

Sao Paulo view from Morumbi Bridge, Brazil



2002 déjà vu for Brazil? Not really.

A current account deficit of -4% of gross domestic product (GDP), a primary fiscal deficit, investment at an abysmal 16% of GDP, and an economy in the midst of a recession. Am I talking about Brazil today? No, actually it's Brazil in 2002.

Brazil's current largesse means it's easy to think history is repeating itself. Back in 2002, debt-to-GDP was 82%, (as opposed to 63% today), its largest trade partner had just undergone a maxi-devaluation^A which threw it into a massive recession and there was no commodities super-cycle to save them.

Turning to markets, in 2002 interest rates were 18%, implying a real rate of 10% and 5-year CDS (Credit Default Swaps – the price of which reflect the cost of insuring against default) was 4000! These figures makes today's interest rate of 13% and 5-year CDS of 290 look like a piece of cake and what is more, foreign exchange reserves are ten times greater now than they were back then.

So what is the big difference now?

Back then Brazil had Luiz Inácio Lula coming in as the new President who defied all sceptics by appointing market-friendly technocrats to run the show.

Admittedly, we're a long way from that today in Brazil (investors take a much dimmer view of the incumbent Dilma Rousseff) but things are starting to change. Of course, the popular appointment of Joaquim Levy to head the Finance Ministry is a step in the right direction. It is true that nobody can face the problems of Brazil alone which is why he has brought in his old lieutenants from Bradesco Asset Management, Rio City Government and his colleagues from his first stint at the Finance Ministry. Levy is no one man show.

Further changes include the appointment of Tony Volpon last month to one of the key director positions at the Central Bank and more recently saw ultra-dove, Luiz Awazu Pereira, announcing that he would be stepping down from his role as Director of Economic Policy. Moreover, the rumour is that we're going to get another banker to be his replacement. This still leaves us short of the 4:4 split we used to have in the good old days of Banco Central in terms of bankers versus career technocrats among the central bank directors, but it's a start.

What about Petrobras? Okay, Aldemir Bendine wasn't the ideal choice to be the new CEO but by all accounts, he and his newly-appointed CFO, Ivan de Souza Monteiro, are there to fix the books. They are a one-year fix and will eventually be replaced by professional management. The putative appointment of Murilo Ferreira from Vale to be the new chairman of Petrobras, replacing foreign Finance Minister Guido Mantega, would represent another step in the right direction. We've also had a complete cleansing of the house of Petrobras' directors whom President Rousseff appointed.

We're by no means saying that Petrobras will be fixed overnight, however the company, in a few years' time, is going to look a lot more like it did a decade ago – that is, one run by professionals.

^A In 2002, the Argentinian peso rose from 1 peso to over three pesos per US dollar.

Slowly but surely, Brazil's economic team is starting to look like the economic team of Lula's first term. Economic reform is not on the agenda like it was under Lula, but Brazil's vulnerabilities were far greater a decade ago and they still recovered. Remember, in 2002 29% of Brazil's domestic debt stock was USD-linked. That meant that any currency depreciation immediately resulted in a deterioration of debt dynamics. Having eliminated such debt over the years, today Brazil now has a much higher degree of flexibility to tolerate currency weakness without it leading to deterioration in sovereign credit-worthiness.

A rising China did help to some extent during Lula's time in office, but really Brazil is in control of its own fate, as it has such a closed economy where exports are a mere 15% of GDP. Indeed, exports to China constitute a mere 2% of GDP. So it's very difficult to credit the surge in

Chinese growth as the reason behind the prosperity which Brazil enjoyed during the Lula years. It was actually good governance that allowed Brazil to raise investment-to-GDP by 5% (from 16% to 21%) by the time Lula left office. Yes, that took eight years and it's going to take further economic reform, which simply isn't on the cards for Dilma – however that is the mission of the next government.

Again, let's try to offer a bit of perspective. Brazil is not unfixable. In 2002 many thought exactly the opposite, yet a huge rally subsequently ensued in financial markets. Under the right leadership there is no reason why Brazil can't turn the ship around yet again. After all, today's challenges are nothing compared to the ones which Lula faced.

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