



CAPITAL & ECONOMICS

The Brazilian Crisis: Lessons From An Emerging Economy

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OVERVIEW

Brazil's growth during the 2000s earned it a place among the global elite of emerging markets – the so-called BRIC countries also comprising Russia, India and China. No longer. Latin America's largest country has suffered a series of setbacks after a widening corruption probe led to policy paralysis, complicating the worst economic slump in three decades.

It would be hard to overstate the seriousness of the situation. The ever-widening contract award scandal that began the political crisis two years ago has now reached the top, recently leading to bribery charges and possible impeachment.

From an aspirational model of economic growth for developing countries, Brazil has become an object lesson in the importance of developing better, more transparent and more accountable governance procedures to prevent such scandals from spreading from the boardroom to the government – and ultimately onto the streets.



IN DEPTH

Brazil's political risks have risen from moderate levels in recent quarters, according to Aon's 2016 Political Risk Map 2016. Although policymakers are now addressing some of the long-standing issues of corruption and state intervention, the report found that government gridlock and the costs of these policies are hitting growth, investment and social cohesion, increasing the chance of a change in the leadership or early elections. Moreover, increased government involvement has undermined private investment and, along with it, Brazil's economy.

At the center of Brazil's current crisis is the country's – and the Southern Hemisphere's – largest company. Petrobras is a semi-public multinational energy giant with \$143.7 billion of revenue in 2014, and was at one point the fourth largest company in the world by market capitalization. It was also actively held up as an example of the country's success by President Dilma Rousseff during her 2014 re-election campaign. Less than three weeks after she was returned to office, police raids across six Brazilian states saw a number of prominent Brazilian politicians and businessmen, arrested over investigations into "suspicious" contracts linked to the company worth \$22 billion.

"The current scandal has raised awareness of the economic damages that corruption causes and the need for corporate compliance programs and controls which benefit Brazil, Latin America and the global market place resulting in increased foreign investment in the region and greater transparency," says Marta Carreira-Slabe, Chief Counsel for Aon in Latin America.

The rise of Brazil's economic crisis

The anger over the perceived corruption at the highest levels of Brazilian politics has been exacerbated by its connection to the country's growing economic crisis. There were already warning signs, as when the country was named the most indebted in the world in 2013, the same year that Brazil's economic growth began to decelerate.

Two decades of heavy investments in oil production allowed the country to become energy self-sufficient beginning in 2006-2007. The falling price of oil means that these investments are failing to pay for themselves, as well as reducing revenues from the largely state-run domestic oil sales. This in turn is leading to less capital available not just for investment and paying off rising government debt, but also for the country's generous and constitutionally-protected state benefits.

With the government's heavy reliance on oil revenues, the economic crisis is spreading far and wide. Brazil's sovereign debt has been downgraded to junk status, while the government budget deficit, interest rates and inflation are all continuing to rise, along with middle class unemployment. Last year, amid worsening recession, GDP fell by 3.8%, the budget deficit was running at more than 10%, with inflation over 10%. Brazil's currency, the Real, was in near free fall against the dollar and other major currencies. With rising consumer prices and unemployment, social unrest is also increasing – with this year's Olympic Games in Rio de Janeiro likely to become a focal point for protests, not unlike the 2014 FIFA World Cup.

On top of this, a severe drought has hit Brazil's agricultural production, further reducing export revenue, while increasing unemployment – and creating new pressures on the state benefits system and social cohesion.

A multitude of underlying challenges

Looking beyond the near-term crisis, Brazil will have to contend with a large number of other challenges.

First of all, Brazil's economy continues to rely heavily on commodities and agricultural exports, for which prices on world markets can be volatile. In addition to being an exporter of crude oil, Brazil is a major global producer of iron ore, raw sugar and soybeans, all of which can be affected negatively by fluctuations in global demand. Credit Suisse's Brazilian commodities index has fallen 41% since its 2011 peak, as the global commodities super-cycle came to an abrupt end. And it could get worse.

The biggest near-term cause for concern is China's economic slowdown – because China is Brazil's largest trading partner, buying over 18% of Brazil's exports as of 2013. China's imports of foreign goods have now fallen for 15 months in a row. If the slowdown in China continues, Brazil's exports of both basic commodities and higher value goods will continue to be hit hard. This is a challenge affecting many emerging economies who are being hit by the commodity price collapse caused in part by the fall in Chinese demand for raw materials.

High public debt and tax rates also present major challenges for Brazil. The country's debt was worryingly high even before the crisis. It now represents 70% of GDP, but is rising quickly due to the state of the economy. And because interest rates are high, the cost of servicing it absorbs 7% of GDP. Worse yet, because there is little the Central bank can do to fight runaway inflation, which could reach 17% by 2017, higher rates risk destabilizing the public finances even more by adding to the debt interest bill.

That leaves Brazil's government little choice but to raise taxes and cut spending. But taxes in Brazil are already among the highest in the world, accounting for 36% of GDP, so it would be difficult to raise these. Moreover, receipts are falling, reducing the government's ability to tackle debt or invest in growth stimuli. There are also constitutional restrictions on public spending reforms: Ninety percent of public spending is protected from cuts, and the constitution includes clauses on job protection, wages and state benefits. Similarly, pensions, which represent 11.6% of GDP, are also constitutionally protected.

The need for simpler, more transparent bureaucracy

An added challenge is Brazil's high level of bureaucracy. The World Bank ranked Brazil 120th out of 189 countries for ease of doing business in 2014. Construction permits take an average 469 days to be authorized, while new businesses need approval from 12 different government agencies. It takes an average of 120 days to start a new business in Rio de Janeiro, versus only six days in Mexico City. Filing taxes takes businesses an average of 2,600 hours to complete. According to the 2016 Aon Political Risk Map, "investors in key resource sectors will likely face additional costs from local content hiring and sourcing regulations."

"Taxes, tax administration, low labor skills, [many] labor rules: It is very difficult to change the current situation, because there is not a single reform that will solve the problems of all sectors of the economy," says Fernando Veloso, researcher at FGV. "It is not a purely technical issue. The country needs a strategy, develop a process to gradually improve conditions, similar to what Colombia did since the second half of the past decade," he adds.

This complexity in itself can increase perceptions of corruption, even if these suspicions are unwarranted, which is another reason why developing economies should look to make bureaucracy more transparent – simplified processes can not only speed up growth, but can also improve businesses' willingness to locate in such markets.

Moving past corruption

Clearly, Brazil is going through a difficult period economically and politically. Without focused action, and badly needed structural reforms, there is potential for the fiscal situation to deteriorate further. The government needs to be seen to be acting on both domestic and international concerns about the state of the economy and the need for reform.

From being held up as an example of economic growth, the country has become an example of how not to approach a crisis. Yet there are positive signs too. The fact that even former presidents are not safe from anti-corruption drives shows that authorities are taking the problems seriously. The ongoing investigations themselves are, despite causing short-term upheaval, an indication that Brazil is trying to move in the right direction. It could yet become another example of how to respond to a crisis.

TALKING POINTS



"In 2016, if adjustments are made, I think there will be recession in the first six months, but the economy will bottom out midway through the year and then begin to recover. Brazil is not destined to have a crisis. There is a way out, although it is difficult and requires political courage from whoever is in power. For things to stabilize, fiscal adjustment is necessary, there's no other way" – Nouriel Roubini, economist, October 13, 2015



"Brazil is paying an extremely high price for [high interest rates...]. If Brazil could manage to reduce inflation, it could have lower interest rates and this would allow for faster growth." – Joseph Stiglitz, economist, November 4, 2015



"Brazil's political risks have risen from moderate levels in recent quarters as government involvement in the economy has increased, undermining private investment... Reforms and infrastructure investments are overdue." – Aon's 2016 Political Risk Map

FURTHER READING

- Why Brazil's Corruption is a Sign of Progress – The New York Times, March 15, 2016
- Brazil's political and economic crisis, Standing by their man – The Economist, March 12, 2016
- More than a million Brazilians protest against 'horror' government – the Guardian, March 14, 2016
- Brazil artist blindfolds Rio statues as protest, BBC News, March 13, 2016
- What You Need To Know About Brazil's Petrobras Scandal, Telesur, March 13, 2016
- Brazil protesters call for President Dilma Rousseff's impeachment, ABC News, March 14, 2016
- 2016 Political Risk Map – Aon

