At a time when many investors are rediscovering emerging markets, Brazil stands poised to capitalize on two global trends that could help sustain that comeback: the overlooked wave of economic reform, and the nascent revival in commodity prices. The benefits, however, may have to await the outcome of a period of uncertainty, as President Jair Bolsonaro waffles on economic reform. The result is a strange disconnect, as doubts about reform prevent Brazil from capitalizing on the rise in prices for its main raw material exports.

For decades Brazil’s fortunes have been closely tied to global commodity prices. Its per capita income was closely correlated with the global commodity indexes.\(^1\) So was the value of the real, and of Brazilian stocks. But starting last year, those links started to break, and Brazil stopped behaving like the classic commodity economy that it is. Commodity prices started to rise in earnest, but Brazil did not. Another odd departure in a surreal year for the global markets.

The main reason is politics. Bolsonaro is a right wing populist with a taste for free market reform, and his two sides are constantly at war. Since he came to power in 2019, markets have been obsessed with every twist and turn in Bolsonaro’s efforts to reform what is arguably the most oversized and overregulated welfare state in the emerging world. Lately, signs of populist backtracking have fed fears that Bolsonaro will run up the public debt, fueling inflation and leading to a classic Latin American meltdown.

Those concerns can’t be ignored. And as they persist, Brazil is missing out on what looks like the start of a commodity revival: after a weak decade for commodity prices, global supply and

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1. MSIM, Bloomberg, Factset, Haver. As of March 2021.
Demand dynamics point to a strong one ahead. But we think investors are too focused on one part of the political story—the populist side of Bolsonaro—and too little on commodities, which have typically mattered more in the long run.

Even the political news is not all bad. Once the pandemic hit last year, Bolsonaro’s effort to downsize the government and its welfare and pension systems took a back seat to relieving financial distress. Brazil rolled out a relatively generous stimulus package compared to other emerging nations, driving its public debt up from 75 percent to just under 90 percent of gross domestic product (GDP). Worries that the fiscal situation could deteriorate further are weighing on the real.

The sense that reform is on hold is based largely on Bolsonaro’s February decision to fire the CEO of Petrobras after he tried to raise fuel prices to market rates. That was widely seen as a populist sop to protesting truck drivers. But much of what Bolsonaro has done reflects his reform side.

Last year investors worried that the central bank would come under pressure to start buying government debt, which would further undermine the real. Instead Bolsonaro signed a law ensuring central bank independence from political interference. Last month, the central bank surprised everyone by pushing through its sharpest hike in more than a decade. Short term rates are still negative in real terms, too low to stanch inflation. But fear that populism would destroy monetary discipline has not played out.

On paper, the fiscal reform agenda is still reasonably strong. Bolsonaro’s party recently pushed through a law designed to restrain public spending—including spending for the popular Bolsa Família welfare program—when it reaches certain trigger points. In the works for the first half of 2021; plans to rationalize a grab bag of state and federal taxes into one value added tax, privatize the big state utility, and restrain civil servant salaries.

Doubters say these measures have been in the works for several years, and action is urgent. Their concerns grew with the recent news that the disgraced former president Luiz Inácio Lula da Silva may be clear to run again in 2022, and return his big-spending Workers’ Party to power. A recent forecast suggests that, even if the government complies with the new spending caps, public debt will remain above 90 percent of GDP for most of the coming decade. At the same time Brazil’s ability to pay that debt is declining. The unexpected combination of rising commodity prices and a weakening real is pushing up inflation. Since last year’s lows, inflation has more than doubled for consumer prices to more than 5 percent, and nearly quadrupled for food prices to 19 percent.

The result is upward pressure on interest rates. Bond yields have already risen to slightly above 8 percent. In short, Brazil needs to accelerate not delay fiscal reform, in order to bring down the debt-GDP ratio more quickly.

Inspiration could come from the accelerating vaccination program. Brazil is one of the few emerging markets that has seen a recent increase in cases and deaths, and its vaccine rollout had been underwhelming until late last month. Brazil nearly doubled the number of doses it delivers each day to more than 600,000, with an aim of 1 million. At that rate, two thirds of the population could be vaccinated by the end of 2021.

Herd immunity could do wonders for the economy, and the president. The recovery that began last year could pick up sharply if the vaccination program slows the pandemic in the second half this year. The current consensus forecast is for 3.5 percent growth in 2021, up from a 4.1 percent contraction for 2020. And if the economy gains pace, Bolsonaro could gain the support and confidence he needs to push fiscal reform and get re-elected.
Following up with deeper fiscal reform would have several beneficial effects, starting with the currency. Based on our model for how commodity prices normally impact the Brazilian currency, the real should be about 30 percent stronger than it is today, against the U.S. dollar.7 Right now, Brazil’s progress is being distorted by the impact of the pandemic and inflation on Bolsonaro, who’s declining popularity is pushing him to indulge in fitful displays of populism. It may take another election, and herd immunity, to put reform back on a consistent track. That should be enough to restore a sense of normalcy, with Brazil, a classic commodity economy, benefiting from the commodity price boom.

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