Brazilian Economy: Long-Term Promise vs Medium-Term Difficulties

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Brazilian Economy: Long-Term Promise vs Medium-Term Difficulties

• Brazil is the largest country in Latin America, by land and population, with a relatively young and dynamic demographic profile.

• Brazil defeated decades of hyper-inflation in the 1990s with a rigorous and disciplined monetary policy, keeping a premium of short-term rates over prevailing inflation. This policy is still in place and provides a basis for economic optimism, as well as the possibility for a continued comeback for its currency (vs the US dollar).

• Brazil’s huge challenges are fiscal policy and government corruption, both of which are now being addressed (albeit with uncertain outcomes).

• Over the next few years, if Brazil can bring its government expenses under control, which is a very big if, then Brazil has the potential to grow 4% to 5% in real terms, approximately twice the growth potential of the US and in line with India and a decelerating China.
Brazil: Current Economic Conditions

- Brazil’s real GDP continues to shrink on a year-over-year basis. Even in nominal terms, growth is very slow. Slow growth in nominal GDP limits the cash flows available to service Brazil’s growing public and private debt burdens.

- High short-term interest rates (14%) make it difficult to service domestically denominated debt.

- Inflation, however, appears to have peaked and the Banco Central do Brasil may be able to ease policy this year and next.

- The Brazilian real hit its lowest point last September 2015 and since February 2016 has been fairly well supported, moving from the 4.00 BRL per USD range into the 3.20-3.40 BRL per USD range.

- The 25%-plus recovery in the Brazilian real is good news for Brazilian entities that have borrowed money in U.S. dollars or other currencies.

- Brazil’s current account deficit has narrowed but is far from surplus. The narrowing has come largely as a result of a collapse in imports due to the deep recession. Export growth has been flat during the past year having contracting from 2011-2014.
Brazil: Political Uncertainty and Fiscal Policy Challenges

• The previous two former Presidents, Lula da Silva and Dilma Rousseff, expanded government social and support programs beyond the capability of the country’s growth rate to support them. The current acting President, Michel Temer, has the huge task to cut spending while the economy is struggling to dig out of recession.

• More than likely, the Brazilian government will turn to asset sales to raise revenues and buy time, while some government social programs are cut back or eliminated.

• This all comes simultaneously with the corruption clean-up, including the management changes at Petrobras, the oil company at the center of many of the scandals. The old senior management was dismissed in February 2016. In May 2016, a new CEO was named -- Pedro Parente, formerly the top executive at the Brazilian unit of Bunge and currently chairman of BM&F BOVESPA.

• The next Presidential election is due in the fall of 2018. There is a small chance that the current Presidential impeachment process could lead to a declaration that the October 2014 elections were invalid, and if so that would trigger an earlier Presidential election.
The Brazilian real started a robust recovery in February 2016, based on (1) Presidential impeachment of Rousseff, and (2) change of sentiment in US toward delayed rate rises. Support for the currency has been amplified by 14% short-term rates, making for an attractive carry trade versus the Mexican peso.
Brazilian inflation is now subsiding. Short-term interest rates at 14%, are likely to be cut in the second half of 2016 and into 2017. The consistency of the central bank’s policy of maintaining a premium of short rates over inflation will assist the currency even as rates are cut.
Brazil’s debt levels are problematic, mainly due to the explosion in Government debt in the last three years. Household debt has grown, however, this is mainly in line with the growth of the middle class in 2002-2008.

Source: Bank for International Settlements (BIS), [http://www.bis.org/statistics/totcredit.htm](http://www.bis.org/statistics/totcredit.htm)
Brazilian Government fiscal policy is the challenge. Expenses are driven ever-higher by unsustainable social programs, while revenues have been flat in recent years, even in nominal terms. Expenditure cuts are coming and will not be popular. Asset sales will be used to buy time.
Brazil is experiencing its deepest recession on record but the worst appears to be over. Even with substantial inflation, nominal GDP is barely growing and this represents a challenge for generating the cash flows for debt servicing.

Brazil: Real and **Nominal** GDP YoY

Source: Bloomberg Professional, BZGDYOY% and BZGDGDPQ
Brazil’s current account deficit has narrowed, as imports collapsed with the deep recession. The smaller current account deficit is relatively easily financed so long as the currency markets sense that political risk is diminishing and an attractive carry is available versus other EM currencies.
A collapse in imports narrowed the trade deficit as consumers aggressively retrenched and cut spending in the face of a deep recession. In short, the private sector has made its adjustments, but the public sector has yet to bite the bullet.
Exports have not contributed positively to GDP since 2010. The problems include slowing global growth (especially China); and relatively low agricultural prices. Neither is within the control of the Brazilian government.

Source: Bloomberg Professional, BZTBEXPM
Brazil’s Long-Run Potential is Excellent. The population is young, dynamic, and educated. Real growth potential over the next two decades is 4% to 5% annually, or twice that of the US. The Brazilian economy will be the anchor of Latin America, assuming it can regain control of its government expenses and clean-up the corrosive atmosphere of government corruption. These are big ifs, however, Brazil beat its hyper-inflation problem in the 1990s, and signs of a recovery are starting to show in the economy.
Thank you.

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