BRAZIL

2003 and 2015: similar adjustments, different times

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- The signals suggest that, as was the case in the first year of President Lula's government in 2003, the first year of President Dilma Rousseff's second government will be marked by an orthodox adjustment to economic policy, with the aim of recovering confidence and dealing with the risk of an economic destabilisation. Even though the domestic climate was more of a challenge in 2003, the current correction may – at least at the beginning – be less convincing, because of the adoption of a set of policies which are very different from those in place in President Dilma Rousseff's first government.
- The most likely outcome is that in 2015 too, both monetary and fiscal policy will make contributions to the move towards orthodoxy. Compared to the previous correction, this one will be based more on the fiscal side, and less on monetary policy. However, it is still not entirely clear whether the political support for the adjustment currently underway is as strong as it was in 2003. Furthermore, the progress in adopting economic reforms made back then is unlikely to be repeated now.
- Despite the features common to both corrections, and the likelihood that, as happened in 2003, part of the credibility that has been squandered will return, the global environment and certain domestic peculiarities will not allow Brazilian activity to perform as positively in the next few years as it did in the years following the adjustment adopted at the beginning of President Lula's first government.
- If the 2003 correction allowed the country to grow healthily in the following years, supported by the emergence of China and the commodity boost, the likely adjustment in 2015 ought to give the country some slack in dealing with the turbulence associated with the moderation in Asia's biggest economy and with the normalisation of monetary policy in the US, but not to enjoy such high levels of growth as in the past decade.

1. The likely correction in 2015[1]

The first year of President Dilma Rousseff's second mandate will probably feature an orthodox correction of economic policy which, in our opinion, is necessary in order to bring back credibility to the country's economic policy, and to recover from the recent fiscal deterioration, the fear of losing investment grade status and inflation, which is still high.

Even though President Dilma Rousseff's discourse was not going in that direction until a few short months ago, in particular during the months leading up to her victory in the October elections, many signs already exist to back up the view that the government will indeed adopt this orthodox adjustment. On the one hand, a few days after the elections, the central bank of Brazil (BCB) began another upwards cycle, which should continue in the first few months of 2015, returning to its aim of making inflation converge with the central target of 4.5%. On the other, when it comes to the fiscal backdrop, the recently appointed Minister of Finance, Joaquim Levy, who has an orthodox technocrat profile, has announced his idea of taking on a credible primary surplus target which is consistent with reversing the upwards trend of public debt. To do this he has set out primary surplus targets for the public sector of 1.2% of GDP in 2015 and "at least" 2.0% in 2016 and 2017, which in practice will represent a reversal of the expansive fiscal policy stance of years past, especially in 2014 when the primary result needs to be approximately 0%. Similarly, it seems likely after the recent announcements that there will also be a reversal of the expansionary policy for public credit employed in the recent past.

Despite all the recent signals, there are still doubts as to whether the next adjustment in economic policy will receive the necessary support from the government, in a less favourable political environment, due to the narrow winning margin of the re-elected President over the opposition candidate Aécio Neves in the October elections, as well as to the potentially damaging impact of the recent corruption scandal involving Petrobras and many of the country's biggest construction firms.

This is not the first attempt to increase confidence in the country by means of a set of more orthodox economic policies, against a background of weak economic activity and increasing risk. Something similar occurred in 2003, the first year of President Lula's first government. We will describe the correction adopted over a decade ago below, in order to put the current correction into context and thus analyse it better.

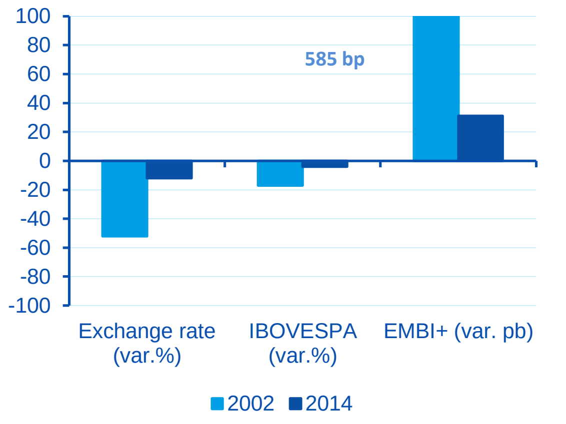
2. The successful adjustment of 2003

The huge uncertainty surrounding the election of Lula da Silva to the country's presidency, the negative environment marked by the crisis in Argentina and low global growth (2.6%), and the risk of insolvency in the public sector, among other factors, meant that Brazilian financial assets suffered major losses in 2002 (Figure 1). The Brazilian real depreciated 52% that year, closing the period at USDBRL3.50 (equivalent to USDBRL5.30 at current prices). The São Paulo stock exchange index, the IBOVESPA, fell by 17%. Likewise, the sovereign spread increased by 585bp, ending 2002 at 1446bp. Finally, 2002 was characterised by downgrades of Brazil's country rating on the part of the main credit rating agencies[2].

The real's severe depreciation contributed to elevating public debt even further, much of it dollar-denominated, and also to inflation. By the end of 2002 these two had reached 77% of GDP and 12.5% respectively, against 68% and 7.7% the year before (Figure 2). The escalation in inflation forced the BCB to raise its benchmark interest rates from 19% to 25% throughout 2002, with a negative impact on public debt and on economic activity (domestic demand grew just 0.5%, while investment dropped by 5.2%), which complicated even further the domestic economic picture.

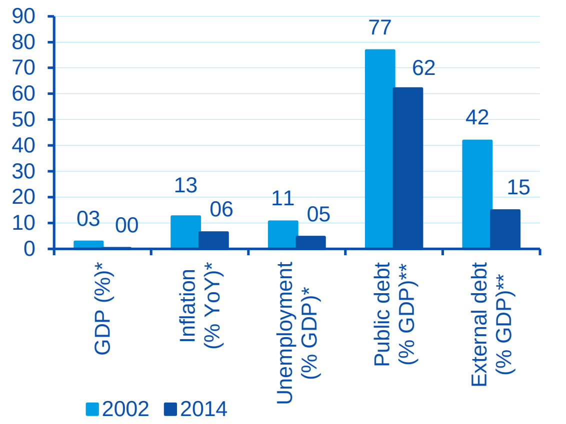
[1] For an in-depth analysis of the upcoming economic situation, including the likely adjustment of economic policies, see our Brazil Economic Outlook 4Q14.
2: At the end of that year S&P rated Brazil at B+, Fitch at B and Moody's at B2.

Figure 1
Selected financial indicators, 2002 and 2014*



* In 2014, data to 10 December.
Source: IBCB, Datastream and BBVA Research

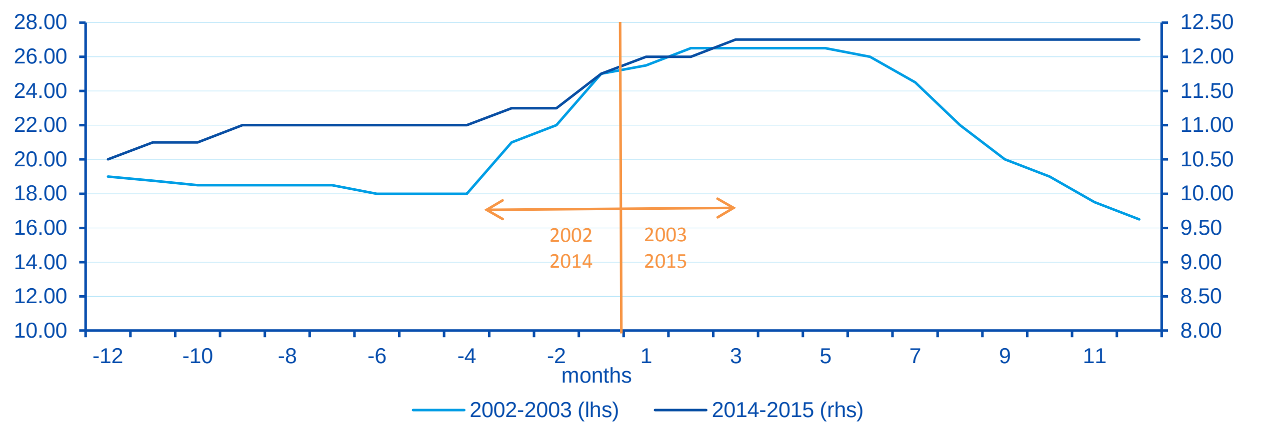
Figure 2
Selected macro indicators, 2002 and 2014



* Forecasts for 2014. ** Latest figure available for 2014.
Source: IBCB, Datastream and BBVA Research

In order to deal with this scenario, much more complicated than today's because of the very real risk of insolvency in the public sector at that moment (Figure 2) and uncertainty about economic policy, President Lula, victorious in the October elections, decided to adopt orthodox policy in an attempt to rescue the country's credibility, partly undermined by the risks that his election represented. Among other measures, interest rates were raised at the beginning of his mandate in 2003 and fiscal policy remained committed to the high fiscal targets. On this second point, as a symbol of his commitment to the solvency of the public sector, the government decided to raise the primary surplus target for 2003 from 3.75% to 4.25% of GDP, in the framework of the agreement that the country had signed with the IMF, by which the latter financed the country in US dollars over that period.

Figure 3
Selic interest rates (%), monthly figures for 2002-03 and 2014-15 (January 2003 and January 2015 equate to month zero)*

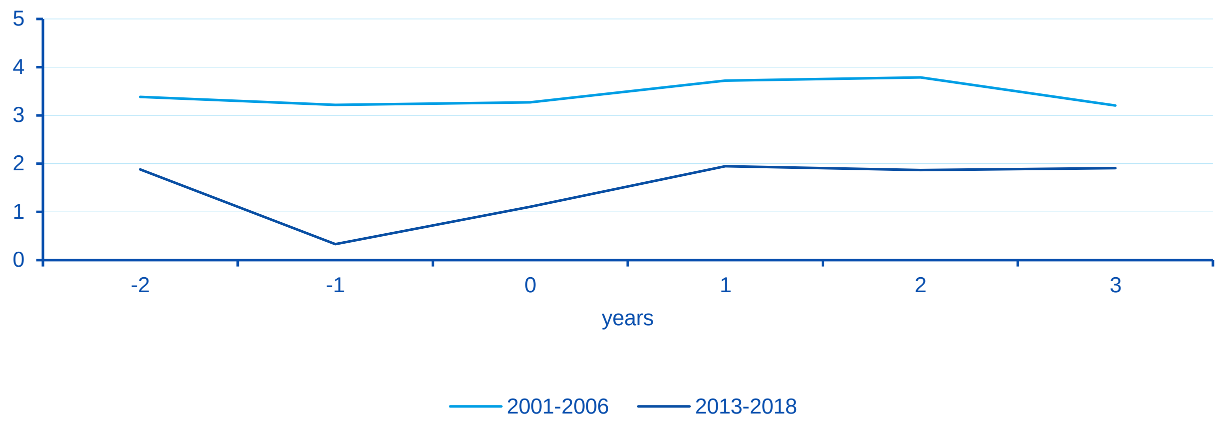


* Forecasts for 2015.
Source: BCB and BBVA Research

On monetary policy, in both periods the Selic correction began at the end of the previous government. This adjustment continued throughout the first year of Lula's government and ought to continue in the first year of Dilma Rousseff's second government. If our forecasts that the Selic will stabilise in 2015 at 12.25 after rises at the start of the year are right, the monetary adjustment will have been sharper this time than last. In any event, in 2003 the credibility gains won at the beginning of the year even permitted rates to fall at the end of the period, something we do not believe will happen in 2015 (Figure 3), mostly because of the unfavourable international environment (see section 3 for further analysis).

On fiscal policy, the adjustment implicit in the targets just announced (1.2% of GDP in 2015 and at least 2.0% in 2016 and 2017) is more significant than that implemented at the beginning of Lula's government. This time it implies a greater fiscal tightening from 2015 onwards, after the deterioration in the recent past (Figure 4)[3]. What is more, the next fiscal tightening has to face greater budgetary restrictions because of the difficulty in reversing the fiscal stimuli adopted in the last few years, the obligatory revision of the minimum wage – which has a negative impact on public accounts – of around 2.5% in real terms in 2015 and the impact on public revenues of very low growth in 2014 (in 2003 GDP grew by 2.7%). Similarly, note that the primary surpluses will be much lower in the next few years that in the last decade. This is a consequence of the very low point of departure at present – a surplus of around 0% in 2014 – and also of the improved situation in terms of public sector solvency (less debt and lower expenditure on interest), which requires lower surpluses in order to ensure a sustainable trajectory.

Figure 4
Primary surplus (% of GDP), annual data for 2001-06 and 2013-18 (2003 and 2015 equate to year zero)*



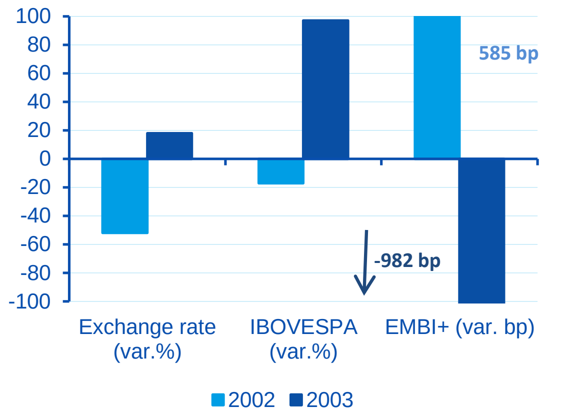
* Forecasts for 2015, 2016 and 2017
Source: BCB and BBVA Research

As well as the adjustment in macroeconomic policies, the first year of Lula's government also featured major economic reforms – the first phase of the social welfare reform and the first, too, of the tax reform. As a result of the limited margin for political manoeuvring of President Dilma Rousseff's second government, among other factors, we do not anticipate similar progress with the reform agenda in the near future.

In 2003, as the facts demonstrated that economic policy under Lula was going to follow the overall orthodox lines of the policy adopted in previous years, during the government of Fernando Henrique Cardoso, the country won back its credibility, which allowed the financial and macroeconomic indicators to signal an economic recovery.

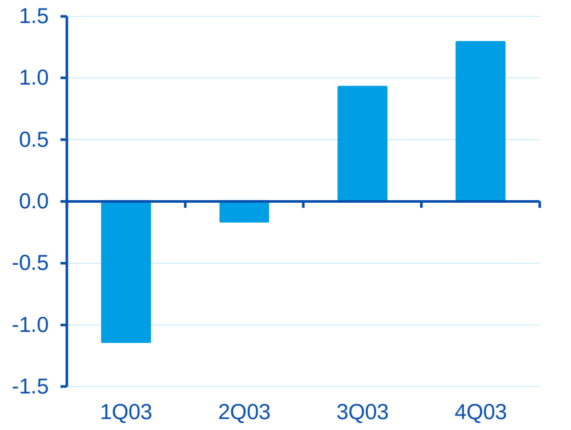
3: The data used in Figure 4 correspond to an official current series published by BCB for the primary surplus. This series has undergone methodological adjustments and includes revisions of the fiscal data and the national accounts, unlike the series used in 2003. For this reason, the primary surplus in 2003 was, in accordance with the current series, lower than 4% even though in that year the target of 4.25% was achieved according to the series used at the time.

Figure 5
Selected financial indicators, 2002 and 2003



Source: BCB, Datastream and BBVA Research

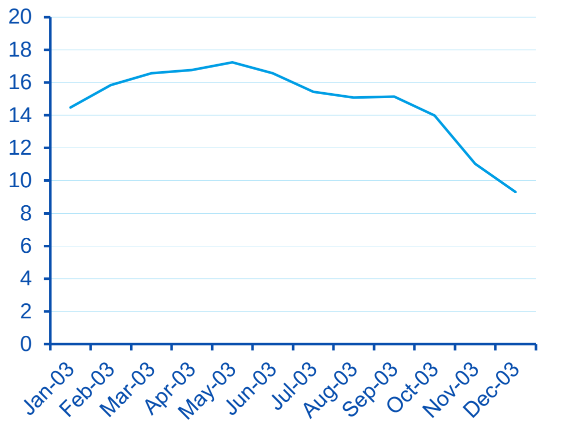
Figure 6
GDP growth in the four quarters of 2003 (% QoQ)



Source: BCB and BBVA Research

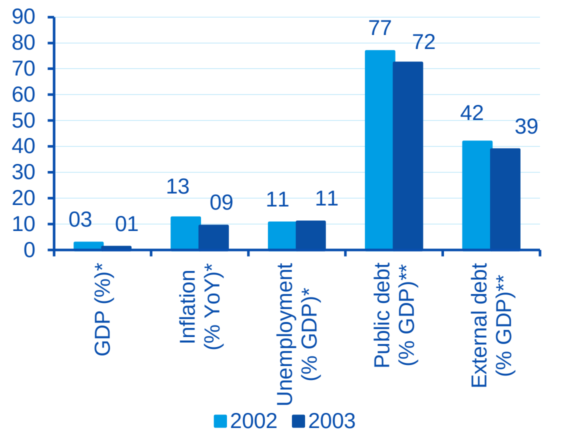
Specifically, throughout 2003 the Brazilian real appreciated to USDBRL2.89, wiping out a major part of the depreciation it had accumulated the year before. The recovery was also visible on the São Paulo stock exchange (+97%) and in the sovereign spread (-982bp). Economic activity and inflation, meanwhile, were positive throughout the year and the country ended 2003 with better fiscal and external indicators than it had started (Figures 6, 7 and 8).

Figure 7
Inflation in 2003 (% YoY)



Source: BCB and BBVA Research

Figure 8
Selected macro indicators, 2002 and 2003



Source: BCB and BBVA Research

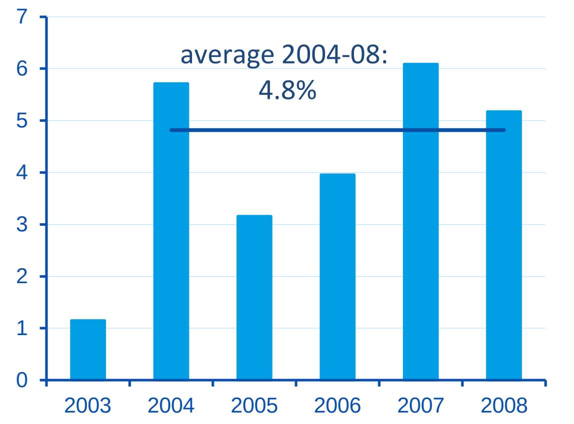
As such, even in 2003 there were clues that would become more apparent in subsequent years (see section 3): the economic policy correction plan driven through by President Lula's government had worked.

3. 2003 and 2015: different times

The rescue of the country's credibility by adjusting its key economic policies in 2003 has been fundamental in avoiding the destabilisation of the economy and in preparing the country for a new cycle of growth, which did indeed occur in the years following.

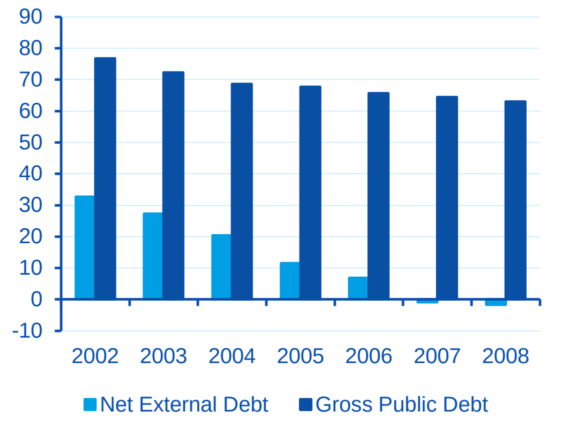
2003 marked a unique period for the Brazilian economy in terms of growth (Figure 9). At the same time, the external and internal solvency indicators, among others, presented a very positive trajectory after that time (Figure 10).

Figure 9
GDP growth in Brazil from 2003 (%)



Source: BCB and BBVA Research

Figure 10
Brazilian gross public debt and net external debt from 2003 (% GDP)



Source: BCB and BBVA Research

However, even if the correction which is being implemented now succeeds in receiving the necessary long term political support and is successful – which we regard as possible – GDP is not likely to jump as strongly as it did from 2003 onwards, nor the solvency indicators to improve as much as they did after this earlier adjustment.

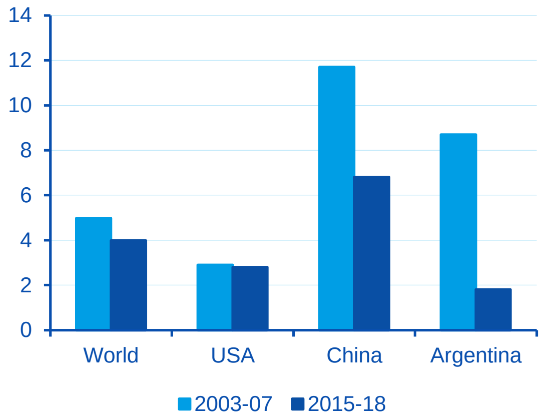
In our opinion, the rescue of the country's credibility through the adjustment of economic policy may head off a scenario of economic recession and an increase in the risk of insolvency. Even so, the most likely outcome is that, after this correction, the Brazilian economy will not grow much faster than 2%, after being virtually stagnant in 2015. In this scenario of relatively low economic growth and primary surpluses, the most probable result is that public debt, which currently stands at 62% of GDP, will continue to increase gradually in the short term and then stabilise from 2016 or 2017 onwards.

The difference between the post 2003 performance and our expectations for post 2015 is accounted for, not so much by the correction, even though it may turn out to be more contractive than the former one, but more by the international backdrop, as well as certain domestic barriers to growth.

In terms of the international backdrop, world economic growth will not be as robust in the next few years as it was from 2003. In particular, neither the US, nor China, nor Argentina will grow as much in the near future as they did a few years ago (Figure 11).

Connected to this, we estimate that Brazil's terms of trade will gradually fall over the next few years, contrasting with the upwards trend it showed from 2003 (Figure 12).

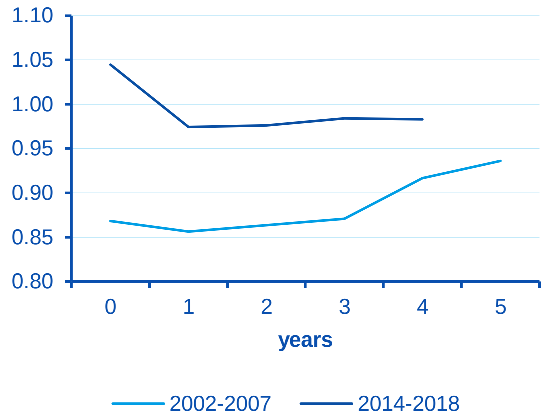
Figure 11
GDP growth (%)*



* 2015-18: BBVA Research forecasts

Source: FMI and BBVA Research

Figure 12
Terms of trade (1997 index = 1), annual data (2002 and 2014 equate to year zero)*

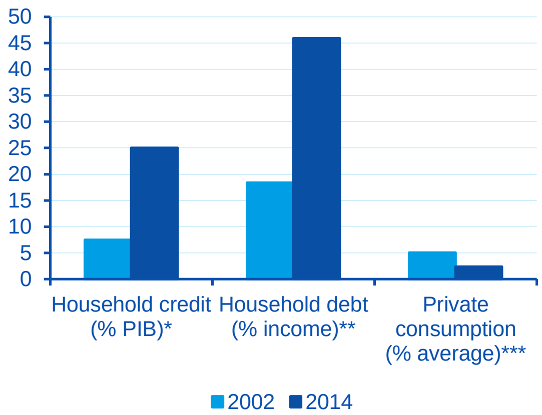


* 2015-18: BBVA Research forecasts

Source: BCB and BBVA Research

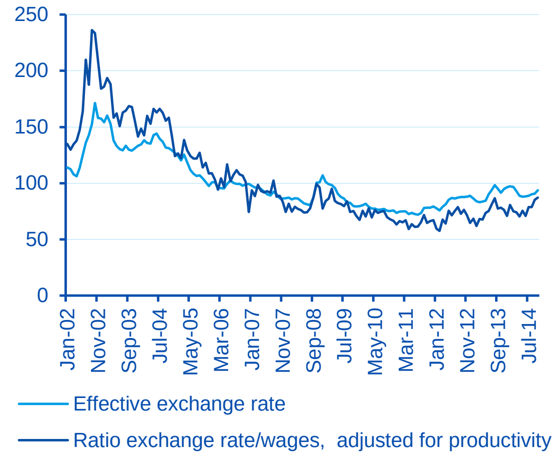
In the year of the earlier correction, 2003, the Federal Reserve made marginal cuts, from 1.25pp to 1.0pp, to its already low interest rates, although afterwards, between 2004 and 2006, it raised them to 5.25pp. By contrast with the first year of the preceding correction, in 2015 the Fed is expected to begin raising interest rates. In any event, the next hike in rates may – more than in the past – prove a source of turbulence, because of the special circumstances of the monetary easing adopted after the 2008 crisis, which will also make the normalisation of monetary policy in the next few years an exceptional event.

Figure 13
Household and private consumption credit indicators *



* 2002: data to the end of the year. 2014: latest data available. ** The banking debt figure for 2002 is actually for 2005, the first available observation for the series. ***Data for 2002 corresponds to the average growth (2004-2008). Data for 2014 represents the average expected growth (2016-2018)
Source: BCB and BBVA Research

Figure 14
Real effective exchange rate and ratio between exchange rate/wages (Jun 94 indexes = 100)



Source: BCB and BBVA Research

Even though the macroeconomic environment was more complex in 2002-03 than it is now – which, if one looks at it from a different angle means that the scope for improvement was greater than it is now - there are at least two factors which currently limit more significantly the potential for growth in coming years: the “exhaustion” of private consumption and the economy’s low competitiveness.

When it comes to private consumption, which in 2002-03 represented little more than two-thirds of GDP and is now slightly above that level, household leveraging and the low unemployment rate make it unlikely that private consumption will grow in the next few years as it did from 2004 onwards (Figures 2 and 13).

In terms of competitiveness, the current situation is more difficult, not only because of major recent growth in labour costs compared to productivity, but mainly as a result of the strong currency appreciation recently (Figure 14).

4. Conclusion

Opting for orthodox economic policy helped President Lula da Silva’s incoming government to rescue the country’s credibility in 2003, which is what President Dilma Rousseff appears to be aiming for at the outset of her second government in 2015. The macroeconomic risks and the uncertainty were higher at the beginning of the last decade, but the current bid for orthodoxy could have a less resounding outcome because of the adoption of a set of very different policies in President Dilma Rousseff’s first government. Anyway, the earlier example shows that, if it has the necessary political support and is adopted as a permanent, rather than temporary, solution, the next adjustment may be as successful as that of President Lula. Nevertheless, the orthodox option in 2003 was reinforced by adopting an economic reform agenda, something to be wished for now but which is unlikely to happen in President Dilma Rousseff’s second mandate. In any event, even if the changes in the management of economic policy succeed in restoring the country’s credibility, we do not expect them to unleash a rate of growth as robust as that enjoyed from 2003 onwards. Although the corrections may be similar, the international scenario will be much less favourable this time round.

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