Brazil’s Economic Forecast: The Factor That Everyone Is Missing

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Brazil’s economy recently entered into recession and economists have climbed on the Brazil in decline bandwagon – and for good reason. Every article generally lists from four to six reasons for the economic decline: growing inflation pressures, weaker currency, foreign direct investment too low to cover the current account deficit, industry has stagnated, intervention by the government. They are all missing one key factor.

Review of Brazil’s Economic Woes

Jim O’Neill, the economist who coined the term BRICs, asserted that the Brazilian government had become too Chinese in a recent interview with the Brazilian newspaper Folha de São Paulo (11/9/2014). O’Neill, who was unabashedly optimistic about Brazil two years ago, confirms that many things have changed to reduce the outlook for Brazil. He believes that one of the biggest negative factors has been the interventionist policy of President Dilma Rousseff.

Otaviano Canuto made a compelling argument for dialing back expectations for Brazil in his recent article titled *Time to Reset the Compass for Brazil’s Economic Growth* made to the U.S. Business Council in Washington D.C. on October 31st. First, the author - and advisor at the World Bank – highlights the inflation pressures that continue to build even though the Copom, the Central Bank’s monetary policy group, has raised interest rates again. He notes that most of the pressure is coming from recent increases in regulated prices that had been repressed by the government and still face additional upward adjustments.

Mr. Canuto is also wary of continued pressure on Brazil’s currency as the United States continues to “normalize” its monetary policy; the USD will continue to pressure the Brazilian Real as the U.S. Federal Reserve starts to raise the Federal Funds rate now that it has stopped buying mortgage-backed securities (MBS). In addition, the World Bank analyst points to the fact that foreign direct investment is no longer sufficient to cover the current account deficit. Canuto believes that the main challenge to the Brazilian government will be to contain “inflationary pressures without resorting to massive doses of monetary tightening” while the “adjustments in relative prices (exchange rates and regulated prices) happens.”

Both O’Neill and Canuto point to the “crowding out” effect of the growth in public banks, especially the BNDES – Brazil’s development bank. They join many economists and market analysts who believe that the BNDES has distorted incentives with its subsidized lending. Furthermore, it appears that Brazil’s government has spent all of its bullets on subsidized lending and now the growing level of debt has caught the eye of all the major rating agencies except for one.

Prior to the election, the Economist weighed in with the article “Why Brazil Needs to Change” that made the case for rejecting a second term for Dilma Rouseff (October 18, 2014). The Economist attributes Brazil’s problems to the end of the commodity boom but points out that Brazil is suffering more than its neighbors and blames Rousseff’s meddling. The article alleges that Rousseff has “revived Brazil’s corporate state” and directed state banks to dole low interest loans to allies. In an article in “Looking for Change” in same edition, the Economist adds that Brazil’s consumption-led economy is losing steam and that is putting recent wage gains at risk. Add lack of infrastructure and corruption to the list and it becomes quite daunting.

The Forgotten Factor

What is the forgotten factor? Water. Hydroelectric power generation accounts for nearly eighty percent (80%) of Brazil’s installed capacity and Brazil is facing a drought of epic proportions (Brazil Ministry of Energy and Mines). In addition, the drought is worst in the South-Central-West region of Brazil that accounts for a bulk of the nation’s economic production and contains some of Brazil’s richest states such as São Paulo. As the table below demonstrates, the South-Central-West region’s reservoirs are at 17% of capacity on average. To put this in perspective, California has declared a “drought state of emergency” with its reservoirs are at 40% to 50% of capacity.



Data: ONS: National Operator of Electrical Systems

The state of São Paulo is responsible for about one-third of Brazil’s GDP. Agriculture, financial services and the service industry in the state account for 33.9% of Brazil’s GDP (Wikipedia). Mina Gerais, Brazil’s fourth largest state with the second largest population, is also in the Southeast/Central West sector. The situation is only getting worse now that hot summer weather has arrived.

The governor of São Paulo just submitted a plea for R$3.5 billion (US$1.4 billion - Globo 11/12/2014) in aid from Brazil’s federal government. The power generation companies, such as Eletropaulo, are already talking about how to ration the water between the thirsty population and its generation plants. Also, electric utilities are firing up their more costly and inefficient coal and petroleum fired power plants. This dependence on alternative sources of energy will drive up the price of electricity.

In summary, nothing seems to be going right for the economy there. Structural and cyclical problems look to weigh down Brazil’s economy for the foreseeable future. Brazil’s interventionist government situation has aggravated the economy’s problems. Now, Mother Nature has joined the stomp-on-Brazil parade. We feel that it is safer to bet on the underperformance of Brazil’s economy for the next few years.