

VERACITY INSIGHTS

POLITICAL RISK & STRATEGY

BRAZIL SCENARIOS: ROAD TO RECOVERY OR “DEAD MAN’S BOUNCE”?

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Over the past month, a paradox has emerged in Brazil: as the country slides ever deeper into its worst political crisis since its re-democratization in 1985, its stock market has rallied and the *real* has appreciated nearly 15 percent from its record low earlier this year. The ever-changing situation on the ground leads to numerous questions, which we explore below, namely: Is Brazil really about to turn a corner, or is this yet another false start? Will President Rousseff really be impeached, and if yes, what will change? How far might the protests go? What are the immediate and long-term risks and opportunities for foreign investors?

In short, the paradox can be explained by the following rationale: With the PMDB (Brazil’s largest party) leaving the government (as it announced it would do on March 29), the potential impeachment of President Rousseff – a prospect that has played favorably in international markets – has become much more likely, if still not a foregone conclusion. And if Brazil’s vice president – PMDB president Michel Temer – takes over, he will likely form a government of national unity focused on economic recovery. Temer, in fact, has already laid out his road map for more market-friendly reforms, which are, incidentally, almost diametrically opposed to the current government’s plans.

Regardless of which of the scenarios below plays out, investors should prepare for political and economic volatility in Brazil to increase in the short term. Despite uncertainty over whether the Rousseff administration will indeed end – and, significantly, what would replace it – one outcome is clear: investors will eventually benefit from a “new normal” consisting of greater transparency and corporate accountability that will positively impact Brazil’s business environment in the medium and long terms.

SCENARIO 1: ROUSSEFF IS IMPEACHED, VICE PRESIDENT TAKES OVER UNTIL 2018

If the Lower House and the Senate approve impeachment proceedings in their expected April vote on the matter, Rousseff will be relieved from her position for six months to mount her defense, and Vice President Michel Temer will assume the presidency. Such an outcome would provide short-term stability, but a Temer administration would ultimately face similar – and potentially destabilizing – challenges as those currently facing Rousseff: difficult coordination between the Executive and Legislative branches, high inflation and unemployment, negative economic growth, and intense public and judicial scrutiny, given the implication of several PMDB politicians in the Petrobras corruption scheme.



The Rousseff administration is making a final effort to remain in power, largely via former president Luiz Inacio Lula da Silva (Lula)'s role as Rousseff's liaison with members of Brazil's Lower House of Congress who remain undecided about how they will vote on Rousseff's impeachment. However, press estimates indicate that the administration is unlikely to secure enough votes to avoid a pro-impeachment vote in the Lower House, especially given that Brazil's largest political party, the PMDB, has largely defected from the government coalition as of March 29. It is possible that Lula will continue lobbying smaller parties in an effort to create a minority coalition big enough to avoid impeachment, but his chance of success is very slim, as is Rousseff's chance of muddling through until the end of her term.

SCENARIO 2: 2014 ELECTION IS ANNULLED AND NEW ELECTIONS ARE HELD

Shortly after Rousseff's extremely tight November 2014 reelection, the defeated PSDB party filed multiple complaints with Brazil's Superior Electoral Tribunal (TSE) accusing the Rousseff ticket of receiving illicit campaign funds through the Petrobras corruption scheme. The case has the potential to annul the 2014 electoral results before the end of the year. The administration would be able to appeal an unfavorable ruling in the Supreme Court, which would have final say in the matter.

In the event that the 2014 election results are annulled before the end of this year, new elections will be held 20 to 90 days from the date of the annulment, depending on the TSE's or Supreme Court's decision regarding the applicability of a 2015 electoral law to the case, as well as broader constitutional questions. There is also a (small) chance that, if the 2015 law is not applied, the courts may grant the presidency to the 2014 election's runner-up, Aécio Neves.

If there are fresh elections, it should be noted that most potential candidates from within the political establishment are facing corruption investigations and are consequently likely to also face intense public and judicial scrutiny, while outsider candidates who have denounced corruption, such as the former environmental minister and left-leaning presidential candidate Marina Silva, may gain traction.

SCENARIO 3: ROUSSEFF RESIGNS, VICE PRESIDENT TAKES OVER

Although highly unlikely, there is a chance that Rousseff will resign the presidency. The Workers Party leadership has indicated that it considers this an option of last resort to avoid further damage to the party's political capital. However, Rousseff has repeatedly declared that she will "never resign," and Lula continues to defend her. In the event of her resignation, Temer would take over until 2018, but his mandate would still be subject to the TSE/Supreme Court's ruling on the validity of the 2014 election (see Scenario 2).

POTENTIAL FOR CIVIL UNREST

Regardless of which scenario plays out in 2016, the already-polarized public sentiment and political discourse in Brazil have the potential to escalate.

In mid-March, Sergio Moro, the federal judge in charge of the Petrobras corruption probe, released taped phone conversations between Lula and various leading Workers Party figures that were highly damaging to the reputation of Lula and others. In one conversation, President Rousseff seemed to



indicate that her offer for him to assume a key ministerial role was in order to protect him from potentially being taken into police custody, days after he was questioned by the Federal Police in connection with the Petrobras investigation. While many view the tapes as evidence of a Workers Party conspiracy to help Lula avoid prosecution, Rousseff's supporters consider their release an affront to democracy and the prerogatives of the presidency, as well as a sign that Moro, elements of the Brazilian Prosecutor's Office (Ministerio Publico), and the Federal Police are politically motivated and actively seeking to topple the Rousseff administration.

If Rousseff is impeached, the Workers Party, Lula, and Rousseff will likely solidify their current discourse that the move is a coup d'état led by some in Congress, the Senate and the Judiciary. Although pro- and anti-government protests to date have been largely peaceful, Brazilian social media continues to demonstrate vicious partisan sentiment and an "us versus them" mentality that has been encouraged by both sides and may lead to large-scale – and potentially violent – street protests if Rousseff loses power.

We do not expect, however, that there will be widespread and long-term violence nor that the military will intervene. There may be isolated protests, particularly in the big cities, but Brazil's society has matured sufficiently, and the current government is so widely discredited, that there is little danger of broad strikes or civil disturbances.

SHORT-TERM TURBULENCE, LONG-TERM BENEFITS

Brazil's current state of crisis will continue to fuel short-term economic and political instability. Yet, regardless of the final outcome for Rousseff and Temer, or in the event of fresh elections, investors will find that the political crisis in Brazil has confirmed Veracity's long-standing position that since the advent of the Petrobras corruption investigation in 2014, Brazil has entered a new era of transparency and accountability.

Major Brazilian conglomerates' high-profile steps to implement or improve internal ethical conduct and anti-corruption policies have set a new tone in the investment landscape. The Brazilian electorate no longer accepts institutional impunity as par for the course, and the Brazilian press has reported on exponential increases in corporate due diligence, anti-corruption compliance, and investigation teams across major firms in Brazil.

In addition, we note that there is a significant potential "upside" for foreign investors that could emerge from the current crisis. If Temer indeed leads a government of national unity and implements parts of his plan, Brazil could see some significant pro-business changes over the next two years. Given Temer's age (he is now 75), he is unlikely to run for President in 2018, and may hence be able to push through some changes that are unpopular but necessary – such as public sector and pension reforms.

Although the identity of Brazil's president six to 12 months hence remains to be seen, the country's operating environment continues to move toward international standards of transparency. The current political crisis has shown that, to be successful, whoever ends up in power will have to demonstrate to the Brazilian electorate that the government will operate according to a higher standard, both in politics and with the private sector.