Ashmore

Brazil's slow rise from the ashes

By Jan Dehn

Brazil looks a little like India a couple of years ago – slow growth, high inflation, a weak currency, external imbalances and policy makers with declining credibility. But, as with India, it is also an economy with a strong FX reserve position, sustainable levels of debt and a promising future owing to its significant geographic size, large population and decent demographic profile.

Can Brazil restore former glories? We think the answer is yes. Brazil's problem hinges mainly on reverting to macroeconomic orthodoxy after favouring ultra-Keynesian economic policies since 2009. This means that fiscal and monetary adjustment hold the key to recovery. A coalition across the political divide, which should last through 2016, supports fiscal reform. Once the public finances respond to the on-going adjustment we expect the economy to recover, entering a 'goldilocks' period of improving growth amidst subsiding inflation.

This bodes well for investors willing to buy into the current weakness. Beyond 2018, the prospect of a new government also offers further potential upside in the shape of a more efficient state.

From hero to zero

When Guido Mantega, Brazil's former finance minister, proclaimed in 2010 that Brazil had entered a global currency war he gained personal fame for a day, but destined his country for a demise that continues to this day.

Mantega's comments were followed by a number of regressive economic policy changes that quickly shunted the country into a policy realm reminiscent of Brazil in the 1950s and 1960s, including taxes on capital inflows, price controls, irresponsible fiscal policy and excessive political interference with the central bank.

The results were predictable: business confidence declined, stock markets drifted lower, foreign investors pulled out, the currency weakened, inflation began to rise and finally growth began to weaken seriously. The economic conditions deteriorated so rapidly that President Dilma Rousseff barely won re-election in mid-2014, a truly remarkable decline given that she had inherited a strong and confident Brazil only five years previously.

Putrid Petrobras

The problems did not end there. Soon after her re-election, Dilma found herself and other members of her administration the targets of legal and media allegations of their involvement in a major corruption scandal that hit Petrobras, Brazil's largest company.

Today, it is widely recognised that the problems at Petrobras are of a scale that qualifies the case as a textbook lesson on how not to govern a state-owned enterprise. The company's top management positions were filled with politicians and their appointees seeking to extract rents from large contracts rather than technocrats focused on the company's core mission to develop Brazil's vast energy resources. Given insufficient capital for prudent investment, the company's profitability was further compromised by ever higher subsidies on gasoline and diesel prices introduced by Mantega. Petrobras was also forced to source inputs locally, despite the local industry being incapable of delivering the specialist goods and services needed for oil exploration at competitive prices. Thus, when the news broke that officials in key executive and board positions had lined their own pockets to a mind-boggling extent, this was but the last in a long line of problematic government interventions undermining Petrobras.

The political basis for a turn-around

Ironically, Dilma's political survival with the slimmest of mandates in the election of 2014 may have been the best thing to happen to Brazil amidst the macroeconomic malaise and the erupting scandal at Petrobras. Arguably, an opposition president without control of parliament would have struggled to pass reforms, whereas Dilma and the PT party now found themselves with few options other than to reach across the aisle, both to fix the economy and to fend off the growing risk of impeachment over the Petrobras scandal.

Brazil's political opposition, as it happens, understood the large problems created by the fiscal erosion. Pursuing an agenda to resuscitate the depressed businesses sector, opposition politicians eyed the possibility of a deal.

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The result was a political agreement whereby the government committed itself to a two-year fiscal adjustment and reform program in exchange for a promise of 'immunity' from impeachment from the opposition. A new finance minister with an unquestionable mandate to adjust the public accounts, Joaquim Levy, has been appointed to lead the reform effort, while the central bank has restored its focus on pursuing the inflation target. Political power shifted away from Dilma and PT towards the PMDB party, which now 'calls the shots' in the legislature, albeit behind the scenes to escape the political fallout from adjustment.

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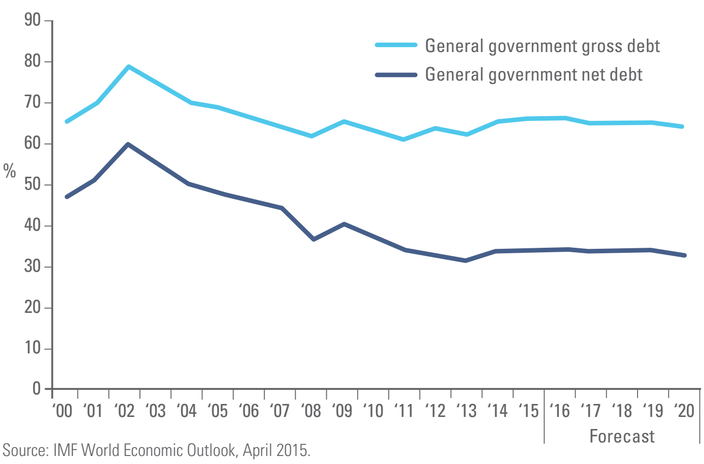
All sides, perhaps with the exception of PT, stand to gain from this deal. Brazil's companies will soon be back in business, which helps the opposition, while Dilma has reasonable hopes of political survival. The PMDB has real power as long as the current arrangement remains in force.

Still, the next year or so will not be smooth sailing. A battle to assign political blame will accompany each adjustment measure. Deals must be struck and heads may roll. Ultimately, the political deal is destined to fall apart, probably in late 2016 or early 2017. But by then Brazil's economic fortunes should look much better. Dilma will hope that the worst of the heat from the Petrobras scandal will have subsided to allow her to serve out her term, helped by returning growth. Her challenge in the intervening period will be to carry with her the support of the PT through the tough period of fiscal consolidation.

The roadmap for recovery

Fixing the fiscal accounts and restoring central bank credibility are critical to Brazil's recovery. Stronger public finances will allow the debt to GDP ratio to stabilise and subsequently decline and bring inflation under control - without which long-term investment and growth will not return. Returning inflation to target will encourage money to stay in Brazil for investment purposes instead of fleeing the country in a bid for capital preservation.

Figure 1. **Brazil gross and net debt to GDP**



Source: IMF World Economic Outlook, April 2015.

The fiscal adjustment is already well underway under the leadership of Levy, so far with strong support from Dilma herself. Ultimately, some of the measures must also clear Congress. This has never been easy in Brazil and this time will prove no different. What makes matters tougher in Brazil is that generations of politicians have introduced rigidities into public spending programmes (so-called 'earmarking'), which means that the cuts will be disproportionately concentrated in investments rather than in current spending. This is inefficient and will dampen the recovery once it takes hold.

Rigidities in the wider economy also place greater onus on the central bank in the fight to bring inflation expectations back in line with the inflation target. The central bank will have to raise policy rates higher than would have been the case in more flexible economies, with a resulting heavier toll on employment. In short, 2015 will be a tough year for Brazil and 2016 will probably be challenging too, at least to begin with.

If the political situation permits, the government may yet go on to review retirement benefits ahead of changes in Brazil's currently relatively benign demographic profile. Another area that could come into focus in the next 18 months is infrastructure investment; more spending is needed to reduce the economy's bottlenecks in energy generation and distribution as well as weak transportation links (railways, ports and airports). A greater role for the private sector will be required. Finally, the government could overhaul the processes of doing business in the country as well as simplify both the corporate tax structure and labour laws. This would go a long way towards improving the business environment.

We think that the government's fiscal and monetary discipline will pay off by gradually removing excess demand from the economy. Conditions are similar to those of mid 2011 which saw a strong rally in bonds

The central bank rediscovers itself

Inflation was allowed to get out of control during Dilma's first term, mainly due to political pressure. This risk has not gone away, because the central bank is not formally independent, but Levy is now pushing the other way. The central bank has thus been allowed to regain its mantle as the "most hawkish in the world", so far hiking 650bps in the current cycle and openly signalling a commitment to continuing to raise rates until inflation expectations have been brought down.

A tough stance on inflation is sorely needed. At about 8.25% yoy, the current rate of inflation is high in spite of the cyclical downturn in the economy, though some of the recent rise in inflation is due to reductions in government fuel subsidies. Indeed, inflation could collapse in 2016 on base-effects as the price increases arising from the scrapping of subsidies roll out of the 12 month numbers. Services prices inflation, the other driver of the Consumer Prices Index, will only decline as higher unemployment gives way to wages deflation. Inflation expectations should moderate as credibility is restored, but this will take time.

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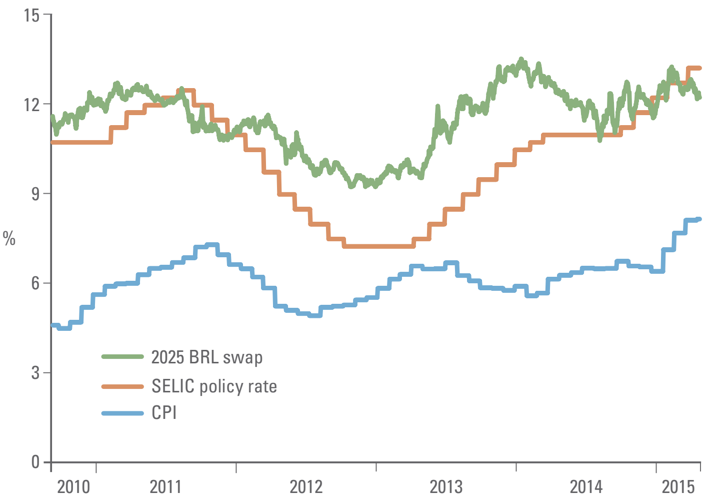
Why we like Brazil

We think that the fiscal and monetary discipline now being exhibited by the government will pay off by gradually removing excess demand from the economy. Conditions are similar to those of mid 2011 which saw a strong rally in bonds. As inflation begins to fall, the central bank will be able to cut rates. Locals will become more convinced about the sustainability of the expansion and stock prices will rise. Investment will slowly begin to pick up along with hiring and, with a lag, employment will improve to support consumption and credit growth. A goldilocks period should emerge that sees gradually stronger growth alongside falling inflation. Foreign inflows will support and even appreciate BRL, which in turn will help to dis-inflate the economy.

Figure 2. **Falling inflation and rate cuts strongly positive for bonds**



Source: Bloomberg.

In the context of this cyclical upswing, which take places against a very positive technical backdrop in the Brazilian fixed income markets, Brazilian government bonds offer some of the highest real yields in the world. Meanwhile, the underlying structural fundamentals are sound. Debt levels are sustainable, demographics are benign, the country is resource rich and the central bank sits on one of the largest stocks of FX reserves in the world.

Despite the company's many current challenges, Petrobras also offers value from a fixed income perspective. Backed by the government, Petrobras remains a highly efficient company in its core business of exploring oil in both shallow and deep water reservoirs. Second-tier executives are capable, so the expected improvement in corporate governance at the top level should go a long way towards fixing the company. The government's authorisation of fuel price hikes should return the company's distribution business to profitability again. Discussions surrounding scrapping the minimum local content law and creating a market-oriented fuel pricing policy with no interference from the government go a long way to restoring profitability in the short/medium term. The introduction of industry professionals to controlling positions at board level and in key executive seats should create the conditions for an eventual recapitalisation of the company. While the execution of these reforms will be gradual, the fact that the congress is debating them shows a positive direction of travel.

Will Brazil remain the 'France of South America'?

All political parties in Brazil will begin to focus on the 2018 election as early as Q1 2017. This means that the truce between the Dilma administration and the opposition over fiscal adjustment will probably not survive much beyond 2016. But by then the medicine should have proven effective, in our view.

While it is too early to say who will emerge to challenge for power in the 2018 election, the odds favour a change of government. This could be good news for investors. A return to power of Brazil's main opposition party, the PSDB (named Social Democrats, but in practice acting as Liberal Democrats), should help reinforce the momentum towards a more liberal and open economy. However, this does not guarantee full liberalisation of the economy. Compared to other countries in the region, the Brazilian 1988 constitution fundamentally entrenches a large and more intrusive state than in many other countries. Even the PSDB would find it hard to totally revamp the current legal apparatus. Thus, like in France, a big state may prove to be a quasi-permanent feature of the Brazilian economy.

Even so, governments can successfully and sustainably improve the conditions of their subjects if they operate more efficiently. This, then, will be the main challenge facing Brazil's next government – to respect Brazilians' preferences for a big state, while at the same time ensuring that it delivers value for money.

Some risks remain

The positive outlook is not without risks. Reform momentum will wane as credibility is gradually restored. The economic team should eventually change as the hard work begins to pay off. These are not major concerns, merely political reality. The most important risk is that President Dilma Rouseff could be impeached. If hard proof of the president's involvement in the Petrobras corruption scandal is found and/or if Dilma loses her support in parliament (for example due to a break with the PMDB party) then the outlook changes for the worse at least in the short term. But while Brazil's courts and press will certainly keep pushing for impeachment, it remains the case that impeachment is unlikely to occur without explicit support from opposition political parties.

Conclusion

In 2013, investment bank, Morgan Stanley, labelled India one of the 'fragile five' EM countries only for India to emerge, phoenix-like, from the ashes of its alleged structural malaise to deliver one of the fastest growth rates on earth.

In the case of Brazil, the analogy with India can only be taken so far; India has a new government, while Brazil is still saddled with a tired, PT-led administration. But the problems facing Brazil today are broadly the same as those faced by India just a couple of years ago – self-inflicted and mainly cyclical in nature.

Brazil is already making important strides in the right direction. Many adjustments are underway, especially on the fiscal and monetary side, others are in the pipeline. A cross-party coalition in Brazil's parliament backs reform. Brazil has excellent chances of extricating itself from the current slump.

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