Brazil turns a page
What to expect of a Temer government

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After a long-drawn battle, Brazil's Senate has removed President Dilma Rousseff and Vice-President Michel Temer will take over.

He will serve initially for a period of up to 180 days while the Senate conducts an impeachment trial, but if Ms. Rousseff is convicted, he will serve out her term until it ends in 2018.

With an accidental President who has no popular mandate, deep structural reform is unlikely, but action can be expected on four fronts: reining in public spending, relaunching infrastructure spending, initiating pension reform and boosting foreign trade.

The key man in the government is Finance Minister-designate Henrique Meirelles, who was previously the Central Bank President and has a track record as an inflation hawk.

Uncertainty remains as Mr. Temer and members of his government could be ensnared in the Lava Jato corruption investigation and supporters of the Workers' Party could wage social unrest.

But if Mr. Temer and Mr. Meirelles can harness Brazilian society's clear desire for change into a workable majority, the government could pave the way for structural reforms, much the way Itamar Franco did under similar circumstances in the early 1990s.

After a wrenching battle and a last-ditch attempt to derail the whole process, Brazil has removed President Dilma Rousseff and is set to install Michel Temer in her place. Now comes the hard part: **getting the country back on track.**

By a vote of **55** to **22**, Brazil's Senate voted at dawn today after a marathon 20-hour session to force out Ms. Rousseff 17 months into her second term for alleged budgetary irregularities in violation of the Fiscal Responsibility Law. She now faces an impeachment trial within the next six months, which could lead to her permanent removal from office. Vice President Michel Temer will be sworn in today, initially for a maximum of 180 days but, if Ms. Rousseff is impeached, he will serve until the end of her mandate in December 2018.

The Senate decision marks a dramatic turning point for the world's seventh-largest economy, which has seen many of the gains it made in the past two decades swiftly unravel. It ends the Workers' Party 13-year hold on Brazil's presidency and brings a form of resolution to a tumultuous, convulsive few months that have left the country deeply divided and the economy paralyzed. While major reform remains an elusive goal given the context, Mr. Temer and his designated Finance Minister, former Central Bank President Henrique Meirelles, will likely try to rein in public spending, relaunch investment in infrastructure, promote much-needed pension reform and boost foreign trade.

But uncertainty remains, and there will be no honeymoon for an accidental president with no popular mandate. Though he has been active in Brazilian politics for decades and has thrice been Speaker of the House, the patrician Mr. Temer is still an unknown quantity. A 75-year-old constitutional lawyer and published poet, one of his main claims to fame is being married to a former beauty queen 43 years his junior who has tattooed his name on the nape of her neck. Though he was elected on the same ticket as Ms. Rousseff, the two are from different parties, have never been close, and Ms. Rousseff has accused him of waging a "coup" to take her place - which he denies, arguing that he has come to power by dint of Brazil's Constitution.

Mr. Temer is stepping into a quagmire. Brazil's economy is in its worst recession since the Great Depression. The country is engulfed in the massive Lava Jato corruption scandal that recently led to the removal from office of House Speaker Eduardo Cunha, who led the impeachment battle against Ms. Rousseff, and now threatens Former President Luiz Inácio Lula da Silva. Ms. Rousseff herself has not been accused of corruption, but investigators are getting close to the sources that financed her two victorious presidential campaigns. Additionally, the political climate is highly polarized, with many supporters of the Workers' Party vowing revenge and promising social unrest.

All this leaves Mr. Temer facing a wave of conflicting pressures that amount to a triple challenge to him and his government:

- **Relaunch the economy while taking tough measures:** Brazil is facing a drop in GDP of up to 4% this year after a 3.8% drop last year, and unemployment is at 9.5%, or 11 million people. But the room for expansionary policies is nil: Deficits and debts are ballooning, and inflation, while falling, is still running at a 9.3% clip over the past 12 months. Mr. Temer is hoping that by appointing Mr. Meirelles as Finance Minister and signalling willingness to launch a few key reforms, he will be able to create a "confidence shock" that will help offset the necessary spending cuts and possible tax hikes and gradually open space for interest rate cuts (Brazil's benchmark interest rate is currently at an eye-popping 14.25%) and private investment.

- **Support Lava Jato without getting ensnared in it:** The Lava Jato or Car Wash investigation (so called because it started as an inquest into alleged money laundering at a gas station in the southern city of Curitiba) has mushroomed into a massive corruption case involving many of Brazil's biggest companies and political parties. The judge leading the investigation, Sergio Moro, has emerged as a folk hero, and the scandal has led to widespread calls for a clean-up of Brazil's political class. Mr. Temer has vowed not to interfere, but the problem is that key members of his own party, the PMDB, his government and even Mr. Temer himself, may end up being involved. Some have called for impeachment proceedings against him, alleging that as acting President during absences from the country by Ms. Rousseff, he approved some of the illegal spending that is the base of the impeachment case against her, and he was elected on the same ticket that may have received illegal funding. His name has also been mentioned in connection with the Lava Jato investigation, but no evidence has been provided..

- **Embody change without a mandate and with a discredited support base:** With broad swaths of Brazilian society clamoring for a break with the past, Mr. Temer needs to act fast. But, as economist Sergio Vale of MB Associados points out in an interview in business magazine Exame, "Temer is not the dream President." He has reached the pinnacle of power through happenstance, not an election. And he will have to contend with a fractious coalition that is itself discredited by the corruption scandal. A key first test will be the size of his government: Mr. Temer was hoping to signal change by cutting the number of ministries to 20 from the current 32, but Brazil's pork-barrel politics may force him to retreat. And he will have to seek to build a coalition to enforce unpopular measures against the backdrop of municipal elections in October. In this respect, the recent removal of Mr. Cunha as House Speaker may be a drawback for Mr. Temer. Though he is arguably Brazil's most reviled politician and his exit removes a liability from the political landscape, Mr. Cunha's unrivalled mastery of Congressional politics would have been an asset in building support for key reforms.

The key man in the Temer government will be Mr. Meirelles. The 70-year-old comes to the finance job with a strong track record as an "inflation hawk," gained when he was President of Brazil's Central Bank under Ms. Rousseff's predecessor, former President Lula, from 2003 to 2010. Prior to that, Mr. Meirelles had a long and distinguished career in banking, rising to become President and COO of BankBoston Corporation, based in Boston, and then, after BankBoston merged with Fleet Financial Group, President of FleetBoston Financial's global banking unit. He has also been a member of Brazil's lower house of Congress, elected as a member of the Brazilian Social Democratic Party in 2002, but later switching to the PMDB, and has held several prominent board positions at major Brazilian companies.

Mr. Meirelles will take on a familiar role: that of reassuring the business community. During his eight-year tenure at the Central bank – which makes him Brazil's longest-serving Central Bank head – Mr. Meirelles played a key role as a counterweight to the left-wing Workers Party, which was pushing for expansionist, Keynesian policies. He raised the country's benchmark Selic rate to 26.5% to curb inflationary pressures, and then gradually brought the rate down as low as 8.75%. The price stability Brazil enjoyed during his tenure contributed to Brazil's rise as the B of BRICS.

In a weekly column he writes for the daily Folha de São Paulo on macro-economic issues, Mr. Meirelles has provided a glimpse of what to expect of him: an orthodox fiscal adjustment and emphasis on stability and predictability to bring back confidence, cut interest rates, favor investment and pave the way for key structural reforms. Here are a few quotes from Mr. Meirelles, in his own words:

While the risk of deflation in advanced economies might persist, in Brazil, the risk of inflation must be attacked quickly given its cost and our history. The solution to the fiscal imbroglio is the first step towards killing the inflation problem before it kills us.

The fiscal question comes first, given the urgency; but it must be followed by a revision of the norms for infrastructure concessions, investments in the quality of education and an improvement in the business environment that result in an increase in productivity.

It is not simply a question of cutting public spending, but organizing and defining budgetary priorities, so as to make very clear to society that the country will grow, create jobs and, ultimately, increase the population's standard of living.

If we overcome the political crisis and define an efficient economic policy – capable of reversing the trend of uncontrollable growth of public debt, creating stable and attractive rules for investment in infrastructure and approving reforms that promote productivity and re-establish confidence – then the international capital markets and available global funds will be fundamental sources of investment in Brazil.

The new Finance Minister will have his work cut out for him. While the transitory nature of this government and its shaky support make big structural reforms unlikely, some measures the Temer government could seek to implement will likely include:

- **Control public spending:** This is the root of Brazil's problems, and it is efforts to mask the size of Brazil's budget deficit through accounting sleight-of-hand that led to Ms. Rousseff's removal. Brazil's budget deficit exceeds 10.4% of GDP and its debt-to-GDP ratio is above 66%. Mr. Meirelles has already signalled that cutting Brazil's runaway deficits is the key first step and it's likely that he will try at the same time to cap public spending (while preserving popular welfare programs), cut various subsidies and seek Congressional support to limit some mandatory inflation-adjustments on social benefits.

- **Favor investment in infrastructure:** Infrastructure investment has been paralyzed by the involvement of major construction companies in the Lava Jato scandal. The government could seek to make concessions more attractive to smaller companies and foreign investors and push for Public Private Partnerships (PPPs) for airports, roads, ports and other projects. Another area that could see change is removing the obligation for Petrobras to participate in all exploration projects of Brazil's pre-salt oil fields, opening them up to other oil majors.
- **Promote pension reform:** Brazil is one of the few countries in the world that has no minimum age for retirement; men can retire after 35 years of work and women after 30 years. As a result, Brazil's social security system runs a chronic deficit, equivalent today to 2% of GDP. Although sensitive politically, the government could attempt to gradually introduce a minimum age for retirement of 65 for men and 60 for women, suggests a recent document prepared by the PMDB entitled "A bridge to the future." It could also seek to introduce a minimum number of years of contribution to the system and seek to introduce greater equity between the public and private sectors.
- **Boost foreign trade:** Mr. Temer is reportedly planning to merge the Foreign Trade Chamber into the Presidency and take charge of it himself, signalling his desire to make foreign trade a key component of his efforts to relaunch the economy. Though an economic giant, Brazil accounts for only about 1% of global trade flows, but the recent depreciation of the Real creates an opportunity to boost exports if accompanied by a simplification of Brazil's bureaucracy. The appointment of José Serra as Foreign Minister also marks a likely switch towards a greater opening to the North rather than a South-South outlook.

In a bizarre incident a few weeks ago, an audio file of Mr. Temer practicing a unity speech was accidentally leaked in which he said **"Let's not think that a possible change in government will solve everything in three or four months."** Pushing through reforms in today's polarized climate - let alone the deep economic and political reforms Brazil needs - could seem a tall order, but there is actually a precedent that Mr. Temer has certainly studied: that of Itamar Franco.

Indeed, only 24 years ago, Brazil already lived through what it is experiencing today. Just two years into his term, President Fernando Collor de Mello was removed from office on corruption charges and Mr. Franco, his seemingly hapless Vice President, took office. After stumbling through his first months in office and running through three finance ministers in eight months, Mr. Franco appointed Fernando Henrique Cardoso to the Finance Ministry. Mr. Cardoso introduced the Real Plan that finally brought an end to hyperinflation. Mr. Franco went down in history books as the man who tamed a Brazilian scourge and Mr. Cardoso rode that success to two terms in Brazil's presidential Planalto Palace, during which Brazil implemented deep structural reforms.

With Mr. Temer having already made clear that he will not seek the Presidency in 2018 (if he makes it that far), some are already saying Mr. Meirelles has a similar opportunity if he and Mr. Temer can harness Brazilian society's clear desire for change into a workable majority that paves the way for structural reforms. It will certainly not be smooth sailing, but as Mr. Meirelles wrote himself in one of his columns: **"For difficult problems, there are no easy solutions."**

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