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Marco Stefanini
CEO Stefanini Group



THE BRAZILIAN ECONOMY

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At the peak of UNCERTAINTY

The worsening political crisis raises more doubts about whether the Brazilian economy can pull through.

FGV IBRE

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THE BRAZILIAN ECONOMY

Economy, politics, and policy issues

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Cover Story

8 At the peak of uncertainty



Though the economic news is getting worse, what's happening on the political front is even more disheartening. The speaker of the House is moving forward on the impeachment of the president even as he is being barraged by corruption charges. Without a clear horizon for resolving the fiscal crisis and with confidence in political leaders plummeting, anticipating how this year will end and what will happen next year is becoming deeply complicated. Solange Monteiro reports on what the experts have to say, and professor Octavio Amorim suggests possible scenarios for what the impeachment proceedings might produce.

Argentina

15 Turning the page

The election of Mauricio Macri to lead Argentina as of December 10 puts an end to 12 years of Kirchner dominance of the country's politics and to the exhausted economic policies of outgoing President Cristina Kirchner. The new president will have a lot to deal with, such as a substantial primary fiscal deficit, and a 30% tax burden as Solange Monteiro reports, but there is also considerable hope that these can be dealt with and that, among other things, Argentina's relationship with Brazil can be normalized.

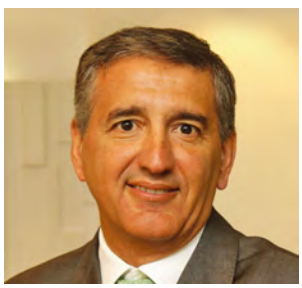
Logistics

23 Brazilian railway concessions: Risks and returns

Previous recent government efforts to attract private investors to combat Brazil's shortage of railways have so far not been fruitful. VALEC, the state-owned enterprise created a few years ago to manage the railway cargo market, is far too costly and far from efficient. Now that and other options to make the railways more effective, such as institution of the short lines (feeders to main lines) that have proved useful in other countries, are again being considered. Three FGV specialists discuss how concessions should be structured to align the risks concessionaires face with the opportunity for reasonable returns.

Interview

25 "2016: As difficult as 2015, or worse"



Marco Stefanini, the CEO of the Stefanini Group, an information technology services company that operates in 35 countries, talks with Solange Monteiro about the differences between what it takes to do business in other countries and in Brazil. Among other topics, he also discusses why IT companies have less trouble finding qualified employees than some other industries do, his company's long-term vision, and the ramifications of changes in the exchange rate for businesses in Brazil.

Editors' Note

ACCEPTANCE BY THE SPEAKER OF the House in early December of the request to start proceedings to impeach President Rousseff is a further jolt to the battered Brazilian economy. If at first the market seemed to respond favorably to the news, since regardless of the outcome impeachment proceedings could bring the country out of its current political paralysis and economic stagnation, the proceedings also carry the risk that as they drag on, expectations might worsen. The already turbulent political situation was further roiled in the second week of December with publication of a letter from Vice President Michel Temer to embattled President Dilma Rousseff, in which Temer accuses the president of having no confidence in him or his party, the PMDB. This is a serious accusation: the PMDB is the biggest party in both houses of Brazil's Congress and the president's main ally in the coalition supporting the government.

It is the general expectation that in coming months, the news about the Brazilian economy will be very bad. Unemployment has been rising for some time, the economy is expected to contract by 3.6% this year and 3% in 2016, according to the projections of the Brazilian Institute of Economics, and for 2015 inflation will exceed 10%. The fiscal situation of the country itself is dire. Interestingly, as yet there has not been a steep drop in workers' incomes—in other words, the crisis has not yet reached the pockets of consumers, especially the pockets of lower-income consumers. Through September, the services sector, which accounts for 68% of all job openings, was still hiring more people than it was releasing. According to IBRE research, this will begin to change in the first quarter of 2016 and worker's incomes will begin to fall.

With all this uncertainty, aggravated by the involvement of politicians in the huge corruption scheme at the state oil company Petrobras, in this month's interview Marco Stefanini, CEO of Stefanini Group, believes that 2016 will be as difficult as 2015, if not worse. He does not expect any change in the country's current predicament until the political deadlock is resolved and confidence in the country returns. Until that happens, Brazil will remain paralyzed, and any conjecture about the future is futile.



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POLITICS

Vetoes on spending bills upheld

Brazil's Congress has upheld President Dilma Rousseff's vetoes of two bills to raise public spending, a victory for the embattled leader as she tries to close a gaping fiscal deficit and regain investors' confidence. Opposition lawmakers failed to reach the absolute majority needed to override the president's vetoes of one bill to raise benefit payments to retirees and another that would have granted steep wage hikes for court employees. The two bills would have cost 47 billion reais (US$12.43 billion) in extra spending over four years, the Finance Ministry estimated. (November 19)

Photo: Wilson Dias/Agencia Brasil.



Speaker of the House Eduardo Cunha

Photo: Fabio Rodrigues Pozzebom/Agencia Brasil.



President Dilma Rousseff

Congress moves to impeach President Rousseff

Eduardo Cunha, speaker of the lower house of Brazil's Congress, has announced plans to open impeachment proceedings against President Dilma Rousseff, in response to charges that in 2014 she violated the law by manipulating government finances to benefit her re-election campaign. If the committee hearing the charges, which is comprised of members of all parties in the lower house, decides against her, and if two-thirds of the entire lower house votes to suspend her, the case will move to the Senate, where there will be a 90-day trial. A two-thirds majority in the upper house would then be necessary to formally remove the president from office.

The impeachment proceedings opened on the same day that the Workers Party, which Rousseff represents, decided to support proceedings in the House Ethics Council to remove speaker Cunha, who has been accused of accepting bribes in the Petrobras corruption scandal. Cunha denied the allegations but it has been confirmed that the speaker and family members had bank accounts in Switzerland with deposit dates and amounts that closely track the changes. (December 3)

Vice President Temer publicly criticizes the President

The political turbulence increased with publication of a letter from Vice President Michel Temer (PMDB) to President Dilma Rousseff (PT) in which Mr. Temer accuses the president of having no confidence in him or his party. The president's press office had no immediate comment. Temer, who would succeed Rousseff if she were impeached and convicted, detailed in the letter a series of events which he said supports his charges and deplored what he called "A lack of trust that is incompatible with what we've done to maintain personal and partisan support for your government." Temer is president of the PMDB. Rousseff will probably need the support of at least some PMDB members to avoid being removed from office, analysts say. (December 8)

Photo: José Cruz./Agência Brasil.



Vice President Michel Temer

ECONOMY

Job losses accelerate

Brazil's economy lost a net 169,131 payroll jobs in October, the Labor Ministry reported, up from 95,602 in September. In the past 12 months Brazil's recession has already cost nearly 1.4 million jobs. (November 23)

Recession deepens

Compared to the second quarter Brazil's GDP contracted 1.7% in the third quarter, according to Brazilian statistics agency IBGE, and was down 4.5% from the third quarter of 2014. Economists surveyed by Brazil's central bank expect the economy to shrink by 3.19% this year and by another 2.04% in 2016. From the second to the third quarter agriculture shrank by 2.4%, industry by 1.3%, investment by 4.0%, and services by 1.0%. Brazil's service sector, which ranges from beauty salons to banks and realtors, employs more than any other sector in the country by a wide margin. Altogether services represent about 60% of GDP. (December 1)

Consumer prices up

Consumer prices in Brazil rose in November, pushing 12-month inflation to 10.48%, according to the Brazilian statistics agency IBGE. The 12-month figure marked the highest level since November 2003, when it reached 11.02%. The acceleration was mainly due to food costs, as food prices went up by 1.83% in November, compared with a rise of 0.77% in October. (December 9)

ECONOMIC POLICY

Levy remains as finance minister

Disagreeing with her predecessor, Lula da Silva, who had criticized the effectiveness of Finance Minister Joaquim Levy, President Rousseff said Levy will remain in office. Reportedly in closed meetings Lula had criticized Levy, saying he puts too much emphasis on the austerity plan and is ignoring the need for pro-growth measures. Rousseff also urged Congress to approve imposition of a financial transaction tax, and said the majority in Congress now backs her economic plan. (November 16)

Central bank keeps interest rate at 14.25 pct

For the third straight month Brazil's Central Bank has kept interest rates at 14.25% in a move to avoid further damage to an ailing economy despite a surge in inflation. However, this time, two of the eight members of the bank's monetary policy committee voted to raise the rate to 14.75%. The current rate is the highest in nine years and well above that of emerging market peers like India and Mexico. (November 25)

Deadline set for government plan to repay state banks

Brazil's federal audit court, the TCU, has given the administration 30 days to present a plan to pay arrears to state banks. The plan must provide a schedule to honor the arrears "as soon as possible," the unanimous court ruled, although the estimated 57 billion reais (US$15 billion) may be repaid in installments. The decision came after the TCU rejected a government appeal that the arrears be considered as regular operations. The TCU also ordered the central bank to revise the official debt statistics to incorporate the arrears. (Decemeber 9)

Photo: Antonio Cruz/Agencia Brasil.



Central Bank Governor Alexandre Tombini

Central bank still committed to controlling inflation

The Central Bank will use whatever measures it considers necessary to ensure that inflation falls back to the targeted rates, Bank President Alexandre Tombini said recently. Twelve-month inflation reached 10.48% in November, more than twice the bank's goal of 4.5%. According to the text of a speech he gave to a Brazilian bankers association, the Central Bank will not limit its actions out of concern over their possible fiscal implications, Tombini explained, He also emphasized the need for the government to get its finances under control in 2016. (December 10)

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At the peak of UNCERTAINTY

The worsening political crisis raises more doubts about whether the Brazilian economy can pull through.

Solange Monteiro

DECEMBER BEGAN WITH more bad news: On the economic front, IBGE, the government statistics agency, announced that for the third consecutive quarter GDP had again contracted, forcing analysts to rethink their projections for 2015 and 2016. The political shock was even greater. First, Worker's Party (PT) members broke with the Speaker of the House Eduardo Cunha (Brazilian Democratic Movement Party, PMDB) and supported revocation of Cunha's mandate in the Ethics Committee of the Congress for corruption. Cunha then launched the impeachment process against President Dilma Rousseff based on allegations that she broke fiscal laws by window-dressing government accounts ahead of her re-election last year. Meanwhile, the Superior Electoral Court had before it the petition of the Brazilian Social Democratic Party (PSDB) contesting the election of President Rousseff and Vice President

Michel Temer (PMDB), on the grounds of abuse of political and economic power.

Although in 2015 there have been 28 requests for impeachment, the chances of the process advancing had been considered negligible. Octavio Amorim of the Brazilian School of Public and Business Administration (Ebape/FGV) pointed out that since the cabinet reshuffle in October, the idea seemed to have lost support, postponing the risk of impeachment to March 2016, when its prospects might be affected by how the economy is performing and whether there would be street protests during the Congressional recess. The initial reaction of the markets was positive, signaling hope for an end to the government management paralysis that had compromised the reform agenda this year.

But optimism dissipated as politics grew more volatile. Jairo Nicolau, political science professor at the Federal University of Rio de Janeiro (UFRJ), describes the situation as having moved from one of the most diffuse and unproductive periods of Congress to another even less productive. "What we saw in 2015 was a voting game … presidential veto, congressmen vote to overturn the president's veto. Substantively, Congress did very little, when it was critical that it work," he says. "For 2016, considering that the impeachment process would take much of the first half of the year, plus election of the Speaker of the House, more politicians tangled up in the state-oil company corruption scheme, and municipal elections in the second half of the year, there will be little time left for Congress to act. Congress may not disrupt the economy, but it will not help it."

Anxiety about how the political future will affect the economy is spreading uncertainty and lowering the confidence of both businesses and consumers.

The PSDB petition before the Supreme Electoral Tribunal may be a fast response to the political impasse, but it is subject to appeal to the Supreme Court, which may postpone any kind of political resolution. Thus anxiety about how the political future will affect the economy is spreading uncertainty and lowering the confidence of both businesses and consumers; there are also doubts about whether the economy, plunged into deep recession with a growing deficit, has the capacity to regenerate itself.

Armando Castelar, IBRE coordinator of applied economics, points out that successful exits from past crises were due to rapid and consistent action, explaining that "In 1998–99, President Fernando Henrique Cardoso made a strong fiscal adjustment, amounting to almost 4% of GDP; that raised the tax burden but delivered on the fiscal targets. In 2002–03, President Lula applied an even more orthodox policy, further raising the primary surplus, cutting spending and investment, and reforming the civil service pension fund." Renato Fragelli, professor at the FGV Graduate School of Economics (EPGE), comments that the list of accumulated economic corrections at the end of the first Rousseff term demanded unquestioned leadership, which did not materialize.

The quest for political resolution is even more pressing considering the staggering speed at which the economy is deteriorating.

Quick spin

The quest for political resolution is even more pressing considering the staggering speed at which the economy is deteriorating: Regis Bonelli, IBRE researcher, explains that while in the 12-month period through March 2014 Brazil's GDP expanded by 3.2% in the 12 months through September 2015 it contracted 2.3%. He adds that "In a year and a half, Brazil had a drop in economic activity of 5.5 percentage points—quite severe for such a short period." IBRE expects that economic activity in 2015 will drop 3.6% and another 3% next year, but a great deal depends on resolving the political impasse and reaching a consensus to address the growing fiscal deficit.

The current recession, which began in the second quarter of 2014, is one of the longest of the nine identified since 1980 by the IBRE Business Cycle Dating Committee. After 1995, recessions shortened; they now average 2.8 quarters.

Castelar emphasizes that "the current crisis did not start with external financing problems. The external balance of payments deficit was reversed quickly, … [But] we have a significant worsening of the fiscal situation. We went from a

Brazil: IBRE baseline scenario for 2014-2016

	2013	2014	2015 Est.	2016 Proj.
Real GDP growth (% change)	3.0	0.1	-3.6	-3.0
Inflation (% change)	5.9	6.4	10.5	7.6
Central Bank policy rate (end-period, %)	10.00	11.75	14.25	14.25
Exchange rate (average, Reais per U.S. dollar)	2.2	2.4	3.8	4.3
Primary balance surplus (% of GDP)	1.7	-0.6	-1.0	-1.2
External current account balance (% of GDP)	-3.1	4.4	-3.6	-2.6
Trade balance (US$ billion)	0.3	-6.1	15.0	28.5
Export (US$ billion)	242	225	189	191
International reserves (US$ billion)	376	374	380	380

Source: Institute of Geography and Statistics (IBGE), Central Bank of Brazil, IBRE staff projections.

primary surplus of 1.8% of GDP in 2013 to a deficit of 0.6% in 2014."

The fiscal deterioration was not entirely due to the political stalemate between the administration and Congress, says Rubens Penha Cysne, EPGE director. He notes that President Rousseff's second term began with important measures to correct imbalances resulting from the "New Economic Policy" of her first term: "The administration began to argue forcefully for fiscal surplus targets, adjusted administered prices, and there was an improvement in the foreign exchange rate that eliminated concerns about financing the current account deficit," he explains. IBRE estimates that the external current account deficit will decline to US$40 billion this year, 2.8% of GDP, from 4.2% of GDP in 2014.

But more was needed, especially in cutting government spending. In November, IBRE projected fiscal primary deficits of 1% of GDP for 2015 and 1.2% of GDP in 2016. IBRE now estimates that recurrent revenue potential, such as the tax on financial transactions, and nonrecurring revenues from sales of assets could add R$78.4 billion to the government coffers. "This adds only 0.1 percentage point of the primary balance—much less than is needed to stabilize the gross public debt," says Silvia Matos, IBRE researcher.

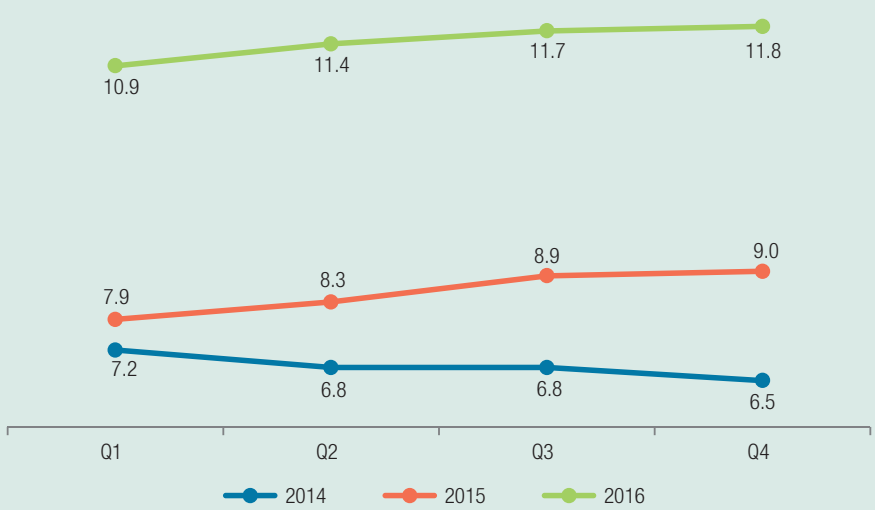
"The longer we put off a more robust fiscal adjustment, the more the economy suffers."

Silvia Matos

Part of the fiscal deficit results from President Rousseff's first-term policies of cutting taxes and contributions. IBRE researchers José Roberto Afonso and Vilma da Conceição Pinto estimate that the cost of these tax cuts has doubled since

Bad news: Unemployment increases

(Quarterly average, %)



Sources: IBGE and IBRE.

"There's nothing structurally speaking to suggest that 2016 will be better than 2015. … The only thing that we can highlight is that the external sector is recovering, but that is associated much more with the collapse of domestic demand than with sales."

Livio Ribeiro

the beginning of Rousseff's first administration, from R$209 billion to R$408 billion, or 6.5% of GDP. Another part is related to the social policy adopted in the Constitution of 1988. Since then, central government spending has grown by 0.4 percentage points of GDP every year. "Of this increase, 70% can be explained by cash transfer policies. It's a very high level, and fixing it will require significant constitutional reforms. The longer we put off a more robust fiscal adjustment, the more the economy suffers," Matos says. She explains that for a time social spending was financed by tax increases and the higher tax revenue during the commodity price super-cycle, which proved unsustainable. Without fiscal adjustment, IBRE estimates that gross public debt will reach 82% of GDP in 2017, up from 67.5% this year.

Without a clear horizon for resolving the fiscal crisis and with confidence plummeting, IBRE expects capital investment to fall by 26% for 2014–16. "There's nothing structurally speaking to suggest that 2016 will be better than 2015," says Livio Ribeiro, IBRE researcher. "The only thing that we can highlight is that the external sector is recovering—but that is associated much more with the collapse of domestic demand than with sales." For 2015 IBRE estimates 4.1% growth in exports and a 13.7% drop in imports, and for 2016 a mere 2.2% growth in exports and a 14% contraction in imports.

The main sectors that will contract substantially in 2016, according to IBRE, are manufacturing 9.5%, construction 5.9%, and services 1.6%. Depressed household consumption, which represents 62% of total demand, is another factor worsening the economic stagnation. Household consumption fell by 3.4% in 2015 and will further decline by 3.2% in 2016. Matos notes that "Household consumption was greatly protected because of a booming labor market and rising incomes. But in 2016 the crisis will get to the streets." She expects unemployment to shoot up from 8.5% in 2015 to 11.5% in 2016.

Despite the slowdown in economic activity observed in recent years, employment increased because of a booming labor market based on low growth in the working-age population. "With the improvement of workers' income, many young people left the labor market to study because they did not need to work to supplement the family's income," recalls Naércio Menezes of the Brazilian Institute of Capital Markets. Compared with the crises in 1998 and 2002, which began with unemployment close to 10%, that rate was much lower, below 7%, when the current crisis started.

Another factor that makes this crisis different is that social protection is much broader than in previous crises. Fragelli points out that "Although some benefits have been reduced this year, such as the more restrictive unemployment insurance rules, we still have many social programs, and an unemployment rate of 10% of the economically active population today has a much lower impact on the well-being of the population than 15 years ago." Matos adds that the share of social benefits in Brazilians' incomes went from 14% in 2000 to 25% in 2014. Also, the number of beneficiaries has risen faster than the working population: "In 2000 we had about 30 million beneficiaries for 70 million workers; now we have 70 million beneficiaries for 92 million workers," says Matos.

Nelson Marconi of EESP-FGV believes that whether the lower-consumption economy will recover will depend on external factors: exports and concessions. "Exports take some time to react to exchange rate devaluation, but they should increase next year," he says. Regarding infrastructure, this year the government has focused on managing the short-term political

The impeachment factor

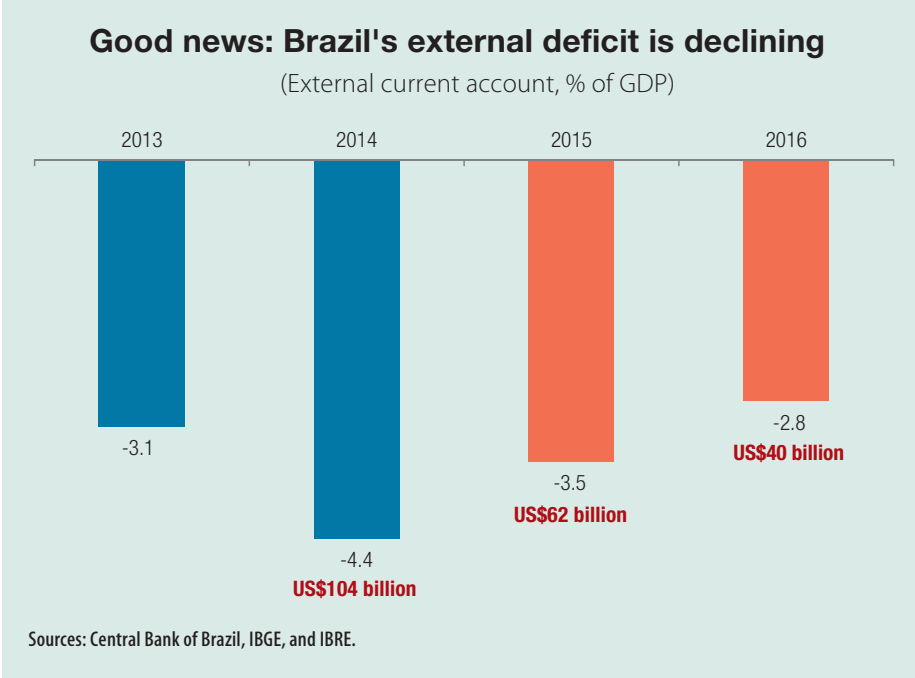


The prospect of the country's leadership changing before the 2018 presidential elections and the ethical problems of the Speaker of the House of Representatives, Eduardo Cunha, have generated a variety of scenarios about what the proceedings to impeach President Dilma Rousseff might mean for the economy in 2016. For Octavio Amorim of Ebape-FGV, the initial positive reaction of markets to the news of the impeachment proceedings reflects a hope that the president will step down and Vice President Michel Temer (Brazilian Democratic Movement party, PMDB) will take over and form a broad coalition that could mitigate the current political deadlock. "In this scenario," Amorim says, "Temer should emulate the government of Itamar Franco, a model of a great agreement, without the participation of the Worker's Party [PT]." He points out that the PMDB party may become more interested in this alternative if during the impeachment proceedings certain minimum conditions for a new government occur. These conditions, he says, "include support from the Brazilian Social Democratic Party (PSDB), and Temer agreeing to not run for re-election in 2018 and committing to rather institutional behavior in the presidency."

If Rousseff wins the impeachment battle, Amorim outlines three possible scenarios. In the first, she would again seek the national agreement that failed in 2015, allowing fiscal adjustment. Although this is a positive scenario, Amorim recognizes that it is the least likely option, since "this type of agreement is not in the Rousseff DNA—it would give even more power to allies and the opposition."

The second scenario would be consolidation of the president's cabinet reshuffling in early October, which has shown some results, such as maintenance of the president's vetoes of measures that would worsen the state of public finances, and approval of the fiscal deficit target for 2015. Amorim considers, however, that this arrangement would be very unstable because it depends on what happens with the economy, which is likely to worsen, and with the corruption investigations at Petrobras. Also, "it would only ensure President Rousseff's short-term survival, without necessarily moving ahead the fiscal adjustment, or enhancing the popularity of Rousseff and the PT ahead of the 2018 elections."

The third scenario, inspired by former President Lula, would be to soften the short-term fiscal adjustment and ease restrictions on credit to the states. That would make the economic situation much more difficult. But "this scenario," Amorim says, "might … recover the support of social movements, businesses, and financial markets that had previously supported Rousseff." He emphasized, however, that the outlook for all these scenarios is highly uncertain.



situation but has failed to look at structural issues as it should. "But the concessions require little fiscal resources and can stimulate economic activity," Marconi says, "as long as the government ensures legal certainty and the rules are clear."

Long term

The recovery of the economy, however, depends on the political outcome. "We already know what to do," Fragelli says, but "we economists have nothing more to say because there is nothing to be done without political authority." He calls for a broad pact to relieve the decision-making paralysis. Otherwise, he says, "We are about to lose another three years of growth, and at best we will end up in 2018 with the same income per capita as in the first term of President Rousseff."

IBRE research associate Braulio Borges believes that reversing the current scenario requires a long-term adjustment agenda: "The market already has a rather skeptical view about there being a reasonable outcome in 2016. But we could have an improvement in the perception of Brazil risk not only if next year's budget is approved with a fiscal primary surplus, but also if there are medium- and long-term reforms that signal a more robust fiscal situation in the future."

EPGE's Cysne agrees with Borges that resumption of economic growth must be powered by medium-term planning: "It is necessary to establish a horizon, for example, from 2016 to 2020, moving decisions from short-term to medium-term. This requires a certain audacity but could promise a much better future than what we see today." Fragelli believes that the worsening of the economic crisis could open a window of opportunity for reforms, especially of social security, that yield long-term results.


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Turning the page



The victory of Mauricio Macri raises hopes of economic recovery in Argentina and normalization of trade with Brazil.

Solange Monteiro

THE ELECTION OF Mauricio Macri to lead Argentina as of December 10 puts an end to 12 years of Kirchner dominance of the country's politics and to the exhausted economic policies of outgoing President Cristina Kirchner. The success of the candidate of the Republican Proposal (PRO), although by a narrower margin than expected, represented a choice to end exchange controls—a topic that dominated the debates before the second round. Established in 2011 to stem the outflow of capital, the controls have depressed the economy's growth, which has stagnated.

Argentina has paid dearly for previous foreign currency constraints, and new President Macri will take over a country in a very difficult environment. If he succeeds in his stated reforms, Macri will have to tame the inflationary pressure stemming from a necessary currency devaluation and the correction of controlled prices; inflation this year is estimated at 25%. Macri will also face a primary fiscal deficit estimated at 4–6% of GDP and an elevated tax burden of 30% of GDP so he must urgently review subsidies and the prices of public utilities. "Macri will have to work various policy instruments together, including a wage bargaining system that can moderate the strength of trade union demands and an active monetary policy, which will depend on the central bank being in tune with his proposals," says Fabio Giambiagi, an economist with Brazil's National Development Bank. He points out that the central bank governor will have to resign and a new board of directors be appointed, "something that can take anywhere from weeks to months."

At a recent event sponsored by the Go Associates consulting firm, Giambiagi expressed cautious optimism about Argentina's short-term



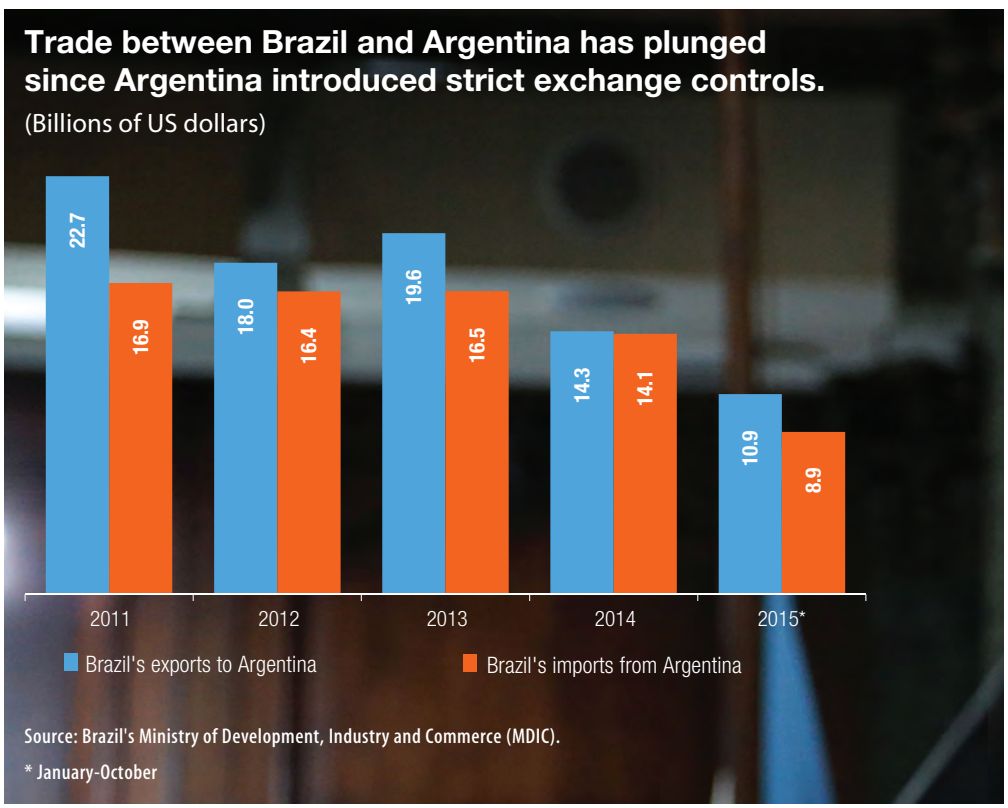
The prospects for president-elect Mauricio Macri are daunting.

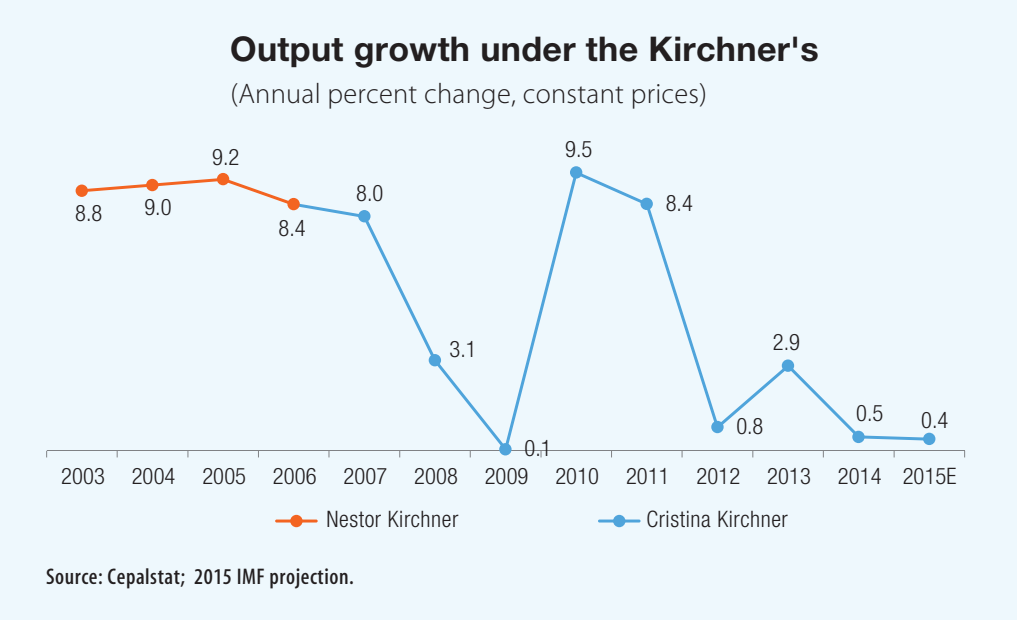
future. He believes that the Macri administration is cohesive, and if the new government can give consistent signals, even without immediate results it may restore some confidence in the markets and society, making Argentina a more attractive place to invest. He also thinks Brazil should trust the new Argentinian administration: "Brazil has had trade problems with Argentina, and it is hard not to respond to the barbarity of the trade controls Argentina imposed. But today it is interesting that China is the most influential country in our neighbor." Giambiagi suggests that it would be good for Brazil to cooperate to mitigate the foreign currency restrictions that hinder the Argentina's recovery in the short term. Since "Argentine's reserves are vanishing, while Brazil has US$270 billion," he suggests that Brazil lend,

Brazil and Argentina should become allies on issues like agriculture, which are vital for both countries, during the December WTO ministerial meeting in Nairobi.

for example, US$5 billion for one or two years with the necessary guarantees, because "that would make economic, strategic and diplomatic sense."

According to Ambassador Regis Arslanian, who was Brazil's representative to Mercosur until 2012, Argentina needs about US$12 billion in reserves, which is a significant obstacle for resumption of Argentina-Brazil bilateral trade





Source: Cepalstat; 2015 IMF projection.

in the short term. The ambassador is optimistic about the possibility that, with Macri's leadership in Argentina, Mercosur will make progress in negotiating trade agreements with the European Union and the United States. The agreement with the EU will be discussed at the next Mercosur summit on December 21 in Asuncion, "which will also mark Argentina's position on the membership of Venezuela in the bloc, with important implications for Brazil, which may be isolated," Arslanian says. The ambassador argues that Brazil and Argentina should become allies on issues like agriculture, which are vital for both countries, during the December WTO ministerial meeting in Nairobi.

If the new government can give consistent signals, even without immediate results it may restore some confidence in the markets and society, making Argentina a more attractive place to invest.

While Macri needs to move promptly to establish policies on many fronts this year, Argentine analysts consider it most important for the government to build up domestic support, since PRO is a minority in Congress and part of society is still polarized around the Peronist party. "If Macri decides to deal with all the evils at once, he will jeopardize his own legitimacy and that of his government," said Matias Kulfas, who was general manager of the Argentine Central Bank in 2012–13. Bernardo Kosacoff, professor at Buenos Aires and Torcuato Di Tella Universities, has confidence that the new president will be successful. "There is consensus on the priority issues, perhaps much more than at any other time in Argentina," he said, indicating that could help support structural changes and mitigate the uncertainties that always accompany the beginning of a new administration.



Argentina: First interview

Matias Kulfas: "We need a managed float"

Matias Kulfas, now director of the Idear Desarrollo consultancy, was general manager of the Argentine Central Bank in 2012 and 2013 and director of the Banco de La Nacion Argentina from 2008 through 2012.

Adjustment path

President Macri's economic team must have calculated that the end of exchange controls would result in the exchange rate overshooting and then stabilizing, with the exchange rate devaluing by 40–50%. But it is necessary to take into account certain factors. One is the unexpected victory of his party in the province of Buenos Aires, which has the highest GDP in the country but significant pockets of poverty and marginalization. The shock of a very large exchange devaluation could generate social problems in a region now managed by the PRO, and the president needs to avoid short-term governability problems. Another factor is that exiting exchange controls depends on discussion of a new social pact because a large devaluation shock carries a risk of accelerating devaluation and prices and consequently a risk of reaction by the trade unions, which will defend the purchasing power of wages. Argentina does not have a good history of transition between exchange controls and a free float. In 2002, for example, we had a great inflationary surge. We need a managed float; the risk of not managing the float is high. Financial and exchange rate instability can bring about unemployment and a major recession. But I think that President Macri is less concerned with rising unemployment. His scheme seems to be to return to a more orthodox policy, with tougher and tighter monetary policy. Unlike Brazil, in the past 12 years Argentina has lived with negative real interest rates, which reduce savings and boost consumption. Now, the policy should be more restrictive, to improve relations with the international financial system to attract a fresh supply of US dollars.

Congress and society: Support?

President Macri has generated a lot of expectations in a number of different sectors, but he has no majority in Congress; his strength does not exceed 25%. Macri was the candidate of those who wanted to turn the page for Argentina, but that does not mean all fall into his political space. If he decides to deal with all the evils at once, he will jeopardize his own legitimacy and that of his government.

Trade liberalization

There is concern because in recent years many Argentine industries—such as footwear, textiles, and metalworking—have fared well and managed to grow, thanks to controls on imports, and they would struggle with competition from other countries. Without an exchange rate that is appreciated by about 50%, industry … will contract, losing market share and generating unemployment. On the other hand, the exports of the agro-industrial sector were affected by the unfavorable exchange rate, and the tax burden—35% since 2007—needs to be reduced. Producers have inventories of at least US$8.5 billion waiting for devaluation and tax cuts, which would ensure greater profitability, and more dollars for the government. But if in the short term that means relief, in the long term we cannot expect international commodity prices to be high enough to generate a new production boom.

Brazil and Mercosur

I think that Macri will bet on Mercosur, and Brazil is its historical ally. It will be necessary to strengthen this relationship. But I also think the new administration will be more open, including to countries aiming at the Pacific region.



Argentina: Second interview

Bernardo Kosacoff: "There is consensus on priority issues"

Professor at the Torcuato di Tella and Buenos Aires Universities, Kosacoff was director of the UN Economic Commission for Latin America and the Caribbean from 2002 to 2010, and chairman of the Economic and Social Development Institute (IDES) from 1999 to 2002.

Adjustment path

Removal of exchange controls will depend fundamentally and simultaneously on changes in the monetary and fiscal fronts and the ability to obtain additional financing, to give the country room to manage its macroeconomic policy. Even with little public debt, Argentina is the country in the region that, after Venezuela, pays the highest interest rate due to lack of international reserves. Normalization of Argentina's access to international credit markets will allow it to better manage exchange rate policy. The withdrawal of controls on foreign currency requires delicate management that takes into account the impact not only on domestic prices but also on wages and incomes. On the fiscal front, public utility rates should be adjusted gradually to avoid a sharp decline in peoples' purchasing power and should include support for utilities rates to meet the needs of the poorest population. Such a move could pave the way for improving public spending and reducing the tax burden, since in many sectors—principally electricity—these subsidies are not necessarily associated with improvement in either the competitiveness of the economy or income redistribution.

Points in favor

Argentina has low debt, both public and private, and low payments of interest and principal in 2016. At the same time, the private sector, which has been cautious in recent years, has created a very robust countercyclical fund of nearly US$400 billion, 80% of GDP, that awaits the return of the economy to normality. On the demand side, between 2000 and 2011, Argentina nearly doubled the size of its domestic market; although that has stagnated in the last four years, there is great potential for it to resume growth.

Congress and society: Support?

Admittedly, the presidential election outcome was close but there is consensus on priority issues, much more than at any other time in Argentina. The long-term structural issues cannot be resolved in the first quarter, but it is possible to improve the investment climate. Macri has invited people for his government who are focused on reducing unemployment and income inequality. In this sense, it seems he breaks the image of a fundamentalist government that believes in the total market capacity and is seeking measures to generate growth as well as inclusion.

Brazil and foreign trade

Macri said his priority is to strengthen the bond between Argentina and Brazil. We acknowledge the impact of Chinese imports in recent years, but today society and the productive sectors agree on the diagnosis that we need to reassess our business relationship with China. To open foreign trade, we must take into account the sectors most vulnerable to trade openness, but I think the president will have a positive attitude to generate complementary policies. Argentina's priority is to expand its offerings and its capacity to generate dollars through exports, despite the current context of slow global trade, and I am highly optimistic that this is possible.

Brazilian railway concessions: Risks and returns

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IN MID-2012 THE government launched the Logistics Investment Program (PIL) to rescue Brazilian railways, promising huge investments to expand the network. The plan was to direct the allocation of R$99.6 billion for the construction and improvement of about 11,000 kilometers (km) of rail.

Three years later and with a second edition, PIL-2, launched this past June, the government has not been able to auction a single stretch of railway. With an area of about 8.5 million square km (km^2) and a railway network that is about 33,000km long, Brazil has a rail network with a density of only about 4 meters (m) of railway line for each km^2 of territory. This number is significantly lower than in countries like the United States (23m / km^2), India (23), South Africa (17), Argentina (11), Turkey (11), Mexico (9m), China (8.11) and Russia (5.1).

The high fiscal cost of VALEC's operations, which the Federal Court of Accounts has identified, combined with the country's current difficult fiscal situation has forced a review of how Brazilian railways operate.

The regulatory framework had been identified as the main reason for the low penetration of rail transport. To address this, the government proposed that Brazil's railways be unbundled. As a result, the state set up a new enterprise, VALEC, to manage the railway cargo market: VALEC buys the full cargo capacity of new railway lines and sells cargo services to independent rail operators.

The high fiscal cost of VALEC's operations, which the Federal Court of Accounts has identified, combined with the country's current difficult fiscal situation has forced a review of how Brazilian railways operate. In the government, the idea has gained momentum that further unbundling and the government's role would require unreasonable efforts. In turn, this has heightened investor perception of the risk of Brazilian railway projects.

PIL-2, as introduced in June, covers construction of new railway lines, extension of existing concessions contracts, and investments of R$16 billion in the existing network. However, it has been questioned whether the instruments authorized can achieve the PIL-2 objectives.

When the PIL-2 was presented, the government stated that projects were already being negotiated with concessionaires to expand traffic capacity through new railway yards, extensions, new signaling, and renewal of rolling equipment.

The National Ground Transportation Agency

(ANTT) and some private operators have expressed interest in reviving unused lines equivalent to almost 22% of the railway network. These lines could function like U.S. short lines—railways that carry lower volumes over shorter distances, usually feeding cargo to main railway lines. In the U.S., short lines account for about 30% of the entire railway network.

The use of short lines, as well as other railway alternatives, needs further reflection and maturation. Analysis of the feasibility of such lines is a good example of how Brazilian infrastructure sectors could benefit from good practices in other countries.

At present, however, the crucial point is early renewal of concessions. Given the difficult fiscal situation, the government is negotiating with leading concessionaires to promote investment in expanding the railway network in return for extending current contracts.[1] Although these negotiations are already quite advanced, it is necessary to analyze how they will affect the structure of the railway sector and whether they are consistent with the strategic objectives of transport and logistics policy.

Another recent development that should be scrutinized concerns the updating of the parameters for estimating the internal rate of return (TIR)) to be adopted as a reference for future railway concessions. Initially set at 8.5% per year, the TIR has been raised to 10.6%, as the government tries to align it with the risks involved.[2] The methodology used is still that presented in Technical Note 64 STN / SEAE / MF, May 2007, updating parameters for estimating the risk-free rate, market risk premium, Brazil risk premium, and U.S. inflation. This standardization of the estimated weighted average cost of capital for railway concessions is similar to the methodology established a few years ago by the National Electric Energy Agency (ANEEL) for tariff revisions and concessions in the electricity sector.

The National Ground Transportation Agency (ANTT) and some private operators have expressed interest in reviving unused lines equivalent to almost 22% of the railway network. These lines could function like U.S. short lines—railways that carry lower volumes over shorter distances.

Despite the current regulatory hurdles, and the many other questions that deserve further consideration, these recent government measures are a move in the right direction to better align investment returns with the risks concessionaires face. What is now necessary to interest investors in the logistics sector and to achieve the government's goals is more transparency about the policy objectives for transport and logistics, and clear and coherent regulation.

[1] According to *Valor Econômico* newspaper (December 1, 2015), the federal government is seeking to speed up the process for extending railway concessions. The plan calls for R$16 billion in private investments in the current network in return for extending the existing concessions. Negotiations are concentrated in three companies: ALL (América Latina Logística), MRS Logística, and Ferrovia Centro Atlântica (FCA).

[2] Ministry of Finance press release, November 23, 2015. http://www.fazenda.gov.br/assuntos/destaques/nota-a-imprensa-2015-11-23-taxa-interna-de-retorno-ferrovias.pdf.

Photo: Stefanini Group



"2016: As difficult as 2015, or worse"

Marco Stefanini

CEO of the Stefanini Group

Solange Monteiro

SINCE 1996, THE Stefanini Group, an information technology services company, has established a presence in 35 countries, which in 2014 accounted for half of group sales—R$2.35 billion, up from R$670 million in 2009, and continue to contribute to the company's consistent double-digit growth. As for Brazil's problems, says CEO Marco Stefanini, "Revenues were not as affected, but the profit margin was." He cites the increase in payroll tax and the proposal to temporarily reduce the tax benefits of the Good Law as examples of Brazil's lack of a strategic vision for the service sector. For 2016, he says, he's been preparing for a year that will be "as difficult as or worse than the current one." It is not possible, he says, to speak of the exchange rate as competitive until factors that undermine the Brazilian business environment are eliminated: An exchange rate of R$4 per US dollar may sound good, "but if inflation is 10% per year, it is no use. If labor costs, taxes, and logistics continue to cause inefficiencies, [a more devalued exchange rate] will be a short-term solution."

In mid-year you predicted that the Stefanini Group would grow 11% in 2015 compared with 15% in 2014. Will this materialize, even with Brazil's worsening economic scenario?

Yes, but it is the growth of the total group. In Brazil, revenues were not affected, but the profit margin was. In Europe, for example, we will grow 20%, about the same as last year. In Brazil … problems abound. The first problem is the increase in the tax burden. That is far worse than the effect of recession on markets,

We are preparing for a year that is as difficult as, or worse than, the current one … In the long term, Brazil is a country with great potential, it will overcome its difficulties. But it will pay a high price.

which comes second. The third factor is higher costs, especially labor, which we have not been able to pass through to prices, and the costs of supplies and equipment purchased in U.S. dollars. The fourth factor is the hostile environment for businesses, with a number of uncertainties. … And there is still more potential negative change, such as the Good Law [in 2016 the government will cut the income tax benefit given to spending on technological research, development, and innovation]. … Unfortunately, there is a lack of strategy.

What is the outlook for 2016?

We are preparing for a year that is as difficult as, or worse than, the current one. This is not pessimism; it's realism. … In the long term, Brazil is a country with great potential, it will overcome its difficulties. But it will pay a high price. Today is the best time to invest in Brazil, I say to foreigners, if you have long-term vision.

What is your basic agenda for next year?

The expected basic agenda is for things to not get worse. We spent the year fighting the payroll tax increase. We expected that at least the change would be fair and equal for all, which was not the case; there were sectors where an increase in payroll tax was less than ours, which rose from 2% to 4.5% of revenues. In a sector that has a net after-tax margin of just 3% to 4%, a payroll tax increase of 2.5% means that the profit disappeared. It's a very dramatic situation. And now the government wants to change the social contribution tax (PIS/COFINS). It will be devastating. The PIS/COFINS tax operates as a value-added tax, but a service company has no product, so it cannot deduct anything. … If this happens, taxes will account for 20% of revenues. For every 100 Brazilian reais you take in, you pay 20 to the government, and your profit is at most 1% or 2%.

In the last decade the services sector has gained a significant share in GDP, but its activities generally have low value-added. How competitive is Brazil in segments like yours?

The increasing share of the services sector reflects, I believe, the maturity of the country. It is worth pointing out, however, that the IT sector is divided into hardware, software, and services. That is why we prefer the European and U.S. markets, which consume more services than hardware and software. China consumes much more hardware. Also, although from the economic point of view, today in Brazil IT has greater importance, from the point of view of politics and representation, it has not. Brazilian leadership is committed to industry, and the mentality

of Brazilian society in general is much more favorable to industry than services.

From the point of view of the quality of services, in the last few years Brazil has become more expensive without getting wealthier. And so we had huge devaluations, which is a way to make goods and services cheaper, but we have not had productivity gains. Undoubtedly IT is an area that helps to increase overall productivity, which is what Brazil needs. The sector should be encouraged to help the country, but we do not see a correlation between its importance from a strategic standpoint and how [the government] treats it on a daily basis. This is unfortunate because Brazil's IT sector is well-prepared. Compared with the rest of the world, we have good resource capacity, and we work basically with the same software and in the same environment as other developed countries, since the Brazilian economy is diversified, and even sophisticated for an emerging country. We should remember that not only in Brazil but also in the rest of the world IT has radically transformed sectors like media, telecom, retail, and financial services. The automobile industry so far not been affected significantly, but … in the next 10 years it will be. Basically 70% of economic activities will be affected significantly by IT.

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The education and training of workers is a sensitive element in Brazil's service sector. How do workers' skills affect Stefanini Group business operations?

Obviously the quality and education of workers affects us. However, there is something strange, but positive in Brazil's IT sector: While basic education in general is not as good as in other countries, we have [been able to find] qualified professionals. One possible explanation is that IT professionals are somewhat self-educated. People end up learning by themselves, investing in their own education. ... The second factor is that companies have invested substantially in job training. In Brazil, we certainly spend more on training compared with world averages, around 4% of revenues, which is quite large. … On average, then, in Brazil IT professional is good, despite educational deficiencies. But I do not think this happens in other services.

Does the industry argue for any specific educational policy?

Within the US-Brazil CEO Forum, we have discussed various options. One idea is the Science Without Borders program, which offers scholarships for 100,00 students. Another is the National Program for Access to Technical Education and Employment

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(PRONATEC). … We have established the Digital Inclusion Stefanini Institute, which has trained about 60,000 people to insert them into the labor market as help desks, call center operators, and office assistants. In collaboration with BRASSCOM [the Brazilian Association of Information Technology and Communication Companies], we have prepared IT strategic plans for the country, which covered issues like qualifications and manpower.

Stefanini Group has business operations in 35 countries in five continents. What do you think about the worsening rank of Brazil in the World Bank Doing Business rankings?

With regard to the business environment, only one of the countries where we operate is comparable to Brazil, and that is Argentina. It is much more difficult to run a business in Brazil than anywhere else. … It has been increasingly difficult to do business in Brazil. For example, the Severance Indemnity Fund for Employees (FGTS) is in principle a good idea … but how it is being executed has distorted the idea. … The FGTS imposes fine for laying off workers and to discourage layoffs, the fine has been increased, … so the cost to lay off a worker has gone up from one annual salary to one and a half. Among the major countries, the average is close to one salary per year worked. In addition, the company has to pay for another 33 days compared to 18 in a European country. … These are examples of difficulties in doing business we do not see elsewhere.

Currently, how does the Stefanini Group intend to expand?

We have a long-term vision. We have adapted the tactics, but the strategy has not changed. Before the crisis we had in place a strategy to grow much more abroad than in Brazil, … and we continue with that strategy. We also have not changed the acquisition strategy we established five years ago: we want to acquire foreign companies that provide the same service as we do, so we have less risk because we've already mastered the sector. We want critical mass, volume, and customers. In Brazil, however, the acquisition strategy is reversed: we may add other areas to our portfolio, as we have done, such as factory automation, ATMs for retail, and software for sales campaign, among others.

How does Brazil's low participation in trade agreements affect your business?

In our case, the direct impact is low, since we export little from Brazil. Indirectly, however, it

has tremendous impact because trade agreements make the economy more dynamic, and if the economy grows, we grow together.

We have a policy, as is common in IT, of exporting from a cheaper country to a more expensive country. … Half of the services we sell to the United States come from outside the country, but not from Brazil. The problem is that as we have become strong abroad, Brazil has become very expensive. Brazil is not as competitive as Mexico, Romania, or the Philippines, which are where we export from most.... With the devaluation of the currency, Brazil has become more competitive and we are able to export, but it's a matter not just of price but also of confidence. Brazil's IT is not well known. Although our technology and quality are good, there is no marketing to sell it the way India does. So we have to convince the customer of the quality of our IT services. In early November some representatives of a large American insurance company came to visit Stefanini Group in Brazil to see if they were comfortable with our work. It is a process. If Brazil remains competitive in the next three to five years, we have good potential, and we will probably export more. But it has to be a long, stable process.

What is the optimal exchange rate for the Stefanini Group?

On this, I'm pragmatic: it's no use to dream about which exchange rate is better... I have to work with the present exchange rate. The principal point is that discussing the exchange rate all the time is a distraction from dealing with the phenomenal inefficiency. We must attack the cause of the inefficiency. If an exchange rate of R$4 per US dollar sounds good but inflation is 10% per year, it is no use. If we continue being inefficient in labor costs, taxes, logistics, [a more devalued exchange rate] will be a short-term solution. What does currency devaluation do? It can give you breathing space to export. But if it does not clear up the inefficiency, in three or four years we will have to devalue again.

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