

Brazil

Politics/governance

Analysts

Elizabeth Johnson
Director of Brazil Research
+44 (0)20 3002 7706
ej@trustedsources.co.uk

For more information please
contact Sales:

sales1@trustedsources.co.uk
+44 (0) 20 3170 7254

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Understanding the risks of the 2010 presidential election

Major policy changes are unlikely, no matter who wins

The 2010 presidential election looms large for investors mindful of Brazil's short history of democracy, but we believe that major worries are misplaced. Increased economic prosperity has made the Brazilian electorate more conservative, leaving little room for a radical Chavez-like candidate or for excessively populist policies. Whoever wins the election in October will likely keep largely to the policies pursued by the Lula administration.

Key judgments

- ❑ Campaigning will only begin in earnest after the FIFA World Cup ends on 11 July.
- ❑ Some market turbulence is likely as the candidates present their platforms, but we expect no major economic or institutional changes to take place in 2011.
- ❑ The markets prefer a Serra presidency because of the likelihood that he would push ahead with much-needed fiscal reform.
- ❑ A Dilma victory could hurt the share prices of state-controlled companies such as Petrobras and Eletrobras because she will likely favour a more interventionist approach than her predecessor.
- ❑ Both candidates will continue to promote large infrastructure projects and work with the private sector. However, Dilma's ideological resistance to private sector investment could limit the number of projects championed by her administration. In contrast, Serra would hit the ground running and apply his expertise in developing projects that balance public and private sector interests.

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Core Case

With Lula ineligible to run for a third consecutive term, Brazilians will elect a new president in 2010. Under Lula, Brazil has made a fundamental leap forward in terms of income distribution and poverty elimination, building on the progress made during the Cardoso administration (1995-2002). Whoever takes office in 2011 must continue this progress or risk being voted out of office in 2014. In this context we believe that regardless of their campaign discourse, whichever of the two leading candidates – Sao Paulo Governor Jose Serra and presidential Chief of Staff Dilma Rousseff – is successful, the status quo will probably be maintained in the following areas:

1. Monetary policy

The macroeconomic policy regime that has been in place in Brazil since 1999 – based on inflation targeting, a primary fiscal surplus and a floating exchange rate – will not be changed by the incoming president. When Lula took office, it was clear that he understood that lower income groups are hardest hit by inflation; both candidates seem to have grasped this concept.

Because of the paramount importance of keeping inflation in check, neither candidate would question the independence of the Banco Central and its Monetary Policy Committee, nor would they change the inflation targeting regime. Inflation in 2010-11 is likely to remain around 4.5 per cent, the middle of the committee's current 2.5-6.5 per cent targeting band.

Both candidates have expressed their concerns about the strong Real and its negative impact on the export sector, but neither candidate would abandon the floating exchange rate. The Banco Central will continue its currency intervention policy, accumulating foreign reserves in order to keep the domestic currency from appreciating too much. Foreign reserves, which reached US\$240.7 billion on 8 February 2010 (up from US\$37.6 billion when Lula took office on 1 January 2003), will continue to grow.

Serra has been more vocal about his apprehensions and has even been dubbed the “3 x 4” candidate because he would like to see the exchange rate reach R\$3/US\$1 and interest rates drop to 4 per cent. For Serra, the best way to reduce interest rates would be to cut government spending via fiscal reform rather than by threatening the independence of the Banco Central.

Both Dilma and Serra are aware that the appreciation of the currency has helped keep prices of food and consumer goods down, and because low inflation will take precedence over the concerns of the export sector, the Real is likely to remain in the R\$1.5-2/US\$1 range.

According to press reports, President Lula is insisting that the Workers' Party (PT) explicitly state in Dilma's campaign programme that if elected she will maintain a floating currency, inflation targeting and a primary surplus. Dilma has also given indications that in an attempt to send the right message to the market, she would appoint someone with a similar profile to Henrique Meirelles as president of the Banco Central. In fact, it is likely that if Meirelles decides not to stand for public office, he could even remain as the head of Banco Central during the transition.

Regardless of who is elected, Brazil is likely to maintain a primary budget surplus, which is targeted at 3.3 per cent of GDP in 2010. This target could even be raised to 4 per cent in 2011 as economic growth continues and many of the temporary tax cuts implemented in 2009 expire later this year.

2. Social programmes

Neither candidate would make any meaningful changes to the “Bolsa Familia” income subsidy programme. At an annual cost of around R\$12 billion, this programme has played a significant role in reducing poverty, especially in northeastern Brazil where economic growth has been in double digits. The low-income housing programme known as [Minha Casa, Minha Vida](#) will also be maintained. Both candidates are highly aware of the role that regular minimum salary rises (scheduled at 9.7 per cent over 2009 levels or R\$510/month in 2010 by the Lula administration) has played in increasing the purchasing power of the working poor. They would be foolish not to continue this policy.

3. Focus on infrastructure spending with private sector participation

Private investment in infrastructure will need to be stepped up, especially as the 2014 FIFA World Cup approaches. The two candidates would differ mainly in the speed with which projects are presented and in their quality. Serra would likely hit the ground running and offer a large number of new projects in his first year in office. Because he has no ideological opposition to private sector investment in infrastructure, projects would be structured so as to balance public sector and private sector interests. We can see his track record in the state of Sao Paulo, where the government has creatively used public private partnerships (PPPs) to undertake sanitation and urban transport projects (the federal government, on the other hand, has yet to employ the PPP model). In neighbouring Minas Gerais, also governed by Serra’s Social Democratic Party (PSDB), the model has been applied to roads and even to prisons.

In contrast, Dilma, while competent, seems to lack Lula’s and Serra’s pragmatism and is more ideologically opposed to private sector participation in infrastructure projects. Although the realities of budgetary constraints have forced her to become more flexible in this area, she sees the private sector as the investor of last resort. In her current role as Chief of Staff, she has been instrumental in working out the models for private sector participation in the energy and highway sectors, where the government has had a [solid record of concession sales](#). However, the development of projects that are attractive to private investors in key areas such as railways, airports and ports has gone virtually nowhere so far. According to Defence Ministry sources, Dilma has vetoed plans to sell operating concessions for existing airports for 2010 despite the fact that the privatization model has already been devised. The same sources say Dilma delayed plans to sell the concessions because she is worried about being labelled as pro-privatization. However, if elected she will likely be forced to push ahead with the sale of airport concessions, due to the time constraints of the 2014 World Cup.

Dilma will also likely encourage state-controlled companies like Petrobras and Eletrobras to take an even more active role in infrastructure investment than has been the case under Lula. This will crowd out private enterprise and increase the risk of over-billing and other types of corruption.

Wild cards

Although Dilma has made some significant advances in the polls recently, Serra is still in the lead – but it is much too early to call the election. One of the leading candidates in the 2002 election, Maranhao Governor Roseana Sarney, was actually ahead of Lula in the polls early in that race until a corruption scandal forced her to withdraw. Likewise, three months before that election, Ciro Gomes overtook Jose Serra in the polls, only to crash and burn after making a series of sexist comments about his own wife (a well-known soap opera star). Dilma is the only candidate currently campaigning, taking advantage of her final months as Lula's Chief of Staff to travel the country with him. The two politicians have been successfully staging photo opportunities at public works projects, increasing Dilma's name recognition. Serra, on the other hand, is not even officially a candidate and is focusing his efforts on the state of Sao Paulo, which he hopes to use as a showcase for his campaign. As the campaign cycle progresses the following factors will also influence the outcome of the election:

1. Running mates

Although vice-presidential candidates have typically been ignored in Brazilian elections, if Minas Gerais' Governor Aécio Neves (PSDB) opts to join Serra, he would be guaranteed more votes in Brazil's second-largest state. Neves, who also aspires to the presidency some day, will only join the ticket if he thinks Serra will win. Otherwise, he will run for Senate and likely be elected as the Senate opposition leader, thus increasing his national visibility for a 2014 presidential bid. Dilma will have to select a candidate from the ideologically nebulous Democratic Movement Party (PMDB), which will ultimately ally itself with whoever wins the election because of its need to be close to those in power to maintain its political machine. None of the PMDB vice-presidential candidates under consideration will likely help Dilma gain a leading edge in the votes. Her most likely running mate, current PMDB President Michel Temer, has had close ties to the PSDB in the past and even supported Serra in his 2002 bid for president. In fact, many leading members of the party have expressed their support for Serra in the upcoming election.

2. Subsalt debate

The government's attempt to push through new legislation for the future development of Brazil's subsalt oil and gas acreage has implications for the election, as we have argued in [recent reports](#). In fact, the administration had hoped to use the proposed regulatory changes as a soapbox for sounding populist notes in the campaign. However, the administration misjudged the importance of the royalties issue, which has become central to the subsalt debate. We believe that this issue has potentially negative implications for Dilma, who is seen as the candidate who wants to redistribute royalties from oil-producing states to the rest of the country. This debate will be especially intense on the municipal level in the state of Rio, where royalties are a significant source of revenues (as high as 45 per cent in the case of some municipalities in the state of Rio de Janeiro, according to one estimate).

3. Other candidates

Ciro Gomes of the Brazilian Socialist Party (PSB) has been waiting on the sidelines to make another bid for the presidency since his failed attempt in 2002, but was passed over as Lula's heir apparent when Dilma was picked as the PT candidate. Since then Lula has been trying to persuade Gomes to stand for governor of the state of Sao Paulo (where he would likely be defeated) just to remove him from the national scene. For now, **Ciro** continues to present himself as a presidential candidate, and polls indicate that he takes votes away from Serra. However, the PSB has indicated that it will support Dilma in the upcoming election, which would leave **Ciro** with few options other than to campaign with Dilma and hope to be nominated to an important ministry.

Former Minister for the Environment **Marina Silva** has yet to officially announce her presidential bid, but it seems almost certain that she will be the Green Party (PV) candidate. **Marina** is more charismatic than either Dilma or Serra and will have strong support from young people and from leftists who have become disenchanted with the more pragmatic PT platform under Lula. She has already garnered strong support from the artistic community, and world-renowned film director Fernando Meirelles ("City of God", "The Constant Gardener") is directing her campaign advertisements. **Guilherme Leal**, president of local cosmetics company Natura, is also considered a possible PV vice-presidential candidate. Although **Marina** is unlikely to win, we expect her presence to force the other candidates to have more defined positions on the environment. She will likely peak in the polls in mid-August, but will be a real factor in the election – potentially stealing votes from Dilma in the first round. However, in the probable event that no candidate wins an overall majority in the first round, these votes could migrate back to Dilma (rather than to Serra) in the final run-off between the two leading presidential candidates.

Conclusion

Roughly 20 years after the first post-military dictatorship presidential elections, Brazilians are increasingly apathetic about politics even though by law all eligible voters must go to the polls on election day. Most are not even aware that Lula is ineligible for re-election. At present the bulk of the population is focused on the upcoming Carnival holiday (13-17 February); after that, all eyes will be on Brazil's national football squad and the FIFA World Cup which will take place in South Africa between 11 June and 11 July.

Brazilians will only turn their attention to politics after the World Cup is over. The campaign will then begin in earnest and we will have a better idea of the outcome of the election. Neither Serra nor Dilma, the two candidates most likely to become president, has Lula's charm or charisma – few politicians do. However, Serra has much more experience of campaigning than Dilma, who has never stood for public office. Serra's public relations team has been with him for eight years and has helped him shed his technocratic image. Nevertheless, while Serra has several advantages, Dilma should not be written off as a candidate. Lula's popularity could yet play a more significant role in the campaign for president than it has in municipal elections.

Despite the benign political outlook, some market turbulence in both the currency and equities markets should be expected in 2010. As the campaign heats up, so too will the populist rhetoric. Recent statements by current PSDB President Sergio Guerra, Serra's campaign coordinator, exemplify the over-the-top language that we should expect. In an interview with national news magazine "Veja", Guerra said that if elected Serra would make "significant changes to monetary policy" and would "modify the interest rate, the exchange rate and the inflation targets". Guerra went on to say that the current policies "only create jobs abroad" and to claim that the PSDB is Brazil's only true leftist party.

In our view, election-related market turbulence could create buying opportunities. Not only is the economic outlook for 2011 and beyond positive; even more important, any new president will be highly unlikely to risk Brazil's new-found prosperity by tinkering with the economic and monetary policy status quo.

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Contact us



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SOURCES

Trusted Sources UK Limited

Europe +44 (0) 20 7183 5280

The Americas +1 (646) 496 9856

Asia +852 2973 6093 (Enzard Ltd)

info@trustedsources.co.uk

www.trustedsources.co.uk