Brazil’s Reality Show

I have just returned from abroad. It feels like déjà vu from a distant past. Explaining Brazil has become complex again. “I read about corruption accusations, popular protests, deficits and crises; what is happening in Brazil?” This was the question asked by an important investor. The answer inevitably tends to be long and full of Buts and Ifs. Nevertheless, I will make an effort here to summarize in a straightforward way. Brazil did not invest enough during the favorable commodity cycle. Moreover, policymakers did not recognize in time the end of the cycle. When they did finally realize it, they tried to go back to a past that no longer existed. Now Brazil has to adjust everything at once in order to avoid a greater crisis. But markets are dynamic: with the recent depreciation of the real, there are already investors looking for opportunities. That is why Brazilian assets have rebounded lately.

All Latin American economies – from Argentina and Venezuela to Chile and Peru – are experiencing declining growth. This is the sign of a common factor: the end of the favorable global cycle – commodity boom and growth in China, abundant capital flows to emerging markets. Corruption allegations and investigations are occurring in many LatAm countries such as Brazil and Mexico, but also in Chile, which signals that even the tolerance for such deviations is cyclical.

The slowdown is general but not uniform. The intensity of the downturn depends on domestic policies. Some policies amplify external shocks, while others create economic resilience. There are examples of both in Latin America. In Argentina, the economy faces its second year of recession, while in Colombia growth is still reasonable (above 3%).

Commodity prices are not currently depressed from an historic perspective. When commodity prices are analyzed from 1913 onward in real terms (i.e., dollar prices deflated by U.S. inflation), we find a slow and sustained downward trend (see our “Macro Vision: Commodities in a secular decline: are we back to the trend?”). The recent commodity boom (2003-2011) was linked to China’s growth. It was preceded by three previous cycles. The first, between 1915 and 1919, was associated with World War I; the second coincided with World War II and the post-war reconstruction in Europe; and the third started with the rise in oil prices in 1973 and continued with the pass-through of higher energy costs to other commodities.

The recent drop between 2011 and 2014 only brought prices back to their long-term trend. We do not expect a sustained recovery in the short run. In fact, the previous upward cycles were succeeded by under-shootings: before they recover, prices first tend to fall below trend.

The secular decline is concentrated in agricultural commodity prices, but prices of manufactured goods also fell in real terms. Both have dropped relative to the price of services, which have increased in real terms.

Thus, the outlook points to lower growth in Latin America, affected by lower commodity prices. The prospect of a global recovery, led by the U.S., obviously helps. But the new normal is lower potential growth.

In Brazil, we are at the peak of adjustment season. We identify at least five major ongoing adjustments: i) fiscal, ii) quasi-fiscal, iii) regulated prices, iv) balance-of-payments and v) inflation targeting.
The fiscal adjustment comprises achieving the primary surplus targets (from -0.6% to 1.2% of GDP) to improve public debt dynamics. It is the main adjustment needed to regain credibility and enable economic recovery.

The quasi-fiscal adjustment refers to public sector credit as well as expenditures that are off-budget (outside the primary surplus target), but are part of the effort to recover fiscal discipline.

Regulated price adjustment is the increase in prices that are set by the government (gasoline, electricity, etc.), which were repressed in recent years, resulting in lagged prices.

The adjustment in the balance of payments is the effort to reduce the current account deficit (from 4% to below 2.5% of GDP). The end of the daily intervention program of FX swap sales and the strong exchange rate depreciation (from 2.65 reais per dollar at the beginning of the year to 3.1 reais per dollar) are part of this adjustment.

The last adjustment is renewing efforts to reach the center of the inflation target (4.5%), even though inflation will probably surpass 8% this year.

This is quite a bit of adjustments to happen at the same time. Each one alone is costly and therefore challenging. Their simultaneous implementation is even more difficult. But the adjustments (at least the fiscal and the quasi-fiscal) are necessary for the recovery of confidence in the short term and for growth to rebound. Here it is critical to persevere in order to advance.

However, even if implemented, these adjustments are just “fixes”. They are needed to recover fiscal, quasi-fiscal, monetary, balance-of-payments and regulated-price discipline. They are not really full-blown reforms such as tax, social security, economic openness or education reforms, which would leverage growth by increasing productivity (or, even if not qualifying as a “reform”, a combination of a large number of small measures that improve business conditions should improve growth). But it is hard to imagine, given the current political circumstances, that the government could move forward with this reform agenda.

Although they may not be real reforms, these adjustments do produce an effect. They distance Brazil from the crisis scenario. The more distant, the better for Brazilian asset prices. Preventing the loss of investment grade status or maintaining the perception of stability (economic, political, etc.) is now seen as a plus. In this scenario of low expectations, previously depressed prices (as the exchange rate) could suddenly be seen as an opportunity.

The government needs to stick to the adjustments. Otherwise, the word “crisis” will return to the table and even depressed prices will fail to attract investors (in the jargon of investors, “prices will become even cheaper”). The world is watching Brazil as if it were a giant reality show, but the real concern is sovereign risk.

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