ANDBANK RESEARCH

Global Economics & Markets

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Brazil – What has gone wrong? What do we expect from now?

ANDBANK Private Bankers

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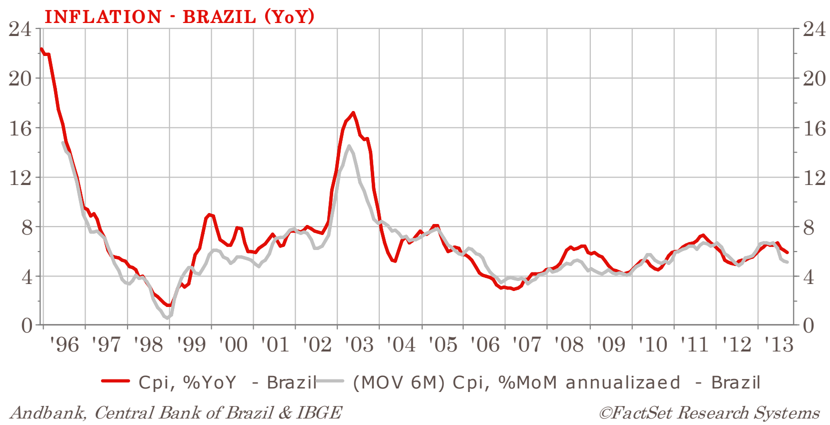
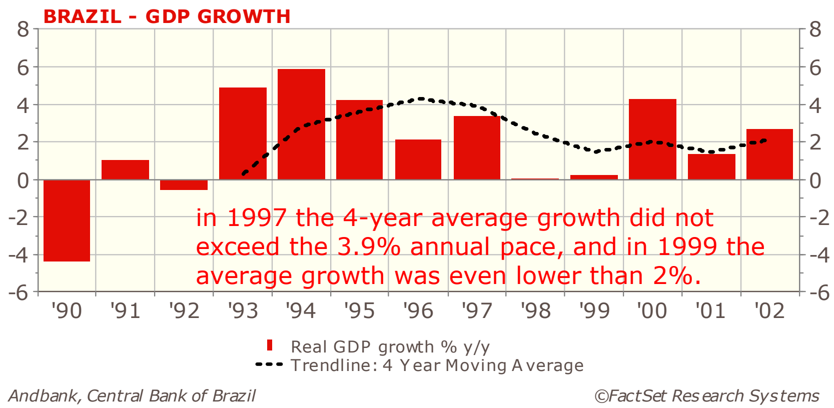
What has gone wrong in Brazil to stop being considered the "It" country?

To better understand this we must fully understand its recent history first:

- 1990 – 1994
    - The lack of growth and the rampant inflation forced much-needed structural reforms.
    - These reforms started under the government of Itamar Franco and included (1) the "Real Plan" -a stabilization plan aimed at controlling hyper inflation that resulted in the replacement of the Cruceiro by the Real-, (2) trade Liberalization, (3) privatizations, (4) the end of several public monopolies and, (5) the financial sector restructuring.
- 1994 – 2002
    - After a temporary spike of growth in 1994, the man who implemented the "Real Plan" (Henrique Cardoso) was elected president (although he was not the designer of the Plan. It was Ed. Bachan).
    - In 1999, president Cardoso continued with the reforms and put in place a "triple target policy" for inflation, fiscal balance and a floating Fx rate. A policy aimed at increase the credibility in the country and boost foreign investments. They had thus almost a decade of credible reforms!
    - The initial result of all these reforms was indeed a more efficient economy **but still failed to deliver a boost GDP growth. After a decade implementing structural reforms, they had not yet seen a substantial improvement in the potential GDP growth rate** (see the second chart).





… understanding Brazil's recent history

- 2002 – 2004

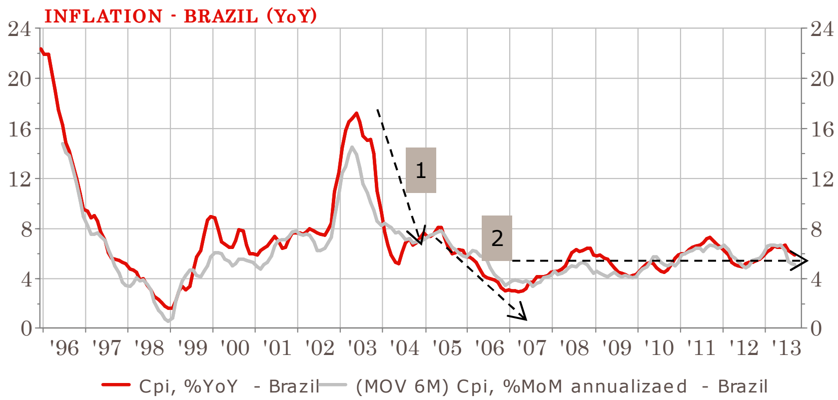
  - When took office in 2003, President Lula kept those reformist character unchanged, even went beyond in the race of the "economic responsibility" due to inflation problems, that appeared again in 2003 (11% in CPI). Lula tightened fiscal policy, monetary policy and raised primary budget surplus, aimed at controlling the secular problem of inflation but also probably because prospects were good for the years that had to come.

  - Early in 2004, these reforms began to bear some fruits: inflation came down (from 11% in 2003 to 5% in 2004), allowing the central bank to reduce nominal interest rates (from 19% to 16%), (see this represented by the "shift 1" in the charts).This prompted the beginning of a credit boom.

- 2004 – 2008

  - These new control of inflation lasted for a few more years, with CPI declining 5 percentage points, from 8% in 2005 to 3% in 2007 (shift 2), prompting an even bigger decline in the Selic rate of about 10 percentage points, from 20% to 11% (shift 2), resulting in a substantial decline of real interest rates, that fell from 12% in 2005 to 8% in 2007, and 4.5% in 2009.

  - These dynamics accelerated even more the credit boom and largely explains how the subsequent economic cycle developed: (1) Credit boom favored labor intensive sectors of construction, retail and finance, (2) and lead to a rise in incomes, (3) Higher wages plus cheap credit made the household consumption (also imports) & corporate profits to expand vigorously and (4) also fiscal revenues expanded, improving fiscal discipline without pain. Despite rising demand, inflation remained relatively controlled in 2007 because of an appreciating currency caused by booming demand in China for Brazilian resources. **THE ERA OF THE PERFECT WORLD WAS STARTING!**



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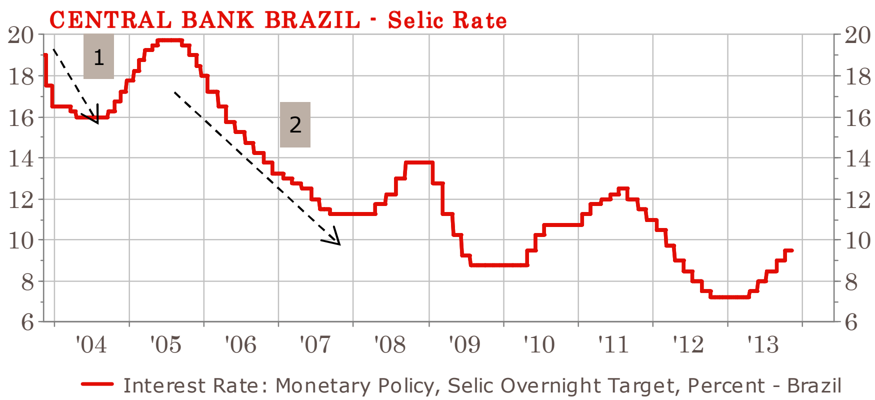

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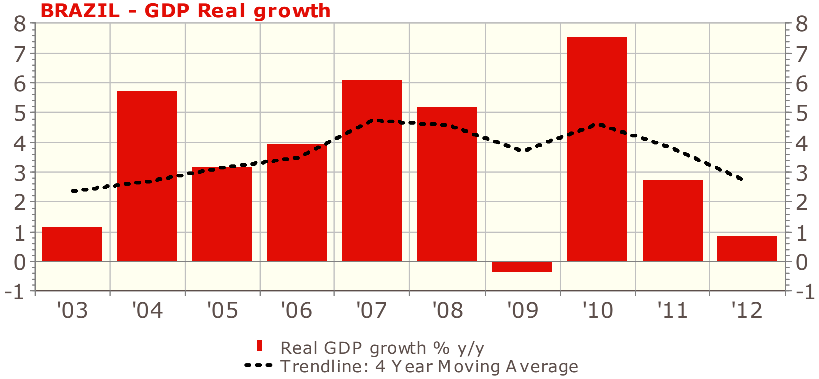
From the perfect world … to the perfect storm!

- 2004 – 2008 **(The perfect world)**
  - So, there we were in 2007 with a full swing business cycle in Brazil. The global financial crisis only briefly halted the party in 2009, in part because the government responded with strong monetary & fiscal stimulus (as every one), but also because the country continued receiving help from the Chinese influence on commodity prices.

- 2009 – 2010 **(The big mistake)**
  - The 2004-2008 economic cycle was in part the result of a "smart" process of economically responsible reforms that started in the early 90s (with Itamar Franco first, and Cardoso later) and continued in the early 00s (with Lula). Therefore, Brazil was "smartly" expanding until 2010. However, although GDP was growing far above potential in 2010 and inflation problems began to revive one more time, Mr Luiz Inácio Lula da Silva decided to keep stimulus at full throttle in order to help his hand-picked successor Roussef win the late 2010 elections. Indeed, Lula catapulted outrageously the GDP in 2010 (to a 7.5% pace) ensuring Roussef's victory (who at that time embodied the idea of continuity)

- 2011 – Today **(The perfect storm)**
  - From the very beginning of his presidency (January 1, 2011), Ms Roussef spent the entire first year in office reversing the stimulus. Guess why? Inflation was dangerously approaching the 8% in 2011 (almost double the official target).
  - The hit from "government's reversal" was much worse than the authorities had foreseen (capital spending plunged from the 21% to a 7% pace in just one year). GDP growth declined abruptly already in 2011 to a dismal pace of 2.7%.
  - Additionally, in August 2011 the fast-metastasizing European crisis made the Roussef's government to panic and decided to take a 180 degrees turn in their policies with their **"new economic matrix"** (ultra loose monetary, fiscal and Fx policy).



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(1) In one year the Selic rate was cut by **525 bp!** (2) Primary surplus deteriorated from 2.4% to 1.4%, and (3) The Government directly lend to state-owned banks (BNDES) at a lower rate than Treasury debt (enabling BNDES to lend at zero real interest rates. (4) Rousseff also doubled down on the weak-currency policy, forcing the central bank to intervene to drive the real down and imposing taxes on foreign inflows. The REER declined by 33% in the 2011-2012 period. **THIS "NEW ECONOMIC MATRIX" WAS THE SECOND BIG MISTAKE!!!**

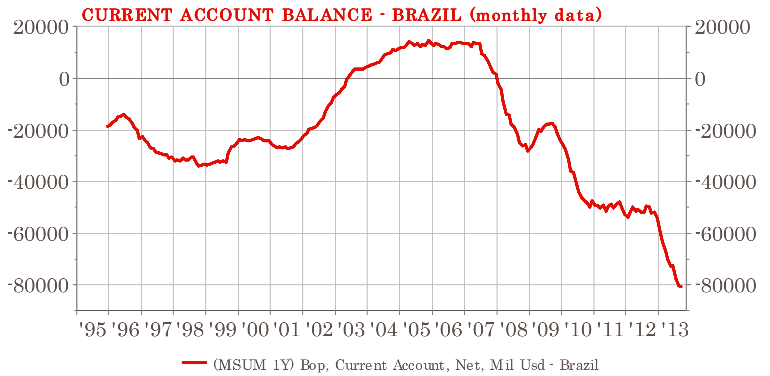
Why do we say that Rousseff's "New Economic Matrix" (NEM) was the second big mistake (the first one was Lula's decision to keep stimulus at full throttle in 2010)

Rousseff's rationale for the "NEM"	Andbank's reading	Andbank's Assessment
"The slowdown in 2011 was due to an insufficient global demand. Not due to supply side factors"	Indeed global demand declined sharply in 2011 (due to fears from the European crisis and the squeeze in the interbank market), however there also were significant and unresolved supply problems in Brazil, (1) the worst level of investment in the region (18% of GDP vs 22% average in the region, and the second worst level of investment in per capita terms). (2) An overly protected (and uncompetitive) industry, and (3) an insufficient level of infrastructures. The result is, for example, a cost of exporting a shipping container of US$ 2.300, when in many Asian countries, the cost of shipping the same container is around US$ 500, and the rest of Latin American countries stay around the US$ 1.000. This difference is due exclusively to supply factors. Ignore them, was a mistake.	The rationale used to implement the NEM was a **MISTAKE**.
"The government certainly believed that the real interest rate had to be lower to boost the economy and thought that the European crisis offered an opportunity to lower them permanently"	Indeed, at that time there were many doubts about the ability of the euro zone members to overcome the crisis. The Phantom of the exit of Greece or Portugal fueled the risk of a breakup in the euro, which certainly justified the use of all the monetary policy measures available to any central bank. However, the countries sharing the euro showed their willingness to remain in the single currency despite the sacrifices required, and were (and still are) precisely those sacrifices inspired in the fiscal orthodoxy which has caused not only the resulting strength of the euro, but also the strong improvement in their risk premiums and the subsequent disappearance of the systemic risks that were used as a rationale for the implementation of the "NEM".	The rationale used to implement the NEM was a **MISTAKE**.

Okay but … What do we expect from now?

Whatever its motives, the Rousseff's New Economic Matrix policy has proved to be a dismal failure. In fact, the second economic mistake in less than 3 years (2010-2012). No economy can withstand so many mistakes without having to pay a toll. Following is an assessment of what is to be, and what will be that toll:

1. Growth expectations continue to fall: Consensus estimates suggest now an average GDP growth of just 2.5% in 2013-2017 (far below the average of near 4% seen in the 2001-2011).
2. Inflation remains clearly above the central bank's target of 4.5% despite the freezing of gasoline prices and bus fares. Expectations are for the CPI to remain at 5.5% in the medium-term (a full point above the target) despite the lowered growth potential.
3. Loss of credibility in fiscal & monetary policy and, what is even worse, It's capacity. Dilma Roussef have overseen a rampant increase in state intervention. Added to this, the frequent changes in regulation and the constant changes of direction in the monetary policy have harmed confidence and slowed business investment (Capex is now at 0% pace y/y using the 4month moving average).
4. The current account deficit has surged precipitously to US$ 80bn (cum 12 months) as of September (3.6% of GDP, from 2.1% a year ago).
5. **This trend in the current account balance (CA) may continue if the terms of trade keep deteriorating (something we consider as plausible given the high prices of commodities). <u>This may convert Brazil into an easy prey for speculators who are in search of countries with CA problems.</u> Why? CA deficits must be financed internationally and we are just entering a new era of tougher financial global conditions (remember that the end of QE is near)**
6. **Because all these aspects, Brazil's potential GDP growth has probably sunk to around 2.5% and the most likely driver for the economy is now a tapering of QE in 2014-2015. If that occurs, <u>Brazil will probably face a harsh transition</u>.**
7. **In terms of markets, all this points to the maintenance of a high credit risk premium in government bonds (NEUTRAL), and certainly a lower potential for corporate profits (that will only be PARTIALLY offset by a relatively healthy dynamics in the Asian demand). The currency will probably be punished in an environment of CA deficit (as in India and Indonesia).**



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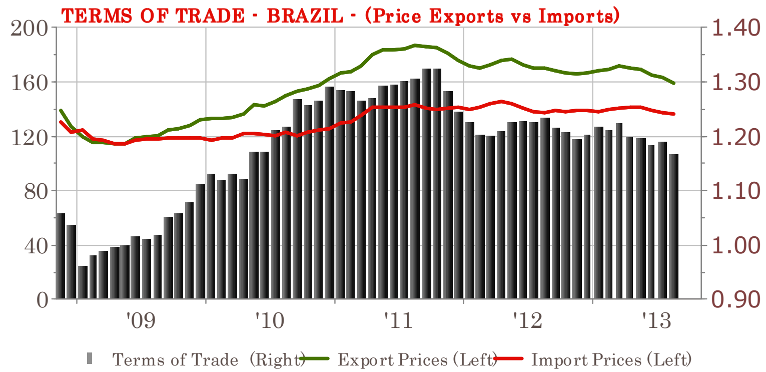

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