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Brazil after the 2014 Elections: A Bumpy Road Ahead

by Sergio Fausto

Summary: Brazil's future prospects, and ability to harness its advantages, will hinge on its own policy choices over the next few years. Yet the outlook for meaningful change is unclear. At present, Brazil is in a weaker position than four years ago, from both an economic and a foreign policy standpoint. Even in a scenario where Brazil's economy gradually returns to the course it was on until 2008, no major strategic changes are likely to happen in Rousseff's four-year term.

Introduction

After eking out a narrow electoral victory in October 2014, President Dilma Rousseff begins her second term at a moment of growing political weakness, beset by burgeoning corruption scandals, major economic stress for Brazil, and unprecedented polarization within the country. New factors, such as higher credit costs, lower commodity prices, and more skeptical foreign investors, further complicate her task.

Brazil's size, stability, friendly relations with its neighbors, natural resources, diversified economic structure, and comparatively robust institutions all remain important assets the country can draw upon to strengthen its development process and its capacity to have positive systemic impact globally. The country's future prospects, and ability to harness its advantages, will hinge on its own policy choices over the next few years. Yet the outlook for meaningful change is unclear. So it is instructive to review briefly the evolution of the policy environment that has nurtured today's problems in order to develop effective responses.

For the last 20 years, Brazil's presidential elections essentially have been contests between the Party of the Brazilian Social Democracy (PSDB) and the Worker's Party (PT). The mass demonstrations that convulsed Brazil in June 2013 convinced some that society was tired of the status quo and eager to vote for a "third way." In fact, a third competitive candidate briefly surged in the race when Eduardo Campos died in a plane crash on August 13 and was replaced by Marina Silva at the head of the Brazilian Socialist Party (PSB) presidential ticket. However, after leading the polls for about a month, Silva's presidential bid flagged, lagging far behind Aécio Neves and Dilma Rousseff in first round balloting on October 3. In the second round, on October 26, Rousseff was reelected by the narrowest margin ever in a Brazilian presidential election. With 51.6 percent of the vote, she earned four more years in office, but not a strong presidential mandate.

A "Divided" Country

Rousseff drew her greatest support from the base of the social pyramid (low-income families and people with formal educations below the national average), smaller cities (under 200,000 inhabitants), and less developed regions (such as the northeast, where she received 70 percent of the votes).

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Compared to the 2010 election, PT's presidential candidate lost ground with the so-called "new middle classes," a segment of the population estimated at more than 30 million people. This grouping moved up the economic ladder during the two terms of President Luiz Inácio Lula da Silva (known simply as "Lula"). In the last four years, as growth and job creation slowed, and with inflation rising, the opposition made inroads with this crucial electoral bloc, and earned half of their votes. Badly defeated among higher income and more educated voters, Rousseff thus owes her victory to those whose family income is strongly dependent on conditional cash transfer programs such as Bolsa Família, which have been expanded under PT administrations since 2003.

Traditionally, party affiliation rates in Brazil are low, parties are not strongly programmatic, and voting tends not to be ideologically motivated. Nevertheless, PT and PSDB represent two distinct political platforms and are perceived as such by the electorate. In presidential elections, they have proven the only parties (in an increasingly fragmented multiparty system) that can articulate a credible national agenda and draw wide support.

Origins and Trajectories of PT and PSDB

Both parties arose in opposition to Brazil's military dictatorship (1964-85). PT was founded in 1980 as a coalition of three different social and political groups: union leaders (especially industrial workers), grass roots catholic militants linked to Liberation Theology, and former members of guerrilla groups returning from exile.

Ideologically, PSDB arose as a center-left party, whose main points of reference were in Europe. The PT developed as a left-wing party more connected to the traditional Latin American Left, although some union leaders, especially Lula, had ties with the labor unions linked to the German Social Democratic Party and to the AFL-CIO in the United States.

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PSDB shifted toward economic liberalism as early as 1989. In the first direct presidential election after the end of the military dictatorship, the party's candidate, Mário Covas, ran on a platform that combined emphasis on expanding social policies with advocacy for privatization and deeper integration with the global economy.

Advances on both fronts were made possible after the Real Plan brought two decades of chronic high inflation to an end in 1994, and during PSDB President Fernando Henrique Cardoso's subsequent two terms in office (1995-2003). During this period, PT opposed the Real Plan and Cardoso's agenda, particularly structural economic reforms such as privatizations, fiscal consolidation, and social-democratic reforms to the education and health systems.

The PT began to accept certain aspects of PSDB's economic program in the early 2000s. In the 2002 presidential election, Lula's running mate, José Alencar, was a business man. Moreover, during the campaign, in order to reassure a turbulent market and a middle-class fearing that Lula would follow PT's "old party line," PT published a "Letter to the Brazilian People" making commitments to economic stability. This surprising move proved not only effective in paving Lula's way to the presidency but also instrumental in enabling the Brazilian economy to take advantage of global economic forces such as high commodity prices during his two terms in office (2003-11).

If continuity was the hallmark of Lula's macroeconomic policy, especially in his first term, Lula's foreign policy represented significant change. Whereas macroeconomic continuity was seen as a transitory concession by most PT leaders, they embraced a "progressive" foreign policy that placed considerable emphasis on South-South relations and state-led regional integration in South America. To underscore the difference, Lula's government deployed a narrative that cast the Cardoso government as subservient to the Washington Consensus and to U.S. leadership.

A South-South Foreign Policy and a "New" Developmentalist Model

In Lula's second term, economic policy began to move toward a "new" developmentalist model, while foreign policy doubled down on its South-South focus in hopes of enhancing Brazil's international influence. This shift became clearer after the 2008 global financial crisis. With its origins in the U.S. and European financial systems, the crisis seemed to confirm the deep-seated view among PT members that liberal capitalism was in decline, if not in existential crisis.

Lula's final two years in office were characterized by a concentrated effort to sharpen the tools of state-capitalism at home and project Brazil's power abroad, especially at the regional/hemispheric level. Examples of this can be found in the regulatory framework adopted for the exploitation of the pre-salt oil and gas reserves; an industrial policy meant to consolidate "national champions," funded by growing federal subsidies through the National Development Bank; and a more ambitious National Defense Strategy.

The Last Four Years: Rousseff's First Term in Office

When Rousseff was elected in 2010, some analysts expected that she would follow a more pragmatic course. According to this view, in the foreign policy arena she would tend to use Brazil's power resources with more prudence and parsimony at the global level (some critics of Lula's foreign policy accused his government of sacrificing Brazil's credentials in the fields of human rights on the altar of unrealistic power aspirations, such as gaining a seat at the UN Security Council). At the regional level, Rousseff's foreign policy was expected to be less oriented by political considerations and affinities with so-called "Bolivarian" neighbors such as Venezuela and Bolivia (according to some critics, Lula's foreign policy was complacent with Chávez's growing influence in regional affairs, in detriment to Brazil's national interests). Those expectations were largely based on an interpretation of Rousseff's biography as a woman, an ex-political prisoner submitted to torture, and a technocrat with a more down-to-earth approach to international relations. With regards to economic policies, though there was no doubt of her developmentalist persuasion, some analysts thought she would have no alternative but to curb public spending and engage with the private sector to invest in infrastructure.

In fact, during her first year in office, Rousseff adopted a tighter fiscal policy and insisted that the defense of human rights was a non-negotiable aspect of Brazil's foreign policy. However, this was short-lived. Deepening the developmentalist model initiated during Lula's second term in office was an alternative much more attuned with the interests and ideologies of the power bloc hat she represented. Moreover, the Brazilian economy was in a positive cycle, in part due to highly favorable terms of trade for commodity-producing countries and liquidity conditions in the global economy, which were also prevalent under her predecessor. This raised expectations and led to policies based on overly optimistic projections, which was fueled by exaggerated rhetoric about Brazil's rise vis-à-vis developed countries.

As the international environment worsened for Brazil, Rousseff bet on maintaining the pace of economic growth by increasing public expenditures on social programs as well as ambitious infrastructure projects and industrial policy initiatives. The private sector reacted defensively to the government stimulus packages by cutting rather than increasing investment. With an increasingly pervasive discretionary approach, trust in economic policy wore thin, to the point where many began to question the commitment to the tripod of rules-based fiscal policy, inflation targeting, and floating exchange rate regimes, which was adopted in Cardoso's second term and kept intact under Lula's two terms.

Not surprisingly, the results of Rousseff's policies have been poor. Growth dropped from an average of 4 percent between 2003 and 2010 to an average of 1 percent between 2011 and 2014, with the industrial output shrinking in relation to the prior period; inflation rose from 5.5 percent in 2010 to 6.5 percent in 2014 (it would have risen even further if it were not for below-inflation increases of regu-

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lated energy rates). Moreover, in the same four-year period, investment fell from 20 percent to 16.5 percent of GDP; the current account deficit rose from 2.2 percent to 4.6 percent of GDP; and the fiscal surplus (before interest payments) dropped from 3 percent to roughly -1 percent of GDP, with the nominal fiscal deficit approaching 6 percent of GDP. Gross public debt increased from 53.4 percent to 63 percent of GDP. Of course, the Brazilian economy was also hurt by the global drop in commodities prices, something beyond Rousseff's control.

In the foreign policy area, Rousseff's first term saw little divergence from Lula's overall strategy — although Brazilian diplomacy became much less proactive. More importantly, in the last four years, it has become increasingly clear that most of the strategic choices taken under Lula were not paying off. With the WTO's Doha Round paralyzed and plurilateral trade negotiations launched by the United States with Asia (Trans-Pacific Partnership) and Europe (Transatlantic Trade and Investment Partnership), the crisis of multilateralism deepened. Having focused its trade strategy on the WTO, Brazil was caught in a strategically uncomfortable position — particularly as hopes of leading regional integration were frustrated by growing cleavages between South America's market countries and the more statist or authoritarian Bolivarian countries, with Brazil staying hesitantly in the middle. With the incorporation of Venezuela in Mercosur (the Common Market of the South), a move strongly supported by Brazil and Argentina, and the adoption of further protectionist measures in both countries, especially Argentina, the customs union has reached its lowest point since its 1991 inception.

From a broader perspective, the South-South direction of Brazilian foreign policy was called into question as the strategic assumptions on which it was based proved less sound than their proponents believed. First, the United States bounced back from recession in a strong geopolitical position, in part due to the shale gas "revolution." Its simultaneous engagement in trade negotiations with the European Union and 12 Asia-Pacific countries demonstrate its continued economic strength, and these two initiatives could redefine trade and investment rules for more than half of the global economy. Second, the prospect of a strategic partnership with China lost appeal as imbalances in the composition of trade with China proved persistent; as Brazilian manufactured exports were increasingly dislocated by Chinese ones in third markets (primarily in the United States and Latin America); as trade barriers to the growing Chinese food market were not lifted as expected; and as China's lack of interest in reforming the Security Council became clear. Third, Vladimir Putin's Russia grew economically weaker and geopolitically more aggressive. Fourth, the Arab world became engulfed in internecine conflict, undermining the value of Brazil's stronger political and economic ties in the region that were developed as part of the South-South strategy.

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Against this new backdrop, the South-South strategy became a polarizing issue with growing political relevance, although with marginal electoral impact. More people started to question whether it aligned with Brazil's "national interest" or if it was based on narrower ideological preferences. Critics of the South-South strategy gained ground in the public debate, after being on the defensive during most of Lula's period in office.

What to Expect for the Foreseeable Future

At present, Brazil is in a weaker position than four years ago, from both an economic and a foreign policy standpoint.

Feeling significant pressure to shift her policy approach, Rousseff chose an economist with strong orthodox credentials, Joaquim Levy, as the new finance minister a month after her re-election. An economist with a Ph.D. from the University of Chicago, Levy announced in late November that fiscal policy will be guided by primary surplus targets of 1.2 percent in 2015, and 2 percent of GDP in the following years. Although apparently gradual, this is a substantial fiscal adjustment given that the current public primary result is a deficit somewhere between 0 and - 1 percent of GDP. Fiscal adjustment will inevitably require cuts in social programs and produce a dampening effect on an already weak economy, at least in the short run.

Sacrifices would be more easily absorbed by society and the political system if they were seen as temporary expedients to accelerate growth. But it will be harder to kick-start and sustain growth than it was in 2003 and 2004 when Lula's government introduced a significant fiscal adjustment in order to gain private sector trust. This time, fiscal adjustment will start from a lower point and with a weaker economy — in 2002, the primary surplus was 3 percent of GDP and the economy grew 2.7 percent. Moreover, it seems unlikely that external factors will counterbalance the contractionary effects of a tighter fiscal policy, which was the case in 2003 when a long cycle of high commodities prices began.

With private and public consumption limited, economic growth will have to come chiefly from a robust and sustained increase in aggregate investment, which is now at its lowest point in years. Given that public sector investment will be constrained by fiscal adjustment, economic growth will depend on private sector investment. A devalued currency will help exports, but the external sector is not big enough to significantly boost economic growth.

To increase private sector investment, the new economic team will need to address the defensive mood prevalent among the business community and increase its confidence. To that end, they will have to not only deliver results on the fiscal front but also to introduce microeconomic measures conducive to private investment. Foreign investors focused on the real sector of the economy (as opposed to those oriented by short-term financial gains) are likely to strengthen a pattern of differentiation in their approach to emerging markets — favoring those with more robust macroeconomic and microeconomic fundamentals as well as less regulatory uncertainty.

The situation is compounded by a massive money-laundering scandal involving Petrobras (Brazil's national oil company), numerous construction companies, and political operatives, many of whom are close to PT. First made public in October, the scandal is still unfolding and promises to have ripple effects in various economic sectors, including some of the largest Brazilian private firms and major players in infrastructure projects. With such a bleak horizon for investment, fiscal adjustment may not be enough to boost economic growth.

Moreover, the Petrobras scandal will continue to have significant political effects since it involves the core of

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Lula's and Rousseff's political base. Rousseff's image might be tarnished given that she was chair of Petrobras' board of directors and then president during the period under investigation.

To make matters worse, Rousseff's broad but heterogeneous political base in Congress has been less stable over the last two years. The administration may be able to make enough deals (such as offering political appointments) to gain the necessary support to implement fiscal adjustment measures requiring Congressional approval, but the political costs of getting them approved will be high, and it is highly unlikely that any bold reforms will pass that could fundamentally change the investment climate in Brazil.

Avoiding fiscal adjustment is not an option. The new administration is conscious of the risk that Brazil could lose its investment grade rating — earned in 2008 — and of the economic consequences that would accompany it. On the other hand, there is no doubt that Joaquim Levy was not Rousseff's first choice for the job of finance minister. She had no option but to choose someone with his credentials. The degree to which the private sector welcomed his appointment was proportional to the feeling of betrayal among PT's base, which was highly mobilized during the electoral campaign. Politically, two to three years of fiscal adjustment may prove to be too long if economic growth does not significantly recover.

Even in a scenario where Brazil's economy gradually returns to the course it was on until 2008, no major strategic changes are likely to happen in Rousseff's four-year term. So far, signs of change are limited to macroeconomic policy. In foreign policy, Rousseff's choice of Mauro Vieira (a career diplomat serving as ambassador to Washington since 2010) as foreign minister may signal a desire for better ties with the United States. However, Rousseff's inaugural speech gave cursory treatment to foreign policy issues, and the foreign ministry's budget remains roughly half of what it was under Lula.

After Brazil's growing international profile under Lula, the country's foreign policy has become less active. The government has been reluctant to prepare for the consequences of TPP and/or TTIP being finalized, betting that these mega-regional trade agreements will fall apart before completion. The appointment of former president of the National Confederation of Industry (CNI), Armando Monteiro, as the new minister of development, industry and external trade, could be interpreted as a change in this attitude. CNI has been publicly advocating for a more proactive trade policy out of fear that Brazil is becoming too isolated. Indeed, one of Monteiro's public comments stated his desire to improve trade ties with the United States and Europe. But one ministerial appointment does not by itself indicate a change of approach.

Brazil has traditionally been inward-looking and is currently absorbed by its own domestic problems. It would be overly optimistic to expect anything besides incremental and limited change. But it does seem likely that relations with the United States will improve from their lowest point in decades. On the Brazilian side, limits are set by the lack of a clear bilateral agenda and the lingering wariness of the U.S. role in Latin America and the international system. On the other hand, regaining ground in the U.S. market is now more crucial than ever for rebalancing Brazilian exports in favor of more manufactured goods. With the U.S. economy resuming robust growth and the real devaluating against the dollar, economic incentives for closer ties with the United States are compelling from the Brazilian perspective. Additionally, the cost-benefit calculus of maintaining ties with the BRICS (Brazil, Russia, India, China, and South Africa) might be changing as doubts about China's trajectory grow and concerns about Russia's future deepen.

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Brazil's desire for a trade agreement between Mercosur and the European Union theoretically increase with the devaluation of the real, making Brazilian exports more competitive, and with the deceleration of growth in China and Russia, making access to European food markets more important for Brazilian agribusiness. However, disagreements between Argentina and Brazil over a potential EU-Mercosur trade deal are still pending. A flexible solution is likely to prevail, allowing Argentina to meet the terms of the deal on a "lower speed" track, which would give it more time to adjust, thereby securing its vote in favor of an agreement. But even Brazil is not ready to rapidly advance in further opening its industrial and services sectors. A flexible solution might give Brazil more "breathing room" in Mercosur, since it would set a precedent for other agreements advancing with different velocities while keeping the customs union intact. However, Mercosur's deeper challenges would remain.

Mercosur is in a moribund state and Brazil has no proposals to revitalize it. There is no articulated alternative to the tactics of "strategic patience," but little left to justify its continuation.

Change in Mercosur's fortunes could potentially arise from the possible combination of two factors: the election of an Argentinian government with stronger economic management credentials in October 2015, and the consolidation and expansion of the influence of Brazil's new economic team within the current Brazilian government.

Revitalizing Mercosur would be important for Brazil in order to strengthen its leverage with the South American Pacific Alliance, whose members (Chile, Peru, and Colombia) are focused on dynamics in the Pacific Basin. But the revitalization of Mercosur requires profound strategic reorientation in Brazil, and Argentina, toward a "new" kind of integration (rules-based and market-driven, but with coordinated regional initiatives in selective areas where the bloc can build upon competitive advantages such as energy and food production).

It is hard to exaggerate the practical obstacles that must be overcome if Mercosur is to move in this direction. The biggest obstacle lies at a more fundamental level: mired in a defensive approach to managing a customs union oriented toward "national development strategies," neither Brazil nor Argentina possesses a coherent vision on how to revitalize Mercosur.

Pressed by short-term financial constraints, Argentina seems more interested in strengthening its ties with China. In January, the Argentinian Senate approved a government-backed bill that gives especially favorable treatment to Chinese investments in the country (not only was a specific tax regime established, but the use of temporary Chinese labor was permitted). In the same context, Argentina allowed China to build a satellite tracking center in the southern province of Neuquén. The agreement between the two countries contains confidential clauses and has become a matter of concern for the Brazilian government, given the potential dual usages of the technology and the unclear purpose of the satellite center. Parties and politicians from the opposition in Argentina have been vocal in their criticism of this agreement, not only because it is not completely transparent but also because it appears asymmetrical in the distribution of rights and benefits as well as duties and costs between the two parties (the accord gives China a 50-year tax exemption on the import of equipment for the satellite center, allows a Chinese workforce to be hired under Chinese labor laws, and establishes that any legal dispute concerning the satellite center will be solved under Chinese law).

In her second inaugural speech, Rousseff re-emphasized, briefly, the centrality of South America to Brazil's foreign policy, even though the country's standing in the region has deteriorated in the last four years. The decision to prioritize the political enlargement of Mercosur has backfired; Brazil's influence over the Bolivarian countries has declined; and the Brazilian government played only a limited role in attempting to mediate the conflict between the Venezuelan government and opposition leaders in the beginning of 2014.

Desperately in need of foreign funding to finance its growing external and fiscal deficits, Venezuela is increasingly turning to China, while Brazilian companies accu-

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mulate overdue credits against the Venezuelan government (the Venezuela-Brazil Chamber of Commerce estimates these credits amount to $5 billion[1]). Bolivia and Ecuador are increasingly reliant on China for infrastructure projects, purchase of military equipment, and other major investments. Big Brazilian construction firms, which led Brazil's "capitalist expansion" in South America with the backing of the Brazilian National Development Bank in the first decade of the century, have lost their unrivalled position. Chinese competitors continue to penetrate South American markets and China's influence with South American governments, especially the Bolivarian ones, is increasing.

Big countries like Brazil tend to change slowly. But the world moves faster and societies change more rapidly today. Experience tells us that change in Brazil normally happens when spurred by acute crisis and inspired leadership. If neither materializes, the default may be four years of muddling through. But the opportunity cost of such an approach may be greater than ever. With large international currency reserves, an uncomfortable but not disastrous trajectory for the debt-to-GDP ratio, and decent

1 "Brasil Vai Propor Que Venezuela Pague Importações com Petróleo," *Valor Econômico*, January 28, 2015, http://www.valor.com.br/internacional/3881662/brasil-vai-propor-que-venezuela-pague-importacoes-com-petroleo.

fiscal and monetary institutions and tools, Brazil is not on the edge of a cliff. However, the postponement of strategic decisions may usher in an era of "diminished possibilities" for Brazil. With a strong civil society that is increasingly engaged, Brazilians themselves will be crucial to determining whether or not the country advances with renewed strategic vision, both domestically and internationally.

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