

# Cornering the globe

February 2019

Capturing profit around the world



# Banking big on Brazil

## Introduction

Within the first few weeks of the new government in Brazil, the Bovespa - its domestic stock market - has hit historic highs - and the Brazilian Real (BRL) is the best performing currency so far for 2019<sup>1</sup>. Riding the “Bolsonaro bump,” incoming officials have promised the advent of an “American-style capitalism”<sup>2</sup> to a country accustomed to very big government, or “state gigantism.”<sup>3</sup>

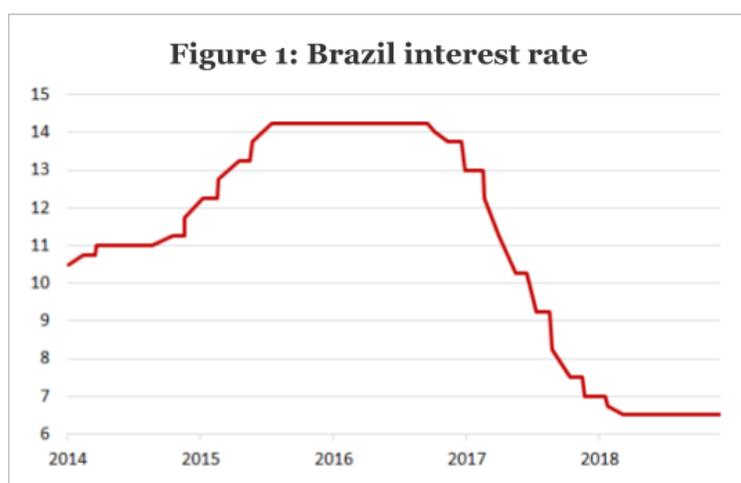
Indeed, some of the world’s largest financial institutions are banking big on the country upon the expectation that ongoing reforms to improve the macro and business landscape - including pension reform, deregulation, reducing bureaucracy and red tape, and tax reform - will be enacted by Bolsonaro’s team, passed by the new Congress, and implemented. Furthermore, in a world of financial volatility - and fragility in the macroeconomic environment - one can argue that Brazil is relatively well-poised to weather the next correction in the markets, or global recession. Its demographic dividend and diversified economy continue to enshrine it as a favorite investment destination, and as a geographical or regional priority for significant global institutional investors.

At the sector level, the potential for new privatizations in infrastructure - including ports and power generation - is material, and for a country with a wealth of sun and wind, opportunities in renewable energy also abound. Brazil is the largest recipient of venture capital (VC) investing in Latin America,<sup>4</sup> and its thriving e-logistics market is alluring for both real estate and VC funds alike.<sup>5</sup>

The real task for the new government - and for the companies and investors seeking a long-term, favorable position in the country - is to grow Brazil’s real economy. Fostering job creation - and sustainable employment - are priorities. Significant reductions in unemployment may of course lead to less crime and a more stable security situation, and will no doubt be bolstered by greater opening to foreign trade, dynamism of exports, and a strong tertiary educational component.

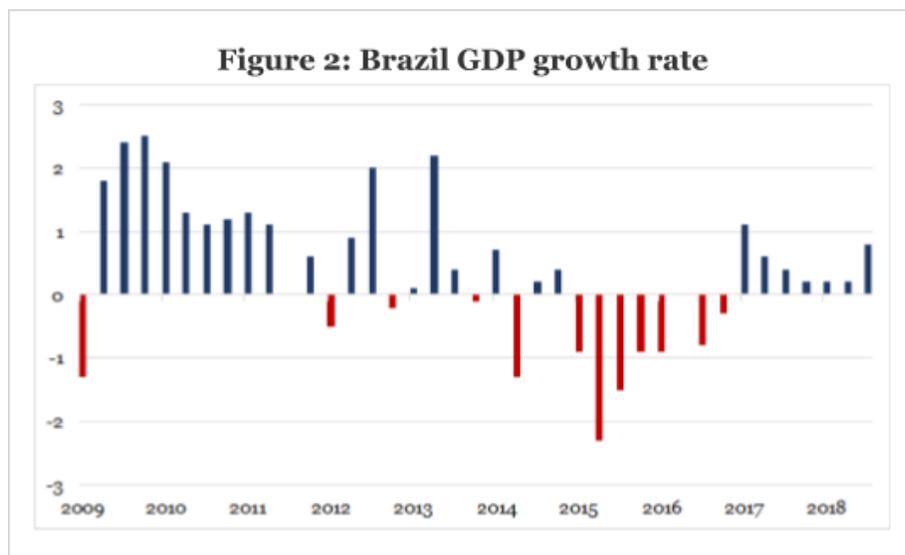
## Part 1: At the macroeconomic level

As Brazil has emerged from its worst recession in recent history, in many ways, Bolsonaro and his team have inherited a healthier economy, in cyclical upswing and posting positive GDP growth. As illustrated in Figure 1, the central bank has maintained its benchmark Selic interest rate at historic lows, and inflation hovers near comfortably low levels.<sup>6</sup>



Source: <https://tradingeconomics.com/brazil/interest-rate>.

And while the rest of the world ponders the timing and source of the next correction in the markets, Brazil is relatively well-poised to withstand external shock, such as a global recession. As illustrated in Figure 2, Brazil emerged from the Great Financial Crisis relatively unscathed, posting some of its highest GDP growth in recent decades just a year after the crisis.



**Source:** <https://tradingeconomics.com/brazil/gdp-growth>

With the previous Temer administration, the focus on maintaining the “tripé” policy - that is, inflation-targeting, reducing government spending, and a floating exchange rate - is the very definition of macroprudential measures adopted by other emerging economies around the world since the late 1990s. In the last few years, Brazil has also bolstered its foreign exchange reserves,<sup>7</sup> adding to its resilience to withstand external shocks. The currency swap program of the central bank also helps the country reduce volatility in its local currency, the BRL.<sup>8</sup> Additionally, with a relatively small percentage of foreign bond holders (roughly 11%),<sup>9</sup> Brazil’s sovereign debt is not necessarily prey to redemption risk - and escalation of debt servicing costs - in the way that other economies have been rocked in recent months.

Despite the improving macro story, all eyes - and particularly those of the ratings agencies - are focused on whether Congress can pass some version of the direly needed pension reform. Even though Brazil boasts a relatively young population, its expansive pension scheme is forecasted to cost the government some 26% of GDP by 2050 (without reform).<sup>10</sup> Even despite the recent ceiling on government spending, with its current pension program, there are long-term concerns that excessive levels of government debt can lead to high inflation. Moreover, this swelling fiscal expenditure may crowd out other initiatives that are necessary to stimulate growth - such as those related to infrastructure, healthcare, and education.

Bolsonaro has recently reported that his plan for the pension reform will result in savings of over \$270 billion over the course of the next decade - and it is important to note that the entire reform package could take up to 10-20 years.<sup>11</sup>

## Part 2: At the geopolitical level

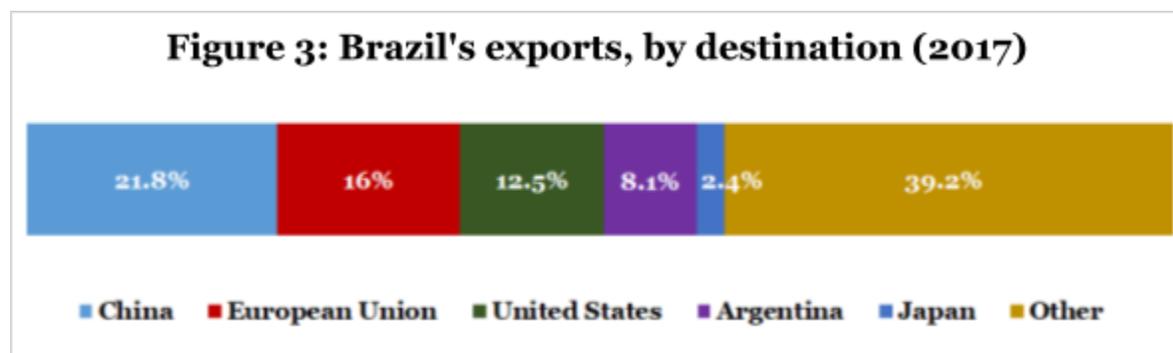
Whether or not the pension reform passes depends on the ability of the new administration to push it through Congress. Bolsonaro's PSL party is not a majority party in either the lower house (the Chamber of Deputies) or the Senate - and passing a new pension reform requires two-thirds of the vote. Bolsonaro's ability to build a "cross-bench" support base will be critical - as will his ability to ally with the new speaker of the house on a pro-reform agenda.<sup>12</sup>

At the central bank, incoming chief Roberto Campos Neto is considered to be "more of the same"<sup>13</sup> of the sturdy pair of hands of its current president, Ilan Goldfajn, who steps down in March. Maintaining central banking independence is intrinsic to macroeconomic stability - and it is expected this independence will be maintained.<sup>14</sup>

Also, on the upside, even throughout the worst recession in its history - and in spite of the perpetual Lava Jato investigation that has swept across Latin America implicating acting and past presidents, officials, and companies alike - Brazil has demonstrated considerable strength in reforming institutions - particularly those of justice and the economy. Perhaps with the wind at his back, Bolsonaro has appointed Sergio Moro as the new "super minister"<sup>15</sup> of justice - a judge who enjoys celebrity in Brazil for leading the Lava Jato proceedings.<sup>16</sup> As the ministry now includes public security, this is likely to be a boon for a population embattled with skyrocketing, record-breaking homicide rates.<sup>17</sup>

Additionally, in terms of the economy, finance, planning, and trade have been streamlined into one ministry,<sup>18</sup> with economist and banker Paulo Guedes as chief. Guedes and his team have been compared to the "Chicago boys" who reformed Chile's economy in the 1970s.<sup>19</sup> In addition to privatization, pension reform, and streamlining bureaucracy, Guedes has also outlined his priority of reducing and simplifying the corporate tax in Brazil<sup>20</sup> - a potential boon for foreign companies weary of a complex tax system.<sup>21</sup>

In terms of trade, Brazil remains relatively undersaturated - with net exports of goods and services only comprising 12.57% of GDP.<sup>22</sup> This presents both an upside and a downside. At the geopolitical level, in our present world of trade skirmishes, Brazil stands relatively resilient against potential barriers or tariffs from the US. As illustrated in Figure 3, China and the European Union are bigger export markets for Brazil than the US.



**Source:** World Trade Organization

<http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Country=BR&Language=>

But in a world of softening demand - potentially amplified by trade uncertainty harming economic growth in both China and the EU - Brazil may also need to recalibrate its export markets to faster-growing economies such as India and southeast Asia. How the Bolsonaro team addresses trade remains to be seen. Incoming Foreign Minister Ernesto Araujo's professed desire for Brazil to "abandon globalism"<sup>23</sup> may be at odds with the objectives of new "super minister" of economy Paulo Guedes, whose calls to privatize and "sell the state" may logically necessitate a hefty dose of foreign direct investment (FDI). Indeed, these asset sales have been indicated as a way of helping the government to plug a hole in the fiscal deficit.<sup>24</sup>

Reducing the role of the government in industry may also be welcomed by a population fatigued by the ongoing Lava Jato - or car wash - investigation.<sup>25</sup> Realistically, in a country beset with staunch vested interest parties,

successful and smooth waves of privatizations are likely to take some time and effort - coupled with adroit communication by policy officials to their voting public on the benefits of their actions to the country as a whole.

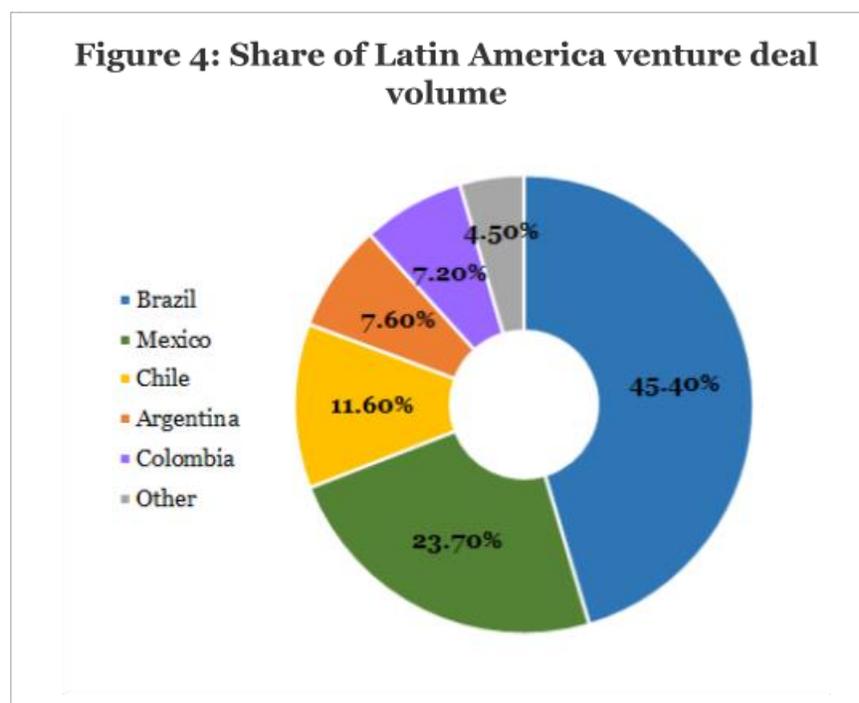
### Part 3: Sector-specific: infrastructure, green, VC, real estate, financial services

#### Infrastructure and green energy

Bullish on the prospects for the new government in Brazil, some of the world's largest infrastructure investors are poised to allocate large amounts of capital - and to potentially take advantage of privatization efforts as and when these arise.<sup>26</sup> Former World Bank executive Joachim Levy has now been appointed chief of BNDES, Brazil's development bank - indicating potentially induced efficiencies in the public-private partnership (P3) space for infrastructure investors.<sup>27</sup> Within the asset class, water and sanitation;<sup>28</sup> power generation;<sup>29</sup> logistics;<sup>30</sup> and ports<sup>31</sup> are prime targets. And despite the sometimes skeptical position which populist governments adopt toward renewable energy, investors continue to look to Brazil as a prized destination for wind, solar, small hydro, and hybrid parks.<sup>32</sup>

#### VC, financial services and real estate

As illustrated in Figure 4, Brazil is now Latin America's largest VC market - and IT continues to be the number one sector in terms of deals.<sup>33</sup> The thriving tech hub in Belo Horizonte continues to woo Silicon Valley funds,<sup>34</sup> establishing JVs in order to invest in Brazil's startup scene. After IT, financial services (FS) is the sector with the highest amount of deals.<sup>35</sup> With relatively low levels of financial inclusion,<sup>36</sup> FS companies are keen to provide services to Brazil's unbanked population - and the potential for e-payments is also a magnet for some of the world's largest players.<sup>37</sup>



**Source:** <https://news.crunchbase.com/news/with-brazil-leading-the-way-vc-investment-in-latin-america-has-more-than-doubled/>.

Foreign banks looking for a licence to operate in the country may be helped by a potential change in regulation, with the mandate to issue licences possibly shifting from the president to the central bank.<sup>38</sup>

And with a greater presence on the ground in Brazil, incoming foreign banks may yield corollary commercial real estate investing opportunities in the country's commercial hubs. Also, as catering to last mile deliveries is a fashionable theme in global real estate investing, opportunities abound in the space for Brazil - with multilateral development banks even investing in the space.<sup>39</sup>

## **Conclusion**

In sum, at the macroeconomic level, Brazil remains relatively resilient against sputtering global economic growth. By continuing the macroprudential reform program put in place by the previous administration, and maintaining safe and independent hands at the central bank, the Bolsonaro team seems poised to carry on the difficult work. The Bovespa and the BRL continue to rally with investors' hope for a passing of some version of the crucial pension reform.<sup>40</sup> The policy of "sell it all" may yield big tickets in desirable asset classes.<sup>41</sup>

In the short to medium term, with external shocks potentially hitting Brazil's largest export markets,<sup>42</sup> the country will need to look to develop trade ties with dynamic economies such as India and southeast Asia. Just how the government manages this - and how it communicates the value of imports and exports to its voting public - remains to be seen.

Ultimately, in a world of shifting patterns of demand, Brazil will equally need to transition to growing its new economy. Agriculture may always be in demand - but creating jobs in the thriving spaces of serving the consumer marketplace, healthcare, and IT is a critical task. This responsibility - which is intrinsically tied to a vocational education component - does not exclusively reside with the government. It is also contingent upon visionary companies and investors with a long-term appetite for Brazil - and a strong stomach to create jobs in an environment mixed with effervescent hope - and ever-present uncertainty.

# Additional information

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# Endnotes

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- <sup>1</sup> <https://www.ft.com/content/f12d55b6-159d-11e9-a581-4ff78404524e>
- <sup>2</sup> <https://www.ft.com/content/ab6d338a-09f8-11e9-9fe8-acdb36967cfc>
- <sup>3</sup> <https://www.ft.com/content/06bfa448-0fb2-11e9-a3aa-118c761d2745>
- <sup>4</sup> <https://news.crunchbase.com/news/with-brazil-leading-the-way-vc-investment-in-latin-america-has-more-than-doubled/>
- <sup>5</sup> <https://www.businesswire.com/news/home/20180502005113/en/Brazilian-Parcel-Logistics-Startup-Manda%C3%AA-Raises-USD>
- <sup>6</sup> <https://tradingeconomics.com/brazil/inflation-cpi>
- <sup>7</sup> <https://tradingeconomics.com/brazil/foreign-exchange-reserves>
- <sup>8</sup> See, for example, <https://www.reuters.com/article/uk-brazil-economy-currency/brazil-to-boost-currency-swap-programme-to-fight-volatility-idUSKCN1IJ2VG>
- <sup>9</sup> <http://agenciabrasil.ebc.com.br/en/economia/noticia/2018-04/foreigners-invest-less-brazil-bonds>
- <sup>10</sup> <https://www.imf.org/external/np/blog/dialogo/120116.pdf>
- <sup>11</sup> Reported by Valor Economico. See <https://www.reuters.com/article/us-brazil-politics-pension/brazil-government-wants-to-save-270-billion-with-pension-reform-paper-idUSKCN1P80XL>
- <sup>12</sup> <https://www.bloomberg.com/news/articles/2019-01-03/brazil-s-pro-market-house-speaker-looks-set-fair-for-re-election>
- <sup>13</sup> See also: <https://www.ft.com/content/09d475d6-e98e-11e8-a34c-663b3f553b35>
- <sup>14</sup> See, for example, <https://www.reuters.com/article/us-brazil-cenbank/brazil-central-banker-says-bolsonaro-agenda-supports-investor-hopes-idUSKCN1PG2ER>
- <sup>15</sup> <https://www1.folha.uol.com.br/poder/2018/11/bolsonaro-anuncia-moro-no-superministerio-da-justica-e-promete-nao-interferir-no-combate-a-corrupcao.shtml>
- <sup>16</sup> <https://www.bbc.com/news/world-latin-america-46063656>
- <sup>17</sup> <http://www.forumseguranca.org.br/publicacoes/atlas-da-violencia-2018/>
- <sup>18</sup> <https://www1.folha.uol.com.br/internacional/en/business/2018/10/bolsonaro-to-merge-finance-planning-and-trade-into-one-super-ministry.shtml>
- <sup>19</sup> Indeed, Guedes also taught at the University of Chile in 1980. See <https://www.ft.com/content/1a2ba4f4-de4e-11e8-9f04-38d397e6661c>; <https://uk.reuters.com/article/us-brazil-politics-chicagoboysexplainer/explainer-chiles-chicago-boys-a-model-for-brazil-now-idUKKCN1OY1OU>
- <sup>20</sup> <https://www.nasdaq.com/article/brazil-considers-taxing-dividends-shareholder-payouts-20190123-00690>
- <sup>21</sup> According to the World Bank, filing and paying taxes requires an estimated 1958 hours per year. <https://data.worldbank.org/indicator/IC.TAX.DURS?locations=BR>
- <sup>22</sup> World Bank. Please see: <https://data.worldbank.org/indicator/NE.EXP.GNFS.ZS?locations=BR>
- <sup>23</sup> <https://www.reuters.com/article/us-brazil-politics-araujo/brazils-new-foreign-minister-says-country-will-abandon-globalism-idUSKCN1OW10Q>
- <sup>24</sup> <https://www.bloomberg.com/news/articles/2018-11-04/bolsonaro-to-push-forward-giant-brazil-oil-sale-adviser-says>
- <sup>25</sup> With thanks to Guilherme Waltenberg, private conversation
- <sup>26</sup> The government plans to liquidate or privatize around 200 state-owned companies. <https://www.reuters.com/article/us-brazil-infrastructure/brazil-plans-to-privatize-or-liquidate-100-state-run-companies-idUSKCN1P2197>
- <sup>27</sup> Additionally, Bolsonaro has announced potential infrastructure projects in the northeast, which may yield additional opportunities in an underpenetrated area. <https://ca.reuters.com/article/businessNews/idCAKBN1E90NR-OCABS>
- <sup>28</sup> <https://www.sovereignwealthcenter.com/Article/3822192/search/results/GIC-Increases-Stake-in-Brazilian-Water-and-Sanitation-Company.html#.XEDSw1xKq2w>
- <sup>29</sup> <https://www.sovereignwealthcenter.com/Article/3839763/search/results/CPPIB-Takes-Controlling-Stake-in-Brazilian-Energy-Company-Through-JV.html#.XEDS2lxKq2w>
- <sup>30</sup> <https://www.sovereignwealthcenter.com/Article/3814992/search/results/CPPIB-Set-to-Join-Brazilian-Logistics-Joint-Venture.html#.XEDS-FxKq2w>
- <sup>31</sup> See, for example, [https://www.joc.com/port-news/terminal-operators/wilson-sons/five-brazil-port-terminals-eyeing-sales-more-investment\\_20180930.html](https://www.joc.com/port-news/terminal-operators/wilson-sons/five-brazil-port-terminals-eyeing-sales-more-investment_20180930.html); [https://www.portstrategy.com/news/101/world/south-america/brazil-needs-\\$6.7bn-of-new-infrastructure](https://www.portstrategy.com/news/101/world/south-america/brazil-needs-$6.7bn-of-new-infrastructure)
- <sup>32</sup> See, for example, <https://www.pv-tech.org/news/votorantim-energia-cppib-form-jv-to-invest-in-renewable-energy-in-brazil>; <https://renewablesnow.com/news/interview-brazils-renewable-energy-finance-landscape-according-to-apex-brasil-624396/>
- <sup>33</sup> <https://www.pwc.com.br/pt/estudos/servicos/assessoria-tributaria-societaria/fusoes-aquisicoes/2018/fusoes-e-aquisicoes-no-brasil-outubro-2018.html>
- <sup>34</sup> See, for example, <https://rpev.com.br/> <https://www.nearshoreamericas.com/us-vc-social-capital-targets-brazilian-startups-with-new-tech-platform/>

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<sup>35</sup> <https://www.pwc.com.br/pt/estudos/servicos/assessoria-tributaria-societaria/fusoes-aquisicoes/2018/fusoes-e-aquisicoes-no-brasil-outubro-2018.html>

<sup>36</sup> <http://datatopics.worldbank.org/financialinclusion/country/brazil>

<sup>37</sup> <https://diginomica.com/2018/04/19/paypal-chases-unbanked-55-million-brazil/>

<sup>38</sup> <https://www.reuters.com/article/brazil-foreign-banks/brazilian-cenbank-may-get-power-to-grant-licenses-for-foreign-banks-newspaper-idUSL1N1Z409T>

<sup>39</sup> <https://www.businesswire.com/news/home/20180502005113/en/Brazilian-Parcel-Logistics-Startup-Manda%C3%AA-Raises-USD>

<sup>40</sup> <https://www.reuters.com/article/emerging-markets-latam/emerging-markets-bovespa-crosses-97000-record-high-latam-fx-weakens-idUSL1N1ZO0SO>

<sup>41</sup> <https://www.reuters.com/article/uk-brazil-politics-bolsonaro/advisor-to-right-wing-brazil-candidate-says-privatise-it-all-idUKKCN1IT1VC>

<sup>42</sup> See, for example, <https://www.reuters.com/article/us-germany-economy/german-government-slashes-2019-economic-growth-forecast-to-1-percent-sources-idUSKCN1PJ0V6>