April 14, 2016

WELLS FARGO SECURITIES

Economics Group

Special Commentary

Eugenio J. Alemán, Senior Economist
eugenio.j.aleman@wellsfargo.com • (704) 410-3273

Brazilian Congress Moves Closer To Impeach Rousseff

Executive Summary

Brazil is at a crossroads, one that many believe the country has approached before and has successfully navigated. However, in this report we call attention to the distinctly different characteristics of the current crisis, which is fundamentally a political crisis rather than an economic crisis, and how difficult it will be for the political system to solve the current issues affecting it. Brazil has a presidential political system, but it is a highly dispersed party system where alliances are difficult and not particularly stable. Today, the current president, Dilma Rousseff, is losing her battle to keep her presidential alliance in place as the largest parties in her coalition, the PMDB and the Progressive Party, have abandoned her.

Realizing her weakness, Rousseff has just proposed to relinquish power by calling for early elections that could occur as soon as October of this year. However, it is not clear if the opposition will accept this proposal. Meanwhile, the Brazilian economy continues its downward spiral with no end in sight for now.

Impeachment Closes In: The Reasons? Highly Political

The Brazilian political system is very complicated. Even many Brazilians have trouble explaining and understanding it. However, the system has already produced an impeachment in the past, that of President Fernando Collor de Melo in 1992, who was accused of corruption by the Brazilian Senate. Collor de Melo resigned before he was removed from office but the impeachment process continued and the Brazilian Congress eventually approved the removal.

Following de Melo's removal, Brazil entered into the Real Plan that introduced a new currency and implemented important structural reforms that helped the country take advantage of the commodity boom cycle that started in the early part of this century. Perhaps this is the scenario that markets are hoping for today, thinking that this is a good opportunity for the country to move past this crisis and embark on a new political and economic revival. However, the current backdrop is quite different today in Brazil as well as in the rest of the world relative to the environment that prevailed in the 1990s.

The current backdrop is very different from the 1990s when Collor de Melo was impeached.

In particular, some of the politicians that are pushing for Rousseff's impeachment are themselves involved in the graft and corruption case involving Brazil's venerable state-owned petroleum company, Petrobras. Eduardo Cunha, the all-powerful speaker of the Brazilian Chamber of Deputies (the lower house of Congress) and the person spearheading Rousseff's impeachment process, has been charged by the Brazilian prosecutor of corruption in the Petrobras graft case, and some are speculating that the impeachment process is just a smoke screen to hide his troubles.

If the approval of the special commission to impeach Rousseff was not enough, the Progressive Party (PP), another large member of the Rousseff coalition, abandoned the governing coalition. The PP is now the second large party to abandon Rousseff in less than two weeks, delivering, perhaps, a fatal blow to any prospect of her surviving the impeachment process. The process continues on Friday when the Chamber starts debating the charges. Two-thirds of the Chamber

This report is available on wellsfargo.com/economics and on Bloomberg WFRE.

needs to vote in favor for the impeachment process to move forward and the vote is expected on Sunday.

If approved by the Chamber, it then moves to the Brazilian Senate (the upper house of Congress), which has ten days to vote on the process and only needs a simple majority of senators voting in favor. If the Senate votes in favor, then President Dilma Rousseff will be separated from the Presidency for a period of 180 days while the Senate judges her for "lying on the country's fiscal deficit numbers."

Once the Senate judicial process ends, the impeachment of the president is official if two-thirds of the Senate votes in favor. President Dilma Rousseff could resign during this period, just as ex-President Fernando Collor de Melo did back in the early 1990s. However, the impeachment process can continue even if the president resigns, just as it did when Collor de Melo resigned.

The whole impeachment process is engulfed in doubts.

However, the whole process is engulfed in doubts, not only because the allegations seem "de minimis," i.e., lying on the fiscal deficit numbers. Moreover, a Supreme Court judge has indicated Vice President Michel Temer, who would take over for Rousseff if she is removed, would have the same responsibility as Rousseff and would have to also be impeached for the same charges. At the same time, there is another judicial process that started in October 2015 which is investigating illegal presidential campaign finance allegations. If this process continues and ends up determining these allegations are indeed accurate, then both Rousseff and Temer will be removed from their posts.

Currently, Temer, from the PMDB party, is scheduled to take over the presidency in case President Dilma Rousseff is impeached. However, Temer's stance as well as the stance of the speaker of the powerful Chamber of Deputies, Eduardo Cunha, is also very difficult. Some polls indicate that Brazilians want Dilma Rousseff out of the presidency but also want Michel Temer out, which tends to indicate that even if Rousseff is removed, the political crisis could continue.

Perhaps Rousseff's biggest problem is her lack of charisma and political savvy, which pales in comparison to her predecessor and mentor, ex-President Luiz Inacio "Lula" da Silva. Lula is a very charismatic politician and an impressive power broker within his Worker's Party (PT) and within the country. However, Dilma's administration's attempt to bring him back as chief of staff was stopped by the courts and by a backlash in public opinion. However, this does not mean that he does not still have enormous power. In fact, the opposite is true and, unless he is imprisoned under the allegations of graft and corruption involving the Petrobras investigation, he will remain a force to be reckoned with. This adds further uncertainty to the country's political future even if Ms. Rousseff is impeached or if she resigns after the Congress decides to continue with the impeachment process.

Rousseff has indicated she will call for a snap election if the vote is not to impeach her.

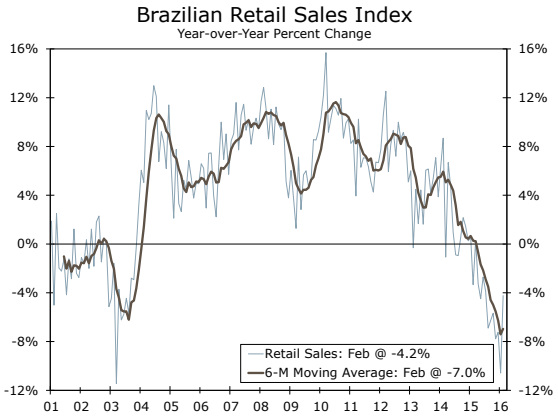
In a recent interview with a Brazilian newspaper, President Rousseff said that if the vote on Sunday is not to impeach her, she was open to call for early presidential elections, perhaps as soon as October of this year, and for a compromise on national unity. It is not possible to know how this proposal is going to be seen by an extremely divided opposition, especially if the opposition believes that this may be a strategy to bring back ex-President Lula da Silva to power. Thus, for now, the Brazilian political crisis will likely linger for a while.

Meanwhile, the Economy Continues Its Downward Spiral

While all of this is happening, the Brazilian economy continues to contract with no end in sight for now, although we have seen very small signs that the economic crisis may be abating or at least not deteriorating anymore. One example of this are recent industrial production data. While industrial production plunged 2.5 percent in February compared to the previous month, it declined "only" 9.8 percent on a year-over-year basis compared to a decline of 13.6 percent in January (Figure 1). Similarly, Brazilian retail sales were down "only" 4.2 percent on a year-over-year basis in February, an improvement from the 10.6 percent decline in January (Figure 2). Still, both of these numbers were likely affected by the Carnival Holiday, which tends to make first quarter, and in some cases second quarter numbers as well, highly unreliable.

Figure 1

Figure 2



Source: IHS Global Insight and Wells Fargo Securities, LLC

Meanwhile, inflation numbers have also started to improve over the past several months. After hitting a year-over-year high of 10.7 percent in December 2015, inflation has slowed down to 9.4 percent in March (Figure 3). Furthermore, our expectation is for inflation to continue to trend down on a year-over-year basis for the next several years if there is no other shock to the economy.

Inflation has edged lower, helped by appreciation in the real.

Furthermore, the Brazilian currency, which hit a low of nearly 4.20 reais per dollar during the first two months of the year, appreciated in March and has continued to do so in April. As of April 14, the currency was trading at 3.51 reais per dollar (Figure 4). While many analysts argue that this appreciation is linked to the potential for the impeachment process to go forward, we believe that this explanation is too simplistic. Indeed, emerging markets currencies have exhibited broad strength against the greenback in recent weeks as global growth has stabilized, commodity prices have improved slightly and the U.S. Federal Reserve appeared to be less hawkish regarding U.S. monetary policy going forward.

Figure 3

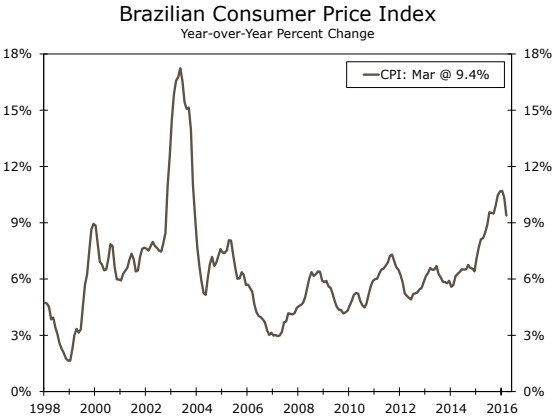
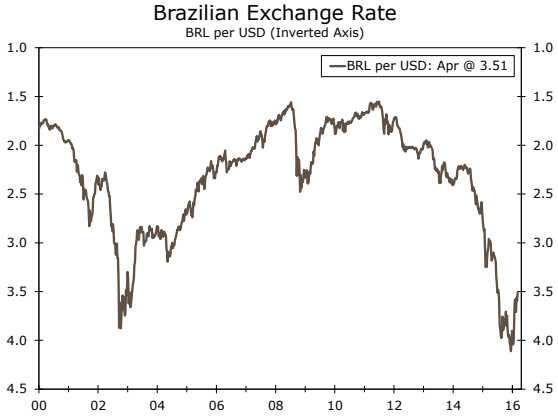


Figure 4



Source: IHS Global Insight and Wells Fargo Securities, LLC

This improvement of the currency threatens the price competitiveness of Brazil's exports, but is good in the sense that it relieves upward pressure on inflation and inflationary expectations, an important development for any future improvement of economic activity. Furthermore, on its own, a slowdown in inflation will improve the competitiveness of Brazilian exports.

Conclusions

In light of all this, we are not saying that things look good for the Brazilian economy this year. We project the economy will contract 3.5 percent in 2016 after plunging 3.9 percent last year, while

we are still expecting very low GDP growth in 2017 of 1.4 percent. What we are concerned with is the simplistic views by many that this crisis is similar to what happened during the Collor de Mello impeachment process or something similar, in economic terms, to what happened during the 1999 devaluation and ensuing fiscal crisis.

A quick and decisive solution to the current political crisis may prove elusive.

Today's crisis is very different than past crises and the potential outcomes are not clear at all. The political system is in crisis and some of the most important political actors are either criminally implicated in it and/or there are other power brokers that could wreak havoc on any potential solution. Dilma Rousseff has proposed to step down and call for early elections if she is not impeached but nobody knows if this will be approved by opposition parties.

From an economic point of view, any improvement in global growth is good news for the Brazilian economy. Other good news would be further slowing in inflation, which would help stabilize economic activity and improve the conditions of those that have fallen back into poverty. However, for a solution to be sustainable, the country needs to devise a political solution to the current impasse. The courts are working relatively efficiently and the country will likely have solutions to the current criminal investigations. However, the country runs the risk of "recent opposition" politicians trying to overturn the current government as a means of affecting recent court rulings against them. Hopefully, the system is capable of surviving this very difficult environment.

Wells Fargo Securities, LLC Economics Group

Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 410-3275	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Currency Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Anika R. Khan	Senior Economist	(704) 410-3271	anika.khan@wellsfargo.com
Eugenio J. Alemán, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Eric Viloria, CFA	Currency Strategist	(212) 214-5637	eric.viloria@wellsfargo.com
Sarah House	Economist	(704) 410-3282	sarah.house@wellsfargo.com
Michael A. Brown	Economist	(704) 410-3278	michael.a.brown@wellsfargo.com
Jamie Feik	Economist	(704) 410-3291	jamie.feik@wellsfargo.com
Erik Nelson	Economic Analyst	(704) 410-3267	erik.f.nelson@wellsfargo.com
Alex Moehring	Economic Analyst	(704) 410-3247	alex.v.moehring@wellsfargo.com
Misa Batcheller	Economic Analyst	(704) 410-3060	misa.n.batcheller@wellsfargo.com
Michael Pugliese	Economic Analyst	(704) 410-3156	michael.d.pugliese@wellsfargo.com
Julianne Causey	Economic Analyst	(704) 410-3281	julianne.causey@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Dawne Howes	Administrative Assistant	(704) 410-3272	dawne.howes@wellsfargo.com