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Brazil

Navigating politics with the end of the “era of abundance”

20 November 2012

Middle class is reshaping the political agenda



Middle class now constitutes a political “winning” coalition

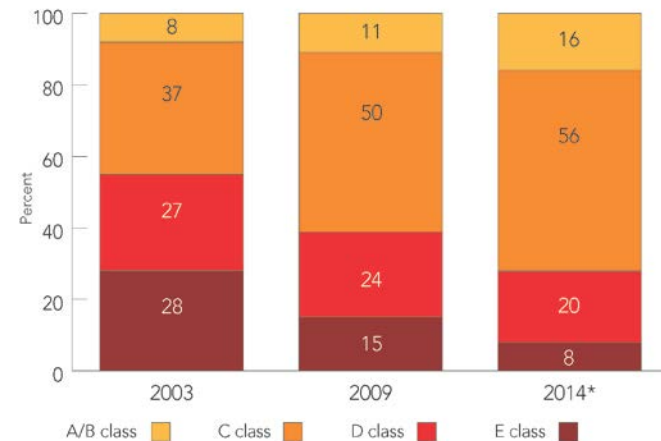
Voters increasingly care about quality of public services

- less concern over employment and income
- education, health and crime are salient political issues

Repercussions on policy

- runs into conflict with coalition management
- explains focus on transport infrastructure, telecom, lower electricity costs
- health and education will gain more attention

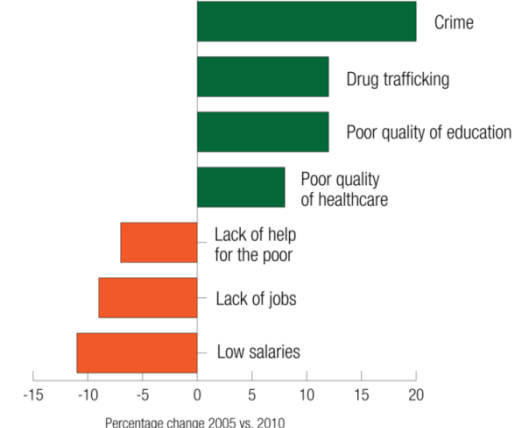
Economic class revolution
(as a percentage of population)



*Forecast

Source: Ministry of Finance

Issues voters view as main concern
(change 2005 vs. 2010)



Finding a logic behind government actions



Industrial policy is back

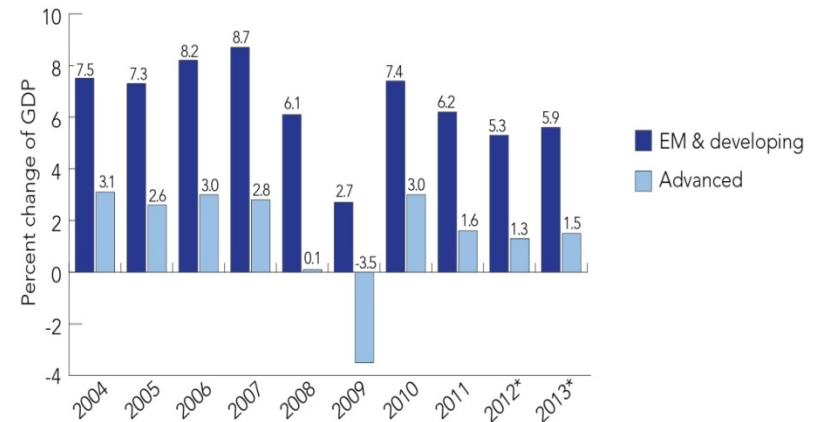
- policymakers have more room to maneuver given no insolvency risk
- tremendous concern over competitiveness of industry

Brazil, like many EMs, is entering a new phase of politics

- lower growth equilibrium than pre-2008
- new demands from rising middle class are reshaping political landscape
- tremendous policy flux in DMs
- industrial policy and reform agenda could very well be on the verge of shifting

Current investor pessimism on Brazil is overstated

Advanced and EM growth rates

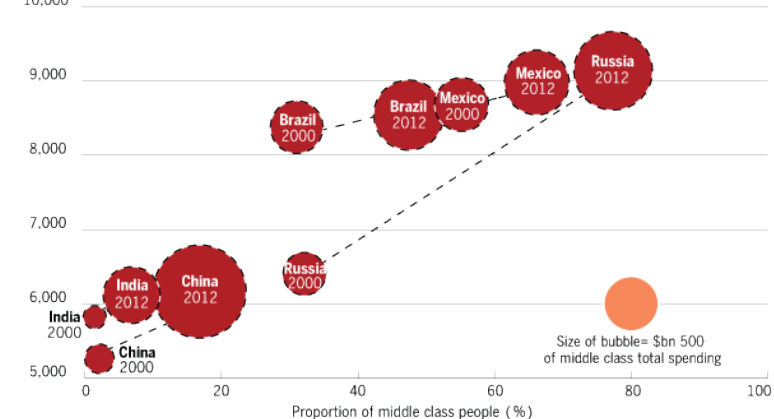


* Projected figures

Source: IMF

Middle class in emerging markets

Average annual middle class spending per person \$



Source: OECD Development Centre/Brookings

Brazil in comparison to its peers



Policy response to a lower growth environment: 2012–2013

	Prospect for economic reform	Willingness to engage in economic stimulus	Direction of economic nationalism*
High political capital			
Brazil	Medium/High	Medium	Conflicted
Mexico	High	Low	Decrease
Colombia	Medium	Low	No change
Philippines	Medium	Medium	No change
Medium political capital			
China	Low/Medium	Medium	No change/Decrease
Malaysia	Medium	Medium/High	Decrease
Turkey	Low/Medium	Medium	Decrease
Russia	Low	High	Decrease
Low political capital			
India	Low	Medium	Decrease
Thailand	Low	High	No change
Peru	Low	High	No change
South Africa	Low	Medium/High	Increase
Indonesia	Low	Medium	Increase

*We define economic nationalism to include policies of resource nationalism and/or measures to protect domestic industry through trade barriers, local content requirements, and subsidies.

Source: Eurasia Group

Macroeconomic policy: mixed policy drivers

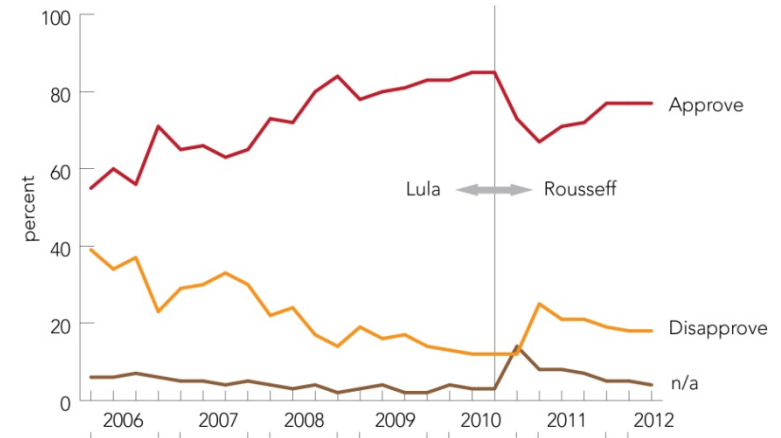


A pragmatic left with high political capital

Competing objectives has lead so “confused” signals, both positive and negative

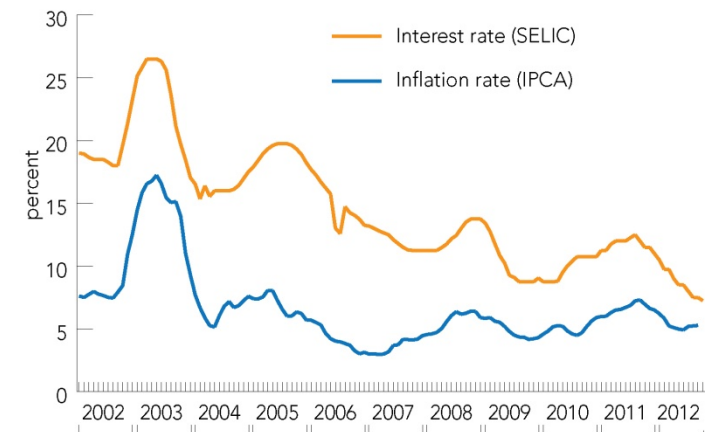
- the big “bet” on lower interest rates
- measures protect industry: trade protectionism, policies of local content, capital controls—all inflationary
- temporary tax benefits on sector by sector basis
- growing concern with infrastructure bottlenecks and investments: more aggressive turn to private sector

Brazil presidential approval ratings



Source: CNI-Ibope

Brazil interest rate and inflation



Source: IPEA

Politics is increasingly driving the business environment



Sector	Date	Policy	Market Impact
Financial Services	April 2012–Present	Federal banks lower lending rates, pressuring private banks to follow suit	Negative
Utilities	September 2012	Utility concession renewal conditioned on stiff rate cuts	Negative
Infrastructure	2012 (Feb, Aug, Nov)	Concessions in airports (Feb, Nov 2012), railroads and highways (Aug 2012), and ports (Nov 2012)	Positive
Automobile	August 2011 & October 2012	Tax hikes on non-local content compliant cars; new sector framework incentivizing investment	Mixed
Telecom	2011–Present/July 2012	<ul style="list-style-type: none"> – National Broadband Plan (PNBL) – Suspension of mobile line sales to some companies 	Negative/Mixed
Oil & Gas	2010	New framework for Pre-salt E&P	Negative

Pivoting to a positive economic reform agenda



Pace of economic recovery will be critical variable

- if growth stays at 3%, officials will begin to panic

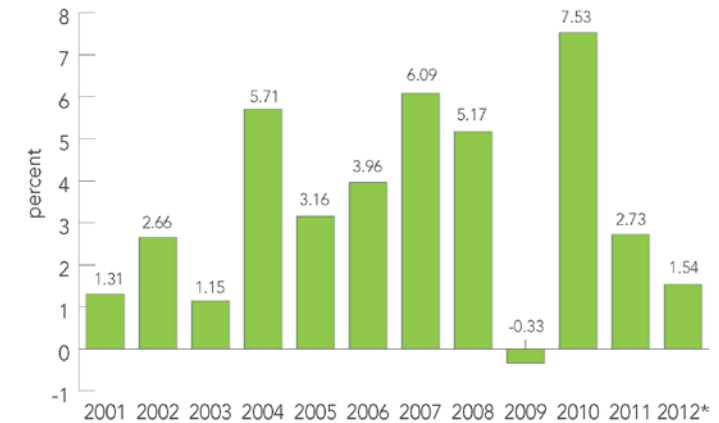
Lower interest rates opens room to lower taxes through tax reform

- PIS/Cofins reform
- state based ICMS reform
- extension of the payroll tax reduction

If growth recovers, challenge will be to keep inflation under control

- pressure to control regulated prices
- macro-prudential measures to limit credit growth

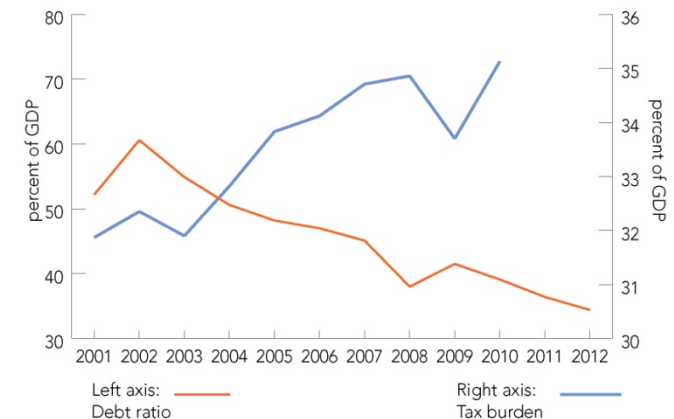
Brazil GDP growth



*Market forecast

Source: Brazilian Central Bank

Debt ratio and tax burden
(percent of GDP)



Source: Ipea, *IBPT

Sector outlook, however, is mixed



Financial services: more risks on the horizon

- pressure on lower lending rates will continue
- risk of macro-prudential measures is high if inflation picks up
- but government may deliver micro-reforms demanded by Febraban

Transport infrastructure: more opportunities for private sector

- aggressive schedule of concessions for rail, airport, port and federal highway and aviation reform

Utilities: tax relief after the concession “fiasco”

Mining: higher taxes and focus on steel production

Oil and gas: dealing with an overburdened Petrobras

- local content won't go away anytime soon, but bid rounds will come; big debate if production doesn't increase

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