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Petrobras fallout adds to pressure on Rousseff

The government's finance team needs to succeed in its mission to reassure investors, writes *Joe Leahy*

Late last year, São Paulo's Museu da Casa Brasileira, a design museum, staged an exhibition, "Excelência Italiana" (Italian excellence).

On the way in, guests could see the latest Maserati and Ferrari sports cars, while inside they could experience examples of Italian food and culture.

The evening was hosted by Azimut, an independent wealth manager based in Italy and an enthusiastic investor in Brazil. The group has made four acquisitions in the country since 2013, including April's purchase of 60 per cent of domestic wealth manager Quest Investimentos for R$70m ($24m).

"We are targeting Brazil as a key market in which to be present, and Azimut's strategy is long term," says Giuseppe Perrucci, president and co-chief executive officer of Azimut Brasil.

Such bullishness has become more the exception than the rule among investors, with the economy sinking into recession, inflation exceeding the central bank's targets and infighting in the ruling coalition of President Dilma Rousseff on the increase.

Add a corruption scandal at Petrobras, the state-controlled oil company, and an adverse external environment — the Chinese economy slowing and the US Federal Reserve expected to raise interest rates — and Latin America's largest economy is facing difficulties.

"Brazil in that context is one of the most vulnerable [emerging markets], because it is sensitive to Chinese demand for commodities and . . . to what the Fed [will] do," says Maarten-Jan Bakkum, a senior emerging markets strategist at NN Investment Partners.

This year was expected to be one of reckoning. Ms Rousseff and her former finance minister Guido Mantega ran a prolonged fiscal stimulus programme in her first term, which lasted from 2011 to 2014, to combat what they saw as offshore economic crises.

On the march: demonstrators against President Dilma Rousseff — Nelson Almeida/AFP

They suppressed fuel, energy and other prices and introduced temporary tax breaks to stimulate industry. This curbed inflation for a time and kept unemployment at bay, helping Ms Rousseff win a second term last year.

But then news of the Petrobras bribery scandal broke. Prosecutors allege that former executives conspired with contractors and politicians to earn kickbacks from the company, which dominates Brazil's fossil fuel industry.

Petrobras flirted with a technical default by delaying the release of its audited 2014 results — the figures are a requirement of some bond covenants — before releasing them late in April.

But the damage caused by the scandal is expected to continue, not only for the company but for its contractors, some of which have filed for bankruptcy protection after being accused of involvement in the bribery schemes.

This in turn is expected to hamper Petrobras's development of its vast offshore oilfields and, together with the lower oil price, make it harder to reduce its large net debt of $106bn.

"Petrobras may face challenges to deleverage its capital structure," said Fitch, the rating agency, which has kept the company on a negative outlook.

The Petrobras scandal has also brought protesters to the street calling for Ms Rousseff's impeachment and sent her popularity to a record low.

Sensing her weakness, a coalition partner, the PMDB, wrested more power. One of its most senior figures, vice-president Michel Temer, now leads the government's "political co-ordination" efforts with Congress instead of Ms Rousseff's own party, the PT.

On the plus side, the dealmaking has helped to stabilise the government, analysts say. The other positive,

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Inside

Middle class starts to lose ground

Consumer spending

As the recession begins to bite, millions fear a return to poverty, writes *Samantha Pearson*

Looking for a better life: Francisco de Lima still lives in a favela, but now owns a bar and pizzeria — Aline Rocha

Ten years ago, Brazilian musician Max Gonzaga shot to fame with "Middle Class", a hit song about the millions of Brazilians who were emerging from poverty to join the middle class, often referred to in Brazil as "C Class".

"I hate buses. I have a car that I bought in instalments . . . I'm always at the limit of my overdraft," say the lyrics, capturing some of the cynicism many wealthier Brazilians felt about the consumerism that had gripped the country.

Since Brazil's ruling Workers' Party (PT) took power in 2003, more than 40m Brazilians have joined the middle class, thanks to government benefit schemes such as Bolsa Família and an economic boom that boosted wages and brought more stable employment.

Greater financial inclusion and the expansion of Brazil's credit markets also meant that, for the first time, many of these families could buy the trappings of a middle-class lifestyle in affordable monthly instalments.

Brazil's Secretariat of Strategic Affairs last defined "middle class" in 2012 as anyone living in a household with per capita income of R$291-R$1,019 ($99-$347) per month, although definitions vary slightly across the country's institutions.

The exodus of millions of Brazilians from poverty has brought profound political and economic changes, winning the PT a loyal base of voter support that has helped keep the party in power ever since, while attracting foreign investors and driving economic growth.

However, Brazil's new C Class is now at a crossroads. Over the past couple of years, many have become frustrated with the limitations of their new status — aside from washing machines, they want better education, hospitals and other public services.

In June 2013 more than a million protesters took to Brazil's streets. But as Latin America's biggest economy faces its worst recession in a quarter of a century this year, the concerns of the new middle class are even bigger, says Mauro Paulino, director-general of Datafolha, the polling company, which has tracked the protests.

"At that moment [during the 2013 protests] there was a feeling that this process of social ascension had come to a halt, but now they are actually afraid of losing everything they have achieved — of going backwards," he says.

Signs of this "middle-class reversal" are already apparent. Last November, Ipea, the government think-tank, said the number of Brazilians in extreme poverty had risen in 2013 for the first time since 2003. Brazil's C Class is also no longer the driver of consumption in the country, according to Nielsen, an information and data provider. The wealthier Classes A and B — 33 per cent of Brazil's population — account for 60 per cent of spending growth in Brazil, while Class C — 53 per cent of the population — only accounts for 33 per cent, Nielsen said in a study released in March. In 2009, C-Class Brazilians accounted for 60 per cent of the country's spending growth, Nielsen said.

While the government's recent efforts to improve the country's fiscal accounts and attract investment promise to help put the economy back on track, uncertainty remains over the long-term future of the C Class and, in turn, Brazil's own social and economic development.

The biggest concern among Brazil's new middle class, says Mr Paulino, is rising unemployment, especially among the young, followed by inflation.

"When families go to the supermarket they can't fill up their trolleys like they used to with the same amount of money, and when they . . . turn on the TV the news is all about corruption," says Mr Paulino. "They're short of money and at the same time they are being told they have been robbed."

Two families, one city, different lives

"The reason I came to São Paulo is the same for anyone who was born in the northeast and left — to look for a better way of life," says **Francisco de Lima**, who lives in Heliópolis, one of the slums or "favelas". After working in restaurants, the 37-year-old now owns a bar and a pizzeria. With his wife and son, he is typical of the new middle class that has transformed Brazil. Mr de Lima says his family has a better lifestyle than 10 years ago, a result of his hard work, the greater availability of credit and government investments.

But Brazil's economic instability and political scenario have interfered with his plans to open another business. Supplies for the restaurant and the bar are becoming more expensive and he fears that next year will not be a good year to invest in the future.

When asked about her family's future plans, **Marcia Del Paggio** says she only has one wish: to leave Brazil. "We only work to pay taxes here, it's very difficult," says the 37-year-old. She owns a property company with her husband and lives in Higienópolis, a central and affluent neighbourhood of São Paulo, with their two daughters. But the future is uncertain. Although the family has not yet had to cut back, Ms Del Paggio has noticed prices rising and business slowing at work.

Like Mr de Lima, Ms Del Paggio and her husband support President Dilma Rousseff's impeachment.

"But I'm optimistic in a way because the media is making people wake up," she says. "It's not the same as before, when corruption was swept under the carpet."

Dealmaking plummets due to economic woes

Corporate investment

The economy is expected to contract by more than 1 per cent this year, writes *Samantha Pearson*

For Dennis Mills, chief executive of Major Events International, which helps foreign companies win contracts for the 2016 Rio de Janeiro Olympics, convincing companies to enter the Brazilian market is relatively easy.

But persuading those same companies to remain in Brazil after the games are over is a different matter altogether, he says.

"Rio procurement is trying to meet some challenging deadlines and therefore there are going to be opportunities for people with expertise," says Mr Mills. "There is interest in coming to Brazil in our market, but there is no doubt scepticism and concern for people who are not in our market."

Once the darling of the emerging markets, Brazil has fallen out of favour with investors over the past few years and faces one of its most difficult years yet in 2015. The economy, which grew 7.5 per cent in 2010, is expected to contract by more than 1 per cent this year, marking the country's worst recession in a quarter of a century. Meanwhile, inflation is stuck above 8 per cent, unemployment is rising, and the country is reeling from the effects of a vast corruption scandal at state-controlled oil company Petrobras.

The impact of Brazil's economic woes on dealmaking is already apparent. According to Dealogic, Brazil-targeted merger and acquisition transactions totalled $9.2bn in the first quarter of this year, down 27 per cent from $12.5bn in the first quarter of last year. It represented the lowest quarterly M&A volume for two years and was weaker than the rest of Latin America, where overall volumes fell 22 per cent from the previous year.

"There is so much uncertainty here in Brazil and many emerging markets, which is slowing down investment," says Mark Weinberger, global chairman and chief executive of professional services provider EY. While there are some headwinds that are beyond Brazil's control, such as slowing growth in China, investors will be watching Brazil closely to see how it deals with those problems it can control, he says.

"How the government deals with these [issues] will determine whether and when the confidence comes back for investors here," says Mr Weinberger, adding that the authorities' efforts to investigate the Petrobras scandal and the government's measures to plug its fiscal accounts were both positive moves.

However, while investors and companies may have more concerns about entering Brazil than they did five years ago, certain individual sectors remain attractive, says Mr Weinberger, citing the telecommunications industry alongside energy and natural resources.

Private equity dealmakers in particular have continued to seek out opportunities in spite of the wider economic downturn, says Luiz Eugenio Figueiredo, vice-president of Brazil's private equity and venture capital association ABVCAP.

'There is so much uncertainty here . . . which is slowing down investment'

After a period of fundraising by Brazil's major private equity firms last year, merger and acquisition activity among buyout firms in the country may even surpass last year's $4.3bn worth of deals, according to the association.

"There are some sectors that are growing at rates disconnected from that of the economy — be it because of repressed demand or cyclical moves or regulatory changes," says Mr Figueiredo, adding that Brazil's current problems could even benefit his industry by capping asset prices and reducing competition. "It's a good moment for investments because the sources of funding for non-listed companies are very restricted," he says.

As raw materials prices fall, meat production could be the answer

Agriculture

Despite expertise in the sector, there are challenges, writes *Luke McLeod-Roberts*

Brazil's abundant natural resources are a blessing or a curse, depending on whom you ask.

The share of raw materials in Brazil's total exports increased from 29 per cent when the ruling Workers' Party (PT) assumed office in 2003, to 49 per cent last year, according to the country's ministry of development. The proceeds of the world's increasing demand for Brazilian agricultural produce, minerals and oil were invested in social programmes and fuelled a consumer boom.

The view that Brazil has become too dependent on commodities, however, is gaining prominence, as Chinese demand softens and a slower-than-expected European recovery depresses key commodity prices. Over the past year, soya beans have fallen more than a third, Brent crude oil more than 40 per cent and iron ore by almost half.

Daiane Santos, from the centre for studies of foreign trade (Funcex), a think-tank, says: "The expectation for the next two years is that prices for these commodities will not return to levels they were at and the alternative we have is to diversify exports." But, despite her bearish short-term perspective, Ms Santos believes that, in the long term, "prices will pick up and it makes sense to use our competitive advantage".

One of the areas in which Brazil is already a leader but where it can further strengthen its position is in meat production. Global demand for higher protein diets and convenience food is growing as a result of urbanisation and rising incomes.

Brazil is home to some of the world's largest food companies, whose portfolios include meat but also ready meals and pizzas. These include the world's largest protein producer JBS, Marfrig, whose Moy Park division supplies the UK's Tesco and Waitrose, and BRF, whose Claybom and Qualy margarines are the preferred brands for almost half of Brazilians, according to FT LatAm Confidential, a research and analysis service.

Brazil has distinct advantages in the meat sector, explains Cesar de Castro Alves, an analyst at MB Agro, a consultancy. "Know-how is well developed and installed capacity is high," he says, while Brazil's access to cheap feed for pigs and chickens keeps production costs low.

But the meat industry faces a number of problems.

Exports in the first quarter of 2015 were down significantly on the same period last year. Revenues for Brazilian beef, pork and chicken fell 29 per cent, 15.7 per cent and 6.6 per cent respectively, according to the ministry of development.

Cesar de Castro Alves: 'Know-how is well developed and installed capacity is high'

Some of this relates to one-off factors: a truck drivers' strike in February; several markets imposed short-term import bans on Brazilian beef; and Brazilian exporters applied greater discounts in an effort to sustain markets such as Russia and Venezuela, where purchasing power has been reduced as a result of the fall of local currencies against the US dollar.

Nevertheless, robust exports are essential to hedge against a softer domestic market, which is depressed as a result of higher unemployment and tighter household incomes, as well as an undersupply of cattle. This has pushed beef to record prices, at a time when consumers can ill afford to spend more.

Brazil's large multinationals have the scale and level of diversification to offset these issues, particularly through their growth of higher margin branded and processed foods, which are less vulnerable to short-term commodity fluctuations. But many smaller companies are going out of business.

There are also longer-term problems. While Brazil has access to relatively cheap feed, exports lose competitiveness as a result of poor logistics, as well as the fact that much of meat production is in remote locations thousands of miles from its ports.

Adolfo Fontes, an agribusiness specialist at Rabobank, the Dutch bank, also points to productivity issues in the beef sector due to low-quality pasture and the lack of food supplements.

"In Brazil, cattle take 36 months to mature; in the US it is 18-24 months," he says. In addition Brazil is not able to export fresh beef to the US yet, although negotiations have been under way for some time to allow this to happen.

This could transform the Brazilian industry because of the impact on exports elsewhere.

"Having a 'US visa in our passport' would increase our bargaining power with [other markets] such as Canada, Mexico and South Korea," he believes.

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Government blighted by scandal and weak economy

Political climate Support for President Dilma Rousseff is slipping away, reports *Joe Leahy*

Standing on a truck on Avenida Paulista, adorned with banners calling for an end to corruption, an activist shouts a familiar refrain to thousands of protesters gathered on São Paulo's main thoroughfare: "Worse than the actions of the bad is the silence of the good!"

The demonstration in early April followed another in March in which more than 1m people took to the streets.

Popular opposition to the government of President Dilma Rousseff is increasing, provoked by the scandal at Petrobras, the state-owned oil company, in which politicians, mostly from the ruling coalition, are accused of colluding with company officials and contractors in a vast bribery scheme. Last month, the company reported R$6bn ($2bn) in losses directly related to corruption.

Underlying the anger at corruption is a slow realisation among Brazilians that the economy has ground to a halt and is slipping into recession. Economists say the slowdown is partly because of the fall in global commodity prices and the depreciation of the real against the dollar. But a series of miscalculations by Ms Rousseff's government in her first term are also to blame.

A central bank survey of economists at the end of April predicted inflation would end this year at 8.25 per cent, well above the central bank's target range of 6.5 per cent, and economic growth would decline by 1.1 per cent against a year earlier.

"The reality is that because all Latam governments are facing exchange rate depreciations and austerity, all of them are paying the price in terms of popularity levels," says Bernardo Wjuniski in the São Paulo office of Medley Global Advisors, which is owned by the FT.

For Ms Rousseff, the fallout has been harsh. As recently as March, 2013, two years into her first term in office, Ms Rousseff was one of the most popular presidents in the world. At that time, 65 per cent of Brazilians thought she was doing a good or excellent job.

In March this year, however, this situation had reversed, with 62 per cent seeing her doing a bad or terrible job and only 13 per cent as good or excellent.

Weakening support was reflected in her re-election last year by a very narrow margin. Corresponding congressional elections eroded her base, so that, where in the past her Workers' Party, the PT, had been able to command a majority, now she is being forced to share power.

Her main coalition partner, the PMDB, now controls a triumvirate of powerful positions in congress.

With the Petrobras scandal rumbling on, the PT's former treasurer Joao Vaccari Neto has been arrested and charged with corruption relating to the scandal, accusations he denies.

While Ms Rousseff was the chairman of Petrobras between 2003 and 2010 when much of the wrongdoing took place, she has not been accused of direct involvement and, in spite of pressure from the streets, few analysts believe the PMDB will call for her removal.

Many PMDB figures are also accused, including the speakers of both houses, Renan Calheiros, leader of the senate, and Eduardo Cunha, leader of the lower house. They have denied involvement.

"With unprecedented control over the Rousseff government, the PMDB — the party of both leaders of Congress and the vice-president — opposes the president's removal," Eurasia Group, a research firm said in a note.

Other commentators also counsel against the upheaval that an impeachment might bring.

With the PT's 12-year hegemony on the wane, an impeachment could spark a power struggle that could threaten Brazil's hard-won political stability, Luiz Carlos Mendonça de Barros, founder of investment house Quest and a former president of Brazil`s development bank BNDES, wrote in newspaper Valor Economico.

Rather than plunging headlong into the crisis that would be created by an impeachment, he said, Brazil should use this moment to debate what reforms are needed.

> Brazilians are beginning to realise that the economy has ground to a halt

Outspoken: Jean Wyllys says what lifted him out of poverty was 'education, quality education' — Givaldo Barbosa/Globo via Getty

Jean Wyllys Gay MP is strident voice of the new left

In 2005, Jean Wyllys became the first openly gay man to enter Brazil's *Big Brother* reality TV show. He went on to win and in 2010 he became a congressmen. Today, he is a strident voice of the new left.

"Mainstream politics has always occupied itself with issues such as the economy and international relations. Themes such as minority rights, the environment, water — these questions were considered of lesser importance," he says.

Rescued from poverty by a foundation that provided schooling to talented children from poor families, he learnt his politics in the leftist pastoral movement of the Catholic church. He went on to become a journalist and university professor in Salvador, Bahia.

Curious about the impact of programmes such as *Big Brother* on society, he entered the show's fifth Brazilian season to "study" it, he says.

The country has a very low reading rate, so such TV programmes have a big effect on how people think, he says.

Brazil's centre-left ruling Workers' party governments have created a lower middle class through better distribution of wealth and incentives to consume.

They have also provided universal access to schools, though the quality of education remains poor.

Social networks, on the other hand, are beginning to allow people to fight back with a more liberal agenda.

He says: "What lifted me out of poverty was education, quality education."

JL

Petrobras fallout and poor growth add pressure

Continued from page 1

economists say, is that Ms Rousseff now seems determined to put public finances in order after the country in 2014 suffered its first primary budget deficit — before interest payments — in more than a decade.

Her new finance minister, Joaquim Levy, a University of Chicago-trained fiscal hawk, wants a primary budget surplus of 1.2 per cent this year and about 2 per cent in 2016.

Brazil's central bank too, after years of seeing inflation drift to the top of its target band of 4.5 per cent plus or minus 2 percentage points, now believes it can hit the centre of the range.

However, even if Mr Levy succeeds on fiscal tightening, what is next for Brazil? The PT is credited with raising millions out of absolute poverty. But with the country's twin commodities and consumer booms of the past decade fading, the country needs to invest in infrastructure, education and other areas to raise falling productivity.

"Growth is eventually going to have to come from infrastructure investments and that's not going to happen until we get new rules regarding concessions as well as bringing in infrastructure players which are able to invest and able to work," says Will Landers, portfolio manager of the BlackRock LatAm Investment Trust.

Some say green shoots are appearing with the weakening of the currency to about R$3 to the dollar, compared with about R$2.20 a year earlier.

Maersk Line, the world's largest container shipping group, says it is seeing some increase in exports. And Apex, a government investment agency, says more investors are setting up research and development centres in Brazil.

Markets, however, are likely to be less tolerant of a prolonged period of sliding growth than strategic investors. If there are no signs of recovery, analysts say, the country's credit rating, which has been under pressure from the budget deficit, could again be on the line.

Success requires painful measures

Economics Creating a business-friendly climate will be tough, says *Samantha Pearson*

For Brazil's economists, 2015 will certainly be a year to forget. Latin America's biggest economy is expected to contract by more than 1 per cent this year, marking the country's worst recession in 25 years.

Meanwhile, inflation is set to end the year above 8 per cent, breaking the target range for the first time since 2003.

To add to the country's woes, the corruption scandal at state-controlled oil company Petrobras — believed to be the biggest of its kind in Brazilian history — has the potential to slow growth further and accelerate job losses.

Yet, despite the storm about to hit the country, Brazil's economists are relatively upbeat. After driving away investors with a toxic combination of unconventional policies, state intervention and a populist economic model that prioritised consumption at the expense of fiscal discipline, President Dilma Rousseff has finally begun to make amends with the markets.

With the help of her hawkish new finance minister Joaquim Levy, Ms Rousseff has introduced a series of measures over recent months to plug a hole in the fiscal accounts and safeguard the country's all-important investment-grade credit rating.

"We are predicting a 1.4 per cent contraction [of GDP in 2015] and inflation at 8.1 per cent, but this is all the result of the choices made in the past — it is not a result of what is being done now," says Silvio Campos Neto, an economist at the Tendências consultancy in São Paulo.

"Now, we are fixing what was broken over the past few years, so it's natural this will be a difficult period. But from 2016, we will slowly start to see better results — slightly lower inflation and some growth," he says.

For Ms Rousseff, this U-turn was not easy. In the run-up to the presidential elections last October, her leftist Workers' party (PT) demonised banks and private capitalism, while vowing not to cut benefits or raise taxes. This strategy won Ms Rousseff re-election, although by one of the narrowest margins in the country's history.

But ad hoc tax incentives and subsidised credit from state banks over the past few years — ostensibly to offset the effects of the eurozone crisis and slower growth in China — had scared off private investment while doing little to stimulate growth. If it had continued on this path, analysts say, Brazil risked being downgraded to junk status by rating agencies, raising borrowing costs and prompting a sharp devaluation of the already weakening currency. As so often, the country looked as though it could slip back into a post-boom crisis.

One of the first, and perhaps most important, measures to correct this trajectory and restore Brazil's credibility among investors was Ms Rousseff's decision to replace Guido Mantega with Mr Levy as finance minister last November. The Chicago-trained PhD economist and former banker is seen as Brazil's best hope of rebuilding bridges with the private sector and restoring growth.

Tendências's Mr Campos Neto also points to other newly appointed officials who have proved to be defenders of greater economic orthodoxy, such as Nelson Barbosa, minister of planning, and Marcelo Barbosa Saintive, treasury secretary. "Mr Levy has a team of people chosen by him who share his convictions," Mr Campos Neto says.

Promising a primary budget surplus this year of 1.2 per cent of GDP, Mr Levy has introduced a series of austerity measures. In December, the government announced controversial cuts to pensions and unemployment benefits and, in January, raised taxes on fuel, imports and consumer loans.

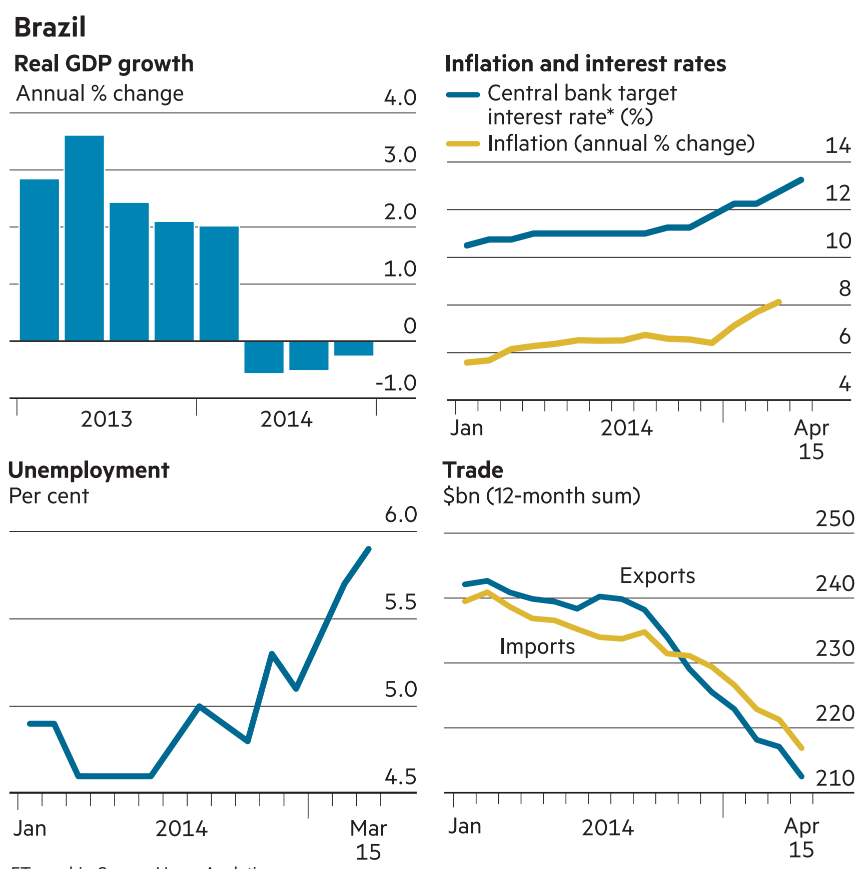
Mr Levy has also pledged to cut off government funding for the country's indebted electricity utilities and called for business-friendly reforms such as the unification of the country's interstate taxes to reduce legal uncertainties and attract investment. Meanwhile, the central bank has continued to reinforce its own autonomy by tightening monetary policy since last year's elections.

The challenge ahead, analysts say, will be to improve further the fiscal accounts without significant cuts to investment, as well as finding a way to curtail lending by public banks to remove distortions in the allocation of capital.

However, the success of Brazil's turnround rests on Ms Rousseff's resolve to see through these painful measures at the expense of voter support.

"The macro adjustment is indisputably costly from an economic, social, and political standpoint," says Alberto Ramos, head of the Latin America economic research team at Goldman Sachs' global investment research division. But he adds: "Failure to embrace the required adjustment would lead to an even costlier path."

President Dilma Rousseff: trying to execute a fiscal U-turn — Evaristo Saevaristo / AFP/Getty



FT graphic. Source: Haver Analytics

* Selic target rate

Braced for recession with no respite in sight

Markets

Asset prices are showing resilience, but investors are right to be wary, writes *Jonathan Wheatley*

Brazilian markets have come back from the brink in the past few weeks, as what looked set to be a rout across all asset classes has moderated. The currency, for example, which hit R$3.30 to the dollar in March, was — briefly — back below R$2.90 in the last week of April. Stocks have been trending up, at least in local currency terms, since February.

But this is unlikely to be the dawn of a brighter future. "It has to do with the cycle of the political crisis," says Luis Costa, currency and credit analyst at Citi Research. "Every crisis starts like this — you have a peak then another cycle. But there are still a lot of difficult battles to be fought. It is going to be tough."

The numbers are still depressed. The real opened the year at R$2.65 to the dollar and even went below R$2.60 before starting its latest slide. Four years ago, it was trading around the R$1.60 mark. The Bovespa stock index, at about 57,000 today, is up from 47,000 in late January, but down from nearly 73,000 in late 2010.

That was when many investors still believed the boom years of the 2000s were set to last. Brazil, after all, had come through the 2008-09 crisis remarkably unscathed and was riding a wave of credit-fuelled consumption helped along with government stimulus.

But since Dilma Rousseff, the current president, came to power in January 2011, the economy has steadily gone into reverse. Critics say this is partly because the conditions for sustained growth had not been put in place.

Growth over the previous decade or so had been powered in large part by a commodities boom led by China and by the floods of cheap capital provided by monetary stimulus in the US and elsewhere. As first one, then the other, ended, investors became increasingly alarmed by the interventionist policies of the Rousseff administration.

Petrobras, the government-controlled oil group that has an overbearing presence on equity and bond markets, lost as much as $20bn by some estimates as it was forced to sell petrol and other products below market prices to keep inflation in check.

Investors were also unhappy at the government's habit of picking winners among individual companies or sectors, handing out subsidised loans and tax breaks that skewed the competitive environment and did little to encourage overall improvements in productivity.

The crisis became acute with the exposure of the corruption scandal at Petrobras. But the economy's woes go deeper. President Rousseff, re-elected in October for a second four-year term from January 1, has appointed a market-friendly economics team to rescue the economy and Brazil's hard-won investment-grade credit rating.

But the policy changes brought about by Joaquim Levy, the new finance minister, are designed primarily to balance the books and are likely in the short term only to deepen what looks certain to be a recession in 2015.

As David Hensley, economist at JPMorgan, notes: "One unusual (and worrisome) feature of the Brazilian landscape is that there is no relief in the pipeline from policy."

Even as asset prices have ticked up, the economy has gone on ticking down. Unemployment, which remained remarkably low as GDP growth fell during the first Rousseff administration, has started to climb. Real wages are falling as inflation moves further beyond the 6.5 per cent upper limit of the government's tolerance band.

73,000 The level the Bovespa stock index almost reached in 2010

57,000 The approximate level of the Bovespa stock index today

It is not only that current policy is likely to worsen the short-term outlook, there is also little prospect of reforms to tackle Brazil's structural weaknesses of inflexible labour markets, a bloated public sector, bureaucracy and other brakes on productivity.

Still, the country has weathered crises before and while barriers to growth remain, there has been progress at the margins.

"The Brazilian market is cheap," says Richard Titherington, chief investment officer for emerging markets at JPMorgan Asset Management.

He adds: "Things will reverse at some point. It's too early to be optimistic, but it's also too early to write Brazil off."

History indicates the country is charting a path back to growth

GUEST COLUMN

Henrique Meirelles

To understand what is happening in Brazil, it is important to put today's facts in the context of the past few decades.

The country experienced high growth in the 1970s, leveraged by ample international liquidity. When the US Federal Reserve raised interest rates in the 1980s, Brazil, like many other countries, plunged into crisis and began the painful process of deleveraging.

At that time, the military regime opted not to make the necessary fiscal and monetary adjustments. The result was considerable fiscal and monetary expansion, which led to hyperinflation.

In 1994, Brazil finally stabilised its inflation rate with aggressive monetary policy and dollar parity. Inflationary control paved the way for growth. However, Brazil was faced with an overvalued currency due to the difference between inflation rates in Brazil and in the US, which led to a currency crisis at the end of the 1990s.

This crisis created the political conditions for a deep economic adjustment with the Law of Fiscal Responsibility and the adoption of a floating currency and inflation targets.

However, the government of former president Fernando Henrique Cardoso was weakened because of the cost of these adjustments and external crises and was unable to stabilise public debt and inflation.

Brazil began 2002 with a fragile economy and the prospect of a victory of the Workers' party (PT) — factors that contributed to a currency, inflationary and also fiscal crisis of great proportions. The PT took power in 2003 and surprised the country by appointing a conservative economic team. This team, of which I was part as president of the central bank, started the process of fiscal and monetary adjustment that made inflation fall rapidly and set public debt on a downward trend. Confidence levels rose and allowed the country to grow at high rates again, based on fiscal, monetary and credit discipline absent during the "boom" of the 1970s.

In spite of the good results, this economic policy faced strong opposition because of an interventionist macroeconomic vision, known in Brazil as "developmentalism".

This vision, which still prevails in several countries and important sectors in Latin America, consists of the belief that the state should play the main role in the economy and should stimulate growth through strong monetary and fiscal expansion, alongside price intervention. It was applied to Brazil with the election of President Dilma Rousseff in 2010. Ms Rousseff applied a "new economic matrix" that involved artificially reducing interest rates, fiscal expansionism, limiting the return rate for private investments in infrastructure and fixing petrol and electricity prices at below cost.

> Confidence in the fiscal adjustment and the return of growth is being restored

The results were the opposite of what was desired and GDP growth, which reached 7.5 per cent in 2010, started to decline, returning to the mediocre levels of the worst moments of Brazil's economic history.

Interventionism, coupled with policies that incentivised demand and consumption but neglected the supply side, reduced investment, increased inflation and created fiscal fragility, generating much uncertainty.

As such, Ms Rousseff faced great difficulties in the 2014 elections, being re-elected by a narrow margin. These difficulties led her to change her economic policy and return to the one we implemented in the past decade.

Henrique Meirelles: perspective

The president appointed a conservative finance minister for her second term, and the central bank is making efforts to achieve its inflation target. These changes should lead to an economic contraction of more than 1 per cent this year.

However, confidence in the fiscal adjustment and the return of growth is being restored. This confidence will stimulate investment and put Brazil back on a growth trajectory.

It is important to stress that Brazil managed to maintain a strong internal market that provides the scale for investments, a public debt still at a reasonable level, almost $400bn of international reserves, political stability and strong institutions.

The expansion of GDP during the next decade is likely to be moderate, but Brazil has developed the conditions to promote fiscal and labour reforms, improve the business environment, and facilitate private investments in infrastructure. These reforms will create the conditions for the country to grow again at higher rates. And if they are not completed by this government, the next one will inherit the foundations to carry them out, allowing the country to grow at rates consistent with the potential of Brazil. The political conditions are already in place.

The writer is chairman of J&F, the largest privately held Brazilian group by sales, and of Lazard Americas. He is also a former president of Brazil's central bank and former FleetBoston Corporate and Global Bank president

Time to face consequences of an unravelling political system

GUEST COLUMN

Paulo Sotero

The severity of the crisis that has engulfed Brazil in the early part of President Dilma Rousseff's second term has generated an unusual degree of candour among officials and politicians.

"State capitalism does not work well in a democracy," said finance minister Joaquim Levy after the gigantic March 15 street protests that revealed the extent of popular anger caused by the nation's reversal of fortunes, and turned Ms Rousseff into a highly unpopular and isolated leader less than six months after her re-election.

Mr Levy was referring to the part of the crisis he is in charge of fixing: the debilitating effects of large-scale state intervention in the economy during Ms Rousseff's first term. It turned fiscal surpluses into deficits, brought inflation back, compromised investors' confidence and threw the nation into a recession expected to last for a while. Mr Levy's task is probably the easier one.

Much more challenging will be how to deal with the consequences of the country's unravelling political system, brought about by revelations of huge corruption at Petrobras, the state oil company. The fact that the alleged crimes were exposed by federal judges, prosecutors and police charged with advancing the rule of law in a country once famous for the impunity of people in high places is a consolation to those who believe the scandal will bring change. Corporate governance will probably be improved.

Cleaning up Brazilian politics will be a huge endeavour. The publication in April of the much-delayed Petrobras audited balance sheets for 2014 illustrated the extent of problem. The accounts revealed total losses of nearly R$51bn ($17bn), a R$44.6bn impairment charge and R$6.2bn directly linked to corruption charges against senior managers who allegedly acted in concert with leading executives of contractors and political operators.

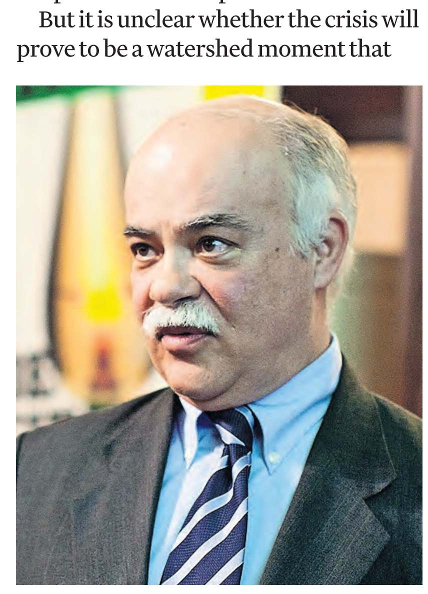
Among those implicated are the treasurer — until last month — of Ms Rousseff's Workers' party (PT) and some 50 politicians from parties of the government coalition named by prosecutors as beneficiaries of the bulk of the estimated $2bn in Petrobras resources taken under the scheme.

They include the speakers of both houses of congress, Renan Calheiros and Eduardo Cunha. Both are from the PMDB, the party formally allied with the PT that has become Ms Rousseff's biggest adversary after she disastrously tried to reduce its influence in congress.

Carlos Lupi, president of the PDT (the Democratic Labour party), a former minister of labour under Ms Rousseff and her predecessor and mentor, Luiz Inácio Lula da Silva, says the scandal "has exhausted" the PT and will change the political landscape.

> The scandal 'has exhausted' the PT and will change the landscape

But it is unclear whether the crisis will prove to be a watershed moment that will lead to a more conservative, pro-market realignment.



Paulo Sotero: testing times

The first test will come in next year's elections for mayor and city council in Brazil's 5,600 municipalities. An electoral disaster for the PT would probably sink Mr Lula da Silva's plan to come back in 2018. Predictably, the former president is undeterred. At 69, he recently shared a video on Facebook in which he can be seen pumping iron at a gym and dispensing advice on how to stay healthy and active. It was a clever attempt to dispel doubts about his physical and political health. Reality, however, may complicate Mr Lula da Silva's plan. He no longer mobilises huge crowds and avoids public places.

After suffering repeated defeats in congress, Ms Rousseff has acknowledged her own political fragility by asking vice-president Michel Temer, who leads her main coalition partner, the PMDB, to take charge of the government's political agenda.

While the PMDB is internally divided among factions headed by Mr Calheiros and Mr Cunha, the opposition is also paralysed. It is caught in the awkward position of having nominally to oppose an economic programme it actually supports and would have been implementing had it prevailed in last October's presidential race.

Former president Fernando Henrique Cardoso, who, at 83, remains the most influential voice of his party, the PSDB, even though he left office 12 years ago, has said it would be unwise to impeach Ms Rousseff. The former president sees the potential for political and ethical renewal in the courageous actions of judges and prosecutors engaged in the fight against corruption.

Mr Cardoso worries, however, about the capacity of the nation's current political elites to rise to the occasion, and wrote in a recent article: "In a moment that requires greatness, what we see is squalor in politics."

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