STRATFOR

The Recession in Brazil

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Summary

As the global financial crisis takes its toll, STRATFOR continues to watch the impact of the global economic downturn on Latin America, a region that has a history of relatively regular economic crises. In this addition to STRATFOR's Recession Revisited series, we consider the impact of the crisis on Brazil, a developing country that is perhaps uniquely well-suited to weathering the storm.

Analysis

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From the very beginning, geography has hampered the development of Latin American states. With enormous geographical barriers to economic expansion, integration and trade, Latin American states started off at a disadvantage. Without major river systems to facilitate exploration, settlement, development and trade, Latin American governments had to attempt to forge transportation links using expensive, borrowed foreign capital to build railways and roads.

The reliance on international capital put Latin American countries at an immediate disadvantage, and the region's early history is characterized by numerous debt defaults to European powers. Without the ability to build the reliable transportation networks necessary for agricultural and industrial development, it has been extremely difficult for Latin American countries to accumulate domestic pools of capital. This has made it difficult to escape the cycle of debt and underdevelopment.

The one river system that could foster the kind of development that has characterized the United States is the Rio Plata. But the Rio Plata system is split among four countries — Brazil, Argentina, Paraguay and Uruguay — and no one country has succeeded at using the river's transportation potential as a stepping-stone toward development, though Argentina came the closest. Indeed, the perennial (if rather anticlimactic) struggle between Brazil and Argentina to exert maximum influence in the politics of the states that buffer the two South American giants (Uruguay, Paraguay and Bolivia) exemplifies the slow-rolling competition for control over the river drainage basin.

At the moment, Brazil appears to be winning the struggle for influence in South America, though it has been a long road for the Amazonian nation.

Since independence in 1822, Brazil has bounced among many different economic management models. Much of Brazil's history was characterized by cycles of boom and bust related to oscillation in the price of key Brazilian commodity exports — primarily coffee and sugar early on. In the 20th century, Brazil has gone through periodic spasms of industrial development and growth, punctuated by severe economic downturns and debt crises. These culminated in an economic crisis in the late 1980s and early 1990s characterized by inflation of more than 2,400 percent per year.

Plano Real finally solved Brazil's hyperinflation problem. Spearheaded by then-Finance Minister Fernando Henrique Cardoso in 1994, it replaced the Brazilian cruzeiro with the real, the currency Brazil still uses. Aimed at cutting to the heart of the inflation problem — massive and persistent government deficit spending funded by monetary expansion (printing money) and debt accumulation — Cardoso and his team drew up a balanced budget. They also started a sustained public relations campaign to convince weary Brazilians that this anti-inflation plan would work (with an understanding that public acceptance of a new currency was key to its success). The real succeeded in maintaining a stable value, and Cardoso rode this success to the top, becoming president in 1995.

Once in office, Cardoso pushed through a series of reforms, many of which necessitated a turnaround in Brazilian economic policy. Brazil abandoned the ideas of export-led growth and import substitution industrialization, instead turning its sights toward cultivating liberal institutions and encouraging foreign direct investment. Cardoso's successor, Brazilian President Luiz Inacio Lula da Silva, continued the country's policies of fiscal prudence (despite initial fears he would turn toward higher spending due to his left-wing background). As a result of Brazil's fiscal prudence over the past 14 or so years, the central bank has managed to store away $190.5 billion in official foreign reserve assets. (Before the crisis, these reserves totaled about $207 billion.) Furthermore, the government has been able to store another $24 billion in assets controlled by the Brazilian Development Bank (BNDES). Brazil's relative economic stability has earned the country the confidence of investors, who have responded with substantial foreign direct investment. Even more important, however, these conservative fiscal policies have put the country in a unique position in the history of Latin American states: Brazil has actually pooled enough

capital to have the capacity to deal with challenges like this economic crisis.

Brazilian Banks

The reforms of the late 1990s included the complete reorganization of the Brazilian banking industry. In the days of hyperinflation, banks were able to turn a quick profit by exploiting fluctuating currency values. For instance, the banks made money by delaying the processing of payments made through their facilities, in essence taking in a certain amount of money at high value, and paying it out at a lower value, which was possible because the currency devalued measurably over just a day or two. Banks in this period were at once very profitable, highly corrupt and run by a unique (and at times counterintuitive) set of rules. Once the currency was stabilized, many Brazilian banks with poor accounting standards — something they could sustain with high profits from hyperinflation — were unable to carry on. Several bank failures, in some cases involving major banks, required a government bailout, led by the Brazilian Central Bank. Once involved in bailing out the banking sector, the Cardoso government was able to lift restrictions preventing foreign investment in banking and establish very conservative regulations on the sector to snuff out such risky practices.

These regulations include some of the highest (if not *the* highest) reserve-to-deposit ratios in the world, at 45 percent prior to the crisis. Inspired in part because of fears that too much liquidity could endanger the stability of the real, this essentially means that for every real put into a Brazilian bank, the bank can only lend half a real, and must keep the other half in a vault (in Brazil's Central Bank). For the sake of comparison, the United States maintains a reserve ratio of about 3-10 percent depending on the size of the bank and type of deposit. China's reserve ratio is about 15 percent.

This does two notable things for Brazil. It slows growth dramatically because the banks have to maintain a tight grip on their capital, and it makes the banks incredibly capital rich compared to other nations' banks.

Brazil has not achieved the kind of growth it has yearned for despite a relatively stable decade. Where China and India have seen growth rates soar, Brazil has had to be satisfied with a growth rate that has hovered around 5 percent in recent years. Though there are many reasons for this, part of Brazil's plodding growth rates can be linked to the reserve ratio. By reducing the amount of loans that can be made from bank deposits, Brazil permanently limits the amount of credit available to Brazilians. This stifles growth by restricting economic activity — capital is simply not as available for start-up companies to get loans or for existing companies to pursue innovation — more, at least, than would a lower reserve ratio. This effect is exacerbated by a culture of extreme caution among Brazilian banks — a remnant of years of hyperinflation — which generally refrain from uncertain investments to maintain a high ratio of capital to risk.

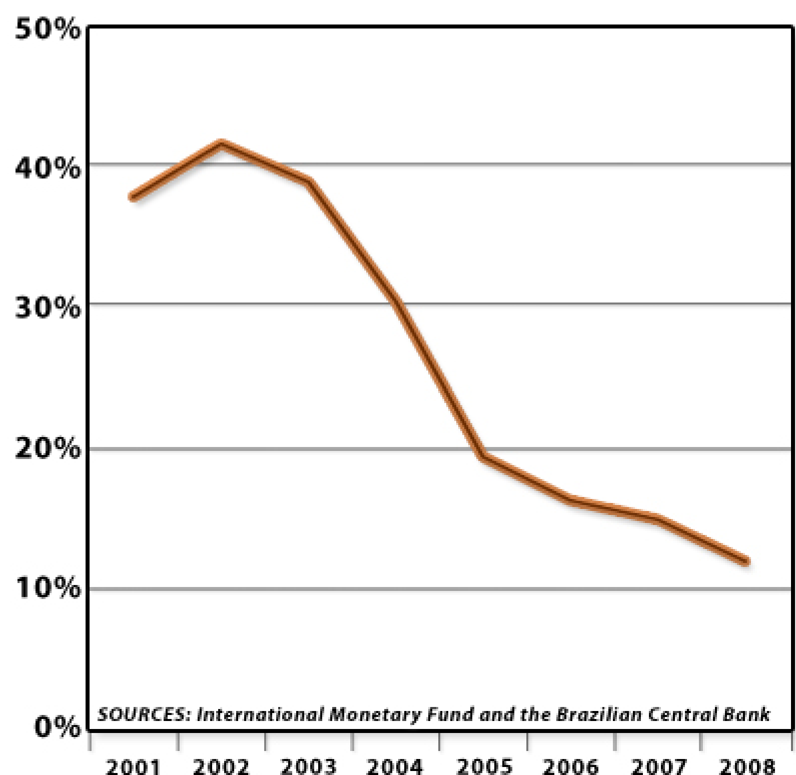
Ultimately, however, the reserve ratio also serves as a very effective insurance policy. It means that banks have a harder time failing, for if some loans go bad they still have plenty of cash on hand, whereas if the banks only maintained a 3 percent reserve ratio, it would not take many bad loans to make the banks insolvent. It also means that in a time of scarce capital resources

worldwide, Brazil has the resources it needs to create liquidity at home.

But an insurance policy only works if it pays out in times of need. In light of the international financial crisis, Brazilian leaders *have* been able to release Brazil's domestic capital reserves in order to relieve some of the pressure on the Brazilian economy. Though officials have been cautious in loosening the reserve requirement, Brazil did lower the demand deposit requirement to 42 percent, allowing banks access to about $50 billion worth of deposits — leaving approximately $100 billion still in reserve — in the months after the crisis hit in order to stimulate lending. This is the kind of flexibility that few countries in the region, not to mention the rest of the world, have had in the wake of the crisis.

The External Sector

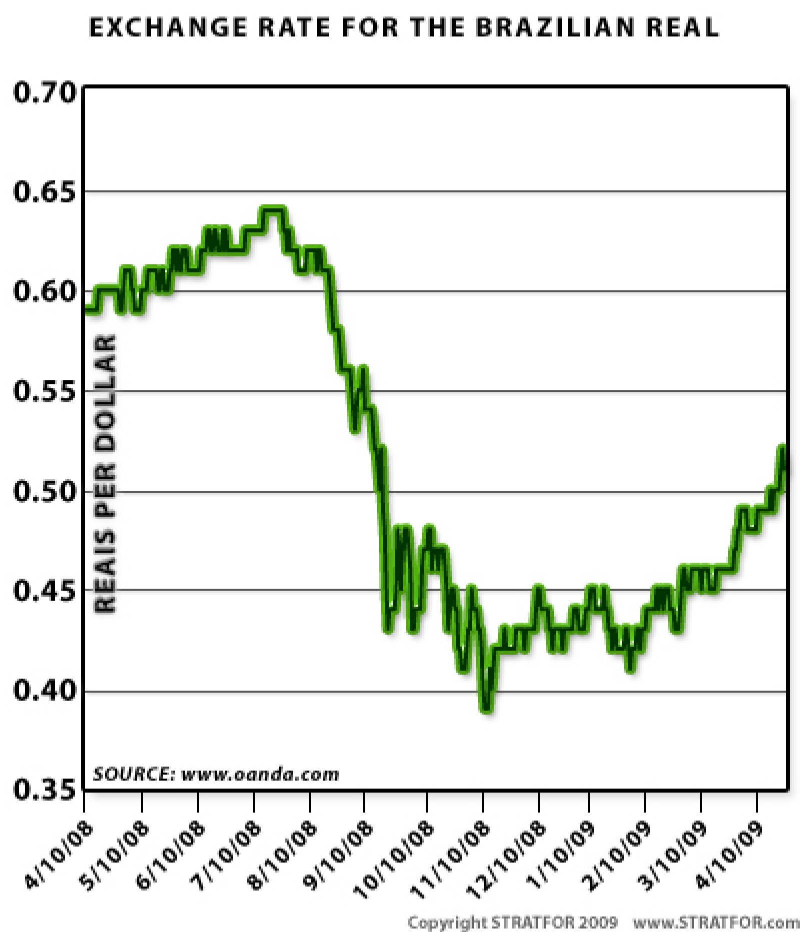
Further strengthening Brazil in the face of the crisis is its declining reliance on external debt. Although Brazil's foreign debt has held steady for the past several years at about $195 billion, Brazil's gross domestic product (GDP) growth has brought foreign debt as a percentage of GDP down from 42 percent in 2002 to 12 percent in 2008. This is not to say that the picture of Brazil's debt structure is entirely rosy, as Brazil's total net public debt remains at 37 percent of GDP. With most of the debt held in domestic hands, however, Brazil has more flexibility to adjust its monetary policy vis-a-vis its external markets. This is an indication of the substantial capacity of the domestic capital markets (although heavy government reliance on domestic capital can hinder private borrowing).



With domestic capital markets secure from the international turmoil, Brazil's biggest worry in the economic crisis is the impact on its external sector, particularly Brazilian exports. Brazil's manufacturing sector has been hit the hardest by the downturn. While commodity exports were up just more than 1 percent in the first quarter of 2009 as compared to the first quarter of 2008, manufacturing exports are down by 29.2 percent.

In part, the impact on the external sector was caused by instability in the real. The immediate turmoil in the Brazilian currency sparked by the financial crisis sent the real's value tumbling almost 40 percent from highs in August 2008 to lows in December 2008. The fall of the real sparked a trade crisis with Argentina, in which Argentina increased its non-tariff barriers to Brazilian goods (to protect its industries from suddenly much cheaper

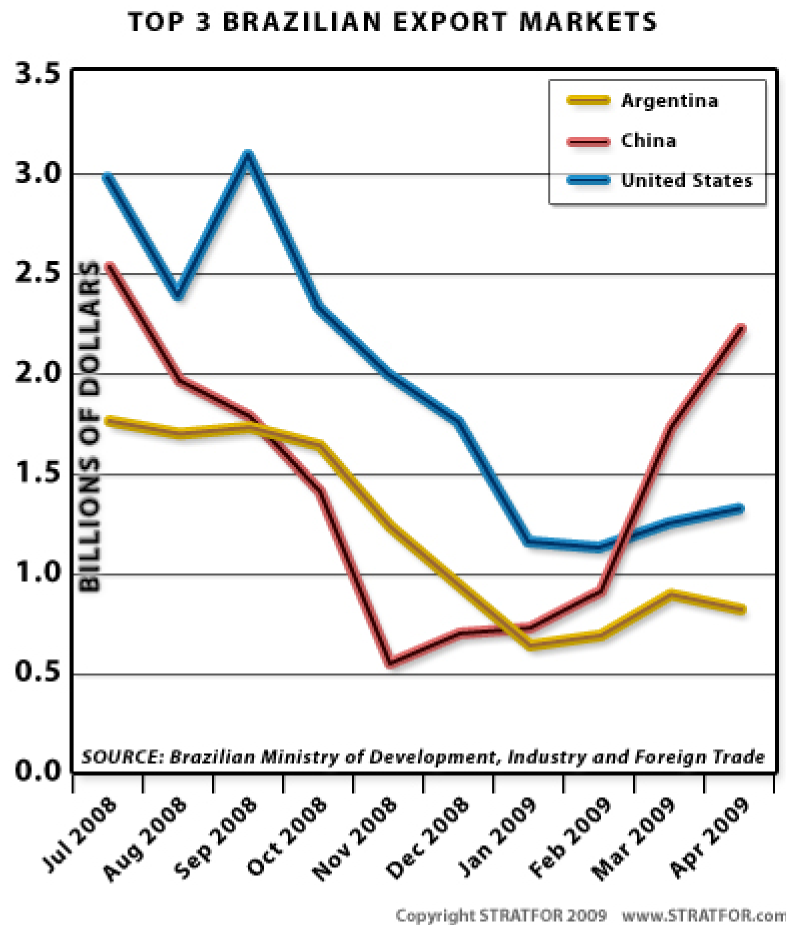
Brazilian imports), and exports to Argentina fell 49 percent from July 2008 to March 2009.



But declining demand in the market as a whole had an enormous impact as well. Over the same time period, total U.S. imports fell 34 percent, triggering a 58 percent decline in Brazil's exports to the United States. Overall, exports have dropped almost 40 percent from highs in June 2008 due in part to the changing seasons and the fall in commodity prices, although they have rebounded 20 percent since January.

Contributing to the rebound have been Brazilian exports to China, which have risen quite a bit in the wake of the crisis (after a sharp fall during the lead up to the crisis in the U.S. financial sector). China's bid to secure access to natural resources all over the world has led the country to use its substantial capital reserves to cement business partnerships while prices are low, with an eye on securing access to the resources of the future. This has led China to stockpile some commodities, and seek partnerships with major natural resource producers, such as Brazil. Although China's increased imports from Brazil have restored demand in Brazil's commodity markets, increased trade with China cannot fix the damage to Brazil's manufacturing sector caused by collapsed trade with Argentina and the United States, which both tend to import higher value-added goods from Brazil.

There already appear to be some signs of recovery here, too, however. After dropping by 17 percent in January, year-on-year, industrial production has increased (slightly) for four straight months. Trade is recovering with some partners, including the United States. The Brazilian real has also begun to appreciate, although it is too early to say if the rally in markets around the world is here to stay. But this is a mixed blessing, since the lower value for the real is a boon to Brazil's manufactured goods exports (commodities are all dollar-denominated), and an appreciation would makes those exports less competitive. Brazilian Central Bank officials have sought to keep the real at its devalued rate to hold on to this advantage.



Brazil's Economic Diversification

Brazil is further aided in its response to the economic downturn because the majority of the Brazilian economy (which is largely services-based) is shielded from the external sector. As compared to many industrialized and developing nations, Brazil has a relatively small export sector, at only about 13 percent of economic output. Of Brazil's exports, about 45 percent are manufactured goods, 30 percent are in raw commodities (such as oil, iron and soy), and the remainder is comprised mainly of semi-manufactured goods.

Of Brazil's raw commodity exports, the energy sector is a particularly strong and promising. Although Brazil will have to wait several more years before its recently discovered massive oil and natural gas deposits can be tapped, the country has an enormous amount of natural wealth that has clearly helped already — as in Brazil's strong relationship with China — and will continue to be a source of capital. Furthermore, Brazil's potential as an energy exporter is enhanced by its role as a leading producer of ethanol, which means Brazil can exploit the growing interest in integrating biofuels into national energy mixes. It also means that as soon as its oil wells do come online, they can translate much more quickly into exports and revenue generation. If Brazil follows through on plans currently under discussion to construct a petrochemical industry around its oil extraction, the country will find itself with a value-added industry that will further contribute to its development.

This commitment to value-added industry can be seen throughout Brazil's economy, which is

characterized by relatively broad sectoral diversification. Brazil manufacturing sector is substantial, especially when compared to its neighbors. Brazil exports a number of industrial products ranging from cars to petrochemicals to aircraft. Much of the industrial sector is led by a set of very able national champions. From Petroleos Brasilieros (Petrobras) to Empresa Brasileira de Aeronautica (Embraer), Brazil has a number of both publicly and privately owned companies that are extremely competitive in international markets, and operate with the full backing of the government. This well of strength is both economic and political. Brazil's ability to extend investment and financing — a product of its substantial capital resources — to partner countries all over the world means Brazil has a growing number of opportunities even at a time of shrinking global wealth.

Looking Ahead

In sharp contrast to the economic crises of Latin America's past, the origins of the current crisis have nothing to do with the Latin American policies, and everything to do with instability in developed nations. This is cold comfort, however, as many developing nations — in Latin America and abroad — have been shaken to the core by shrinking capital markets and plunging commodity prices.

While Brazil has experienced a number of very serious challenges in relation to the international economic crisis, it is remarkably well-positioned to handle the crisis as a result of its prudent policies and capital accumulation — something that distinguishes the southern giant from most of its fellow Latin American states.

Although Brazil's first-quarter GDP shrank 1.8 percent, this was much smaller than expected by many observers, and the country appears to be in a strong position to weather the current economic storm. Official government estimates put Brazilian growth at about 1 percent in 2009, which would make it one of the few states to see economic growth in the coming year. But even if Brazil's economy does shrink this year, it will be slight. And following the recession, Brazil may well be one of the countries in the best position to emerge from the crisis stronger than it went in.

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