

## EM Political Economy

## Brazil

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### Brazil: Little time left for reform

*President Temer's focus on winning the second indictment vote means there is a rapidly closing legislative window to pass even micro reforms*

Scandal-hit President Temer stepped up his efforts this week to remain in power, meeting with dozens of legislators in a bid to guarantee that he has enough votes to avoid being removed from office in the second indictment vote. Although our base case remains that he will easily survive the vote, barring the emergence of a "smoking gun", the President still cannot let down his guard.

#### Key judgments

- With a mere 11 weeks left until the yearend legislative recess – part of which will be focused on Temer's fight for political survival – even the passage of uncontroversial micro reforms will be challenging.
- Furthermore, the timeframe for other important legislation to be passed next year is narrow, too, since key members of Temer's cabinet must resign by early April if they want to run for elected office.
- To compound the difficulties, the relationship between Temer and Speaker of the Lower House Rodrigo Maia has soured, which could further complicate obtaining approval of reforms going forward.
- The outlook for the 2018 presidential election remains clouded, but the latest Datafolha poll brought some good news for former Environment Minister Marina Silva: she has re-emerged as a strong contender in the race after slipping in recent polls, particularly in scenarios in which former President Lula is not in the election.

**Important information**  
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## Temer pushes reform agenda to the back burner

*Although Temer should easily win the second indictment vote, his allied base will still exact a high price for his victory*

President Michel Temer this week redoubled his efforts to win over legislators' support, scheduling dozens of meetings with congressmen ahead of the Lower House floor vote on a second criminal indictment against him (for more background, see our 20 September 2017 note [Temer shifts back to survival mode](#); for more details on the timeline of the indictment process, see Table 1 below). Although few in Brasilia believe that Temer will lose the indictment vote – barring the emergence of a “smoking gun” on the eve of the vote – it is by no means a slam-dunk for the President either, in large part because the majority of his allied base views this event as a unique and possibly last-ditch opportunity to extract political favours and other fiscal concessions from the embattled leader ahead of the October 2018 general election.

**Table 1: Timeline for Temer's second indictment process**

Date/projected timelines	Event
14 September	Outgoing Attorney-General Janot files a second indictment motion against Temer at the nation's highest court (STF) for <b>obstruction of justice</b> and being a <b>leader of a criminal organization</b> . Six members of Temer's PMDB party are indicted in the same motion on the charge of racketeering, including Temer's two closest advisers: Presidential Chief-of-Staff Eliseu Padilha and infrastructure tsar Wellington Moreira Franco.
21 September	After the STF rejects a key appeal by Temer to suspend the motion, the court sends the indictment to the Lower House.
<b>At the Lower House:</b>	
26-27 September	The Lower House formally begins its process of reviewing the indictment motion after failing to achieve a quorum at the two previous sessions; Temer is officially notified on 27 September.
4 October	Temer and the other defendants present their defence to the Constitution and Justice Committee (CCJ) in the Lower House.
Up to 5 legislative sessions, in theory	Once the defence is presented, the CCJ has up to five legislative sessions to write up a report and vote on the indictment. However, if necessary, the CCJ can extend this timeline by a few more sessions.
1-2 sessions, as long as a quorum is achieved	Once the CCJ votes on the report – and irrespective of its decision – the motion goes to the full Lower House floor for a vote. Should three-fifths of the full Lower House vote to indict Temer, then the motion will be sent back to the STF; otherwise the motion will be shelved. Lower House Speaker Rodrigo Maia recently forecast that the Lower House floor vote is likely to occur the week of 23 October.
<b>If the motion is sent back to the STF:</b>	
A few days to several weeks	1. The STF could ask for preliminary testimony from Temer and other suspects before the full court reviews the indictment motion.
A few sessions	2. Once the case begins, a majority of the STF must accept the indictment motion for it to proceed; if this occurs, the President will be suspended from his post for up to 180 days, during which time his trial will be held.
Up to 180 days	3. If Temer is suspended from his post, the Lower House Speaker will take over as interim President during this period.
<b>Scenarios after the final STF verdict:</b>	
30 days to an indirect election	A. Should the STF vote to sentence Temer, the Speaker would continue as interim President for another 30 days, followed by an indirect legislative election.
	B. Should Temer be absolved or the trial take longer than 180 days, he would return to the presidency, at least until the end of the trial.

Sources: Local press reports.

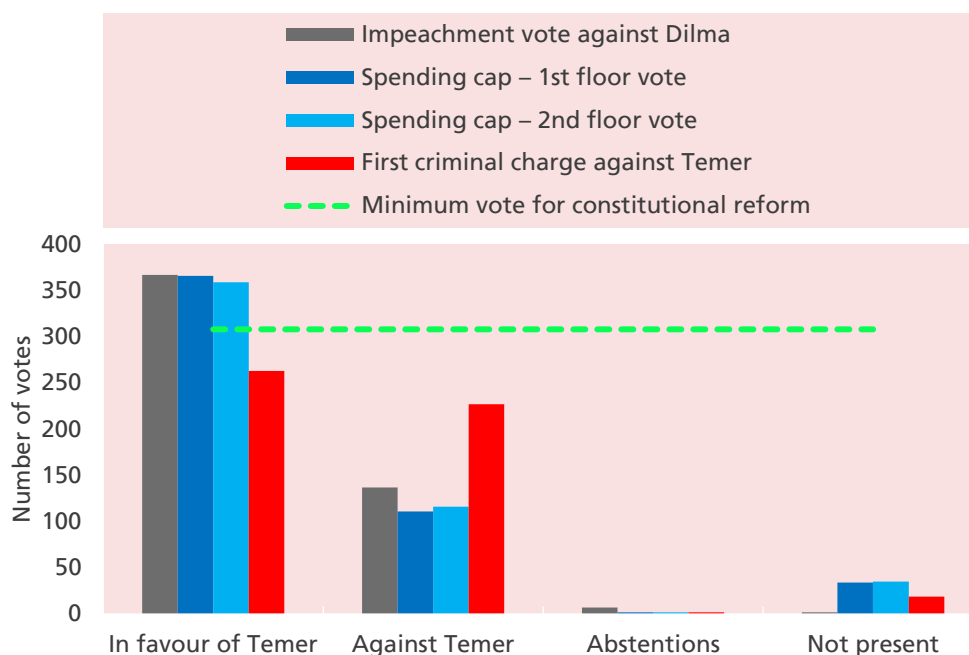
*The new charges will delay the legislative reform agenda*

Such favours are all the more important for implicated legislators who are seeking to win re-election for themselves and their allies, particularly at a time of fiscal austerity and ballooning government deficits (for more details, see our 3 August 2017 note [The cost of Temer's victory](#) and our 17 August 2017 note [Closer to the fiscal precipice](#)). An added wrinkle for the government this time around is that six members of Temer's inner circle were indicted at the same time – including Presidential Chief-of-Staff Eliseu Padilha and infrastructure tsar Wellington Moreira Franco – all of whom also belong to Temer's PMDB party. Allied congressmen have warned that the government will have to pay a higher price to save them too. The upshot is that if Temer takes his eye off the ball or attempts to move forward with more controversial pieces of legislation at the same time (notably, [pension reform](#)), he runs the risk of shooting himself in the foot. Not surprisingly, he has already signalled that it will be his political survival – rather than his reform agenda – that will be on the front-burner for the next three to four weeks.

*The vote count for the second indictment vote will be important to monitor as a sign of the government's strength (or weakness)*

Another reason why Temer cannot let his guard down with the second indictment vote is that the legislature and the market alike will be watching the final vote count to gauge the government's likely strength going forward. In the first Lower House indictment vote against the President, Temer had 55 per cent of the vote (including abstentions and absences) in his favour; this was far higher than the one-third plus one vote of the Lower House (including abstentions and absences) needed to defeat the indictment motion. Positive as that was for the President, it was still far lower than the votes in his favour at the beginning of his term, as Chart 1 below illustrates – not to mention the three-fifths minimum vote needed to pass a constitutional amendment such as pension reform.

**Chart 1: Recent Lower House votes on key proposals**



Sources: Lower House of the Congress, local press reports.

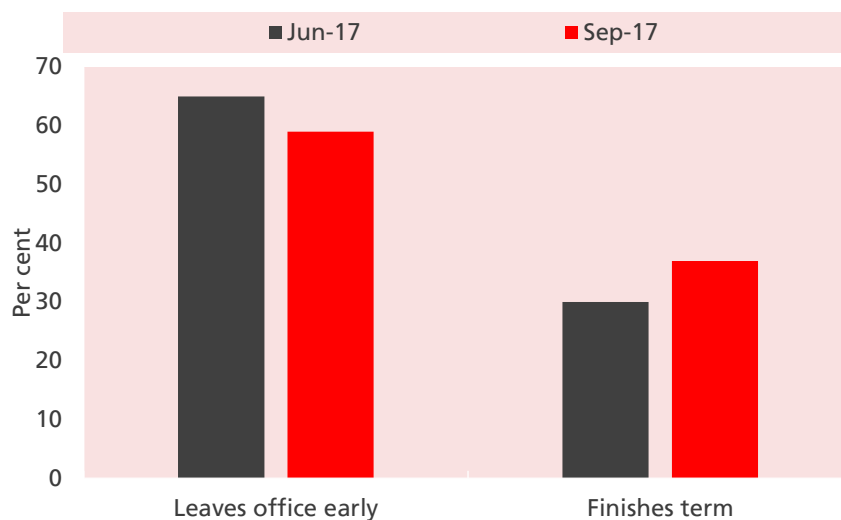
*Temer will do his best to match or exceed the first indictment vote, but if he falls short of 50 per cent, it would be a danger sign*

At the same time, because 55 per cent is more than the simple majority needed to pass micro-reforms in the legislature, Temer will be doing his best to ensure that his support for the second indictment vote does not fall below that of the first such vote. If, however, it drops markedly below 50 per cent, the already enfeebled President will find himself increasingly side-lined in Brasilia during his remaining time in office and market concerns about his lame-duck status will justifiably grow as a result.

*Although six out of 10 Brazilians still want Temer to leave office early, this number has edged down since June*

One other positive element for the President is that members of the Lower House increasingly believe there is no political benefit to be gained by removing Temer from office just one year before the election. This sentiment appears to have taken hold for a growing minority of the population too, even though all recent major polls have confirmed that Temer has the dubious distinction of being Brazil's most unpopular President in more than three decades (with a mere 3.4 per cent approval rating in the latest CNT/MDA poll and 5 per cent in the latest Datafolha poll). Even so, although six out of 10 Brazilians (59 per cent) surveyed in the latest Datafolha poll published this past weekend continued to say that it would be best for the country if Temer left office, that number has actually edged down from June, when 65 per cent said he should leave office early (see Chart 2 below).

**Chart 2: Is it better for Brazil if Temer leaves office early or stays until the end of his term?**



Source: Datafolha.

## The window for reform will narrow further

*Since the second indictment vote is not expected for three weeks, October will be a lost month for reform*

As the Lower House focuses increasingly on the indictment process over the next few weeks, the bulk of legislative work will stall until the final floor vote is held. Lower House Speaker Rodrigo Maia recently projected that if there are no unforeseen delays at the Lower House's Constitution and Justice Committee (CCJ), the floor vote for the second indictment vote is likely to take place in the last week of this month (23–27 October).

Key micro-reform bills are stuck in the Lower House pipeline, including bills aimed at advancing Temer's privatization agenda

If so, that will leave a mere seven to eight weeks for the legislature to make progress on the Temer administration's ambitious micro-reform and privatization agenda before the yearend recess begins (see Table 2 below). Important bills in the sectors of mining, power, oil & gas, biofuels, agricultural land, domestic airlines, environmental regulation and banking are in the legislative pipeline, as we have previously highlighted (see our 24 August 2017 note [The tough road ahead for electricity reform](#)). However, nearly all of them still need to pass Lower House committees and the floor vote before they can advance to the Senate.

**Table 2: Calendar of upcoming political events**

Date*	Event
<b>2017</b>	
12 October	Our Lady of Aparecida Day**
23-27 October	Projected Lower House floor vote on the second indictment motion against Temer
2 November	All Souls' Day**
15 November	Proclamation of the Republic Day**
23 December – 1 February, 2018	Yearend recess
<b>2018</b>	
2 February	Start of new legislative session
10-14 February	Carnival**
7 April	Members of Temer's cabinet and other politicians must resign from posts in the executive branch by this date to be eligible to run in the October 2018 elections.
14 June – 15 July	2018 FIFA World Cup
20 July – 5 August	Party conventions
15 August	Last day for political parties to register their candidates
31 August – 29 September	Period of free, mandatory TV/radio electoral ads
7 October	First round of presidential, legislative and gubernatorial elections
28 October	Runoff round of elections

\*Some dates subject to change.

\*\*National holiday.

Sources: TSE, local press reports.

Fiscal austerity bills are also on the back burner, putting next year's primary deficit target in jeopardy

Furthermore, Temer has indicated that he is also planning to delay several previously announced fiscal austerity measures that require legislative approval (notably a planned one-year postponement of salary hikes for federal workers in 2018) so as not to run the risk of strikes or protests contaminating the vote. Unfortunately, this means that the government's [planned primary deficit target for 2018](#) will remain in jeopardy, notwithstanding the fact that the administration already loosened fiscal taps in August by pushing up next year's primary deficit target by an additional R\$30 billion. As we have highlighted before, Temer's allied base has previously proven itself recalcitrant to vote through unpopular fiscal adjustment measures, even in less electorally sensitive times (for more details, see our 28 April 2017 note [Growing signs of friction in Temer's allied base](#)).

*Two national holidays in November could add delays to the legislative agenda*

To make things even more challenging, the last two weeks of a legislative session are usually devoted to voting through the budget for the following year. This will whittle down the effective period for passing reforms before the end of this year to a scant five to six weeks, even assuming that the legislature does not start its recess early in December, as it often does. Furthermore, November has two important Brazilian holidays – All Souls’ Day (2 November) and Proclamation of the Republic Day (15 November) – both of which will fall mid-week and which mean that the necessary quorum to vote key bills through may not be achieved in all the legislative sessions in those weeks because many legislators will take advantage of the holidays for an extended break from work.

In short, even in the best-case scenario, key micro-reform bills that face little opposition could easily fail to get voted through before yearend on account of the lengthy pipeline of bills in the Congress and the shrinking legislative window for bills to be passed. The bar is even higher for structural fiscal reforms like pension reform (for more background, see our 22 July 2016 note [Why the window for Temer’s structural reforms is already closing](#) and our 10 August 2017 note [Is pension reform still possible?](#)).

## The 2018 window is limited too

*There are only six weeks between Carnival and the deadline for ministers to resign from the cabinet to run for office*

Nor is there a lot of time for important legislation to be passed in 2018. Not only will members of the legislature be reluctant to pass unpopular reforms as Election Day approaches; there are also other issues. Once members of the Congress return to work after Carnival, they will run up against a tight schedule, since any minister who plans on running for office is legally required to resign by 7 April to be eligible to enter the 2018 election. So far, Mines and Energy Minister Fernando Coelho Filho has already indicated that he will run for Governor of Pernambuco state. And it is possible that Finance Minister Henrique Meirelles – who has long harboured presidential aspirations and has been courting the evangelical vote in recent weeks – will run for President. At least three other ministers – Transport, Tourism and Environment – are expected to resign to run for the Senate and there are more than a dozen other cabinet ministers who have legislative mandates who could also join them.

*If the Finance and Energy Ministers resign, fiscal austerity measures and the privatization of Eletrobras will be much harder to achieve*

Although most of the latter politicians are not key advocates of reform, both Coelho Filho and Meirelles have played essential roles in pushing their respective reform agendas. If either of these ministers resigns, it will make it that much more difficult to push tough reforms, such as the [privatization of Eletrobras](#), in the case of Coelho Filho (for more background on market-friendly energy legislation that he has championed, see our 28 September 2017 note [Foreign investors buoy energy auctions](#)), or fiscal austerity measures, in the case of Meirelles. Without these reforms, the new leadership will take office in 2019 with both a long to-do list and fragile fiscal accounts. Moreover, as the government redistributes the vacated ministerial posts in April to other political allies who are not running for office, the reform agenda could fall victim to other priorities touted by the new ministers.

## Maia at odds with Temer

*Speaker Maia has stepped up his criticism of Temer in recent weeks*

To make matters more delicate for the beleaguered President, Speaker of the Lower House Rodrigo Maia has been increasingly vocal in his criticism of Temer in recent weeks. Although Maia has grown more comfortable in the Speaker position in the 14 months since he was elected, his political power has increased significantly since the JBS scandal broke around the President in May. This is in part because Maia carefully navigated the political storm that hit Brasilia after the JBS/J&F plea bargain was released. As we highlighted in our 13 July 2017 note ([Temer fights to stay in power, while Maia gains traction](#)), Maia was one of the few high-profile political leaders who publicly supported Temer. Although he opted not to weigh in on the discussions about possible replacements for Temer, he quietly strengthened his ties to market-friendly economists and had regular meetings with Finance Minister Meirelles.

*Both Maia and Temer are seeking to increase the membership of their respective parties . . .*

Although Maia positioned himself as a reliable alternative to Temer, he also worked tirelessly to help the President win enough votes to avoid being removed from office. Now he has publicly accused Temer of betraying his loyalty. The background is that Temer and Maia were both trying to woo members of the Brazilian Socialist Party (PSB) to join their respective parties. Despite all of Maia's efforts, Temer was ultimately the victor, having persuaded Mines and Energy Minister Fernando Coelho Filho and his father, Senator Fernando Bezerra Coelho, to join his PMDB party rather than Maia's centre-right Democrats party (DEM).

*. . . in order to fill the political vacuum left by the continuing implosion of the PSDB*

While the impact of this spat on the reform agenda has yet to be seen, there is little doubt that the good working relationship enjoyed by Temer and Maia last year has deteriorated. In one sign of his disaffection, Maia on Tuesday warned that Temer would have "difficulties" winning the second indictment vote with as many votes as he garnered in the first indictment vote. It is also worth highlighting that Maia is increasingly looking ahead to 2018 and trying to position his party to capitalize on the vacuum left by the infighting in the market-friendly Brazilian Social Democratic Party (PSDB) of presidential hopefuls São Paulo Governor Geraldo Alckmin and São Paulo Mayor João Doria. Electoral concerns are likely to play an increasing part in the calculations of all political parties as the clock ticks down to next year's general election, which also means that legislators ultimately will kick more unpopular bills down the road, delaying the reform agenda.

## Marina gets a boost

*In the latest poll, Marina got some good news, particularly in those scenarios in which Lula is not in the race*

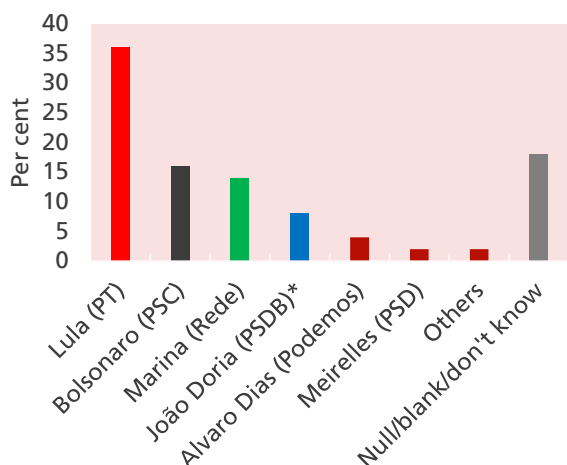
In recent polls, former Environment Minister Marina Silva – who placed a strong third in the presidential races in 2010 and 2014 – had appeared to have lost steam, as we recently underlined (see our 31 August 2017 note [The Lula factor in the 2018 election](#); for more background on the current field of presidential contenders including Marina, see our 12 May 2017 note [Looking ahead to the 2018 elections](#)). However, this weekend's Datafolha poll brought some welcome news for her. Although she continues to lag in third place

when pitted against both former President Lula and extreme-right Rio de Janeiro Congressman Jair Bolsonaro (see Chart 3 below), in nearly all scenarios in which Lula is not in the race, Marina enjoys a three to five percentage point advantage over the second-place candidate, Bolsonaro (see Chart 4 below).

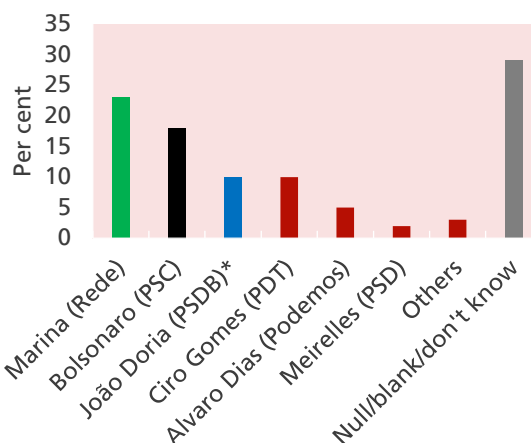
*If Marina inherits a majority of Lula's voter base, it would be good news for investors . . .*

As with other early electoral polls, this survey must be taken with a grain of salt, particularly as the rejection rate (null or blank votes plus the undecided vote) continues to total a significant 23–29 per cent of those polled, not least when Lula is not in the race. Moreover, new dark horse presidential candidates could easily join the race over the next six to nine months. Even so, the poll indicates that a considerable portion of Lula's voter base would be open to supporting Marina should the former President fail to become a candidate in the race. If so, we believe this would be encouraging news for investors, as Marina has taken pains in recent elections to signal that she would be market-friendly.

**Chart 3: First-round voter intentions in the 2018 presidential election with Lula in the race**



**Chart 4: First-round voter intentions in the 2018 presidential election without Lula in the race**



\*If São Paulo Governor Geraldo Alckmin replaces São Paulo Mayor João Doria as the PSDB presidential candidate, voter intentions for the PSDB candidate remain the same but Bolsonaro's voter intentions rise by one percentage point. Source: Datafolha.

*. . . but if the former President's voter base migrates to Ciro Gomes or a similar candidate, market jitters could increase*

By contrast, other centre-left candidates such as former Ceará Governor Ciro Gomes – who is eager, too, to inherit Lula's base and also has a chance of winning part of this vote – has recently made more controversial utterances, such as vowing to overturn all of Temer's reforms. Ciro has also pledged he would nationalize the oil & gas blocks auctioned off to oil majors under the Temer government (although the proper "compensation" would be offered in exchange).

However, we continue to see Ciro as his own worst enemy. For example despite his goal of receiving backing from Lula and his Workers' Party, Ciro recently slammed the former president as having "insulted the intelligence of the people". In the wake of such statements, we believe it is increasingly unlikely that the PT would back Ciro rather than



sponsor its own candidate in the event Lula is unable to run, which would help to split the centre-left vote.

Nevertheless, should Ciro begin to rise in the polls, we fear that market jitters would increase. If, however, Marina continues to surge in future polls, the market is likely to be more receptive to her candidacy.

## Conclusion

*As the 2018 election approaches, politicians will likely seek to distance themselves from the unpopular President*

Despite heartening signs that Brazil's still-fragile economy is finally gathering steam (for more background, see our 13 September 2017 note [The return of consumer-led growth?](#)), the government's upcoming battle for political survival will invariably delay progress on the reform agenda, in spite of continued investor confidence in Temer's economic team. We believe that as the election approaches, politicians who are concerned about their re-election bids will be increasingly likely to try to distance themselves from the unpopular President. Furthermore, even those politicians who recognize the urgency of passing unpopular reforms – such as an overhaul of the pension system – are more likely to opt to postpone the tough reforms until after the election.

*Brazil's next government will face significant fiscal and political challenges*

This means that in our base case, Brazil's next popularly elected president will face a series of fiscal and political challenges early in his or her term in office. For example, it looks increasingly likely that in order to avoid violating the [federal spending cap legislation](#), the new government in 2019 will be forced to suspend all wage hikes for public workers and even suspend the minimum wage hike. The other option would be for the next president to try to roll back the spending cap, which would likely result in a significant selloff of Brazilian assets – unless the president could leverage this into political capital by simultaneously trying to muscle through a fiscally substantial pension reform as a result. Even so, the upshot would likely be more near-term fiscal erosion for the next government, which would add to the country's ballooning gross debt levels and make it hard to win back an investment grade rating.

*The next president's political honeymoon period could be short, especially if he or she wins by a narrow margin*

And while it is all but guaranteed that the next popularly elected president will have a stronger mandate than Temer, at least at the start of 2019, it looks increasingly likely that Brazil will have another close presidential race next year. This means that an already sharply polarized country will remain divided and that the next government will continue to face strong opposition to its agenda. In this scenario, the political honeymoon period could be cut short. Moreover, if the next president fails to use his or her time wisely, there is a serious risk that the country would quickly descend into legislative paralysis – notwithstanding the watered-down political reform that was passed in the Congress this week and which we will examine in a forthcoming note.

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