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Brazil's corruption crisis: What next for an economy and political class undermined by systemic bribery?

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After two years of deep recession, Brazil's economy appears set for no more than a modest recovery -- if that. Most of the economic doldrums are domestically driven; a perfect storm of high unemployment, heavy household debt burden and an unsustainable fiscal deficit. Overshadowing its failing economy, fallout from the Petrobras-Odebrecht corruption scandal has affected politicians across the spectrum, leaving few unscathed. President Michel Temer's dismal approval ratings question his ability to push unpopular fiscal and pension reforms through a divided Congress. Temer may, perversely, continue the systemic political bribery that has ravaged Brazil's political and business class. Even presidential elections due next year are unlikely to reverse this spiral of systemic corruption. Questions arise as to whether there is any way forward for Latin America's largest economy.

Business-state relations

Brazilian business is facing two prominent concerns -- rising unemployment in the oil/gas and construction sectors, and substantial financial and reputational losses following multiple corruption scandals. Amid deep recession, the government has been forced to announce austerity measures including cutting expenditures, freezing investments, halting critical infrastructure projects, and ending tax exemptions. Additionally, President Michel Temer and Finance Minister Henrique Meirelles have announced a programme of urgently needed structural reforms. While the wide-ranging labour reforms can be passed through ordinary legislation, the social security and pension reforms will require a constitutional amendment. The latter will be a difficult process as a strong opposition, and even government allied deputies, are reluctant to support an unpopular government in achieving such unattractive measures ahead of election season.

Despite internal strife, the projected image of Brazil abroad remains buoyant. The Getulio Vargas Foundation (FGV)'s business confidence index for March is the highest it has been since May 2014. This is supported by strong foreign direct investment, with 75 billion dollars expected this year, while a trade surplus of 50 billion dollars is forecast. Trump's isolationism has encouraged Mexico to diversify the Pacific Alliance trade bloc after the Trans-Pacific Partnership (TPP) fell through earlier this year. This prominent development could offer fresh opportunities for Brazil.

Congressional politics and reform prospects

President Michel Temer is entering the final 18 months of his political career, with no indication of pursuing re-election in 2018. This could prove to be a favourable circumstance for Brazil, with a chance to undertake some painful reforms with a president who will not face an electoral verdict. Temer has primarily focused on two signature initiatives, the 20-year spending cap and social security and pension reform. The latter is facing greater opposition: more than half the votes needed to pass these reforms exist within the presidential coalition, but even among Temer's allies many appear poised to vote against. Ideally, the Lower House would vote on the reform before the July recess, and the Senate would take it up again in August. Two negative scenarios could potentially arise -- a lack of success in voting on the reforms before the July recess, or an outright failure on the vote. Either situation would cast an ominous cloud over Temer's remaining months in office, as a vote closer to the 2018 elections would almost certainly fail.

Complicating matters more, Congress is independently debating a political reform that would change several electoral institution rules, such as allowing politicians to run simultaneously for governor and congress, closed list proportional

representation, a gender quota for female candidates, and an end to the electoral coalition system. This has a fair chance of passing and could result in a 50% reduction in the number of Brazil's political parties.

The Tribunal Superior de Cuentas (TSC) investigation of illegal campaign funds could retroactively disqualify Temer's 2014 ticket. However, this is unlikely given Temer's relationship with the current head of the Supreme Electoral Court and ability to choose two new justices in May. Also, it is not likely the TSC would want to deprive Brazil of a president during these particularly difficult times. Looking towards the 2018 presidential election, leaked testimony of former President Luiz Inacio Lula da Silva's involvement in the Odebrecht scandal may damage his candidacy. However, if unimpeded, he will almost certainly be a candidate in the 2018 presidential election.

Wider regional impacts

Brazil is the largest country in South America and Latin America, and, for a considerable amount of time it has been an important world player. Its internal dynamics are extremely complex, meaning the crisis has had considerable international implications. The corruption crisis came 10 years after a period in which Latin America benefitted from the commodity boom. Undoubtedly, the crisis has contributed to the retreat of the 'pink tide' in other countries, and as the commodity super-cycle collapsed, these countries started to face more internal dilemmas. Across the region, there was a rise of social protest against the political class that was judged in Brazil and elsewhere for misleading the public with borrowed redistributive policies which were not able to fulfil expectations.

One repercussion of the Petrobras-Odebrecht scandal in the region is the level to which the Brazilian judiciary became more forceful and independent in pursuing investigations; this would not be expected of many Latin American countries. Second, the United States Department of Justice's jurisdiction over legal cases has made it impossible for other countries implicated in the scandal to sidestep or internally resolve their misconduct without further damage. This showcases a generalised discredit of the political class in many Latin American democracies, and therefore reinforces the loss of confidence that Latin America has a distinctive role to play. As a result of the collapse of the Lula administration, the impeachment of Dilma Rousseff and the rise of Temer, Brazil has retreated from the world stage. However, it now situates itself in a different, more conservative position as reflected by its new economic policies. There was a time in which Brazil may have played a balancing and legitimising role within the BRICS, or could have been a counter-weight to US President Donald Trump's regional policies. However, until its internal crisis is resolved, Brazil has little leverage.

Q & A Session

Effect of inflation decline on government's ability to pass reforms

The drop in inflation is due to the falling off of demand. 53% of households in a recent survey said they would review their expenditure going forward, while more than three out of every ten people have declared that they are unable to pay off their credit card debts.

Candidate scenarios for the 2018 presidential election

Former President Lula is expected to seek re-election. If his candidacy goes forward, his strongest competitor will be Sao Paulo governor Geraldo Alckmin running as the Social Democrat (PSDB) candidate. The presidential race will also presumably include ex-Minister of the Environment and Green Party candidate Marina Silva and Democratic Labour Party (PDT) candidate Ciro Gomes. Jair Bolsonaro remains a potential wildcard and would be the nation's first extreme right and anti-system candidate since Brazil's return to democracy in 1985.

Prospects for a populist candidate to emerge in 2018 presidential election

Jair Bolsonaro is a prospective populist candidate who is aiming to unify the pro-authoritarian and pro-Pentecostal strains of the Brazilian Right. The only defence the political class has against Bolsonaro is a rule against independent candidacy. It would be easier for Bolsonaro to run as an independent, but as he is not permitted to, it is anticipated

that he will take the nomination of the Social Christian Party. He is an internet and television phenomenon, but other candidates are expected to refuse to debate on TV or otherwise interact with Bolsonaro owing to his frequently expressed extremist views.

Investment in infrastructure development

Exactly when Brazil has a government that is more willing to adjust regulations to become more attractive to infrastructure investors, it is faced with the impact of a deep recession and a low prospect of recovery. This has resulted in a freeze of one-quarter of all infrastructure capital, and massive layoffs within the construction sector. Due to their illegal entanglements, larger construction companies will be unable to bid on government projects. Smaller construction companies could bid on projects, such as the affordable housing project, and could potentially create more jobs.

Social unrest risk

Any new social unrest between now and the election would be policy-based, rather than generalised anti-government or anti-political class protests. Raising the retirement age of teachers or public service workers could cause a protest leading up to final vote of the social security and pension reform in the second half of this year. This issue could also potentially revive the Workers' Party (PT) and its union arm, the Unified Workers' Central (CUT), which are both currently facing a crisis of leadership.

Brazil-Trump trade dimensions

The Trump administration is willing to inflict a significant amount of trade damage on Mexico, which could lead Mexico to consider diversifying trade to Brazil. Both Mexico and Brazil have grounds for a common approach. However, this will take time due to past rivalries.

Brazil has not been trade-dependent on the United States, and will not likely suffer as much as other countries if Trump follows through on new economic policies. In fact, Brazil is likely to have modest new opportunities arise to fill the spaces that the United States retreats from.

Impact of meat scandal on Brazil's agribusiness

Initially, there was a drop in production and sales for a 2-3 week period. However, the market is returning to normal, and almost all the countries affected have lifted their import bans. The government has sought to emphasise the effectiveness of the accountability and monitoring measures which exposed the lower level bribery and unethical practices that were taking place.

Impact of various corruption scandals at sub-national level

The leaks from the Odebrecht investigation continue to affect sub-national executives, as many state governors maintained direct negotiations with Odebrecht over various public works. In mid-March, public prosecutor Rodrigo Janot asked the Supreme Court of Justice for permission to investigate 320 individuals, 83 of whom are incumbent politicians. In every state, there is at least one governor or former governor implicated in the Odebrecht scandal. However, this is not likely to have a directional impact as these individuals are spread across different political parties. The impact will be a more generalised dissatisfaction with the political class.

Petrobras prospects

Depending on who wins the 2018 election, there is going to be an effort made to improve corporate governance which will include separating decision-making related to Petrobras. Given the revelations of Lava Jato, all politicians will be more cautious during transactions. However, Petrobras's close links to the government are not likely to disappear completely. The first quarter of 2017 has shown a small return in profits for Petrobras.

Capacity for change

Brazil has suffered through an abundance of pain over the last two to three years. The full consequences of the shock and repositioning that therein follows have yet to be recognised. This may take a very unpredictable form, or the old familiar Brazil may resurface. Prediction is always hazardous, especially with Brazil's current state of affairs.