

# ISSUE BRIEF 02.17.17

## The Lengthy Brazilian Crisis Is Not Yet Over

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Since the first quarter of 2014, Brazil has been living in “crisis mode.” September 2016 marked seven consecutive quarters of negative economic growth that resulted in a cumulative negative variation in the GDP of more than 7 percent, the greatest recession ever registered in the country. In the same period, investigations conducted by public attorneys and Brazil’s federal police uncovered the largest corruption scheme in Brazilian history. The scandal was rooted in the largest state-owned company in the country, Petrobras, but had widespread ramifications. By the end of December 2016, nearly 200 people had been indicted or imprisoned. Most were businessmen and politicians, including the former president of Brazil, Luiz Inácio Lula da Silva, who was a defendant in five judicial inquiries. At the confluence of the economic and political crises, President Dilma Rousseff, a member of the Partido dos Trabalhadores (PT) and reelected in October 2014 to a four-year term, was removed from office in April 2016 and permanently impeached the following September. She was replaced by Vice President Michel Temer, who is affiliated with the Partido do Movimento Democrático do Brasil (PMDB).

The economic crisis and the corruption probe (called *Operação Lava Jato*, or Operation Car Wash) destroyed the power system that had been expanding throughout the PT administrations from 2003 to 2016. This system was composed of an ideologically heterogeneous alliance of parties under the PT’s hegemony; trade unions; state-owned companies’ pension

funds, which were controlled by unionists affiliated with the PT; and a relatively restricted but powerful group of companies that were the primary beneficiaries of federal government-subsidized credit and contracts. With resources diverted from state-owned companies, these private companies provided electoral funding for the dominant political coalition (the opposition also received funding, but on a smaller scale). Intellectually speaking, it is an interesting case of an attempt to develop state capitalism in a competitive political environment. The lesson to be learned is that this kind of experiment ends up undermining democracy by giving the incumbents an extraordinary electoral advantage and compromising the system of checks and balances, and/or generating fiscal disarray and financial crisis. In the case of Brazil, the experiment was interrupted before democracy mutated into a semi-democratic regime. That it fell short of causing a mutation in the nature of the political structure can be explained to a great extent by the strength of some institutions: the independence of the judicial branch, the autonomy of public attorneys, and the freedom of the press, all of which are guaranteed by the Brazilian Constitution and upheld by society.

The destruction of the party’s system that was dominant between 2003 and 2015 turned into a crisis of the entire political system, as the opposition parties also became involved in the criminal investigations carried out by the Lava Jato operation. This picture is similar to the



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one that prevailed in Italy in the wake of the Mani Pulite investigation in the mid-1990s. Conducted by public attorneys, this investigation revealed the existence of widespread and systematic corruption schemes involving businesses and political parties. As a consequence, the Italian political party system that had developed since the end of World War II collapsed. In Brazil, however, the political crisis came in conjunction with a deep economic crisis.

In the short span of this issue brief, I analyze both the anatomy of these mutually reinforcing crises and the challenges that Brazil faces in overcoming them.

### **FROM THE PRE-SALT TRIUMPHALISM TO THE PETROBRAS TRAGEDY**

Lula's first term in office (2003–2007) demonstrated continuity with the economic policies adopted by his predecessor, Fernando Henrique Cardoso. During his two terms in office from 1995 to 2003, Cardoso brought decades of chronically high inflation to an end and liberalized the Brazilian economy, ending state monopolies on oil and gas and telecommunications, among other infrastructural sectors. He also created independent agencies to regulate competition in these sectors and eliminated legal discriminatory treatment against foreign direct investment. Long-term commitments with sustainable public accounts and low inflation were translated into new institutions such as the Fiscal Responsibility Law, which was approved in 2000. These commitments, as well as the general framework of Cardoso's economic policy, were kept by Lula in his first term in office. This started to change during his second term (2007–2011).

Three factors produced this change: First, by maintaining his predecessor's economic policies and even tightening fiscal policy in his first year, Lula's administration rapidly dissipated initial market distrust and benefited hugely from the commodities boom that started in 2004. The combination of consistent macroeconomic policies domestically and an extremely favorable economic atmosphere abroad for

commodities-producing countries led to Brazil's long-term sovereign credit rating being raised to "investment grade" in 2008. In this context, Lula's government felt emboldened to distinguish itself from its predecessor. Second, in 2006 Petrobras announced the discovery of reserves in the pre-salt layer located in ultra-deep waters within the country's maritime territory. They were estimated to be large enough to double the proven petroleum and gas reserves of the country. Thus strengthened, Brazil responded effectively to the impacts of the global financial crisis of 2007–2008 by adopting counter-cyclical fiscal and monetary policies made possible by the economic gains obtained during Lula's first term. The resulting economic contraction was intense but short-lived. Much deeper and longer-lasting, however, was the ideological impact of the financial crisis. It seemed to confirm the long-held belief of most of the Latin American left in the unsustainability of liberal capitalism, as well as in the superiority of state capitalism as an instrument of national development for developing countries (now rebranded "emerging countries"). These three factors resulted in the introduction of fateful policy changes in Lula's second term, which were to be deepened under Dilma Rousseff's administration.

Petrobras played a major role in the "national development" venture that took shape almost in tandem with the global financial crisis. To that effect, in 2010 the government used its super-majority in Congress to approve a package of interrelated bills changing the regulatory structure established to govern the oil and gas industry after the end of Petrobras monopoly under Cardoso. The bills were approved with much nationalistic fanfare in the midst of a presidential campaign that would lead then-Chief of Staff Dilma Rousseff to the presidency. This legislation created a new regulatory structure for the pre-salt region.

Under the new structure, all exploration and production activities in the pre-salt region were to be conducted exclusively by Petrobras. Foreign investment was permitted only as long as Petrobras held at

least a 30 percent share in any consortium formed to bid in the region. A new local content policy—much stricter and more detailed than the prior one—was applied to the oil and gas productive chain. A production sharing agreement (PSA)—used almost exclusively in authoritarian regimes—was substituted for the concessions program that had been adopted with great success after the end of Petrobras monopoly (the old structure remained in place for areas outside the pre-salt region).

Such a major policy change can only be explained by the confluence of ideological and more practical factors. To increase the participation of the Brazilian state in the future revenue stream that would come out of this new source of wealth, adopting a higher level of taxation for the pre-salt region would have sufficed. But Lula's government insisted that changing the regulatory structure was the only way to ensure that the oil coming out of the pre-salt region would belong to Brazil. They invoked the slogan *O petróleo é nosso* ("The oil is ours"), reminiscent of the nationalistic campaign that led to the creation of Petrobras as a monopolistic company in the 1950s.

After the pre-salt discovery, the expansion of investments in the petroleum and gas sector became, all at once, one of the main gears of the Brazilian economy and the principal source of financing for the parties belonging to the coalition led by the PT. The overbilling of approximately US\$2 billion in contracts irrigated a vast and heterogeneous political coalition that included 13 parties at its high point. The electoral donations were the counterpart of the resources diverted from Petrobras to a cartel of approximately 20 contractors that was commanded by the five largest ones. Odebrecht, a leading Brazilian multinational company in heavy construction and the petrochemicals industry (in association with Petrobras), occupied a position of *primus inter pares*. Chosen by the PT government to be a national champion, Odebrecht was granted the lion's share of government contracts domestically and was financially and politically leveraged abroad, particularly in countries where governments closely aligned with the PT and Lula were in power.

Between 2011 and 2015, the Petrobras investment program quadrupled in comparison with the previous five years. To finance this unrealistic program, Petrobras started to rapidly acquire debt. At the same time, it lost revenue due to the government-dictated policy of deterring inflation by controlling the price of fuel and saw its expenditures rise as a result of the excesses of the national content policy. Between 2009 and 2015, Petrobras' debt increased five-fold—becoming the largest corporate debtor on Earth—and its capacity for cash-flow generation was considerably reduced, bringing the company to the brink of financial ruin.

### THE DOOMED INHERITANCE FROM DILMA ROUSSEFF

The Petrobras disaster is the most prominent case in a general process of deterioration affecting Brazil's economy and public accounts that had grown throughout President Rousseff's first term.

Between 2011 and 2014, all the macroeconomic pillars established during Cardoso's presidency (1995–2002) were shaken. Those pillars had proven to be instrumental for Brazil's economic takeoff under Lula's administration, which took place in an external environment that was highly favorable to commodities-producing countries. Rousseff not only abandoned the policy of generating fiscal surpluses to reduce the public debt but also compromised the principles of fiscal transparency and accountability established in the Fiscal Responsibility Law. She also undermined the policy of inflation targeting—putting both the monetary policy structure and the *de facto* autonomy of the Central Bank in jeopardy—and undercut the floating exchange rate policy as well. In the field of microeconomics, she introduced numerous distortions via ad hoc tax exemptions and control of administered prices, among other means.

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state's active role in leading investment either directly via state-owned companies or indirectly, by funneling subsidized credit to the private sector. According to this belief, economic policy should also try to proactively determine relative prices in order to favor growth, even at the expense of stability. This line of thought became influential in Lula's administration and achieved dominance when Rousseff took office. The prospect of a second recessive dive of the global economy—a risk that increased by the end of 2011—was the justification that had previously been missing for an attack on all fronts on the so-called “neoliberal” inheritance from the Cardoso administration, which for the most part had been preserved during Lula's administration.

The only reason that the economic disaster produced by Rousseff was not on a larger scale was because foreign exchange reserves remained high. In the absence of a crisis in the balance of payments, the deterioration of the Brazilian economy—which had become visible to analysts starting in 2011–2012—took awhile to be felt by the majority of the population. Although the economic growth rate decreased to less than half of the average of the previous four years, barely surpassing 1.5 percent annually, the unemployment rate kept declining, reaching less than 5 percent by the end of President Rousseff's first term.

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### ROUSSEFF'S SHORT SECOND TERM

In October 2014, the president was reelected by a difference of only three points over Aécio Neves, a Partido da Social Democracia Brasileira (PSDB) candidate. In her campaign, Rousseff promised more of the same policies and accused her adversaries of intending to destroy the “social achievements” of the PT administrations with a draconian fiscal adjustment.

In December 2014, she appointed an orthodox economist named Joaquim Levy as minister of finance, executing a program shift without precedent in Brazilian history. Levy promoted a correction of fuel and energy prices and instituted budgetary cuts

with a view to generating a pre-interest surplus of 1 percent of the GDP in 2015—a fiscal shift equivalent to 3 percent of the GDP and all the more difficult to be implemented in an economy already in recession. This shift proved to be unfeasible, even more so because the government was forced by a ruling of the Federal Court of Accounts to recognize liabilities that were not accounted for in previous years (between 2011 and 2014, public banks paid for treasury expenses with their own funds in ever-growing numbers).

One year after being appointed, with the inflation rate above 11 percent, an ongoing recession, and fiscal adjustment measures blocked due to lack of political support, Levy was fired. Rousseff's administration entered its death throes. By the end of April 2016, a two-thirds vote by the Chamber of Deputies authorized the initiation of the president's impeachment trial in the Senate. The aforementioned unaccounted-for liabilities provided the judicial basis for the president's political judgment, since they represented a violation of the Fiscal Responsibility Law. With the impeachment authorized by the Chamber of Deputies and accepted by the Senate, the president was removed.

The replacement of Rousseff with her vice president, Michel Temer, in May 2016 awakened positive expectations in the domestic and international markets and also in the political system. For the markets, the change in government represented the possibility of correcting the disastrous economic policies of the previous administration. For the political system, it meant the possibility of somehow limiting the prominence of the judicial branch and the advancement in the investigations of the Lava Jato operation. Up until that point, the investigations had dealt mainly with the PT and the Partido Progressista (PP), a right-wing party that had been a member of the government-backing coalition since the beginning of the PT administrations.

In the final moments of her government, Rousseff appointed Lula as chief of staff. The former president was her last remaining strategic asset in her attempt to rebuild her support base, especially in

Congress. However, the Supreme Federal Court prevented Lula from taking office, claiming that such an appointment aimed to obstruct justice (Lula was already under investigation). In wiretapping authorized by the Judiciary and made public by the press, the former president made it clear that it was time for politicians to fight back against the Lava Jato operation. Blocked from taking office, he was not able to lead the counterattack that most of the politicians had looked forward to.

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## THE NEW ADMINISTRATION

Although Temer took office provisionally with a very low popularity rate, the majority of the population did not consider him illegitimate (support for Rousseff's impeachment stayed above 50 percent starting in March 2015, when it first became a rallying cry). The accusation that President Rousseff had been overthrown by a "parliamentary coup" had much greater resonance abroad than in Brazil.

The new president appointed a team with indisputable technical credentials to fill positions at the core of the government's economic sector—roles in the Ministry of Finance, the Central Bank, the National Bank of Economic and Social Development, Petrobras, and Eletrobras (a federal holding of the electric energy-generating companies)—and formed a cabinet with representatives from all parties, with the exception of the left-wing parties. He did so with the intention of securing the necessary majority not only for a confirmation vote of impeachment in the Senate, but also for the approval of amendments to the Constitution considered essential for regaining control over public accounts.

With the economy in recession, the new administration opted not to increase the already high tax burden, despite the deficit in the public sector having reached 10 percent of the GDP after the payment of interest on the public debt by the end of 2015. It also did not promote any significant expenditure cuts, considering that Levy had already implemented the possible cuts in non-mandatory expenses. The strategy was

focused on attacking structural factors in the expansion of public expenditure.

In fact, from 1997 to 2015 the total public expenditure grew at an average of 6 percent above inflation, and mandatory expenditures expanded until reaching approximately 90 percent of the total expenditure. The main cause of this trend was the expenditures associated with pension benefits, which were on the rise due to the rapid aging of the Brazilian population and the absence of a minimum age for retirement.

When the revenue growth started to slow down in 2011, the structural deficit began to reveal itself much more clearly. In order to tackle it, Temer's government bet on the approval of two constitutional amendment proposals: one establishing a cap on federal government expenditures for the next 20 years, limiting their increase to the previous year's inflation rate, and the other reforming the pension system in both the public and private sectors.

With an economic team respected by the markets and a parliamentary majority capable in principle of approving these constitutional reforms, the new administration came in with a plan of putting in motion a virtuous cycle where the shock of favorable expectations would boost economic recovery sooner rather than later, leading to higher popularity rates, accumulation of political capital, the approval of reforms in Congress, and so on.

Up until the third quarter of 2016, the country watched this script playing out accordingly. Asset prices were at a high. The constitutional amendment capping public expenditures was approved in Congress and in municipal elections in October. The PT suffered a historic defeat, and the PSDB and the PMDB (mostly the former), the main parties in the coalition of support for Temer's administration, showed a good electoral performance.

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## THE CRISES ARE NOT OVER

In November and December 2016, a sequence of events rapidly changed the scenario, showing that Brazil still lives under the aegis of political and economic uncertainty.

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The release of data on the economic activity pertaining to the third quarter of 2016 showed that the recession is ongoing and that a recovery will not happen anytime soon. The debt burden on deleveraging families and companies is diminishing, albeit slowly, with financial costs still high, consumption levels low, a high rate of unemployment, and family income in decline. Also heavily indebted, the public sector cannot accelerate a recovery. The hope for a faster investment recovery boosted by a new privatization and concession program is limited by regulatory and political uncertainties and by the virtual paralysis of the large contractors involved in the Lava Jato scandal. In the short term, the only factor that favors the expansion of the economy is the now-existing space for larger cuts in the benchmark interest rate established by the Central Bank. With the market projections pointing to 4.5 percent inflation at the end of 2017, most analysts believe the benchmark interest rate can drop at least 300 basis points by the end of 2017. Still, the market consensus is that growth will not exceed 1 percent this year.

Along with the longer-than-expected recession, the Lava Jato investigations continue to unfold. The first testimonies, made by 77 Odebrecht executives who benefited from a plea-bargain agreement with the public attorneys, struck a blow to president Temer's inner circle of ministers as well as leaders of the PSDB, the main partner of the PMDB in the government's coalition. The president himself was mentioned in the testimonies, which describe the illegal financing of electoral campaigns.

Three of the largest states (Rio de Janeiro, Minas Gerais, and Rio Grande do Sul) have also declared a state of financial calamity. The federal government is still trying to negotiate measures that will combine immediate financial relief with structural adjustment counterparts by the states. An agreement has already been struck with Rio de Janeiro, but its implementation depends on Congress approving a general framework for debt renegotiation and financial recovery that would be valid for all states, and on the Legislative Assembly of Rio de Janeiro

approving drastic fiscal measures. Street protests organized by civil servant unions and leftist parties have been happening frequently and gaining momentum. Similar movements can erupt in other states that are also facing acute financial challenges.

In this environment, it remains to be seen whether the social security reform will be approved under terms desired by the government. On one hand, the calamitous financial situation of large states dramatizes the need to reform social security, showcasing how unsustainable fiscal accounts can turn into social calamity. On the other hand, the electoral costs of reforming social security are higher in the midst of a recession, and Congress is sensitive to this.

With the deterioration of expectations, rumors of an early termination of the Temer government started to circulate in December 2016. Such rumors could become fact under two scenarios: one, if the Superior Electoral Court (TSE) rules in favor of a lawsuit filed by the PSDB against the Rousseff-Temer ticket a few months after the 2014 election accusing their campaign of being financed by resources diverted from Petrobras; and two, if Congress approves a constitutional amendment calling for early direct elections. If the TSE nullifies the Rousseff-Temer ticket with half of the presidential term fulfilled, the Constitution calls for the indirect election of a new president by Congress to fill the position for the rest of the term.

Despite the aggravation of the political crisis, the possibility of an early interruption of the Temer administration seems remote. The president has allies in the TSE and a large enough majority in Congress to prevent the approval of a constitutional amendment to call for direct presidential elections this year. It is more likely that the current president will serve his full term. The executive branch's control over Congress was reinforced in February 2017 by the election of two of its staunchest allies to preside over the Senate and the Lower House. This not only reduces the chance of Temer's term been terminated by calling for direct presidential elections to almost zero, but also increases the chances of Congress not watering down social security reform.

Going forward, the key question is what the state of the economy and the political atmosphere will be in the months leading up to the October 2018 election. The correction of the disaster produced by the PT cycle will take time and will not bear political fruit in the short term. One should also factor in the destruction that the Lava Jato is already causing within the existing political leadership.

After the latest elections in the United States, some analysts, half-seriously, half-ironically, started asking who would become the Brazilian Trump. The national realities are not the same, but one thing is certain: Brazil does not lack the same anti-establishment anger that brought Donald Trump to the White House.

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