the 513 seats: the PT holds 70 seats, the centrist Partido do Movimento Democrático Brasileiro (PMDB) holds 66, the centre-right Partido da Social Democracia Brasileira (PSDB) holds 54, and the rest are divided among 25 smaller parties. Constitutional changes required to alter the tax or labour legislation for instance would require the support of at least 308 votes in the lower house. This labyrinthine system of governance has often led to corruption and political horse-trading, which has been an obstacle to enacting real reforms. Under the PT, the number of ministries in the Brazilian government has expanded to 39, as appointments served as valuable awards in the political game of chess. A proposal by Aécio Neves, the presidential candidate of the PSDB, to decrease the number of ministries is unlikely to prosper during Ms Rousseff's second term, particularly considering her weaker mandate and a likely increased difficulty in pushing legislation through Congress.

Macroeconomic environment

The country's macroeconomic environment is among the most problematic areas for doing business in Brazil according to the BER (48th). The government of Ms Rousseff has eroded the macroeconomic policy framework pursued by her predecessor, Luiz Inácio Lula da Silva (2003-10), which emerged from a decade of stabilisation policies begun in the early 1990s. Monetary and fiscal policy credibility has been undermined by higher inflation tolerance and accounting tricks, and exceptional revenue to try to conceal an underlying deterioration in the fiscal accounts. Ms Rousseff is responsible for the lowest average growth rate during her term in office since the administration of Floriano Peixoto (1891-94)—1.7% if The Economist Intelligence Unit's estimates for 2014 turn out to be correct.

Chart 3: Primary budget surplus
(% of GDP)



Source: The Economist Intelligence Unit.

During her first term, inflation has remained persistently high; it has been above the target ceiling of 6.5% over the past 12 months, and reached 6.75% in September.

During her first 18 months in office, Ms Rousseff tightened fiscal policy, but this became more expansionary after mid-2012 as the economy weakened, with tax reductions to boost manufacturing. Ms Rousseff conceded to demands for more spending, particularly after the social unrest and demonstrations across the country in mid-2013. The underlying primary fiscal surplus has eroded markedly (Chart 3), inflicting significant damage on the fiscal accounts, which are very unlikely to meet the primary surplus (the balance before debt interest payments) target of 1.9% of GDP for this year (we estimate that the primary surplus will average 1.2%, significantly lower than the target).

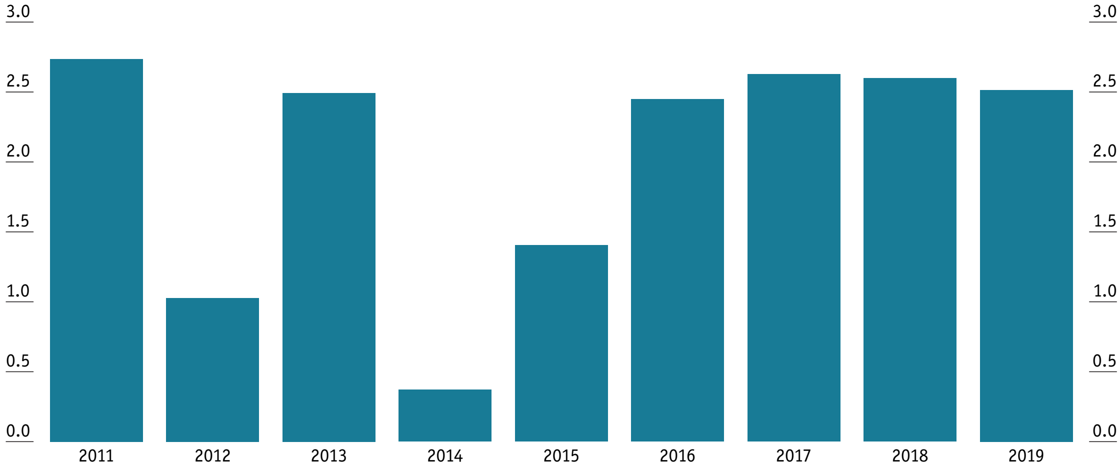
In the medium term, policymakers face the challenge of addressing structural weaknesses in the economy, such as low domestic savings and investment rates (both of which are well below 20% of GDP). Ms Rousseff has shown more of a pragmatic streak in her efforts to upgrade Brazil's rickety logistics infrastructure through private-sector concessions, but it has taken various adjustments before policymakers could offer investors adequate returns, delaying many projects. Auctions for several major airports have, at least, been successfully held, and upgrading works have made some progress. Concessions for road expansions have also begun to advance, but those for ports and railways have made little progress.

After a brief pick-up in activity in the first half of 2013, arising partly from a good harvest, output has almost stagnated. These difficulties have been compounded by the mid-2013 nationwide protests to demand improvements in healthcare, education and urban transportation. A year-long monetary tightening cycle has dampened investment and consumption, while business confidence levels are at lows last recorded during the 2009 global financial crisis. Private-sector companies have put off investment plans until there is greater clarity over the policy outlook under the next administration. In addition, the staging of the football World Cup in June-July 2014 led to a hiatus in activity and investment decisions. We estimate that GDP will expand by just 0.4% in 2014, but the outlook over the medium term is somewhat brighter, assuming that pessimism lifts. Although the outlook for the US economy has improved, key external risks relate to a structural slowdown and rebalancing in China, and to whether European economies are able to recover well.

Ms Rousseff will probably continue to pursue interventionist policies in her second term, and we do not expect the quality of macroeconomic policy management to improve greatly in 2015 or beyond. Ms Rousseff will be hoping that oil and infrastructure concessions will buoy activity. However, barring much stronger macroeconomic policies than expected, confidence in policymaking will remain fairly low, keeping business investment and economic growth below potential. Our baseline average GDP growth forecasts for 2016-19 of 2.5% (Chart 4) are well below the rates achieved during the 2004-10 boom (averaging 4.5%), reflecting weaker labour market dynamics, softer Chinese demand, slower credit growth and a failure to advance structural, growth-enhancing reforms. Economic expansion will have to be driven more by productivity gains, with limited progress amid low investment rates.

Chart 4: GDP growth rates

(%)



Source: The Economist Intelligence Unit.

Market opportunities

At 18th, Brazil's market opportunities represent one of its main attractive points for investors. The country boast the largest market in Latin America and is the seventh-largest world economy in US-dollar GDP terms. Its GDP per head at purchasing power parity (PPP) is lower than that of Chile and Mexico, but higher than China's and more than three times that of India. Solid GDP growth rates, lower inflation and more stable adherence to the rules of the game observed in recent decades, which have supported Brazil's attractiveness as an investment destination, have partially subsided since 2011, depressing sentiment towards the country. The tailwinds that propelled Brazil have dropped, and economic growth hinges more on productivity gains, which the country has struggled to achieve in a context of little political appetite for structural reform.

Although income inequality remains high, it has decreased notably in recent times, with Brazil's Gini coefficient falling from 0.60 in 2001 to 0.52 in 2012, amid active income policies, notably sustained increases in the minimum wage in 2003-13. In addition to this, faster GDP growth over this period, greater price stability and anti-poverty programmes—such as Bolsa Família, which began under the Lula administration—have been expanded since Ms Rousseff took office. Although these programmes have supported the development of underprivileged regions, disparities between the more developed southern states and poorer northern areas (including the north-east) have remained wide.

Brazil is also the third-largest agricultural exporter, a leading producer and exporter of hard commodities and processed goods, and host to an extensive and diversified industrial base with a successful national-scale biofuels industry, which offer significant investment opportunities. Moreover, the country's diversified industrial base and, owing to its huge domestic market, scale-related productivity gains offer opportunities for Brazil as a regional export base. However, stagnation of world trade talks will constrain the prospects for a significant expansion of market access. The May 2013 round of oil and gas auctions marked the resumption of new exploration opportunities after a five-year hiatus, during which time politicians hammered out the new regulatory framework for exploiting the "pre-salt" offshore oil reserves.

Policy towards private enterprise and competition

In 36th position, this is an area of relative strength for Brazil, reflecting measures to attract private investors (through airport and other transport logistics concessions). However the Rousseff government has also shown an interventionist streak, notably in the electricity and energy sectors, and some policy actions have undermined the predictability of the legal environment, generating uncertainty over adherence to the rules of the game. A dominant role has been granted to Petróleo Brasileiro (Petrobras, the state-controlled oil company) in the exploitation of pre-salt oilfields and the pursuit of state-led development policies through Banco Nacional de Desenvolvimento Econômico e Social (BNDES, the national development bank), which has received transfers of R330bn (US$150bn) from the Treasury since 2009. Owing to aggressive lending policies, public banks now account for 52% of total lending, up from 35% in 2008. Ms Rousseff is likely to continue with her policy to create "national champions" and put pressure on some large companies to ensure that their operations are aligned with public priorities—namely by increasing investment domestically. Repeated pledges to cut red tape have led to limited progress, but there will remain ample opportunities for private investors. Indeed, the government will continue to seek their help in upgrading the country's transport infrastructure and logistics.

Under successive PT governments, the quality of Brazil's institutions has been eroded by political appointments to key posts, as well as heavy political influence. Regulatory agencies, such as ANEEL, ANP and ANAC—which cover, respectively, the electricity industry, the oil and gas industries, and aviation—to name just a few, are now headed by government appointees, often individuals with little or no expertise in these areas. In recent years, the board of directors of Banco do Brasil (a large public bank) has come under direct political influence, as have those of major companies such as Petrobras and electricity provider Eletrobras. Brazil has, therefore, slipped back towards a model characterised by greater direct intervention by the state in major decisions governing key areas of the economy.

Policy towards foreign investment

Policy towards foreign investment is another attractive feature of Brazil's business environment, in 32nd place, owing to its substantial market opportunities and the Rousseff government's generally favourable stance on foreign direct investment (FDI)—a series of capital controls were imposed at some point, although later removed, on portfolio investment (and intra-company loans) to stem currency appreciation.

Huge "pre-salt" deepwater oil reserves discovered in 2006-07 have been a draw for foreign investors and will continue to be so going forwards. Petrobras will remain in a commanding position as it will be the mandatory operator of the pre-salt oilfields, with a minimum stake of 30% in all of these. During the first auction of a pre-salt field in October 2013, Shell (UK/Netherlands), Total (France) and two Chinese companies—China National Petroleum Corporation (CNPC) and China National Offshore Oil

Corporation (CNOOC)—joined Petrobras in the consortium that presented the only bid to develop the ultra deepwater Libra field (reserves at which are estimated at more than 10bn barrels). Shell, BG (UK) and Galp (Portugal) are among the companies that are already partnering with Petrobras in the exploration of "pre-salt" fields under the previous legislative framework. Foreign medium and large suppliers have also enjoyed (and will continue to enjoy) considerable investment opportunities, despite local-content requirements. More auctions will be held, but none is scheduled in 2015 for pre-salt fields.

Foreign trade and exchange controls

In 51st place, Brazil continues to position quite low on foreign trade and exchange controls, despite a general trend towards increased openness in trade and exchange controls observed since the 1990s, and a reduction of taxes on portfolio inflows. However, the Rousseff government has adopted a series of protectionist measures to try to offset the loss in competitiveness of domestic industry. Bureaucratic procedures are also hindering foreign trade operations. The long cycle of rising commodity prices, which had allowed Brazil to sustain a substantial trade surplus in recent years, has faded amid a deceleration of growth in the Chinese economy. As growth in developed markets remains fragile in the medium term, a push for multilateral trade liberalisation is unlikely to be on the Brazilian (or the global) agenda. This protectionist bias means that Brazil's manufacturing base will continue to struggle to become more integrated in global production chains, where other emerging-market manufacturers in Asia and Mexico have succeeded.

Brazil has sought to strengthen its relations with China, its main trading partner, during the visit of the Chinese president, Xi Jinping, in July 2014. A Brazilian aerospace group, Embraer, has secured a contract for the delivery of 60 jets, and China has pledged to resume imports of Brazilian beef. However, Brazil will struggle to diversify its exports to China beyond commodities, which currently account for the bulk of its foreign sales (over 80%), while China will continue to export mainly manufactured and high value-added products to Brazil. Chinese firms will have a greater presence in banking and the modernisation of Brazil's infrastructure, owing to investment in electricity transmission and railways. The loss of trade preferences to the EU and poor prospects for multilateral trade liberalisation increase the importance of negotiating a free-trade agreement (FTA) between the EU and the Mercado Comum do Sul (Mercosul, the Southern Cone customs union), but Ms Rousseff is likely to remain ambivalent over a deal, and progress is likely to be slow.

While maintaining the floating exchange-rate regime, the government will seek to keep the Real trading within what it considers an adequate range. Having fought to counter currency appreciation since 2010, stemming from abundant global liquidity, there was an about-turn in mid-2013, when the US dollar strengthened as investors began to anticipate the exit from exceptionally loose monetary policy in the US. The Banco Central do Brasil (BCB, the Central Bank) has therefore been intervening in foreign-exchange markets to contain the inflationary fallout from currency depreciation. The use of US-dollar currency swaps has been extended until the end of 2014. Numerous taxes and reserve requirements introduced since October 2009 have since been removed, but these measures could be reinstated in the future.

Taxes

The tax system is by some margin the weakest area of Brazil's business environment, ranking 76th. The Rousseff government has made piecemeal changes to the tax structure, but these have not had substantial effects on the overall tax burden, which is high for an emerging market. A more ambitious reform effort that aims to simplify Brazil's unwieldy tax system has been repeatedly frustrated. A myriad of taxes will continue to prove costly and challenging to manage. Large companies typically employ dozens of staff to deal with changing and complex tax regulations. Some small businesses enjoy a simplified tax regime (known as Simples or Super Simples), but medium-sized businesses struggle.

The Rousseff government has delivered on some of its promises to lower payroll tax rates (for more than 50 targeted sectors, mainly in manufacturing), making what was originally a temporary measure introduced in 2012, a "permanent" one in mid-2014. Efforts to harmonise state sales taxes have met with resistance from state governors wary of losing the ability to offer "tax breaks" for inward investment, but a deal is possible. The Rousseff administration has failed to progress a limited version of tax reform and, although we expect renewed efforts to simplify the tax system in the president's second term, little progress is likely amid low political appetite and the unwieldy nature of Brazil's legislative processes. Businesses will continue to face a high corporate tax burden until a far-reaching fiscal reform enables the government to cut budgetary rigidities and thereby reduce its high level of primary spending. Although Brazil's income-tax system is considered relatively efficient, its systems of corporate and indirect taxation are excessively complex and porous. The many indirect taxes impose large compliance costs on business.

Recent initiatives to switch from payroll taxes (employers' social security contributions) to a new tax rate on turnover (Contribuição Social sobre Lucro Liquido, or CSLL) have reduced the tax burden for some businesses. Tax breaks granted for some manufacturing sectors, notably the automotive industry, have provided some relief, but effects are unlikely to prove long-lasting. A deterioration of the fiscal accounts has eroded the scope for more tax breaks.

Financing

Financing is the area in which Brazil performs the best in the BER, in 11th place, on the back of a strong banking system, which, by and large, managed to weather the 2008-09 global financial crisis well. However, aggressive lending by public banks has pushed up their share of total loans to 52%, from 35% before the crisis. Successive PT governments have engaged in consultations with capital-market investors to find ways in which to modernise the market and set up long-term financing mechanisms, which have long been limited to subsidised BNDES loans. Measures include tax relief on convertible bonds (debentures) tied to infrastructure projects, and streamlining of securities issuance and trading.

Credit has more than doubled in the past six years, reaching over 55% of GDP in mid-2014. Credit growth has slowed somewhat, but continues to be fuelled by public-sector banks, while private-sector banks have taken a more cautious stance. Non-performing loan (NPL) ratios have decreased to 3%, after a peak in 2012. However, consumers have piled up debts in recent years and consumer NPLs are higher than this headline rate. Spreads between funding and lending rates are expected to remain a major barrier for some time, despite government pressure. Nonetheless, the BNDES also supplies subsidised corporate loans at rates of 5%. Many large companies have borrowed cheaply on foreign capital markets, exposing those that have not hedged for exchange-rate risk in the light of the recent depreciation of the Real.

The BM&F Bovespa stock exchange remains vulnerable to developments in the global financial markets and trends in commodity prices. However, domestic factors have weighed negatively on the performance of the largest companies in recent months, such as Petrobras, and a mining firm, Vale, owing to government intervention and reduced iron-ore exports to China respectively.

Labour market

Labour market is the second worst ranked area in Brazil's BER performance, at 72nd, pointing to the extent of the challenge that this represents to improving the country's competitiveness. Payroll taxes have been reduced for more than 50 sub-sectors (mainly manufacturing, but also some services), lowering labour costs. However, the political will to reform the labour market more extensively, in order to alleviate rigidities, has remained weak. Hiring and firing rules lack flexibility. The minimum wage has been indexed to past inflation and real GDP growth, eroding competitiveness.

Public investment in education has increased steadily in recent years, with education expenditure as a percentage of GDP rising from 3.5% to 5.6% in 2000-10, according to the OECD. The Rousseff government committed to increasing public spending in education to 10% (compared with an OECD average of 6.3%) of its GDP by 2024 as part of the Plano Nacional de Educação (PNE, the national education plan), which was approved by Congress in late June. The extra funds to reach the 10% of GDP target will come from future oil royalties and from a social fund created to receive revenue from oil exploration in the pre-salt offshore area. A 2013 law earmarks 75% of oil exploration royalties for education. In addition, 50% of the pre-salt social fund will be invested in education. Estimates by the Chamber of Deputies (the lower house) say that R364.5bn (around US$160bn) from oil revenue would be invested in education over the next 17 years. A national plan to increase public investment in education is a very positive development, but it will take more than extra cash to improve the quality and effectiveness of schools in Brazil, and to lift Brazilian students from near the bottom of global education rankings. Brazil faces challenges everywhere in its education system: the distribution of funds is uneven; a serious deficit of teachers (estimated at around 150,000 by the Ministry of Education) means that hundreds of thousands of students simply do not learn certain disciplines; infrastructure often lacks the most basic needs, such as desks, especially in rural areas; a large number of teachers earn less than supermarket cashiers and childcare workers; violence and drugs seriously affect learning in many areas of the country; teaching methods are antiquated; and schools lack new technologies to keep students motivated.

Learning indicators show that basic skills are not improving among Brazilian students. Two out of every three students aged 15 are unable to understand percentages, fractions or simple graphs, according to the OECD's 2012 Programme for International Student Assessment (PISA) report. In reading, the average performance of Brazilian 15 year olds was 410 points, compared with an average of 496 points in OECD countries. On average, 15 year olds scored 391 points in mathematics, compared with an OECD average of 494 points. Broader indicators remain grim: over 13m Brazilians are purely illiterate, of a population of 200m, according to data from the Instituto Brasileiro de Geografia e Estatística (the national statistics institute). In addition to the purely illiterate population, 33m Brazilians are considered functionally illiterate.

Skills shortages and low productivity are the norm amid record low unemployment rates. However, net job creation has faltered in 2014 amid the weakness of the economy and there is a growing mismatch in highly specialised sectors, such as in oil and information technology (IT), with skill gaps spreading through many other sectors. Employing foreign workers has become somewhat easier, with the number of working visas doubling in the last five years, but is still much lower than in other countries. Education quality and vocational training has improved amid the adoption of performance targets for schools and the National Programme of Access to Technical Schools and Employment (Protanec), which has trained over 7m people, among others.

Infrastructure

Infrastructure is another major weaknesses in Brazil's business environment, at 53rd, although there is an ambitious medium-term concessions programme in place that should bring improvements by 2019. Public and private infrastructure spending amounts to 2.5% of GDP, according to InterB, a local consultancy—below the level needed to keep pace with asset depreciation and increased demand from a growing economy and population. Public investment capacity remains limited by a high level of recurrent spending rigidities and administrative capacity. Pressure on energy supply has led to the construction of “mega-dams” in the Amazon, but there have been construction delays. Moreover, drought this year has led policymakers to reduce reliance on hydro-generation, including by turning to fossil-fuel sources. The implementation of the US$257bn Programa de Investimentos em Logística (PIL) investment drive, launched in August 2012, has been uneven and below expectations. It was complemented by a set of key investments in transport ahead of the June-July 2014 football World Cup, which proved sufficient to avoid logistical chaos during the tournament, but which fell short of the mark (especially in terms of urban mobility, with frequent delays in the construction of subway or tramway lines in large cities). The PIL will only be successful if the investment drive is pursued after the elections, which, in turn, depends on how investor-friendly the regulatory framework proves to be.

In highways, five stretches totalling some 5,000 km have been auctioned since 2013 after the government eventually offered sufficiently high returns on investment (previously, three auctions had failed to attract bids). Five other concession contracts are to be awarded by the end of 2015. Some 20,000 km of roads have already been managed by the private sector since the start of the privatisation programme in the 1990s (road haulage accounts for 61% of freight). Railways and ports have seen little progress, amid private investors' concerns over the regulatory framework, including the provision of rail transport services by the state-owned company, Valec. None of the planned 12 concessions for a total of 10,000 km, with investments of US$28bn over five years, has been implemented. Some old projects, such as the 1,700-km Transnordestina railway, are already four years late and may now be ready only by 2016. None of the 159 port terminal concessions included in the

PIL has so far materialised, owing to legal wrangling in the wake of the 2013 port law (according to the legislation, companies with contracts dating back to before 1993 are not allowed to renew their concessions).

The management of five of the country’s main airports has been transferred to the private sector after the government agreed to end the monopoly of the state-owned Empresa Brasileira de Infraestrutura Aeroportuária (Infraero). This includes the international airports of São Paulo and Rio de Janeiro, the country’s main business centres, as well as those of Belo Horizonte and Brasília, and also Viracopos (in the state of São Paulo). International operators joined local engineering companies to bid for the control of these airports, while Infraero kept a minority stake (49%). In spite of delays (especially at Viracopos), improvements have already been made. A new terminal was opened in São Paulo before the World Cup. Infrastructure was also modernised at other airports around the country to avoid bottlenecks, with overall capacity increased by one-third to 210m passengers per year, according to official figures. The government has not yet envisaged the privatisation of the domestic airports in São Paulo and Rio, which are frequently used by business travellers, but this may occur by 2018.

The PIL has overshadowed public investment plans, but projects continue through the Programa de Aceleração do Crescimento (PAC, or growth-acceleration programme) launched in 2007. However, by April 2014 only 12% of the projects had been finished, according to Contas Abertas, a non-governmental organisation (NGO) focusing on public accountability, and one-third had not been started. A subsidised programme aiming to build 3m homes is to be extended during Ms Rousseff's second term.

Dilma 2.0: Plus ça change

The outlook for substantial policy changes under a second Rousseff term appears fairly grim, given that throughout the electoral campaign, the president has failed to acknowledge that the economy has any major problems, despite all signs to the contrary. Ms Rousseff has repeatedly stated that inflation is under control, that growth will return, and that the policies that her government has pursued to date have been on the right track. Therefore, there is little reason to believe that major changes will be made in her second term in office, besides some minor fiscal and price adjustments which will be unlikely to be sufficient to rebuild confidence fully. Unlike Mr Neves, her challenger in the election run-off, Ms Rousseff made no announcements regarding her new economic team. The outgoing finance minister, Guido Mantega, will not remain in office, according to a recent statement by the incumbent, but a replacement has not yet been announced. Whoever is appointed, Ms Rousseff will retain considerable control of the country's economic policy.

Central Bank independence and public banks role

Market confidence was further damaged during the campaign by a series of harmful statements by Ms Rousseff about the role of the central bank, emphasising her lack of belief in the BCB's operational autonomy and reinforcing market speculation that monetary policy is dictated directly from the highest executive office. In response to her two main opponents' support for full independence (Marina Silva of the Partido Socialista Brasileiro) or operational autonomy (Mr Neves), she has stated that greater central bank independence would lead to famine by allowing profit-seeking bankers to raise interest rates usuriously.

The role of public banks in the economy is not likely to change either, with no credit retrenchement expected from these institutions. The then PT government launched an aggressive credit policy in 2009 to counteract the effects of the financial crisis, making public credit available at below-market interest rates. Currently, credit from BNDES, which is the country's largest financial institution, is still expanding, and most financing lines are heavily subsidised. Although nominal interest rates are running at or above 11% per year, the government-set taxa de juros de longo prazo (TJLP, the long-term interest rate) is currently set at just 5% per year. However, a significant part of BNDES credit paying the TJLP goes to large companies that also have access to other sources of credit. Greater transparency regarding the criteria for loan concessions, as well as with respect to the impact of subsidised credit lines on the fiscal accounts, was one of the main pillars of Mr Neves's programme. Credit retrenchment would also be an important part of deepening domestic financial markets: currently, public banks represent over 50% of the credit market in Brazil, thereby crowding out private banks.

Restoring fiscal stability

Although countercyclical fiscal policies have failed to spark the economy, the Rousseff government has been reluctant to tighten discipline much ahead of the elections, leaving adjustments until after October. In August the 12-month primary surplus stood at 0.9% of GDP, below the 1.9% of GDP official target for 2014. However, the headline rate includes non-recurrent revenue and delayed payments, and the underlying position is weaker still. Our forecasts assume that some adjustments will materialise in the medium term, lifting the primary surplus to an annual average 1.7% of GDP in 2015-19, but debt interest payments of more than 5% of GDP (owing to a higher Selic policy interest rate) mean that the nominal deficit will remain around 3.5% of GDP. As spending commitments are rigid in Brazil's budget, adjustments are more likely to come from higher revenue, perhaps by reversing some of the tax breaks given by Ms Rousseff to targeted sectors of the economy, mainly in manufacturing, as well as other measures. At the same time, the slowdown this year will hit corporate profits next year, and economic growth is unlikely to pick up much, increasing the policy challenges facing Ms Rousseff in her second term.

Electricity sector imbalances and infrastructure shortcomings

Ms Rousseff will also need to tackle resolve problems created by her recent policies towards the electricity sector. So far, she has not outlined how she will deal with the substantial financial imbalances that the electricity sector is faced with, nor has she explained how the policy of maintaining a tight hold on electrical rate increases will not further damage the budget. To date, the government has transferred billions of Reais to the distribution companies in an attempt to stave off the effects of tariff increases on inflation. This has obviously contributed to deteriorating fiscal indicators.

With regards to infrastructure, the current president has repeatedly insisted that projects are on track, despite evidence of delays. She has promised to continue to invest in infrastructure, particularly in connecting important economic zones to ports by rail, which is one of the major bottlenecks to growth in Brazil's economy. She has said that she would like to bring universal broadband Internet access to the country. However, in her first four-year term, a government programme to increase broadband access to the poor accounted for a little over 1.8m of Brazil's current 23.2m broadband subscriptions. It appears that in an environment of extremely high uncertainty and a lack of confidence, public banks will continue to take the lead in financing infrastructure investments, squeezing out private-sector institutions.

Inflation

Annual inflation stood at 6.75% in September and, although food prices have eased, core measures of inflation suggest that price dynamics are entrenched above the annual rate of 6%, while services price inflation remains well above this (9%). Were it not for the Rousseff government's policy of holding down some key prices artificially—such as fuel prices and electricity rates—inflation would be even higher than presently. Owing to high indexation (including minimum wage rises linked to nominal GDP), a tight labour market, infrastructure bottlenecks, sticky services price inflation and a weaker Real, consumer price inflation will remain above the 4.5% central target in 2015-19. Some upward adjustments that will need to be undertaken next year to administered prices are likely to raise inflation further in the short term.

Labour legislation

In a nod towards business demands, Ms Rousseff has stated during the electoral campaign she would like to implement changes to Brazil's labour legislation to make the system more internationally competitive—an issue that has been on the agenda for a number of years, but that she has made no attempt to reform in her first term—reducing the burden for business and cutting red tape. However she has signalled that changes will have to be negotiated with the unions. Given the close ties between the PT and labour unions, and lower income segments of the population, major changes that could negatively affect the party's support are unlikely. Moreover given the unwieldy nature of Brazil's Congress and the 60% majority required for constitutional changes, it is unlikely that much progress would be achieved should Ms Rousseff tried to push through substantial changes.

Social programmes

On the social front, Ms Rousseff has promised to maintain conditional cash transfer social programmes such as Bolsa Família, and to expand on these in her second term. These programmes have helped millions of poor Brazilian families to join the lower middle class, and have the added bonus of increasing the country's educational enrolment rates—this is likely to remain the hallmark of PT governance.

On October 5th Ms Rousseff addressed the country against a backdrop that read "new government, new ideas," promising change in her second term. To really brighten Brazil's economic outlook and restore market confidence, she will have to embrace sounder macroeconomic policies and pursue more market-oriented, predictable policies. She will also have to push for the type of comprehensive reforms needed to address Brazil's competitiveness shortcomings highlighted above and ensure long-term growth. This scenario appears very unlikely for a variety of reasons, mainly because of Ms Rousseff's policies and beliefs, and legislative obstructionism. Therefore, the private sector will have to brace for another four years of "more of the same". A continuation of current policies is likely to result in lacklustre growth and high inflation, coupled with deteriorating fiscal conditions, a weakening of the Real, and possibly a widening of the current-account deficit.

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