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TRIP NOTES

Brazil: Two Steps Forward, One Step Back

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After a recent trip to Brazil in early March 2020—before the precipitous shift of the global economic outlook triggered by COVID-19 and ensuing financial turmoil—we came away somewhat more concerned about the outlook for future reforms and the economy under the government's stewardship. The fallout of the Coronavirus will add to the persistent weakness of economic activity, likely resulting in a recession and a fourth consecutive year of lackluster growth. Heightened acrimony between the executive and legislative branches could delay, if not derail, the government's market-friendly reform agenda. Monetary policy steps have been inconsistent, thereby undermining its credibility. Brazilian policymakers are sending mixed messages on the ESG front.

A Softer Growth Outlook

At the time of our visit, the persistent softness of economic activity along with the impact of the coronavirus was being internalized in Brazil, leading local economic analysts to revise their growth forecasts for 2020 from the low- to mid-2% territory to a range of 1.5-1.9%. As of early March 2020, COVID-19 was thought to be behind a 0.2-0.3 percentage point drop in the annual growth number. As disruptions to the global economy and commodity price declines have continued to deepen, forecasts have been cut further. Some houses (including PGIM Fixed Income) now project a contraction in 2020.

Provided that these forecasts crystallize, it would represent the fourth year in a row of sub-1.5% growth in Brazil, further confirming the sluggish recovery from the 2015-16 recession. This performance cast doubts on Brazil's potential growth. Despite the variance of point estimates, there is a broad acknowledgement of Brazil's low potential growth. Some local analysts place it at about 1% p.a. while others have a relatively more sanguine view and reckon it is closer to 2% per year. Against this backdrop, there is a widespread belief that the output gap remains negative, though estimates of its size vary.

We spoke with one academic economist from one of Brazil's top universities who attributed the underlying weakness of growth to the economy's structural shortcomings to achieve sustained productivity gains. In particular, this economist singled out the prevalence of an informal labor market (circa 40% of workers) as a key obstacle as research suggests that the productivity gap between formal and informal workers is approximately fourfold.

Increased Animosity Between Executive and Legislature Clouds the Reform Outlook

The relationship between the Bolsonaro administration and Congress has recently deteriorated on the back of disagreements over budgetary allocations, differences over reforms, and the executive's general attacks on Congress, particularly its leadership. We spoke with one Congressman who stressed that the cumulative effect of these attacks, which have occurred since the early months of the Bolsonaro administration, are truly poisoning the reform environment. Despite these tensions, some political analysts maintain a constructive view of reform passage, citing the aligned incentives of Congress and the President. In our view, this rationale is not that clear cut. From our conversations, we infer that legislators' political calculations may be shifting, as cooperation with the Bolsonaro government could be turning into a liability.

Officials from the Finance Ministry, on the other hand, reiterated their determination to stand their ground in negotiations with Congress. While this uncompromising approach could lead to some brinkmanship, which might delay reforms longer, it could also improve the quality of reforms (if they go through). Yet, the continued tug-of-war between the executive and the legislative branches, whereby each flexes its muscle publicly, further thins their lines of communication.

These developments add complications to a political backdrop in which governability is a structural challenge, thereby reducing our conviction about the reform outlook. Yet, we continue to envision additional progress on the reform front as our central scenario. One reform that could be somewhat inoculated from this acrimonious political backdrop is the "fiscal emergency" bill (automatic spending adjustments that are activated if current outlays cannot be covered without incurring debt). The reason is that without it, the constitutionally enshrined spending cap could be violated next year unless other constitutionally enshrined increases in mandatory spending are curbed. A constitutional-level fiscal crime would be hard to avoid in this context, which amounts to an impeachable offense. This scenario is one that political actors are arguably deeply keen to avoid. Another likely reform is central bank independence given the substantial progress that has been achieved to adopt this important reform. On the other hand, the prospect of tax reform appears slim, at least in 2020. The Bolsonaro administration's controversial management of the coronavirus crisis might become an additional headwind to reforms.

Gradual Fiscal Consolidation Plans Put on Hold Due to Coronavirus

In early March, the Finance Ministry appeared unlikely to yield to pressures to loosen the fiscal purse to stimulate the economy as authorities actually view such action as counterproductive. This position is underpinned by the overarching belief that excessive public spending stands at the crux of Brazil's troublesome fiscal situation. Consistent with this view, policymakers have prioritized three objectives: placing pensions on a more sustainable path (hence last year's flagship reform to social security), improving the government's balance sheet (hence the privatization drive), and reducing the central government's wage bill (hence the fiscal emergency bill and decentralization efforts).

In the context of this fiscal hawkishness, officials would have been expected to freeze some spending with the revisions to their macroeconomic projections in late March that penciled in lower growth, lower oil prices and a weaker exchange rate in order to meet the deficit target. The government targeted a primary fiscal deficit of 1.6% of GDP in 2020, versus 0.9% in 2019, 1.7% in 2018, and 1.8% in 2017. While some local analysts anticipated that the government might have beat the target, the underlying trajectory has been one of very gradual consolidation (only temporarily improved by the repayment of loans by a public development bank and FX sales last year).

Nevertheless, this game plan was quickly unraveled by the economic fallout of COVID-19. Instead, authorities declared a state of "public calamity" that allows a relaxation of the aforementioned fiscal target to accommodate the impact of lower growth on revenues as well as some fiscal and quasi-fiscal stimulus measures. Against this backdrop, the debt-to-GDP ratio will likely resume its upward trend after 2019's decline. Authorities project the gross debt burden to peak north of 80% of GDP by the mid-2020s.

Brazil's economic underperformance of the economy has triggered rumors of a potential departure of Finance Minister Paulo Guedes, which would likely carry negative market implications. Based on our conversations, we did not get the impression that Minister Guedes has any intention of leaving.

Inconsistent Policy Framework Could Erode the Credibility of Monetary Policy

At the time of our trip, the most likely policy response to Brazil's weaker growth outlook appeared to rely more heavily on additional monetary accommodation—the central bank (BCB) cut its policy rate by 50 bps in mid-March—notwithstanding the currency's poor performance. While there was consensus regarding the BCB's future course of action, views regarding its adequacy were mixed given the sizeable year-to-date weakening of the currency. Under these circumstances, local market participants overall held a bearish view of the Brazilian real.

Underpinning the BCB's likely flight plan is the authorities' textbook approach to monetary policy in the context of a weakening currency: the monetary framework targets inflation, not FX, so currency dynamics only enter policy deliberations insofar as they affect inflation and inflation expectations. The favorable behavior of those variables—along with the notion that the fallout from the coronavirus and softer global growth are net disinflationary amid lower energy prices and weaker domestic activity—as well as the additional space afforded by the policy response of core central banks should provide some flexibility to slash the policy rate further. That said, BCB authorities appeared genuinely uncertain as to how much space may be left for additional monetary stimulus.

BCB authorities indicated that deliberation on FX policy is conducted separately from rate setting decisions. In our view, this policy framework could lead to inconsistencies, thus harming the effectiveness and credibility of monetary policy. For instance, rate cuts could actually backfire by tightening financial conditions via weakening pressures on the real exchange rate. Given that Brazil's exports rely heavily on commodities and that its economy is relatively restricted to trade, the income and confidence effects stemming from a real depreciation of the currency could blunt the boost to domestic demand from further rate cuts.

Mixed Messages from the Government Regarding ESG

In terms of ESG, we learned that CB governor Roberto Campos Neto has been voicing his concerns that ESG-driven capital flows could shun Brazil, and that a commission (chaired by Vice President Mourão) meant to enhance Brazil's ESG conditions has been set up. This arguably underscores an awareness among some policymakers of the surging relevance of ESG considerations in portfolio allocations as well as the market's perception of Brazil's ESG shortcomings following high-visibility developments, such as the Amazon wildfires. On the other hand, other officials showed an unequivocal lack of sympathy towards ESG issues, and one Congressman admitted that they are plainly not a priority for the administration. Some local analysts acknowledged that the lack of a coherent ESG policy and message could become an additional headwind to Brazil's appeal as an investment destination.

Conclusions

While generally moving in the right direction, the fundamental outlook for Brazil has become more challenging owing to a weaker growth outlook, the gradual approach to the correction of the fiscal situation—both worsened by the global fallout from the coronavirus—a less benign external stance, a less supportive political backdrop for reforms, and growing skepticism over the quality of monetary policy. Potential upward revisions to Brazil's credit rating will likely follow a more protracted path as agencies remain on the sidelines, chiefly waiting to see a consolidation of the economic recovery and progress on reforms, both of which are being temporarily sidetracked due to COVID-19.

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