

Tales From the Emerging World

Brazil: Restoring the Fiscal Anchor Is Key

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For decades the fortunes of Brazil, the world's fourth largest commodity exporter, were closely tied to global commodity prices.¹ Its economy, per capita income, value of the Brazilian currency and Brazilian stocks were positively correlated with the moves in the global commodity indexes.² The arrival of right-wing populist President Jair Bolsonaro in 2019 and the COVID-19 pandemic created a break in the past relationship preventing the country from fully benefiting from the rise of its main exports. Commodity prices have recovered from the COVID-19 lows, but Brazilian stocks and its currency have not yet returned to their pre-pandemic peaks.³ Back in April of 2021, we warned that with Bolsonaro misfiring on economic reform, it may take another election to set things right (*Brazil: Populism Versus Commodities*) so that the country can benefit from the current boom in commodities exports.

That election is now here.

On a recent trip to Brazil, we had a chance to witness firsthand the impact of the presidential election that pits left-wing Luiz Inácio Lula da Silva, better known as Lula, against the incumbent Bolsonaro. Opinion polls suggest Lula is on track to win back his old job. Yet, this election could prove to be less disruptive than previous cycles. After three years of Bolsonaro's chaotic rule, this vote is more of a referendum on the current president than a leftward political shift, similar to what took place in Chile and Colombia.

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¹ MSIM, Bloomberg, FactSet, Haver.

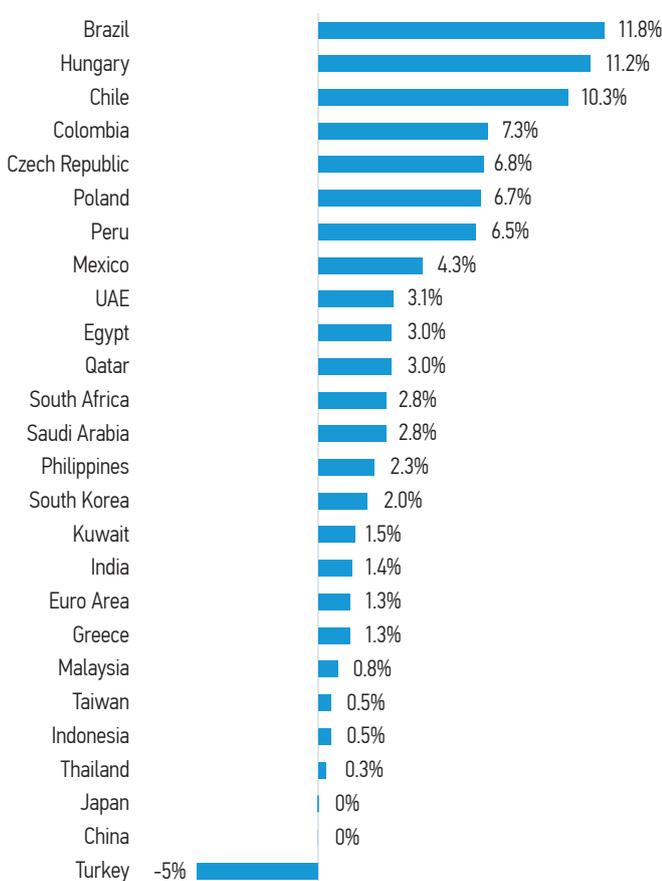
² MSIM, Bloomberg, FactSet, Haver.

³ MSIM, Bloomberg, FactSet, Haver.

DISPLAY 1

Brazil Has Acted Aggressively to Fight Inflation

Percent change in policy rates: January 2021 – August 2022

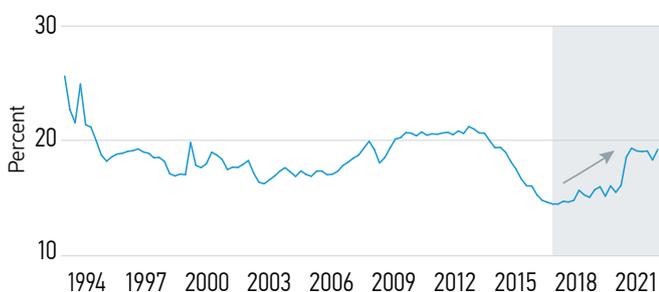


Source: MSIM, Bloomberg, FactSet, Haver.

DISPLAY 2

Investment Is Back on the Rise in Brazil

Investment as a percentage of GDP



Source: MSIM, Bloomberg, FactSet, Haver.

Lula's likely return to Alvorada Palace once seemed too farfetched even for producers of the country's popular telenovelas. Described by former U.S. President Barack Obama as "the most popular politician on earth," Lula left office in 2010 with an 80% popularity rating.⁴ The adulation did not last as a series of scandals tarnished his reputation and he was sentenced to 12 years in jail in 2018 for corruption and money laundering. Most Brazilians blamed Lula's big-spending Workers' Party for the country's rampaging crime and corruption. Yet, after serving 580 days in jail, the Brazilian Supreme Court last year annulled his sentence, freeing him to make his presidential bid.

Bolsonaro faces an uphill battle, with rejection rates higher than Lula. Nine months ago, this would have been a source of worry for the markets. But as we discovered in our meetings, business leaders seem comfortable with either candidate winning, a marked departure from past elections. Even Lula mixes his hard-left rhetoric with a moderate choice for vice president, Geraldo Alckmin, the former Governor of Sao Paulo. In addition, recent institutional reforms have empowered the National Congress, controlled by center-right parties, to play a bigger role in checking the excesses of the executive branch.

The Central Bank of Brazil (CBB) continues to be a strong independent institution and maintains high credibility as evidenced by raising rates sharply early last year in a bid to stanch inflation. This was at a time when the U.S. Federal Reserve was not even talking about raising rates in the U.S., their thinking instead focused on the transitory nature of inflation. In a series of aggressive hikes, the CBB raised rates 12 times, by an aggregate 1,175 basis points, from a historic low of 2.0% to 13.75%.⁵ The central bank is now edging closer to ending its rate-hiking cycle and is likely to be the first in the world to ease rates. We expect rate cuts to be enacted in mid-2023 as inflation peaks.

The July 2022 Consumer Price Index declined to 10 percent and economists expect inflation to slip further, to around 6 percent, a year from now.⁶ Government tax reductions on fuel have pushed electricity and gasoline prices lower, and with crude oil prices now also trending lower, we believe the worst in terms of inflation is over.

Bolsonaro's efforts to reform and privatize state-owned enterprises (SOEs), push through new private infrastructure concessions and ease labor laws were overshadowed by his combative and chaotic management style. Nevertheless, he has overseen an economic team that enacted reforms that are cumulatively yielding material improvement in the economy and business climate; investment at 20% of GDP being one of the key positive inflections for the country that was in a deindustrialization mode for the past decade.⁷

In 2021, manufacturing made up 10 percent of the economy, the country's agricultural-related businesses accounted for

⁴ Bloomberg, The Economist.

⁵ MSIM, Bloomberg, The Wall Street Journal.

⁶ MSIM, Bloomberg, FactSet, Haver, Reuters.

⁷ MSIM, Bloomberg, FactSet, Haver.

nearly 7 percent and both are now well positioned to benefit from a commodities tailwind in a post Ukraine war world.⁸ Investments in infrastructure and agriculture are led by private firms and banks, rather than SOEs and state banks. The law that formalized the independence of the CBB included a constitutional amendment that allowed private investment in sewerage works. Year to date, foreign direct investment flows have reached nearly \$53 billion, within striking distance of what the central bank had predicted for the entire year.⁹ The underlying economic activity remains vibrant, and the labor market is buoyant with unemployment rate at 9.1%, a seven-year low.¹⁰

The Achilles heel of Brazil remains its fiscal situation. The benefits of the long-awaited pension reform passed by Bolsonaro is already diluted by pandemic and inflation spending. Credibility in the government's ability to maintain spending caps is eroded. Restoring the fiscal anchor will be

the primary economic challenge of the new administration. For now, the market seems comfortable that the progress will proceed in the right direction.

The incoming president will inherit a much more positive structural economic situation. If Bolsonaro were to win, this will likely lead to further economic reform and more privatization, at the cost of sensational headlines in the global press. If he leaves, voluntarily or after a fight, the Brazil that Lula will inherit will be in much better shape than when his successor, Dilma Rousseff, left office. And his room to maneuver will be constrained, by a country still decidedly center-right in the main. Once Brazil is past this inflation cycle, the economy should be ready to grow based on a revitalized private sector investment, a thriving agricultural and commodity sector, a credible central bank and a competitive currency.

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⁸ World Bank.

⁹ Reuters. Data as of July 2022.

¹⁰ MSIM, Bloomberg, FactSet, Haver, IBGE.

DEFINITIONS

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. It includes all private and public consumption, government outlays, investments and net exports.

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