THE BRAZILIAN ECONOMY
TOWARDS SUSTAINABLE GROWTH

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THE ECONOMIC CRISIS AND ITS OPPORTUNITIES

The scope of the recession

According to data from the Brazilian Institute of Geography and Statistics (IBGE), combined negative GDP growth for 2015 and 2016 is expected to reach almost 7%, a rate which exceeds those of the recessions of 1929-1933 (-5.3%), 1980-1983 (-6.3%) and 1989-1992 (-3.4%). High rates of inflation and unemployment (surpassing 10% and 11%, respectively) point to a scenario that—upon initial observation—might be perceived as an economic crisis that is larger in scope and graver than those faced in the past.

Source: IBGE

The recession in perspective

The recent recession must be seen in its proper perspective. The Brazilian economy is now—in contrast to past crises—far more resilient and able to withstand turbulence. A system of floating exchange rates ensured rapid adjustments to foreign accounts, such as trade in goods and services, travel, and transfers of profits and dividends. The current account deficit has declined consistently, from US$104 billion in 2014 (4.24% of GDP) to US$58.9 billion in 2015 (3.28% of GDP), and US$ 23.5 billion in 2016 (1.30% of GDP). At the same
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time, foreign direct investment (FDI) remains steady, at levels that allow for a consistent flow of funding to the current account. Finally, high foreign reserve levels practically guarantee that the present recession—in contrast to past crises—will not jeopardize Brazil’s foreign accounts.

![Graph: Current Account Transactions and Direct Investments in the Country (% of GDP)]

![Graph: Foreign Debt and International Reserves (% of GDP, US$)]

*Source: Central Bank of Brazil*
Opportunities

Present challenges give rise to great opportunities. Recent political normalization opened the way to stabilization of the economy. Finally, a reasonable degree of popular and political consensus seems to support the view that an effective and sustainable recovery can only be brought about through a series of structural reforms that inject dynamism into the economy, expand productivity, and reduce dependence on state-run stimulus measures.

To this end, the government has formulated and followed an ambitious reform plan to restore short and medium-term confidence in the Brazilian economy and provide the necessary foundation to increase its growth potential over the medium- and long-term, enabling the country to take full advantage of its economic and social possibilities and bringing Brazil closer to fulfilling its development goals.

2. CONFRONTING THE FISCAL QUESTION

Fiscal imbalance was identified as the principal structural risk facing Brazil’s economy. After the monetary stabilization brought about by the Real plan, the federal government’s primary expenditures rose from approximately 10.5% of GDP in the 1990’s to 19.5% of GDP by the end of 2015. This increase, which occurred under all governments of the period, was funded mainly by tax increases and, over the final years, by an increase in gross debt that grew from approximately 51.7% of GDP in 2013 to 68.51% in 2016.

Source: National Treasury

Should the current trend continue, federal government primary expenditures would surpass 23% of GDP by 2025. The strategies employed over the past decades to fund these
expenditures, however, are showing signs of exhaustion. While the citizenry is expressing its unequivocal stance against further expansion of one of the world’s greatest tax burdens, the market signals the risk inherent in increasing the debt, which led, for example, to the loss of the investment grade status conferred on Brazilian securities by the main credit rating agencies. However controversial the criteria and efficiency of the referenced agencies might be, there can be no doubt that their assessments directly affect both investors’ decisions and economic activity in general.

Sources: Heritage Foundation / Central Bank of Brazil

3. CONSTITUTIONAL AMENDMENT 95 (EC/95)

To reverse the trend of growing expenditures, the Brazilian government presented a Constitutional Amendment proposal seeking to curb growth in public spending. The New Fiscal Regime under Constitutional Amendment 95 (EC/95) establishes a period of at least 10 years during which federal government annual primary spending can increase by no more than the previous year’s rate of inflation. In the subsequent 10 years, each president will be able to propose to Congress new criteria—along with the Multi-year Plan (PPA)—to increase primary spending for the following four years. The amendment ensures that the government will be able to maintain satisfactory levels of economic activity while restoring the primary balance and reducing the ratio of debt and expenditures to GDP. Approval of the proposal in December of 2016 (through two sessions of both the Chamber of Deputies and the Senate by a wide margin of legislators) reflected popular and political consensus for reforms required to limit growth in spending and, in effect, the public debt.
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The New Fiscal Regime established under EC/95 increases the degree of transparency of the federal budget. With spending under control and respecting overall limits, public debate in the National Congress will determine resource allocation levels for specific areas. In addition, bills and legislative proposals will be debated and considered in light of their budgetary effect, thereby allowing greater streamlining and definition of priorities. The debate surrounding resource allocation will then be more conspicuous and transparent.

Special attention has been given to health and education—sectors afforded priority status under the constitution. EC/95 affirms an important guarantee (already established under the Federal Constitution): a spending floor for the areas of health and education. In the past, however, the minimum spending threshold corresponded to a percentage of federal government net receipts; now, the minimum outlay is corrected according to the rate of inflation (based on 2017 figures). Should minimum health and education outlays remain a function of the performance of government revenue, they would fall short whenever revenue growth was below the rate of inflation, as was the case over the past few years. In 2015, for example, minimum outlays for health grew by 6.9% against a 10.7% rise in inflation, resulting in a real decrease in health spending.

Real health and education budgets, therefore, will be maintained over the following decades, both relative to inflation and in proportion to what these outlays represent in terms of federal government primary expenditures.
The remaining items, although maintained at real levels, will compete for a portion of a limited budget. Prioritizing reforms that enable sustainable government spending, therefore, will become ever more relevant.

With a view towards improving the new fiscal regime, the Brazilian government, at the same time of the promulgation of EC/95, postponed until 2023 the Detachment of Government Receipts (DRU). This gave the administration the authority to reallocate receipts obtained from specific taxes and contributions for specific funds. In addition, the percentage of specific receipts that can be reallocated was increased from 20% to 30%.

With the extension, resources for specific purposes are to be made available to help the government comply with its primary spending goals; and, for the first time, states, the Federal District, and municipalities closed their accounts. The measure is expected to make available R$117.7 billion for 2016 alone.

In the long term, controlling spending guarantees the sustainability of the Brazilian state, the continuity of essential public services, and fiscal responsibility and transparency. In the short term, it restores the confidence necessary to invest, operate businesses and consume in Brazil, without the need to resort to fiscal shocks with the ensuing contracting of the economy. Untying the fiscal knot, furthermore, will open the way towards the normalization of a monetary policy that is currently founded on rates of interest that discourage economic activity.

4. SOCIAL SECURITY REFORM

Because EC/95 requires that the federal government budget remains constant and at real levels, and ensures that spending floors on health and education are maintained, there is a clear need for reform of the social security system. At its present rate of expansion, the system would take up an ever greater share of the budget, to the detriment of other priorities and public policies. Therefore, Brazilian social security legislation, designed in response to a different demographic, social and budgetary reality, must be brought up to date and in line with what exists in the majority of countries. This means, for example, instituting a minimum retirement age that endows the system with the basic degree of sustainability that it requires.

There appears to be little doubt that the present social security model is fiscally unsustainable. Without structural reform, outlays of the National Social Security Institute (INSS) as a portion of GDP would practically double over the next 45 years, from 8% to 17.5% of GDP by 2060—only to avoid the social security deficit growing beyond the current R$150 billion (the equivalent of 2.4% of GDP planned for 2016).

Furthermore, the current model is unsustainable in that it fails to account for changes to the age pyramid of Brazil’s population. According to IBGE statistics, 40% of the total population...
will be 65 or older within the next few decades. In 2015, approximately eight individuals contributed to maintain a single beneficiary of 65 years of age or older, by 2040, this number will have halved to four contributors per beneficiary 65 or older.

The social security reform proposed by the government is an attempt to correct irregularities in the current system by establishing a minimum retirement age of 65 for both men and women, with the prospect of eventually raising the age requirement to 70 years of age for future generations. Current legislation allows women to retire after having contributed for five years less than men. The new rule would be applied to women up to the age of 45. Women age 45 or older would be subject to transitional rules, ensuring a gradual pace towards equality over a period of 20 years.

Social security reform seeks to cover all employed workers. Those who are 50 years of age or older will be subject to transitional rules, with additional time allowed for them to request benefits. Retired workers and those having satisfied the requirements necessary for requesting benefits by the reform’s approval date will not be affected.

As with EC/95, social security reform, by ensuring the sustainability of public spending and repelling the specter of tax increases, brings together a series of measures that will lead to a favorable environment for Brazil to grow again, create more jobs, and seek social equality. Another aspect of this effort is labor reform, which is analyzed below.

5. LABOR REFORM

Brazilian labor laws will be updated by introducing provisions that are more consistent with current practices in the labor market. This includes making the work hours more flexible and allowing outsourcing, which will enable a large portion of the labor force, working in the informal economy, to enter the formal economy, resulting in more productivity and competitiveness to the Brazilian economy and Brazilian companies.

Proposed changes establish that employers and workers will engage in collective bargaining to agree on the work week so as to legitimize collective agreements. Therefore, once basic rights are respected, collective agreements will be allowed, ensuring freedom of negotiation between employers and workers. These agreements cannot be reversed by a judge’s decision, and will increase legal certainty.

The reform proposal maintains the contract based on current established working hours and adds two additional contracts: one based on hours worked and one based on productivity. Hourly contracts will be formalized and allow signing with more than one service
provider, with proportional payments to the Employment Security Fund (FGTS), proportional vacation time and thirteenth salary. This measure will simplify payment of social security contributions and tax, consolidating workers’ social rights.

With regard to outsourcing, the proposal will allow employers to hire employees of another company to carry out company’s core activities. Currently, employers are allowed to outsource the company’s secondary activities only.

6. TAX REFORM

The reform under consideration by the government seeks to reduce the complexity of the tax system, making tax collection more efficient and simplifying the process. The main goal is to reduce the burden on economic actors for the purpose of stimulating economic growth.

The Brazilian tax structure is very different to that of other Latin American countries. Its economic burden is great, the equivalent of 36% of GDP, which increases costs for companies and reduces their competitiveness. The graph below shows how similar the Brazilian tax burden is to those of advanced economies while contrasting to those of Latin America and emerging markets.

![Overall Government’s Tax Load (% GDP)](image)

Sources: IMF and Brazilian Federal Revenue (RFB)
Although the Brazilian fiscal situation makes it difficult to reduce taxes in the short term, with tax reform the government plans to meet demands to simplify compliance through secondary obligations by reducing its cost and lowering the cumulative effect of some of the primary federal taxes.

7. REGULATORY FRAMEWORK FOR INVESTMENT IN INFRASTRUCTURE

In September 2016, the Brazilian government launched Projeto Crescer [project for growth], which changes the concession models in Brazil in order to attract domestic and international private sector enterprises wishing to partner in infrastructure and privatization projects. Established under the Investment Partnership Program (PPI), the project will provide partnership contracts with more transparency and legal assurances. The program will also expedite the administrative process for granting concessions, in an effort to increase cooperation with the private sector.

The overall objectives of the project include expanding investment, creating jobs, stimulating technological and industrial development, improving the quality of public infrastructure, and promoting competition and legal confidence in establishing partnerships with the private sector.

Requests for tender will be issued only after the corresponding environmental license has been issued. This will ensure a more expedited process after the request for tenders is published, as well as attention to environmental rules.

To enhance transparency and legal certainty, the possibility of amending contracts will be limited, as will economic and financial readjustments. In addition, contracts will include performance clauses.

Finally, in the new model, the deadline for submitting tenders will extend beyond 100 days from the date on which the request was issued. This will stimulate competition and increase the number of potential investors.

The Council of the Investment Partnership Program was created under the Office of the President as an advisory agency to establish and oversee the PPI. As such, the government can ensure that all relevant agencies will carry out their tasks expeditiously and that public infrastructure projects are duly released.

The BNDES will be responsible for creating and participating in the Investment Support Fund (FAEP) in order to organize investment partnerships under the PPI. Along with the Federal
Savings Bank, BNDES has made US$30 billion available in initial funds for concessions. In addition to BNDES and the Investment Fund of the Employment Security Fund (FI-FGTS), the new model will include private banks. Each project is expected to include at least 20% of investors’ funding, with the rest being funded through loans and debentures.

After the first meeting of the Council, in September of 2016, the Brazilian government issued Decree no. 8893 of November 1, 2016, which lists 18 priority projects for private-sector concession under Projeto Crescer. With special lines for public and private financing, these projects will be fast tracked by public agencies along all processing phases.

Projects established as priority are the following:
- 14th round of bidding for the concession of petroleum and natural gas exploration blocks;
- 4th round of bidding for the concession of marginal petroleum and natural gas fields (ground fields);
- 2nd round of bidding for a production share agreement (unit areas);
- Privatization of the following energy distribution companies:
  a) Amazonas Distribuidora de Energia S.A. and the concession of its power distribution utility;
  b) Boa Vista Energia S.A., concession of its power distribution utility and those for which it has been assigned temporary responsibility;
  c) Companhia de Eletricidade do Acre and the concession of its power distribution utility;
  d) Companhia Energética de Alagoas and the concession of its power distribution utility;
  e) Companhia de Energia do Piauí the concession of its power distribution utility;
  f) Centrais Elétricas de Rondônia S.A. the concession of its power distribution utility.
- Concession of the following hydroelectric power plants:
  a) Volta Grande hydroelectric plant (state of Minas Gerais);
  b) Miranda hydroelectric plant (state of Minas Gerais);
  c) São Simão hydroelectric plant (state of Minas Gerais);
  d) Pery hydroelectric plant (SC); and
  e) Agro Trafo hydroelectric plant (state of Tocantins).

8. BUSINESS ENVIRONMENT
In addition to fiscal, labor, social security, and tax reforms, other key measures have been adopted to create a microeconomic scenario that is conducive to investment, increased productivity, transparency, and job creation.
- Sale of property belonging to the Companhia de Pesquisa e Recursos Minerais (CPRM), which includes the following projects:
  a) phosphate in Miriri, states of Pernambuco and Paraíba;
  b) copper, lead and zinc in Palmeirópolis, state of Tocantins;
  c) coal in Candiota, state of Rio Grande do Sul; and
  d) copper in Bom Jardim de Goiás, state of Goiás.

The Brazilian government plans to conduct the first auctions in the first half of 2017, with estimated revenues of about R$ 24 billion in 2018.

In addition to the projects included in Decree 8893, the following projects are also being considered under the PPI, as announced by the Council in September 2016:

- Porto Alegre airport (state of Rio Grande do Sul);
- Salvador airport (state of Bahia);
- Florianópolis Airport (state of Santa Catarina);
- Fortaleza airport (state of Ceará);
- Fuel Terminals in Santarém (state of Para) (STM 04 and 05);
- Rio de Janeiro Wheat Terminal;
- Interstate BR-364/365/GO/MG;
- Interstate BR-101/116/290/386/RS;
- Railway EF-151 SP/MG/GO/TO;
- Railway EF-170 MT/PA;
- Railway EF-334/BA – FIOL;
- Water utility (service of water distribution, collection and sewage treatment) - Companhia Estadual de Águas e Esgotos do Rio de Janeiro (Cedae);
- Water utility (service of water distribution, collection and sewage treatment) – Companhia de Águas e Esgotos do Estado de Rondônia (Caerd);
- Water utility (service of water distribution, collection and sewage treatment) – Companhia de Saneamento do Pará (Cosanpa); and
- Lotex lottery (Ministry of Finance).

8. BUSINESS ENVIRONMENT

In addition to fiscal, labor, social security, and tax reforms, other key measures have been adopted to create a microeconomic scenario that is conducive to investment, increased productivity, transparency, and job creation.
A potentially relevant example is Brazil’s new stance regarding the *Doing Business* report, published by the World Bank since 2002, to assess the ease of doing business in 189 countries. Brazil is now more forthcoming in recognizing its weaknesses, primarily the “Brazil cost”, which obstructs the economy and, to a large extent, is responsible for Brazil being ranked 123rd in the report.

The *Doing Business* report will be used as a diagnostic tool, when appropriate, for adopting international best practices that can be applied in light of the Brazilian reality. Measures currently being considered include the following: i) reducing the number of procedures necessary to register property; ii) centralizing the process for obtaining a construction license in a “one-stop shop,” to save time and reduce the number of procedures; iii) supporting the validity and effectiveness of settlements reached by Previous Conciliation Committees, so as to reduce the burden on Labor Courts; and iv) making judicial and extrajudicial reorganization processes of companies more flexible to increase their efficiency (currently, only 1% of companies that undergo reorganization in Brazil are able to recover, while in the United States the rate is 30%).

Other efforts current underway have to do with improving the governance of state-owned companies, the best example of which is the case of Petrobras. These include: i) approval of technical requirements to become a director; ii) a proposal to increase flexibility in national content regulations; and iii) proposed changes to the rules that require Petrobras’ participation in all pre-salt petroleum exploration.

In addition to greater transparency and efficiency for state-owned companies, these efforts will make production chains of key economic sectors more dynamic, with positive impacts on the business environment and the Brazilian economy.

9. INITIAL RESULTS

The economic policy changes implemented by the government, as well as the positive signs regarding the business environment and investment opportunities have already improved expectations for the Brazilian economy. Debt securities, stock market indices, and confidence indicators from various sectors have all seen steady increases. At the same time, interest rates for pre-DIs and 5-year CDS, indicating Brazil risk, have decreased. Inflation rates estimated by public agencies and the market are now more in line with government targets, and growth expectations are no longer negative and are gradually improving.
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### INITIAL RESULTS

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Economic actors believe that the political transition is well under way and that the phase of high economic uncertainties is over. Furthermore, economic actors seem to be buying into the reforms proposed by the government because they believe that they can be implemented and that they will benefit the economy.

Although it is reasonable to assume that the worst is over, it is certainly too early to affirm, based only on these initial positive results, that a new cycle of growth and tranquility is already ensured. However, the newly established economic dynamic, together with the perspective of further reforms, seem to indicate that Brazil is embarking on a new growth cycle.

10. CONCLUSION

Instead of only working to recover previous levels of economic activity, the Brazilian government is taking advantage of the opportunity created by the crisis and the ensuing social and economic consensus to drive institutional change that will ensure sustainable growth cycles.

In this context, approval of Constitutional Amendment 95 is essential to stabilize and reverse upward trends in primary expenses, public deficit and public debt. Its long-term prospects are already yielding results in terms of a positive confidence shock, while fiscal adjustments are gradually implemented, without causing an economic contraction. The budget is now more transparent, allowing for the establishment of priorities, facilitating accountability and driving new structural reforms that are essential in areas such as social security, labor law and tax provisions. In the long run, fiscal adjustment will normalize the monetary environment,
which is still characterized by high interest rates that inhibit economic activity and discourage business investment.

Changes to management rules for state owned companies, the regulatory framework for bidding in infrastructure projects and the creation of a friendlier business environment will result in an institutional environment that is more transparent, dynamic and competitive, driving increases in investment, productivity and job creation.

The world is still grappling with low rates of growth, the general effects of the economic crisis that began in 2008 and the end of the commodities boom. For internal reasons, Brazil entered into a deep recession from which it has only now begun to emerge. The Brazilian economy today is more solid than it was during past crises, when it faced balance of payments difficulties that are absent from the current scenario. Brazil’s potential is enormous, and the markets seem to be responding to the proposed structural changes that will guide Brazil towards its real potential.