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Economics Group

Special Commentary

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Brazil: Been There, Done That

Executive Summary

Brazil has, once again, fallen from grace, as it has done so many times in the past. However, with the loss in investment grade classification, the country has an opportunity to revive its economy by becoming more competitive. The current depreciation of the currency will help to achieve this goal, but it will not be enough. Brazil has to put forward a long overdue agenda of structural reform that was cut short by strong economic growth during the first decade of this century.

The path will not be easy, as the global environment is no longer friendly to a Brazilian revival. However, the current environment presents a favorable opportunity to continue with the structural reforms that started with the implementation of the Plan Real back in 1994. It is true that the current political environment is not fertile for a reform process to take a hold, but at the same time, it is a great opportunity to move in that direction. We are not naïve on the difficulties an attempt to right the wrongs of the past decade implies for such a convoluted political environment, but the Plan Real was born after another serious economic and political crisis in the early to mid-1990s. Although it is very difficult to know how the current political crisis will end, the current environment is a fortuitous opportunity to move in the direction of important reforms.

Falling From Grace, Again

On September 9, 2015, S&P ended Brazil's 7-year run of investment grade status.

On September 9, 2015, S&P cut its rating of Brazil below investment grade, roughly 7 years after it first deemed the country worthy of investment grade status in April 2008. Brazil's achievement of investment grade status was originally supported by a strong economy benefiting from robust growth in China and the commodity boom cycle. Although the story could have ended differently if economic policy during the go-go years had been a bit better, every single Brazilian export market is in shatters and nobody should have expected the Brazilian economy to emerge unscathed by the turnaround in Brazilian economic fortunes. Again, this does not mean that Brazilian economic policy did not contribute to the fall from grace—it arguably did. The economic boom hid the need for major reforms and supported a temporary renaissance of sorts that has been cut short. However, as we have argued in the past, the current depreciation of the currency will go a long way to help Brazil come back from the current economic environment faster than what markets seem to be expecting.

This is also an opportunity to make things happen on the structural reform front. However, it is difficult to see how this could happen with a government in such a difficult political standing, with the political opposition calling for the impeachment of the current president. The only impeachment in modern Latin American history occurred in 1992 when Brazil's then-president Fernando Collor de Mello was impeached for corruption. Interestingly enough, the same Collor de Mello, currently a Senator for the state of Alagoas, has also been implicated in the current corruption scandal in Petrobras. For now, the current President Dilma Rousseff has not been implicated in the fraud, even though she was a member of the Petrobras board during the time when bribes were supposed to have been paid.

We do not want to underplay the seriousness of the current economic and political crisis in Brazil. However, Brazilian institutions are already in the process of righting the wrongs, and as long as those institutions are allowed to operate, then the solution and the end to the crisis may not be as far away as many have estimated. The country has already gone through an impeachment process and the end of that impeachment process saw the implementation of the Plan Real in 1994, which reintegrated the Brazilian economy into the global economy through the implementation of macroeconomic policies that allowed the country to de-couple from its past. Thus, although this process is going to be painful, it will help open the doors to continuing the path of reforms.

Maybe, the Downgrade Is a Good Thing, for Now

Emerging market countries dream of achieving the coveted "investment grade" risk classification.

Emerging market countries dream of, one day, achieving the coveted "investment grade" risk classification, as it opens up the doors to capital flows that otherwise would not be available to those countries and reduces the cost of capital as interest rates for investment grade countries are generally lower than for non-investment grade countries. Furthermore, local firms tailgate on that sovereign investment grade rating to get better financing terms as well as lower interest rates. Many countries work hard in achieving this status and often they do whatever it takes to keep that coveted distinction. However, not all sectors benefit from investment grade classification. In many cases, exchange rates appreciate considerably in nominal (Figure 1) and real terms (Figure 2) as capital flows into the country. Thus appreication of the country's currency often puts pressure on exporters, as the goods they produce become less price competitive.[1] Furthermore, not only did Brazil achieve investment grade status, but the significant increase in the price of petroleum throughout the prior decade as well as the new discoveries of petroleum reserves in deep water exploration sites contributed to make the Brazilian real appreciate considerably.

The devaluation of the Brazilian currency in early 1999 and the commodity boom cycle that started at the turn of the century were very timely and helped Brazil post some of the strongest rates of growth in history. However, strong growth helped sow the seeds of the current crisis, as the manufacturing sector became less competitive, a phenomenon largely overshadowed by the strong growth elsewhere in the economy.

Figure 1

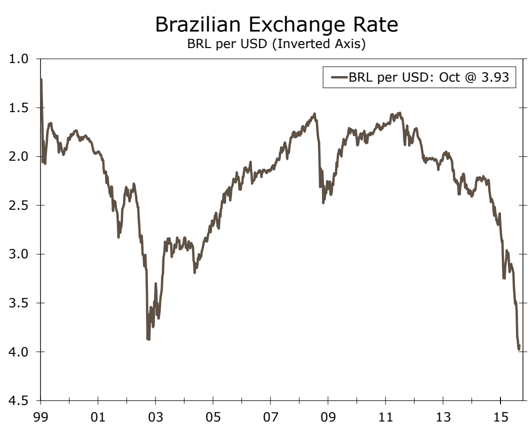

Figure 2

Source: IHS Global Insight and Wells Fargo Securities, LLC

As Figure 2 clearly shows, the real effective exchange rate (REER) is still strong compared to levels seen after the 1999 devaluation of the currency. Thus, it is not impossible for the currency to depreciate further in nominal terms during the next several quarters and years. However, the

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[1] This is referred to as Dutch disease, defined by the Financial Times Lexicon as "The negative impact on an economy of anything that gives rise to a sharp inflow of foreign currency, such as the discovery of large oil reserves. The currency inflows lead to currency appreciation, making the country's other products less price competitive on the export market. *http://lexicon.ft.com/Term?term=dutch-disease*

sustainability, over time, of the real depreciation will depend on how inflation behaves. Brazil's central bank was able to contain inflationary expectations after the devaluation of 1999 and up to the run-up of the presidential elections that elected Lula da Silva. Inflation expectations surged during 2002 and 2003 at which time we started to see the real exchange rate appreciating again, a process that continued up until 2012 almost unabated (the only exception was during the Great Recession). The appreciation of the real was driven by the combination of higher inflationary expectations and actual inflation, the strong increase in petroleum and soy prices, the increase in commodity exports to China and elsewhere, plus the designation of Brazil as investment grade in April 2008.

Figure 3

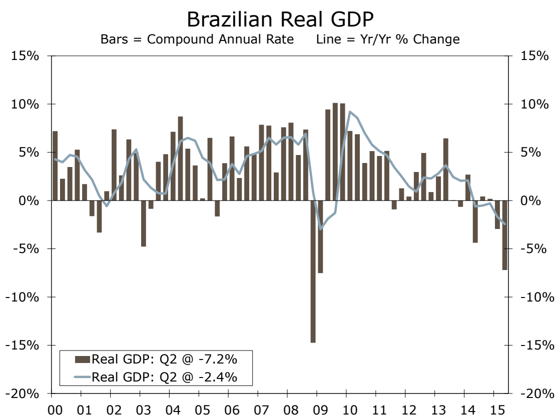
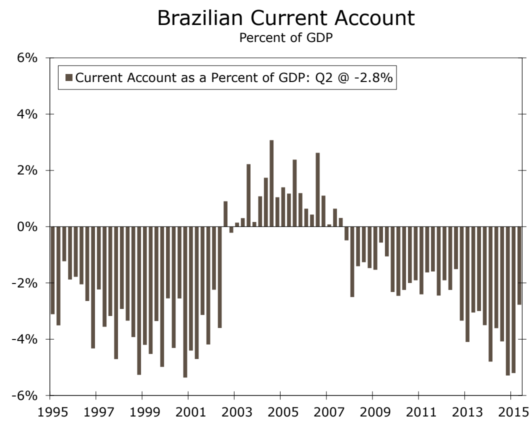


Figure 4



Source: IHS Global Insight and Wells Fargo Securities, LLC

The real's upward trajectory turned around in 2012, soon after Dilma Rousseff became president of the country, and has not abated since. At the same time, inflationary expectations de-anchored as soon as Rousseff took over the presidency and inflation started to increase once again. The process was similar to what happened during the first year of Lula's administration, but Lula's reaction to this process seems to have carried more conviction than what the current administration has been able to convey. Furthermore, Lula da Silva relied on a more forgiving and even more supportive global environment, underpinned by the factors we have mentioned.

Lula da Silva relied on a more forgiving and even more supportive global environment than President Rousseff currently has.

However, the Brazilian economy started to weaken in late 2011 as the Chinese economy started to downshift from double-digit real economic growth. Thus, the Brazilian currency did not need a downgrade to depreciate over the last several years; the unwinding of the commodity boom cycle had already started the process. Yet, the downgrade has made the currency depreciate at a faster pace than it previously had been. The biggest problem today is that if inflation continues to pick up, then the nominal exchange rate will need to depreciate further for the country to achieve a depreciation of the real exchange rate that will help it become more competitive and thus help its external sector. Figure 4 shows the widening in the country's current account deficit, another factor contributing to the significant downward pressure on the real.

Figure 5

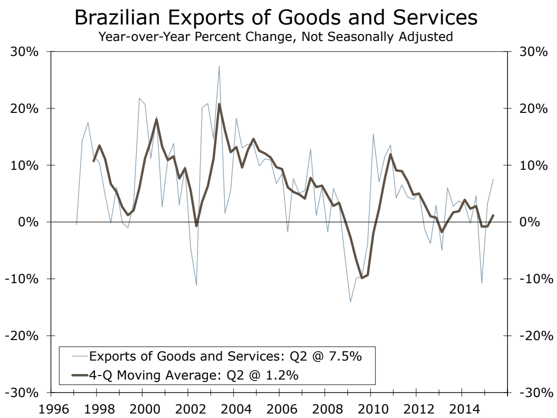
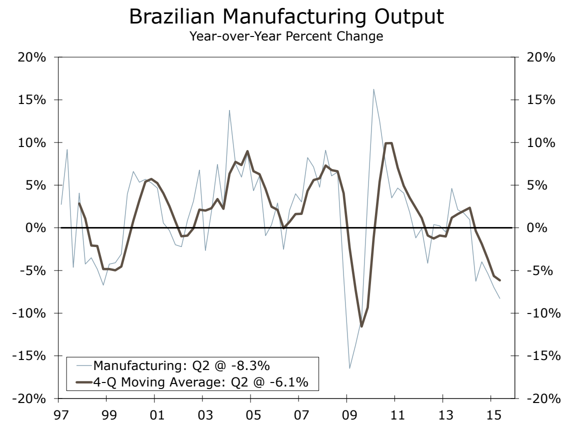


Figure 6



Source: IHS Global Insight and Wells Fargo Securities, LLC

Although commodity prices have plummeted, real Brazilian exports of goods and services have continued to outperform the rest of the Brazilian economy.

Although commodity prices have plummeted, real exports of Brazilian goods and services have managed to hold up fairly well (Figure 5). However, every other sector of economic activity is in a deep recession. Figure 6 shows the Brazilian manufacturing sector, which could be viewed as the "poster-child" of the current economic malaise. Furthermore, although the current crisis seems to pale in comparison to what happened back in 2008 and 2009, few are expecting a similar recovery in economic activity to the one that followed the Great Recession.

Thus, policy missteps have been compounded by a global environment that will make it difficult for the country to recover as it did after the 1999 fiscal and currency crisis. Today's economic recovery needs more commitment to sound macroeconomic policies and a stronger commitment to fiscal responsibility. From this point of view, while the Lula da Silva administration had a very lenient and forgiving environment, Ms. Rousseff will continue to confront serious issues from within as well as from the global economy.

Conclusion

Nobody knows how this chapter in this country's rich history of crises and subsequent recoveries will end, but this is a tremendous opportunity to right the wrongs of the past and to push for structural reforms that will enable the economy to move forward. Once again, trying to figure out how Ms. Rousseff and her party are going to get out of this situation unscathed looks challenging. The ability of the political system to tackle the arduous reform process will determine the ability of the Brazilian economy to recover its importance among emerging markets and the broader global economy.

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