Can natural gas make power supply reliable?

Power interruptions make it clear that something is needed to plug the holes in Brazil’s energy matrix. Can natural gas do the job?
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5 Retail sales up, but fewer jobs created … record external current account deficit … taxes go up, vehicle sales fall … inflation crashes through target ceiling … turmoil at Petrobras: management team out, new CEO, balance sheet audit problems … Petrobras and supplier credit ratings downgraded … new Speaker of the House a Rousseff critic, new Senate president an ally … Rousseff approval ratings plunge … budget gap swelled in 2014 … Finance Minister warns of austerity … central bank policy rate hits a new high.

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Power interruptions make it clear that something is needed to plug the holes in Brazil’s energy matrix. Is natural gas the answer? Barriers to that solution are current regulations, a lack of incentives to attract new investors, questions about current contracts with Bolivia, and other complications that prevent competitive pricing of gas for consumers. With the help of experts Solange Monteiro analyzes the present situation and future prospects.

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In 2014, only 9 states of 26 complied with the Fiscal Responsibility Law limits on personnel spending as a share of net current revenue. The problems were worst in the Northeast and North, but Southeast states have different financial problems—such as daunting amounts of public debt generally. And uncertainty about how much the country will grow in 2015 and in 2016 will reduce expectations about state revenues. Solange Monteiro reports.

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20 Where does Rio go next?
Rio de Janeiro city celebrates its 450th birthday this month amid questions about what permanent gifts the World Cup, Olympics, and discovery of deep-sea oil will leave for the city. The city’s revitalization plans are ambitious but inflation above the national average is eroding local purchasing power and optimism and raising questions about sustainability. Solange Monteiro searches for answers to the problems.

INTERVIEW

22 Higher savings and investment will drive growth
Samuel Pessôa, IBRE associate researcher and economic advisor to presidential runner-up Senator Aécio Neves, talks to Solange Monteiro about economic management in the early stages of Dilma Rousseff’s second term as president. He believes that finance minister Joaquim Levy has made a good start but argues that fiscal adjustment will succeed only when Brazil addresses the external current account deficit and begins to save and invest more.
NO ONE IS NAIVE ENOUGH to believe that a simple change of economic team will instantly improve Brazil’s economy, but the new administration is making efforts to give greater transparency to government accounts and ending the accounting gimmicks that have left Brazil with a much larger public deficit than was expected. New state governors will also face difficult fiscal adjustments (p. 18). Left unchecked, the anemic economy and large public deficits would destroy Brazil’s international investment grade ratings, with obvious serious consequences.

Though Congress has yet to approve the measures announced—from abolition of tax rate breaks to reduction of pension benefits for surviving spouses, salary bonuses, and unemployment benefits—they appear to pave the way for replacing the previous policy of stimulating consumption at any cost with a policy based on increasing savings to finance investment.

But economic recovery and sustained growth will not come easily. The economic adjustments will inevitably reduce demand, and therefore production. The possibility of recession is looming, and 2015 may close with zero or negative growth. Unremitting drought and disruptions in electric power supply could make current growth projections even worse (p. 8). The external outlook will probably not help either; the fall in oil prices is not expected to boost growth in the world’s major economies. According to market projections, lower prices mean that Brazil could lose US$14 billion on such commodity exports as soybeans and iron ore.

Credit tightening is expected to get even worse, with rising interest rates and resistant inflation, undermining the purchasing power of households (p. 15). Current very low unemployment rates are unlikely to last, as household consumption and manufacturing output, which fell 3.2% in 2014, are still looking feeble.

Brazil will undoubtedly have a rough 2015. However, only when there is fiscal transparency, increased savings, lower inflation, and a healthy business environment will it be able to attract foreign investment and regain business confidence. The medicine may be bitter and the cure prolonged, but Brazil is laying the foundations for more sustainable growth and a more resilient economy.
November retail sales grew for the fourth month
Retail sales grew unexpectedly 0.9% month-on-month and 1% year-on-year in November, government statistics agency IBGE said. Analysts nevertheless expect continued weak sales well into 2015 because of slow economic growth and recent falls in consumer confidence, which fell in January by 6.7%, from 96.2% to 89.8%. (January 14)

Workers cut, fewer jobs created
In 2014 Brazil generated only 396,993 formal jobs—the fewest since 2002, according to the Ministry of Labor and Employment. Although the service sector did create 476,108 jobs in 2014, manufacturing led the losses in other sectors by eliminating 163,817 jobs. (January 23)

The total number of workers employed in industry fell by 0.4% month-on-month in November, according to statistics agency IBGE. In the first 11 months, the number of jobs in industry dropped 3.1% compared with the same period in 2013. (January 15)

Record 2014 external current account deficit
In 2014 Brazil recorded a current account deficit of US$91 billion (4.2% of GDP), its worst ever, mainly because of a steep drop in the prices of key exports and a sluggish global economy. For the second year, foreign investment in Brazil (US$61 billion) was not enough to cover the deficit. (January 23)

Consumer confidence falls in January
In January the Getulio Vargas Foundation consumer-confidence index fell by 6.7 percentage points to 89.8 points. In addition to concerns over inflation and slow growth, consumer confidence has been negatively impacted by the intensifying drought, which has raised the prospect of power cuts and electricity rationing. (January 26)

As taxes go up vehicle sales fall
Sales of autos, light commercial vehicles, trucks, and buses fell 31.4% in January compared to December and 18.8% from January 2014 last year, announced the National Association of Vehicle Manufacturers. The main reason was the end of the discount on the tax on vehicles that went into effect in May 2012. (February 5)

Inflation shoots up
The official consumer price index rose 1.24% in January—the highest monthly rise since February 2003. Year-on-year inflation through January rose 7.14%, far above the government’s target ceiling of 6.5%. Electricity rates and bus fares, among the biggest drivers of the rise, jumped 8%. Food prices rose by 1.48%, driven by a severe drought. (February 6)

Budget gap swelled in 2014
For 2014 the consolidated public primary budget deficit (excluding interest payments on public debt) was of R$32.5 billion (US$13.76 billion), equal to 0.63% of GDP, the central bank said. That was the first annual deficit since 2001 and a steep drop from 2013’s R$91.3 billion surplus (1.93% of GDP). The Rousseff administration originally targeted a primary surplus equivalent to 1.9% of GDP but abandoned that target as tax revenues dwindled and public spending surged ahead of the October election. The results were much worse than the already grim estimates of investors and ratings agencies. (January 29)

Finance Minister warns of austerity
Brazil is in for a period of austerity and supply side reform, notably the potentially controversial overhaul of social welfare programs, such as unemployment benefits, Joaquim Levy, the new finance minister, said to a Financial Times interviewer at the World Economic Forum in Davos. To rationalize government finances, he said, the administration intends to “get rid of subsidies and get prices right,” highlighting “energy and other areas” as potential targets. Levy added that a period of austerity might mean that “Flat growth cannot be discarded as a possibility although GDP growth in Brazil is resilient.” (January 22)

New peak for Central Bank policy rate
At its January meeting the central bank lifted its policy interest rate by 50 basis points, to 12.25%, the highest rate in more than three years, thus extending a monetary tightening cycle that began 3 days after President Dilma Rousseff was re-elected in October. (January 22)
Turmoil at Petrobras

Managing team resigns: Petrobras chief executive Maria das Graças Silva Foster and five other executives have resigned over the corruption scandal; Graças Foster has also resigned from the board. The departures mark another scene in the drama that has crippled Petrobras. None of those who resigned have been targeted by prosecutors.

New CEO appointed: Aldemir Bendine, currently chief executive of state-owned Banco do Brasil, will replace Graças Foster as Petrobras CEO. Bendine, 51, has spent more than 30 years at Banco do Brasil, rising to CEO in 2009. Investors reacted negatively to the news that Mr. Bendine would be the next CEO of the company, sending Petrobras shares down as much as 7.8% in recent trading in São Paulo. Bendine is perceived as too close to the government. (February 6)

Balance sheet problems: Petrobras last week released its financial results for the third quarter ended September but was unable to quantify the extent of the losses from corruption, disappointing markets. External auditor PricewaterhouseCoopers has refused to sign the accounts until there is more clarity on the financial impact of the scandal. (February 4)

Petrobras ratings downgraded

The kickback-corruption scandal has led Moody’s Investors Service to downgrade the rating on unsecured Petrobras debt from Baa2 to Baa3, the lowest investment grade, and to keep it on review for further downgrade. (January 29)

Shortly after, Fitch Ratings downgraded Petrobras ratings for foreign and local currency issuer default and outstanding debt from BBB to BBB—and has placed all Petrobras ratings on Rating Watch Negative. (February 3)

Rousseff critic elected Speaker of the House

In a setback for the ruling Workers’ Party (PT) that split the coalition of President Dilma Rousseff and will complicate her legislative agenda, the Chamber of Deputies elected conservative Eduardo Cunha as speaker. Cunha belongs to Brazil’s largest party, the PMDB, Rousseff’s main ally in the governing coalition. The new speaker, a 56-year-old economist of the Evangelical faith, is known for doggedly representing the interests of lobbying groups in negotiating legislative proposals, which has often put him at odds with Rousseff’s policies.

Earlier on the same day, the Senate re-elected a loyal Rousseff ally, Renan Calheiros of the PMDB party, as president. Calheiros and Cunha will preside over a more fractious Congress with 28 parties, fewer members representing labor and environmental interests, and more Christian conservatives and farm lobby representatives. (February 1)

President’s approval rating plunges

Dilma Rousseff’s approval rating has fallen to a record low. Responding to a Datafolha survey, 23% said the Rousseff administration was “excellent or good,” compared with 42% in the December poll. The rating was the lowest for a Brazilian president since 1999, when Fernando Henrique Cardoso had the job. The drop in approval appears to be based on both the Petrobras scandal and the failure of Brazil’s economy to regain traction. Stagnation is expected for the economy and inflation is at nearly 7%, above the tolerance band of 2.5–6.5%. (February 8)
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Can natural gas make power supply reliable?

Power interruptions make it clear that something is needed to plug the holes in Brazil’s energy matrix. Can natural gas do the job?

Solange Monteiro

BRAZILIANS STARTED the year paying more for less electricity. Interruptions in electric power have become depressingly routine in São Paulo city and elsewhere. Due to the power failure that struck 11 states and the capital, Brasilia, on January 19, the country again does not have enough electricity to support domestic demand, which rose 3.5% in 2014—far above GDP growth. The prolonged drought has reduced water reservoirs to a historic low, cutting hydropower supply to the point that even household faucets dried up in São Paulo.
One possible long-term solution for the recurring drains on energy may be natural gas. In recent years, the trends have been contradictory: while new hydroelectric plants have relatively small reservoirs and are thus much more dependent on rainfall, thermal power plants have multiplied, consuming more natural gas. However, thermal power plants supply only peak load, not base load, electricity, which makes contracts for gas supply more expensive. “The use of thermal as emergency power does not encourage investors to look into gas as an alternative for producing electric power,” says Marcos Tavares, managing partner of consultant Gas Energy.

Demand for electric power could well become a major stimulus for the expansion of the gas market, using gas reserves related to deep sea oil. Ernst & Young has pointed out that, with the help of deep sea gas, Brazilian natural gas production could double by 2020. When it peaks in 2024, the Libra block alone will produce 40 million cubic meters a day. This volume is comparable to what all blocks together produce today (about 47 million cubic meters a day). However, experts warn of many uncertainties about when and how much of this potential can be realized. If successful, the country would follow the global trend of gas taking a larger role in energy consumption. The global share today is about 22%, compared to 12% in Brazil, stimulated mainly by exploration of shale gas in the US, new discoveries in Australia, and heightened production in Africa and Asia.

“The use of thermal as emergency power does not encourage investors to look into gas as an alternative for producing electric power.”

Marcos Tavares

For this to happen in Brazil, however, it will not be enough to ensure production of deep sea gas. Among barriers on the road to a strong gas market are current regulations, a lack of incentives to attract new investors, and complications that prevent competitive pricing of gas for consumers.
Brazil's consumption of natural gas
(Millions of cubic meters per day)

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¹ Industry and commerce.
² Input in refineries, fertilizer plants and industries.
³ Oil refineries’ consumption.

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The oil shadow

Edmar Almeida, coordinator of the Energy Economics Group (GEE) of the Federal University of Rio de Janeiro, points out that lack of a comprehensive policy for natural gas owes much to the fact that most gas production is associated with the oil in offshore drilling. “In this case gas has been regarded as a byproduct—more a problem than a marketable product,” he says. “Today Brazilian gas production adds up to only about 20% of oil production, in terms of equivalent barrels. It is the smallest amount among all oil-producing countries.”

Both supply and demand for gas have been irregular. Even though the share of gas in Brazil’s energy mix tripled from 4% to 12% between 1999 and 2014, GEE’s Marcelo Colomer points out that this happened despite frequent changes in public goals. “Initially, policy focused on supplying gas to industry. Then in 2004 it changed to giving priority to the construction of thermal electric power plants to reduce the risks related to hydropower plants. In 2004, with the prospect of reduced consumption of thermal power, state oil company Petrobras launched a program to stimulate industrial, residential, and automotive consumption of gas,” he says. Gas consumption did increase, but since 2007 so did thermal power and changes in gas contracts with Bolivia resulted in large gas imports and higher prices. “At that time, there was frustration among industrialists—they had converted production to gas expecting an abundant and cheap gas supply that would
improve their competitiveness,” said Cristiano Prado, manager of Industrial Competitiveness and Investment of the Federation of Industries of Rio de Janeiro.

Lucien Belmonte, superintendent of the Brazilian Association of the Glass Industry, says that conversion to gas in that industry was 100%.”The most striking case was the factory that the Japanese AGC built. Between the time of the announcement of the factory construction, in 2011 and the start of operations in 2013, the gas price increased by 42%. In that kind of situation how can anyone make a business plan?” he asks. The result? More imports of glass products, Belmonte says—"perfume bottles from Mexico, enamel glasses from India, and car windshields from China.” He points out that “At the time, the gas price was US$8 per million of BTUs; today it is US$15; and we also have competition from US shale gas at US$4.”

**Vertical concentration**

Among analysts and players in the gas market, there is a consensus on the need to attune gas market regulations to electric power needs; review the pricing policy that makes Brazilian gas expensive; and take a hard look at gas production, which today is vertically concentrated in state oil company Petrobras. The company is responsible for 81% of gas production, owns virtually all marketing operations and transportation pipelines, and has shares in several distributors. “We cannot operate in the gas supply chain without having to go through Petrobras,” Tavares says. He recalls that the Gas Law of 2009 was intended to decentralize the gas sector, but it needs supporting regulation before it can really go into effect. Major improvement has occurred in gas transport since a 2014 regulation prohibited companies controlled by the same group to own both the gas and the pipeline. But gas transport will change only gradually because concession agreements for Petrobras pipelines will not expire until 2018.

**With the help of deep sea oil,**

Brazilian natural gas production could double by 2020. When it peaks in 2024, the Libra block alone will produce 40 million cubic meters a day.

Transformation
Gasification terminal for liquefied natural gas (LNG) of state-oil company Petrobras in Rio de Janeiro state has handled the increased LNG imports.
“Today Brazilian gas production adds up to only about 20% of oil production, in terms of equivalent barrels. It is the smallest amount among all oil-producing countries.”

Edmar Almeida

To date, major advances have come about only through high-stakes projects. In the last energy auction late in 2014, for example, Bolognesi Energy acquired two gas-fired thermal power plants, in Rio Grande do Sul state and Pernambuco state, each with a capacity of 1.2 GW and with investments in two liquid natural gas (LNG) terminals and a 311 km pipeline that would connect the gas terminal port of Rio Grande to the Triunfo petrochemical complex. Another project under study, eagerly awaited by the market, is Route 4, a private pipeline (the first) that would take deep sea gas into the Santos Basin and distribute it in the São Paulo metropolitan area. The main project proponent is Cosan, a shareholder of Comgás gas distributor. “Our estimate is that this pipeline will carry about 20 million cubic meters a day, more than the total consumption of São Paulo state in 2014, which was 17.2 million,” says João Carlos de Souza Meirelles, São Paulo state energy secretary. Today São Paulo state consumes more than a third of all natural gas sold in the country. With only two gas-fired power plants in Cubatão and Piratininga, Meirelles says, São Paulo is supporting industrial consumption and cogeneration, especially for projects in malls and corporate buildings, and more residents are using gas for water heating.

Ieda Gomes, consultant to FGV Energy, underlines the importance of expanding the supply of gas: “Brazil is increasingly dependent on imported LNG, which has low prices now but at times has cost 50% more than Brazil’s own gas and gas imported from Bolivia.” Currently, about half the gas consumed in the country is imported.

Potential gross production of natural gas in the deep-sea oil fields

(Millions of cubic meters per day)

She also points out that the future of the gas supply from Bolivia is uncertain; the contract will be renegotiated in 2019. Investment in gas exploration in Brazil has been low, and Bolivia’s gas reserves have fallen by at least half since 1999. “To stimulate national gas production,” she says, “it is necessary to ensure conditions for investors to negotiate securely and have a tax system that is compatible with the difficulty and size of the project, so as to reduce market risk.”

Joisa Campanher Dutra, of the FGV Center for Regulation and Infrastructure Studies (Ceri), highlights the need to also encourage gas production on land: “Geological studies of gas reserves on land are expensive, so we have few. However, think about how Colombia has encouraged exploration. It grants the right to operate to increase information about gas reserves, in exchange for a simplified procedure for signature bonuses and sharing gas production.” She points out that investors in onshore areas can be smaller, which could attract new companies to the gas market.

**Cloudy without rain**

Prospects for efforts to carry out gas projects are grim, Petrobras is still the great locomotive of the sector, but its current investment capacity is limited. Adriano Pires, director of the Brazilian Center for Infrastructure (CBIE), believes, however, that low oil prices and the electric power crisis may offer a unique opportunity for the gas sector. “In the current situation,” he says, “I think Petrobras will have to review its investment plans and necessarily divest. In that case, it should sell assets that are not its core business,” Pires says, suggesting that Petrobras should sell its shares in gas distribution companies, pipelines, and regasification units.

In a paper commissioned by the Brazilian Association of Large Industrial Energy Consumers and Free Consumers (Embrace), Gas Energy estimated in 2013 that the Petrobras transportation assets, pipelines totaling 11,000 km, would be valued between R$12 billion and

**Brazil’s demand for imported natural gas increases**

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<td>2014</td>
<td>3,827</td>
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*Source: Ministry of Development, Industry and Commerce.*

Gas consumed by Brazilians

- **48%** are supplied domestically
- **33%** are imported from Bolivia
- **19%** are imports of LNG

*Source: Ministry of Mining and Energy.*
Among barriers on the road to a strong gas market are current regulations, a lack of incentives to attract new investors, and complications that prevent competitive pricing of gas for consumers.

R$20 billion. Taveres believes that selling those assets to finance investments in deep sea oil would be an efficient use of Petrobras resources.

Heron Miguens, executive director of the Ernst & Young Center for Energy and Natural Resources (EY), observes that what the history of other countries teaches is that opening markets and reducing concentration brought investment and increased demand, which can be an opportunity to develop a more balanced gas market.

CBIE’s Pires also points out that low international oil prices, which guide the price of LNG, can be an ally in this time of transition, allowing gas to be imported in the short term while tidying up the house. To expand imports of LNG, he argues for Petrobras to divest its gasification assets, which today have idle capacity, and its transport facilities. Miguens believes low international gas prices will also promote use of gas by industry. He also argues for reviewing what he calls the “tax cascade” on gas. He points out that each step of the gas supply chain pays value-added tax, adding to the cost to the consumer.

Lavinia Hollanda, FGV Energy research coordinator, points out that in the next five years the outlook for gas will change little, “which does not reduce the importance of planning the coming decades,” she says. “Today the gas market is almost a blank page,” Pires adds. “There’s work for everyone to do: state regulators, market players. If everyone does their share, in the end the result will be a country where gas has a more important role than it has now. It will be the era of natural gas. Gas may be a fossil fuel, but it is the cleanest fossil fuel. Brazil cannot remain on the sidelines of this transformation.”

International prices of natural gas
(US dollars per million BTU)

Source: FGV Enerov and EIU. June 2014.
Is there an upside to tighter credit?

Cristina Alves

RECENT INCREASES in the central bank policy interest rate, the National Development Bank loan rate, and the tax on financial transactions (IOF) should have little effect on the credit market, which has been sluggish for months. However, the measures may pave the way for replacing the current policy of stimulating consumption by one based on encouraging investment.

So far, the government has favored “national champions.” That policy, says new finance minister Joaquim Levy, will end. The national champions policy, “would provide subsidized credit for companies to take over infrastructure concessions [to make up for] low tariffs,” says José Júlio Senna of the Getulio Vargas Foundation Monetary Studies Center of the Brazilian Institute of Economics (IBRE).

The rise in the IOF from 1.5% to 3% should improve tax revenue but will have little effect on credit. As for the other increases, household demand for new loans has been dropping, reflecting low consumer confidence. At the same time, given the uncertainties of the economic outlook, banks have been lending less. Senna points out that “When a bank does not want to lend, it increases the spread [between the interest rates on lending and deposits], which has been happening.”
According to the Central Bank, the spread on consumer loans rose more than 2 percentage points between June 2013 and November 2014—from 16.2% to 18.9%—and the spread on loans to companies rose from 6.8% to 7.6%.

The volume of credit granted has also slowed significantly. In November 2014, bank credit to companies was R$143 billion, down from R$186 billion and to households was R$165 billion, down from R$172 billion in December 2013. Throughout 2014, despite government efforts to unlock it, bank credit dwindled, and loan maturities shortened. When the threat of rising inflation, especially in the second half of 2014, forced the government to tighten its credit policy, the credit market itself was already adjusting.

Steep drop
The market adjustment is clear from the 10% drop in National Development Bank (BNDES) loans to industry and agriculture in the first 11 months of 2014. BNDES approval of new loans dropped by 34% (R$44.8 billion) for industry, 9% (R$14.8 billion) for agriculture, and 11% (R$47.9 billion) for trade and services.

Conditions for the BNDES program to support investment have also been revised. Depending on the industry, the bank’s financing share of a project dropped from 100% to 50–70%. Interest rates also went up. Interest on loans to buy buses and trucks, for example, increased from 6% to 10% for large companies and to 9.5% for small and medium companies; and interest on loans for capital goods investments increased from 6% to 9.5% for large companies and 4.5% to 7% for small and medium companies. The bank also raised its long-term annual interest rate from 5% to 5.5%—the first increase since April 2003.

Sarah Bretones, an economist at MCM Consulting, estimates that there was nominal credit growth of about 4.5% in 2014. For 2015, however, she foresees very modest growth, only about 1%. She agrees that increasing the IOF to 3% should raise bank spreads. “Households are more cautious about taking out a mortgage,” she says.

Difficult times
Analysts recognize that the government’s restrictive measures come at a time when the economy is feeble—incomes are growing less and unemployment is expected to increase.

Paulo Francini, director, Department of Research and Economic Studies, Federation of São Paulo State Industries (FIESP), points out that a recent FIESP survey found that 130,000 manufacturing jobs were lost in São Paulo in 2014. “The outlook is bad. The [federal government] announcement of new measures is aimed at reducing inflation. Today we cannot know exactly how these tightening measures will affect companies, many of which are already struggling,” he says, noting that the FIESP survey in 500 industries learned that 80% of the companies surveyed do not plan to hire in the first half of 2015.

Francini expects that GDP will decline by 0.13% this year. “The situation is discouraging. For private investment to take off again, we must have confidence in the fundamentals of the economy,” he says, adding that doubts about what will happen to Brazil’s risk rating, worsening of the water crisis, and risks of power supply
Throughout 2014, despite government efforts to unlock it, bank credit dwindled, and loan maturities shortened. When the threat of rising inflation, especially in the second half of 2014, forced the government to tighten its credit policy, the market itself was already adjusting.

Santacreu also fears the consequences of the corruption investigations at the state-owned oil company Petrobras on the balance sheets of the many banks that have lent to Petrobras suppliers.

Asked about the tightening of credit, Nicola Tingas, chief economist, National Association of Credit, Finance and Investment Institutions, comments that “It was necessary to stop the deterioration of public finances. Later, we will see a credible recovery framework. And finally,” he predicts, “in the second half of 2015 or in 2016, the economy will be able to begin to expand again. However, he also warns that it will be crucial to find solutions to Brazil’s electric power and water supply problems, because if they persist they certainly will affect GDP growth and investments in electricity. One alternative, he suggests, is to encourage investments in other power sources, such as wind power.
States must tighten their belts, too

Solange Monteiro

THE ROUSSEFF ADMINISTRATION is not alone in facing a difficult fiscal adjustment. So do the new state governors that start their mandates this year. In 2014, most states raised personnel spending past the danger threshold defined in the Fiscal Responsibility Law (LRF). Moreover, the fiscal primary balances of all Brazilian states and the main municipalities were negative.

In 2014, only 9 states of 26 complied with the LRF limits on personnel spending as a share of net current revenue. Six states and the Federal District entered the alert system with personnel expenses exceeding 44.1% of the net current revenue; seven other states reached the prudential limit with personnel expenses equal to or greater than 46.5%; and four of those exceeded the LRF ceiling of 49%. The problems were worst in the Northeast and North, with Tocantins, Piauí, Alagoas, and Sergipe states exceeding 50%. Compared to 2010, the number of states that reached the prudential limit and beyond more than doubled, from 5 to 11. “In general, the deterioration of state finances results from a failure to fully assess the risk of hiring more personnel and raising wages, and from a significant drop in revenues,” says Gabriel Leal de Barros, IBRE researcher.

Although the Southeast states have not breached personnel spending limits, Barros points out that Minas Gerais, São Paulo, and Rio de Janeiro states still must reduce their high public debt. Last year, the ratio of public debt to net revenue was 167% in Minas Gerais, 154% in São Paulo, and 130% in Rio de Janeiro. Moreover, the debt of Rio Grande do Sul state, now 204.7% of current revenue, has always been above the Fiscal Responsibility Law ceiling of 100%. In other regions, the only state ratio that was above 100% ceiling was Alagoas, at 142%. “South and Southeast states hold too much debt; furthermore, the Southeast had the highest fiscal primary balance deficit in 2014,” says Barros. He points out that the uncertainty about how much the country will grow in 2015 and in 2016 will reduce expectations about state revenues. In Rio de Janeiro state, for example, authorities are discussing cuts in spending because 2014 tax revenues from consumption of goods and services were lower than expected in 2014, forcing a downward revision of likely 2015 tax revenues.
One factor that should benefit state economies is the change on the interest rate on state and municipal debt owed to federal government that was approved last November. The annual interest rate is no longer based on the IGP-DI price index plus 6–9%. It was replaced by the Central Bank policy rate or IPCA price index plus 4%, whichever is smaller. The change was also retroactive to contracts signed as of January 2013. The federal government may authorize restructuring of older state debt based on the central bank policy rate. Barros believes that, although that would bring relief for several states, excessive restructuring of old debt can send a bad signal. “Even in difficult times, some states have managed to reduce their debt, proving that it can be done,” he says. “The restructuring could be a negative signal to the market, weakening the Fiscal Responsibility Law, which is important for the country’s fiscal stability. Every rule change made in this way creates legal uncertainty and is unfair to states that have struggled to make the necessary fiscal adjustments.”

“The deterioration of state finances results from a lack of assessment of the risk of hiring more personnel and raising wages, and a significant drop in revenues.”

Gabriel Leal de Barros

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**RISK ZONE**

**Most states have raised personnel spending past the danger threshold defined in the Fiscal Responsibility Law.**

(% of net current revenues)

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<th>On alert</th>
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Where does Rio go next?

Solange Monteiro

RIO DE JANEIRO city celebrates its 450th birthday this month amid questions about what permanent gifts the World Cup, Olympics, and discovery of deep-sea oil will leave for the city. Between announcements of huge investments and ambitious revitalization plans on the one hand and inflation above the national average eroding the purchasing power and optimism of both locals and visitors from other countries on the other, there are many questions about how sustainable the recovery of the economy of Rio de Janeiro is.

Mauro Osório, professor of political economy of the Law School of the Federal University of Rio de Janeiro, believes that so far Rio’s path will not end in a virtuous economic circle. “There have been advances, but I still do not see the consolidation of a new era for Rio, either the city or the state,” he says.

The data confirm the inconsistency. Between 2003 and 2013, the average wage adjusted for inflation grew 40.3% in metro Rio de Janeiro, well above the 29.6% average for the six major metropolitan areas, according to the Brazilian Institute of Geography and Statistics. In contrast, employment in Rio has increased less than the national average. “Rio de Janeiro is one of the places in Brazil where income inequality has declined least. Income grew there because of high wages paid by the oil and gas sector,” Osório says.

The announcement by state-owned oil company Petrobras that it will cut investments by 25% this...
year will certainly have a major impact on the economy of Rio de Janeiro state.

Osório believes that for Rio a necessary change is a clean break with the old ways of doing things and a move to more planning, transparency, and above all integration between state and municipal administrations.

To illustrate, Osório points out that the periphery of metro Rio consists of dormitory suburbs. Today most manufacturing jobs (199,000) are concentrated within the city, forcing large number of workers to commute between suburbs and work. This impairs the quality of life for residents as it increases the average commuting time between home and work, he says.

Osório argues that companies need to see more investment in infrastructure and governance. “The Metropolitan Arch—the highway designed to connect the five main highways that cross the municipality of Rio de Janeiro—is a breakthrough,” he says, “but cities need other infrastructure as well. Recently a businessman told me that he was thinking of moving his factory from the suburbs of Rio because of the irregular supply of electricity and internet.” Other areas lack regular bus lines.

Osório also pointed out the need for planning that encourages urban densification along the Metropolitan Arch corridor to facilitate transport of people and cargo: “The Rio metropolitan area has the advantage of having a large green area and unoccupied land. However, if there is no urban zoning, we will soon have to deal with disorderly land occupation.” To promote metropolitan integration and more targeted urban policies, in August the state government created the Metropolitan Integration Chamber of the Government of Rio de Janeiro.

At the state level, Osório called for policies to build up sectors that could diversify the Rio de Janeiro economy. “We offer seven times more jobs than the Espírito Santo state, but there agriculture absorbs 300,000 jobs, against 150,000 in Rio. We could encourage small farms to meet the local consumer market,” he suggests. He also believes that in addition to the oil and gas sector, other hubs such as health care should be encouraged. That would take advantage of such local factors as a significant share of the national pharmaceutical industry (12%), and a well-developed research center, Fiocruz. “Health and defense are sectors that have potential and can generate transfer or development of technology,” he says.

Tourism is another underdeveloped sector. Food and hospitality sectors in such tourist cities as Cabo Frio and Petropolis in Rio de Janeiro state could employ many more people. Osório cites the example of Rio Grande do Sul state, where partnerships between municipalities have created products and services to convince tourists to extend their length of stay. Rio de Janeiro state, he says, is well known for its touristic potential, and building up tourism “could have great results.” Finally, he believes the Port of Itaguai container terminal and Açu Port could change the face of the region.
The Brazilian Economy

In January, after the first fiscal adjustment measures, the new economic team was confronted by a rapid deterioration of growth expectations. How does this affect Finance Minister Joaquim Levy’s management of the economy?

Samuel Pessôa—I think that the measures were not only well received but also correct, and...
the minister has managed to convince society of the need for fiscal adjustment. Even the unions, which were hurt by cuts in unemployment insurance and pensions for surviving spouses, have demonstrated that they are willing to talk compensatory measures. Now, when we speak about public finances, there are two questions that still must be taken into account. One is whether the fiscal adjustment is sufficient to fight inflation, which is a serious problem in Brazil today. The other is whether the adjustment is enough to keep public finances sustainable, that is, whether the fiscal primary balance surplus (fiscal balance less interest payments) is high enough to ensure that public debt will plateau and ultimately decline. Because the fiscal deficit was bigger than was expected, it will take a bigger effort to bring down public debt. The primary balance surplus will have to be bigger. Because we have already had a lot of bad news, the risk that Brazil will lose its international investment grade has gone up.

As for controlling inflation, what matters is the variation in the primary balance. The bad news showed that last year’s fiscal primary balance was far worse than we imagined. If we can reach the projected improvement in the primary balance, a surplus of 1.2% of GDP, the fiscal effort will support monetary policy to curb inflation. Even if the surplus is a little less than 1.2%, the variation will be enough to help curb inflation.

The market, which is currently looking closely at the fiscal adjustment, has already accepted that this year inflation will be above the target and is probably already working with projected inflation of 7.5%.

The worsening expectations about inflation, mainly driven by increases in electricity rates, seem to have ruled out the possibility that inflation will converge to the 4.5% target in 2016. Is it likely that confidence will recover later this year? The market, which is currently looking closely at the fiscal adjustment, has already accepted that this year inflation will be above the target and is probably already working with projected inflation of 7.5%. We must simply forget the idea of 4.5% inflation in 2016. The market does not see as a problem the fact that inflation may at best reach 4.5% in 2017.

The real question is whether the fiscal adjustment will be sufficient to reorganize the economy as a whole. I don’t think so. The fiscal effort would have to be much higher to address the large external current
account deficit. Last year, that deficit was US$90 billion, and this year it is likely to be US$80 billion. Inflows of foreign direct investment—FDI—are about US$55 billion, which means that for now we do not need much more in short-term capital inflows to close the external financing gap. But continuing anemic growth will eventually drive away FDI. Minister Levy’s strategy addresses the fiscal sustainability issue but not the large external current account deficit. That will be addressed only when the world stops financing our external current account, which will trigger an overshooting of the exchange rate, followed by stronger corrective inflation and further domestic price adjustments.

Does the market’s concern with the fiscal surplus indicate that in an economy with low savings, inflation will always be higher than desired?

The low-savings model implies that we will have high real interest rates all the time, though not necessarily high inflation all the time. Correcting imbalances created in the past will require high inflation for a short period of time. One of the fiscal imbalances to be corrected relates to correction of controlled prices, which will heighten inflation. This is only part of the adjustment; it will also be necessary to reduce wages. Today the external current account deficit is large, US$90 billion, because consumption is high. As a consequence savings and investment are low. Increasing savings will require cutting wages, there’s no way out. There are two ways to reduce wages: you can do as Europe has done, increase unemployment to 20%, or you can steeply devalue the exchange rate. Devaluing the exchange rate will reduce the purchasing power of wages, increasing savings and reducing the external current account deficit.

This will only happen when the world stops financing our external current account. When it does, the exchange rate will go up, generating the process I have described. We are moving in this direction, though I do not know whether it will happen this year or next.
In his inaugural speech, Minister Levy signaled the end of stimulus measures for industry. What support can the government offer ailing industry? The best support we can give industry is a stable economic environment. We have tried a lot of policies to save industry, and these policies have lowered growth; at the end of the day we are worse off. The government granted a lot of tax exemptions to support industry that have undermined fiscal sustainability. As a result, it became more expensive to borrow abroad. We also risk losing Brazil’s international investment grade rating.

The policies to support industry did not work because they helped with one hand and messed up with the other, causing economic disruption. I believe industry should ask the government for a stable macroeconomic framework—which requires a quality macro policy. This would be better than the vast experimentalism we had in the last six years, which generated burdens rather than generating bonuses. … I do not know of any research showing that those policies worked. Reducing taxes is good, but only when there is fiscal space to do so. Reducing taxes without fiscal space brings only problems.

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The market was not pleased with the appointment of Aldemir Bendine as CEO of Petrobras. It sees him as too close to the government. What is your opinion?

Petrobras has a serious problem: it has four months to submit its audited accounts. If Petrobras fails to do so, the consequences will be disastrous. Will the appointment of Bendine help Petrobras deal with its auditors, PricewaterhouseCoopers? It is difficult to say. The impression is that it will not. Despite all his merits, the new CEO is not from the oil industry and does not seem to have the necessary independence to facilitate negotiations with the auditors and get them to sign off on the Petrobras accounts.

Petrobras has debts that have acceleration clauses. This means that if the terms are not met, they fall due immediately regardless of whether they were scheduled to mature in one, two, five, or ten years. And one of the requirements to prevent acceleration is to publish audited accounts. So Petrobras has only until June to submit an audited
Petrobras has debts that have acceleration clauses. … If the terms are not met, they fall due immediately regardless of whether they were scheduled to mature in one, two, five, or ten years. And one of the requirements to prevent acceleration is to publish audited accounts.

Are the recent increases in interest rates and taxes a concrete sign that policy is changing from boosting consumption to encouraging investment?

Investment depends on many things. One is savings. We need to raise the country’s savings—the current 13.5% of GDP is ridiculous. We are a middle-income country, and we cannot grow with that level of savings. All recent policy measures indicate that there is emerging an understanding that we have to increase the country’s savings, primarily public savings, and that depends on fiscal adjustment. Increasing the fiscal primary balance surplus will also help. More savings reduce the cost of capital and encourage investment. But to encourage investment we also need better regulation and a better tax system.

If the government is successful in carrying out the adjustment, what will drive growth in 2016?

It will have to be investment. If our projections are correct, for 2014 and 2015 there will be a cumulative decline of 14% in investment. After that, investment will have to go up again. My sense is that a better-organized economy with corrected prices will raise productivity a bit in 2016 already. This will be a new investment cycle that will boost growth.
FGV’s Brazilian Institute of Economics carries out economic research and analysis, stimulating the growth of public and private businesses across the country. The Institute’s statistics forecast principal short-term economic trends, serving as an excellent tool for planning and strategic decision-making.