Brazil

Rebuilding confidence for a fresh start

- **Brazil is in the midst of its worst economic recession ever.**
- **Resolving the crisis lies first in political change, which should usher in the first positive signs that the economy is levelling off.**
- **Thereafter, structural reforms will be needed to lend credibility to economic policy, and fiscal policy in particular, and to consolidate confidence and the country's medium-term growth potential.**

Coming soon: the final episode of Brazil's political telenovela?

The political crisis that has swept Brazil since late 2014 reached a climax in March 2016. Through the revelations of legal investigations, the country's ex-president Lula has been directly implicated in Operation Car Wash (Lava-Jato). On Sunday, 13 March, about 3.5 million protestors marched in Brazil, the largest popular protest in the country's history. At the same time, Lula was appointed chief of staff (equivalent to Prime Minister), officially to solidify the ruling coalition, reassure the markets and improve the country's governance, but above all, to grant him immunity and to avoid the impeachment of President Dilma Rousseff (Workers' Party, PT). On 17 March, a judge annulled the appointment, which is now pending approval by the Supreme Court. On 28 March, judge Moro, who is head of the Lava-Jato, submitted documents to the Supreme Court that were found at the headquarters of Odebrecht, which raises questions about more than 200 political figures. Accused of irregularities in the financial statements of her 2014 presidential campaign and poor management of public finances (Pedaladas), impeachment proceedings seem to be tightening the noose around President Rousseff. PMDB, PT's main ally, has just walked out of the coalition. Exasperated, 68% of Brazilians now favour impeachment. Official procedures have been launched in the Lower House of congress and could be completed by a final vote in the Senate in June.

If the Congress validates the impeachment proceedings, under the constitution, Vice-President Temer (PMDB) would be asked to ensure the presidency temporarily until elections can be held in 2018. Negotiations are currently underway to forge a new alliance with PSDB, the main opposition party, and to agree on a reform agenda based on the PMDB's "Bridge to the Future" programme. Given the segmentation of the political landscape (23 parties in parliament, including 12 in the current coalition), however, there are no guarantees that the country's governability can be restored in the short term.

Summary of forecasts

	2014	2015	2016f	2017f
Real GDP growth (%)	0.1	-3.8	-4.0	0.0
Inflation (CPI, year average, %)	6.3	9.0	9.1	7.3
Fiscal balance / GDP (%)	-6.2	-10.3	-8.4	-8.2
Gross public debt / GDP (%)	58.9	66.2	73.8	78.9
Current account balance / GDP (%)	-4.4	-3.3	-1.0	-1.1
External debt / GDP (%)	23.3	29.3	35.2	34.1
Forex reserves (USD bn)	354	349	350	355
Forex reserves, in months of imports	15.5	15.1	14.8	14.7
Exchange rate USD/BRL (year end)	2.7	4.0	4.4	4.6

Table Source: BNP Paribas Economic Research

Nominal exchange rates (indices: May 2013 = 100)

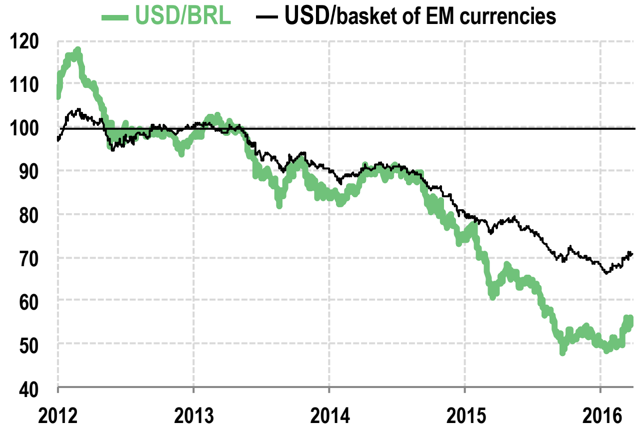

Chart Sources: Datastream, BNP Paribas

Economic policy dilemma: halting fiscal erosion before tackling inflation

Brazil's central bank, Banco Central do Brasil (BCB), has seen its credibility shaken by soaring inflation, due not only to the real's depreciation, but also to the government's decision to sharply raise certain administered prices (25% of the CPI basket). Consumer price inflation (IPCA) reached 9.4% y/y and core inflation, 7.3% y/y in March 2016. Some BCB board members are calling for another selic rate increase (14.25%) to anchor inflation expectations at a lower level. Yet the monetary status quo seems more probable, given the large output gap, the slow pace expected for the normalisation of US monetary policy, and the sharp rise in public debt interest burden (more than 8% of GDP). In the quarters ahead, inflation will converge very slowly on the BCB's target (4.5% +/-2pp since 2006 and 4.5% +/-1.5pp in 2017).

Although the central bank is not independent, its monetary policy has been relatively autonomous in recent years (with the exception of 2012). Yet the alarming deterioration of Brazil's public finances de facto restricts the BCB's scope of action. Its inflation target could endanger fiscal solvency (debate over fiscal dominance), which is facilitated by mild interest rates and high inflation. With Congress blocking reforms and with structural and cyclical constraints straining the public accounts, the primary deficit rose to 1.9% of GDP in 2015, the overall deficit was 10.3% of GDP, and public debt increased by more than 7 points of GDP in one year. Faced with rumours about a new stimulus package to boost demand, the replacement of the BCB board, and attempts to use part of Brazil's hefty foreign reserves to pay down the public debt, Mr. Barbosa, the new finance minister, has struggled to reassure the markets. Several measures were announced in late March (limits on primary spending, rescheduling of local government debt with the federal government, creation of a special regime for unexpected spending, and the possibility for commercial banks to voluntarily deposit liquidity with the BCB to reduce repo operations, which de facto increase the public debt ratio), but they do not seem sufficient and some are even dubious.

Economic recovery: a 2-stage rocket stuck on the launch pad

The year 2015 ended with real GDP down 3.8% (vs. +0.1% in 2014). The Petrobras scandal and the political crisis are largely to blame, along with structural constraints and the international environment. Hit by a 14% decline in investment (70% of which can be attributed to the Lava-Jato scandal alone, according to Bradesco) and a 4% decline in household consumption, domestic demand made a very negative contribution to growth. Net foreign trade's contribution was lifted by the 14% decline in imports and a strong export performance (+6%), bolstered by the sharp depreciation in the real (-33% against the US dollar). As to supply, industrial output contracted by another 6% in 2015. The automobile sector reported surplus production capacity of 70% and the resilience of the services sector finally eroded (-3%). The agriculture output increased by 1.5%.

The negative carry-over from 2015 is a negative 2.2%. Consequently, we are maintaining our growth forecast of -4% in 2016 and 0% in 2017. Since the start of the 20th century, Brazil has experienced two periods of contraction over two consecutive years, once during the Great Depression of the 1930s and again during the Second World War. Yet the size of the current recession is unprecedented, and the cumulated decline in GDP is estimated at about 10% between mid-2014 and early 2017. In addition to the negative factors pointed out previously (see the January 2016 issue of EcoPerspectives), there is also the public health crisis caused by the Zika virus. Even though we see no signs of a return to growth in the short term, our growth forecasts would have a slightly positive bias if there were any favourable developments on the political front. The government's recent misfortunes sparked a positive reaction from the markets. Even though political uncertainty is likely to weigh on household and investor confidence in the short term, a change in leadership could end the political stalemate and obstructions, as well as the wait-and-see attitude of economic agents in recent months. Positive political developments would trigger the first stage of a 2-stage rocket: consumption and investment would finally level off before slowly beginning to recover thereafter.

The second stage can only be fired by large-scale structural reforms, which would restore the credibility of economic policy, especially fiscal policy, and consolidate confidence and medium-term growth potential. The potential growth rate plunged from about 2.5% in 2014 to less than 1% henceforth, notably due to the impact of the drop-off in the structurally weak investment rate, to 18% of GDP.

Note that in the early 1990s, it took three years to implement the Real plan. Several vital measures are needed, notably an inter-temporal and structural ceiling on public spending increases and a strict target for the primary balance in order to restore the credibility of fiscal policy. They must be accompanied by an overhaul and simplification of the tax code (overhauling the 66 different taxes would require the approval of 27 states) and the creation of an equalisation fund to reduce the tax war between states. It is also essential to end indexation: social spending and wages are indexed to prices (since Lula 1), triggering a wage/price spiral and contributing to the rigidity of inflation (notably in the services sector). In industry, structural wage pressures are also caused by the shortage of skilled labour, which requires substantial investment in education and training as well as greater job market flexibility. The pension system also needs to be reformed by raising the legal retirement age, especially since the over-60 age group is increasing 4.2% a year. Opening the economy is also ineluctable (deregulate the energy sector, privatisations, infrastructure concessions) to attract investors capable of stepping in for the government, and to foster competition with local companies in order to optimise the country's economic potential. Lastly, institutional reforms are also needed to improve governability, notably by consolidating the political landscape (introduction of election thresholds requiring a minimum share of the vote to secure any representation).

Brazil has major strengths that should serve as the foundation for future development: a large domestic market, abundant natural resources, immense agricultural potential, a firmly anchored though relatively young democracy, and stable, albeit perfectible, institutions (separation of powers, independent judicial branch).