BBVA | RESEARCH

Travel Report

Brazil

Madrid, 14 April 2014
Economic Analysis

Latam Coordination Unit
Juan Ruiz
juan.ruiz@bbva.com
+34 913745887

Enestor Dos Santos
enestor.dossantos@bbva.com
+34 639827211

Politics starts to take centre stage while pessimism about the performance of the economy continues

This report builds on a series of meetings with local analysts during our trip to Brazil at end-March, 2014

- **The probability of more market-friendly economic policies during forthcoming years is increasing**

  Local analysts consider that the probability of the President Dilma Rousseff not being re-elected at the end of 2014 is around one-third, higher than some months ago and than recent polls suggest. The “normalization” of economic policies would certainly follow the victory of opposition candidates (Aécio Neves or Eduardo Campos). But even in the case the President Dilma is re-elected, many local analysts think that current policies would be adjusted, although this is not taken for granted.

- **Growth will continue to be weak and inflation will remain under pressure in 2014 and 2015**

  There is a wide consensus about the fragility of the economy going forward. The conditions for a bad 2014 are mostly set and the generalized perception is that 2015 will be an adjustment year, independently of who wins the presidential race. There’s a widespread perception among analysts that fundamentals of the economy are not bad, but current dynamics are not very good. Local analysts remain more pessimist than foreign ones, as we have been observing since at least 2009. Among other negative risks, analysts highlight the probability (around one-quarter) that a prolonged drought and delayed investment trigger a widespread electricity rationing, which would drive growth further down and inflation up. The blackout risk further increases the (already very high) likelihood of social unrest during the Football World Cup.

Brazil: Travel Report

This reports build on series of meetings with local analysts in Sao Paulo (March 24, 25 and 26) as well as our participation in the IADB Annual Meeting in Salvador (March 27, 28, 29 and 30). The main goal of this note is not to provide an exhaustive view of Brazil's economic situation, which was done in our recently released 1Q 2014 Brazil Economic Outlook, but rather to highlight some of the issues currently under discussion in the country as well as some interesting, new insights. In addition, more than focusing on our view of the Brazilian economy, the focus will be on the views of people we met.

Political scenarios: even after losing some momentum, President Dilma is still the favourite to win 2014 elections

- Even though the period for political parties defining their candidates is still some months ahead, it is very likely that the main candidates for the Presidential election to be held in October will be the current President, Dilma Roussef, who will run for re-election, Aecio Neves, from the former President Cardoso's PSDB, and Eduardo Campos, who is currently Governor of the State of Pernambuco and should be accompanied in the PSB ticket by Lula's former Ministry Marina da Silva.
- Both Aécio Neves and Eduardo Campos, who are respectively seem as centrist and as center-leftist, are expected to deliver orthodox economic policies. They are supporters of the model based on exchange rate flexibility, inflation targeting and commitment with the generation of primary surpluses to guarantee fiscal solvency. They are both seen as more market-friendly than President Dilma.
- The chance of the former President Lula being PT's candidate instead of the current President Dilma is considered very small, but cannot be completely ruled out. However, the former President is seen as highly likely to run again in 2018.
- Recent polls show that the President Dilma is losing moment. That coupled with the "sentiment of change" reflected in last year's protests and in recent polls make many to think that she could be beat by either one of the other two main candidates, especially if she is not able to win in the first round of elections in October. In case of a second round, both Aecio Neves and Eduardo Campos will very likely group together against President Dilma. At this point, analysts attach a two-thirds probability of re-election. This probability falls below those coming out of current presidential polls, as many analysts point out that opposition candidates have not yet been prominently displayed in mass media, and will not be until campaign starts after the World Cup is over.
- A straightforward re-election of Dilma was more than discounted by markets some months ago and her current lower chances could be a factor behind the recent rally in domestic financial markets.
- Some of the events that could erode President Dilma's probability to win the October elections are (from the more likely to the less likely): i) electricity rationing; ii) popular protests, especially during the Football World Cup to be hold by the country in June/July; iii) problems in the organization of the football tournament; iv) increasing inflation; v) corruption scandals; vi) deterioration of the labor market.
- There is significant uncertainty regarding a likely second government of Dilma Rousseff. Many think that, pressured by markets and by members of the government coalition (in particular by former President Lula), she will be forced to adopt more orthodox and less

interventionist policies. This scenario would be more likely the lower the margin by which she beats her opponents. On the other hand, a good share of analysts sees no strong reasons for a significant change in her government policies during a second term. However, even this group sees likely some tightening of fiscal and monetary policy in 2015.

- In any case, even if there seems to be some agreement among analysts that the next government will undertake more orthodox economic policies (more likely if opposition candidates win), there also seems to be some agreement that there are no major reform programmes likely to be started after the elections by any of the candidates, and the discussion of reform programmes does not figure prominently in the political debate.

Energy: the rationing risk hovers around the economy

- Due to weather conditions (a severe drought reducing hydroelectric output), delayed investment and some policy mismanagements (such as the decision to cut electricity tariffs last year, which naturally stimulated consumption), the risk of a widespread electricity shortfall is now around 25%, according to experts.
- In comparison to the previous electricity crisis that Brazil faced in 2001, and that was one of the factors behind PSDB's defeat and Lula`s election in the 2002 presidential elections, this time the system is more interconnected, meaning that hydroelectric resources can be moved from surplus to deficit regions. In addition, nowadays the country owns a set of thermoelectric plants that work as an insurance against energy shortages as they can be turned on, although at a much higher price, in case of low hydroelectric supply and / or high demand.
- In spite of the advances in the last decade, the domestic energy system is currently very exposed to weather conditions. The fact that thermoelectric plants have been working continuously since the end of 2012 (even as they were designed to run for just short intervals at peak times) shows that the system is working at its limit.
- Although electricity rationing scenarios depend heavily on forthcoming weather conditions (there is still about one more month in the regular rainy season), many think that the government would able to avoid widespread power shortages ahead of October elections by, among other measures, pressing some energy-intensive industries to reduce their electricity consumption. However, the generalized view is that perhaps shortages can be postponed but not avoided. Some analysts even consider that electricity rationing should have started already, and it has not because of the impending elections. Thus, if rationing does not materialize in 2014 it will become even more likely in 2015.
- The recent drought has already impacted food prices. In addition, it will impact inflation through higher electricity tariffs, especially from 2015 onwards as the government has been postponing some tariff revisions to prevent inflation from running even higher before elections.
- Moreover, as the government has been supporting energy companies, the problems in the sector will certainly impact fiscal accounts starting this year.
- Even though local analysts are more worried about the impact of power shortages on inflation and fiscal accounts, it could clearly impact economic activity.

Protests: another source of uncertainty

- The consensus is that generalized popular protests, such as those observed last year, will occur during the World Cup to be organized in June/July and potentially can impact the result of the forthcoming presidential elections.
- However, there are very heterogeneous views about the probability of these events and the impact they can have. But the probability of protests will certainly increase with rolling blackouts and the expected increase in inflation in the next 3 months (see below).

Sovereign credit downgrade: earlier than expected

- While we were in Brazil, S&P cut Brazil's rating by one notch to BBB- .
- The decision was widely expected. However, many seemed surprised by the timing of the announcement as the downgrade was seen more likely after the October elections. According to some, this earlier-than-expected downgrade was triggered by the extra fiscal costs generated by the recent drought and rising energy prices (see above).
- In our view, local markets were slightly surprised by the muted reaction of Brazilian financial markets (the recent rally continued in spite of the announcement). Apparently many saw the S&P announcement of a stable outlook as the positive spin on the news, as the downgrade had already been discounted.
- The chance of other agencies following S&P and downgrading Brazil's sovereign debt during the remainder of the year are seen as limited. 2015 action will depend on new government's policies.
- Most analysts think that the downgrade will not have a direct impact on the October elections, as people's concerns seem mostly focused on employment and inflation.

Economic growth: no recovery in sight

- Most analysts expect GDP growth to be no higher than 2.0% in both 2014 and 2015. According to their political scenarios (see above), some expect 2015 to be a more difficult year than 2014, while others expect 2015 to be slightly better than 2014.
- There is a broad consensus about the deceleration of private consumption ahead, due to less supportive labour and credit markets. There is more uncertainty regarding the behaviour of both exports and investment.
- Estimations of potential growth fall between 2.0% and 3.0%.
- Analyses of domestic growth perspectives were highly concentrated on supply-side limitations. Practically no analyst we talked to referred to risks that the economy runs significantly below the (lowered) potential due to demand-side problems (for example, a sharp deterioration of labor markets following a sudden depreciation of the currency, a more significant increase in inflation or a tighter than expected monetary policy). In our view, demand risks are being somewhat downplayed.

Inflation: trending up

- The wide consensus is that inflation will inch up from now on and breach the ceiling of the target range (6.5%) during the World Cup and right before the October elections. Even though some moderation is expected at the very end of the year, most see inflation around 6.0% at the end of 2014 and during 2015.

- The recent drought is helping to drive up food and energy prices. That adds to pressures on service inflation (due to a tight labor market, inertia, the impact of high inflation expectations) and on administered-price inflation, which is trending up sharply as the government has no more room to subsidize some prices (such as energy tariffs and fuel costs).

Monetary policy: tightening has still some way to go

- The 2011-2012 monetary policy easing, which took the SELIC rate to 7.25%, is considered by most as a policy slippage, among other reasons because it was not accompanied by a tightening of fiscal policy. The (sharper-than-expected) on-going monetary tightening is, among other reasons, a consequence of this previous slippage.
- Local analysts expect still some adjustment of the SELIC rate in the next few months (one or two 25bp hikes, depending on the magnitude of food inflation and expectations) and some extra adjustment in 2015.
- Many highlighted that domestic interest rates are again at very attractive levels. In practice, interest rate differentials have been triggering carry-trade operations and are seen as one of the main factors behind the recent appreciation of the exchange rate.

Fiscal policy: target of criticism

- Even though most local analysts do not seem worried about solvency issues, fiscal policy is a clear target of criticism because of lack of coordination with monetary policy, generation of lower primary surpluses (which are recently not enough to put public debt into a decline), lack of transparency, among other reasons.
- Most acknowledge a recent change in the tone of fiscal policy and expect some extra adjustment in 2015 after this year’s elections, depending on the political scenario.
- It was still not clear if the sovereign credit downgrade would put additional pressure on fiscal policy, at least in 2014.

Exchange rate: (temporary) appreciation

- The Brazilian real (BRL) gained around 6% since it reached 2.43 at the end of January and is now at 2.27 per dollar. Most cited high domestic interest rates and carry-trade as factors to explain this recent appreciation. An excessive depreciation at the end of 2013 and beginning of 2014 as well as the rising probability of more orthodox economic policies from 2015 on (see above) were also cited as drivers of the appreciation seen in the last few months.
- We noticed a large degree of heterogeneity on exchange rate forecasts among local analysts. That is in contrast with the homogeneity we saw on other macroeconomic forecasts (GDP, inflation, SELIC, fiscal and external accounts…) Forecasts for the exchange rate at the end of the year vary from 2.3 to 2.7.
- Some mentioned that an additional appreciation in the short-term was not unlikely. However, according to these analysts, the BCB would not be willing to accept a much stronger BRL.
- In spite of the recent and of the diversity of opinions, most local economists we met with expect the BRL to start to weaken again at some moment in the next few months due to factors such as i) need to drive competitiveness and exports up and reduce the current account deficit; ii) less favourable terms of trade; and iii) a global appreciation of the USD.

External accounts: gradual improvement ahead

- Following the sharp deterioration of the current account in 2013, which reached -3.7% of GDP vs. -2.4% in 2012, most expect some improvement ahead. We noted no significant worries about the current account deficit, in particular, and about external vulnerabilities, in general. However, few economists mentioned that a sharp change in the external mood could be a source of a “mini” balance of payments crisis.
- The view that the current account deficit will gradually shrink in the next few years build on i) the fact that the 2013 worsening was mostly due to short-term, supply problems in the oil sector; ii) exchange rate depreciation (in spite of the recent appreciation); iii) moderation of domestic demand.

Banking sector: public credit moderation, room for private credit to accelerate and a big risk for both segments

- After growing much faster than private banks and getting more than 50% of credit markets, there are already signs of moderation in public credit. Most of the analysts we talked to in Sao Paulo expect this moderation to continue ahead.
- Moderation of public banks and very low non-performing loans (NPL), due to more selective credit in the last two years, will now allow private credit to start to grow at a less timid pace again, although not at the rates observed until 2010-2011.
- Private banks have been recently focusing on cutting expenditure and improving efficiency ratios.
- Banking sector analysts do not expect a sharp increase of NPLs (either on public or in private banks) following the recent tightening of monetary policy.
- Regarding regulatory issues, currently the main issue is by far the risk that banks are made responsible for the losses that millions of depositors incurred on inflation-linked deposits, during anti-inflation plans in the 1980`s and 90`s.
- There is a high degree of uncertainty regarding the potential magnitude of banking losses. Estimates vary from around R$30 billion to around R$300billion or, equivalently, from 7% to 70% of bank`s net worth. Therefore, the impact of the Supreme Court decision on this issue is potentially huge.
- Analysts we talked to suggested that the most likely outcome is that banks are condemned to pay an amount that is in the lower part of the wide range referred above. Moreover, one economist mentioned that banks have already provisioned a good amount of resources to face losses related with this issue.
- The Basel III implementation continues. Most of the big issues were already dealt with. Its impact is considered to be credit-neutral.