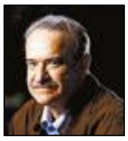
Brazil braces for a rough ride, but its strengths remain

The drama of Brazil’s immense political and economic crisis has reached a sort of “ground zero” point, from which it can develop in any direction, leading to a positive or very negative outcome for the country.



Carlos Eduardo Lins da Silva

In early December 2015, Brazil’s Congress unexpectedly and abruptly moved to impeach President Dilma Rousseff. After her allies appealed to the Supreme Court, the process was put on hold until mid-February, as the legislative and judiciary branches went into their usual, year-end recess.

Brasilia, Dec. 15, 2015: Brazilian President Dilma Rousseff expresses indignation at Congressional proceedings to impeach her (source: dpa)

Retaliation in kind

The impeachment appeared to have been an act of revenge by Ms. Rousseff’s nemesis, House Speaker Eduardo Cunha. The two have a long history of backstabbing each other. Last year they appeared to have reached a sort of a political truce, but it ended when Ms. Rousseff learned that Mr. Cunha had been secretly negotiating her downfall in Congress.

The speaker himself is in danger of losing his own mandate, as he apparently lied under oath, claiming to have no secret bank accounts in Switzerland. Such accounts have since surfaced in the course of investigations by Brazilian and Swiss authorities. Most observers expect Mr. Cunha to be gone from his job earlier than the president.

When Ms. Rousseff’s Workers’ Party (Partido dos Trabalhadores, PT) and its seven allies in Congress voted against Speaker Cunha in the House Ethics Committee, the speaker responded by accepting one of many impeachment bids against the president that had been waiting on his desk. The case for this one is not persuasive.

Essentially, Ms. Rousseff stands accused of having improperly used funds from state banks to cover budget shortfalls, a practice known in Brazilian politics as “pedaling” (*pedalada* in Portuguese) and often used by her predecessors. She now counters the charges by saying that she repaid all such withdrawals on the last day of 2015, which indeed she did. However, the practice further undermined the country’s financial position; the primary budget deficit increased to 2 percent of gross domestic product (GDP), and the debt to GDP ratio now stands at some 67 percent.

Economy, stupids

The president is hugely unpopular (the latest polls give her support of just 12 percent of the population) and many believe that she ought to leave office. A resignation seems improbable, because of Ms. Rousseff’s stubborn personality. The course of her impeachment is more likely to depend on how she deals with the economy in the first months of 2016 than on other factors.

President Rousseff worked hard to get herself into this

Brasilia, Dec. 21, 2015: President Rousseff (R) greets Treasury Minister Nelson Barbosa (L) during his inauguration ceremony (source: dpa)

predicament. She mismanaged Brazil's economy during her first term, then proceeded to hide that fact from voters with accounting tricks. The dismal truth of the fiscal situation was not fully revealed until after the presidential campaign of October 2014.

Reelected by a thin majority, the president surprisingly appointed Joaquim Levy, an economist who had always aligned with the opposition, as Brazil's new finance czar. The University of Chicago alumnus had been renowned for his efficacy in cutting expenses and adjusting fiscal deficits.

The appointment frustrated Ms. Rousseff's leftist constituencies but gave her a credibility boost in the financial markets and in Brazil's business community. At the onset of 2015, Mr. Levy promised a 1.2 percent GDP primary budget surplus for that year.

As expected, he tried to achieve this goal by moving to raise taxes and aggressively cutting the government's expenses. However, most of his initiatives were either blocked or dramatically reduced in Congress, in a large part by PT and its allies. As a result, the government ended 2015 with the worst public accounts results in 25 years, exposing the severity of the deficits and Ms. Rousseff's inability to manage a better outcome.

Minister Levy then started to fight for a 1.7 percent primary surplus in the 2016 budget. Again, he met with resistance, this time within the cabinet itself, most of it coming from Planning Minister Nelson Barbosa, a ranking member of PT and a confidante of President Rousseff.

Dark clouds

The ministers began to publicly disagree. The government finally sent Congress a budget bill with a 0.5 percent targeted primary surplus. Minister Levy lost the political clout necessary to keep his job. He resigned on December 18 and was replaced by Mr. Barbosa, who took office on December 21 and immediately … committed himself to keeping most of his predecessor's austerity pledges.

But investors were unimpressed and responded with a sell-off on the stock exchange and by putting pressure on the nation's currency, the real. The markets calmed after a couple of weeks, but their distrust towards the new finance czar continued. At the same time, most of

Rousseff's traditional supporters: unions, social movements and the Workers' Party, began knocking Mr. Barbosa as hard as they did Mr. Levy.

The Brazilian economy, meanwhile, suffered acute decline in 2015. The GDP contracted by about 3.7 percent – the worst result since 1990 (then it shrunk 4.3 percent). In 2016, the contraction is expected to reach some 2.8 percent. Economists reckon that the country has entered its worst economic crisis in a century; in any case, 2016 is going to mark the first time since the 1930s that Brazil will see its GDP contract for two consecutive years.

Inflation is another problem. It reached 11 percent in 2015 and is expected to be 7 percent in 2016 (the Central Bank's target is 4.5 percent plus or minus 2 percentage points). It has not been so consistently high since the mid 1990s, which worries Brazilians who suffered from protracted, rampant inflation in the past.

Brazil's sovereign credit rating has been downgraded in the last two months to junk status by Standard & Poor's and by Fitch, and it is widely predicted that Moody's will soon follow suit. The country's Credit Default Swap (CDS) – essentially, insurance against non-payment – was raised to 450 points, higher than any other country's with an economy similar to Brazil's. The much smaller and more unstable CDS of Colombia, for example, is presently 250.

Public accounts are in disarray. The nominal budget deficit is running at 9.5 percent of GDP and the gross public debt is expected to reach 70 percent of GDP in 2016. Despite the recession, the central bank's benchmark interest rate is high (14.25 percent a year) and is expected to rise another 50 basis points in January to curb inflation. Interest rates at such levels, of course, are going to cause further deterioration in public accounts, as the cost of servicing debt balloons.

Decisive factor

The most dramatic indicator of Brazil's predicament, though, is the surging unemployment rate. In December, it stood at 8.9 percent and is expected to reach 10 percent by March. As recently as October, the rate was only 5 percent, after years of virtually full employment. Millions of Brazilians who have climbed above the poverty level in the last 22 years are now faced with a prospect of falling back into indigence.

It is this economic deterioration that may cause the legally feeble impeachment against Ms. Rousseff to grow fangs. And that is why the president wants the case to be put to a vote in Congress while she still enjoys support from important sections of Brazilian society: most of the trade unions, NGOs and social movements, as well as her party – still the second largest. Another important ally is President Rousseff's predecessor and mentor, Luiz Inacio Lula da Silva, who remains the most influential politician in the land.

The former president harshly criticized the fiscal adjustment orchestrated by Mr. Levy and stood among those in the left who loudly demanded his ouster. Now that the former finance czar is gone, Ms. Rousseff is expected to shore up her left political flank. She must also try to please the markets, though, and this will be a tall order for her. As a politician, she never displayed a knack for delicate balancing acts.

If she decides now to turn inflation loose, further enlarge the public deficit and pursue interventionist policies in the economy, President Rousseff might see her impeachment become viable by May 2016 – when most of the Brazilians who lost their jobs in the last quarter of 2015 stop getting their unemployment benefits checks.

Presidential accountability

Having gotten rid of Mr. Levy, President Rousseff is now solely responsible for the economy and state finances. She will not be able to blame Mr. Barbosa for further trouble: her new minister has no clout of his own and, in contrast to Mr. Levy or Guido Mantega, the finance minister during Ms. Rousseff's first term, is known to follow her orders without discussion.

The embattled president's remaining advantage is that she has been able to avoid formal corruption charges. Ms. Rousseff chaired the supervisory board of the state oil company Petrobras when appalling financial abuses were taking place there. She was also accused of having illegally financed her reelection campaign with money from a kickback scheme. So far, investigators have not made a single charge against her. The case against her main enemy, House Speaker Cunha, meanwhile, is devastating. This contrast has helped the president politically.

Scenarios

What is certain at the moment is that Brazil is sinking into a deep recession that will last for two or three years. It is also clear that, politically, 2016 promises to be a volatile year. In August, the Rio Olympic Games will provide vast opportunities for public demonstrations; in October, the municipal elections may show support for new political parties that are forming now, especially Marina Silva's Rede, which presents itself as an alternative that can resolve the current deadlock.

Another certainty is that the democratic institutions that were created after the end of a military dictatorship three decades ago are working well and remain the foundation of stability, peace and democracy in the country. The democratic accumulation of the 16 years of the governments led by Fernando Henrique Cardoso and Lula da Silva has not been lost on the country. Brazil still has what it takes to overcome its dire present situation.

With all the bad news pouring out, there is no capital flight from the country. No waves of bankruptcies have been registered and wages have not been dramatically reduced. The country's external accounts are in order (with US$356 billion in reserves) and its trade balance shows increasing surpluses. Also, the Brazilian military are staying put (under a defense minister who is a civilian and, incidentally, a registered member of the Communist Party) and no extra-Constitutional shortcuts are being entertained for dealing with the crisis.

It is possible, even probable that when this nightmare is over, Brazil will have better economic fundamentals to face future challenges, a much cleaner political environment, and healthier relationships between the public and private sectors. It could have all that without the loss of any of the strengths that derive from its geographic and demographic size, its wealth of natural resources, its cultural unity, peaceful history, human tolerance, and other national qualities that have made the country so attractive to foreign visitors and investors alike.

2016, short optimistic script

A positive scenario would see President Rousseff resist the attempts to impeach her, with a small but sufficient majority in Congress to keep her mandate to 2018. Her Workers' Party would be soundly defeated in the municipal elections and the campaign would help new parties and leaders to emerge. Eduardo Cunha is stripped of the House Speakership and his mandate as Congressman. More business people and more of the Brazilian Democratic Movement Party (PMDB) – the country's largest political party and main congressional ally of Ms. Rousseff's WP – are prosecuted and jailed. The country's GDP contracts by between 2 and 3 percent.

2016, short pessimistic script

A negative chain of events would see public demonstrations against the government grow during President Rousseff's impeachment proceedings; there would be protests against her probable acquittal. Social unrest and dissatisfaction with the contracting economy finally lead to her resignation. The recession worsens and the country sinks into depression, with escalating unemployment and bankruptcies. Some states and municipalities go into bankruptcy as well.

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