Global Expeditions

Key Takeaways from Trip to Brazil, Argentina and Venezuela

By: Eric Fine, Portfolio Manager

Summary

I recently spent one week in Latin America, meeting government officials and independent economists. In the case of Venezuela, I also met with independent pollsters. Here are the key takeaways.

Regional Themes

More tolerance for inflation. In each country, sensitivity to inflation was noticeably reduced. This is noteworthy, given these countries' high-inflation histories and their populations' understanding that inflation can get out of control and undermine political and economic stability (unlike the thinking in the US that inflation allows the nominal to look real and will never get out of control).

The U.S. is no longer a role model. Many policymakers lamented the fact that the U.S. is no longer setting a good example for fiscal and monetary discipline. This is making it more difficult for local politicians in Latin America to stand up to pressures for more deficit spending and monetary stimulus. Printing money and ignoring or denying fiscal constraints has been part of every Latin American country's experience, and historically they have looked to the U.S. as the paradigm of discipline. Now, they are confused as to why U.S. policymakers are ignoring history's lessons. The voiced concern was that the U.S. has changed course and is no longer a positive role model for policy in Latin America.

Weak currencies are good. Each country's policymakers appeared consistently biased towards a weaker currency. The details obviously vary by country, and the Brazilians were the most reluctant to actually voice weak-currency aspirations. But based on current sentiment, I think that we should expect devaluations in Argentina and Venezuela, usually around elections, as an ongoing feature.

The wall of money is a problem. Authorities in Latin American countries are wary of the wall of money escaping the US and flooding into other economies, and this concern was clearest in the case of Brazil. Policymakers fear the wall of money is creating complacency, and is a reflection of problems in reserve-currency just as much as it is a reflection of confidence in emerging economies.

Jobs, jobs, jobs. In the trade-off between jobs and inflation, the desire to grow jobs is winning in each country. This was confirmed by policymakers explicitly and repeatedly. In the high-inflation countries, Argentina and Venezuela, policymakers emphasized that they are steadfastly focused on job-creation, despite already-high inflation. As long as most people are employed, leaders believe inflation impacts will be politically acceptable, even if they lead to reduced living standards.

Argentina

Policy unpredictability. Argentina appears to be lacking a coherent policy framework, to the extent that officials can't even explain how or why certain policies are implemented. For example, we did not hear any rationale and process behind the recent nationalization of YPF, an Argentine energy company. One person, the President, makes such decisions, most people believe. How and why they are made may be a matter of personal psychology.

The state is great. The centrality of the government's role in the economy is perhaps Argentina's only firm policy pillar. If there's a problem, the government is the institution that addresses it, not private actors.

Inflation is not a concern, which is concerning. Given progress in reducing unemployment, policymakers feel vindicated in tolerating inflation. This is particularly worrisome in Argentina, where a recent economic slowdown has not eased inflation.

Where will investment come from? FX controls and policy uncertainty mean that foreign investment will remain far lower than economic constraints require. Thus, investments in Argentina will be ad-hoc, idiosyncratic, and always at-risk. YPF's nationalization took even government officials by surprise.

Politics and populism (is there any other kind of Argentine politics?) dominate Argentine politics. To the extent that it is understandable, the YPF nationalization seems to have emanated from a view that it would give the government a political boost. In fact, the boost has proven to be fleeting.

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Regions in play. The central government seems willing to game its allocation of fiscal resources to the regions, in order to gain political power. This could create brinksmanship that affects the prices of regional debt. Buenos Aires dominates the most important region in terms of population, wealth, GDP and political clout. But it also is the weakest region fiscally, so the risk of turbulence is growing.

Risks are longer-term. Low investment and sticky inflation usually take time to show up. However, inflation expectations can materialize quickly and sharply once they cross a psychological threshold.

Even though the country might merit a credit rating upgrade based on the numbers, policies are weighing on the sovereign rating. No progress on Paris Club negotiations, no market access, and growing contingent liabilities are real problems. However, Argentina's lack of near-term payments makes these slow-burning fuses.

Does a default hurt, politically? Among policymakers, common wisdom is that any default is political suicide, whether or not it is risky for the country. The rating agency with which we met, however, sees a default as irrelevant politically, and it is not very comfortable with the country's willingness to pay its debts.

Politics favor President Cristina Kirchner. Nobody is benefiting from Kirchner's setbacks, so mid-term elections are hers to lose. Inflation is a growing concern among the population, but not one that any opponent has leveraged. Opposition by the military, and weak protection (literally, as in physical protection), has led to greater use of the National Guard and even quasi-mobs for physical control.

Next steps? The next policy moves could be in any direction. On the populist front, the war against the leading print media (Clarin and La Nación) could continue. Devaluations and inflation still are not viewed as biting, politically. Similarly, the administration could try to encourage investment and might feel constrained by growing concerns about inflation and investment.

No appreciation for the country's energy potential. The potential for exploiting shale and other energy resources just doesn't seem to be under consideration.

Soy giving joy, for now. 60% of grain production is now soy, making the agriculture sector very vulnerable to price movements in one commodity. Generally, high prices have created complacency.

The central case is a muddle. Without any external trigger (e.g., a collapse in soy prices), there are no obvious crisis moments on the horizon, despite unpredictable politics. The current account, growth and employment situations are currently "OK," in our opinion. The balance sheet is strong, and there aren't big bond payments coming due in the near future.

Brazil

The problems are known. Policymakers and independent economists know the main problems which boil down to low investment (among others, such as a less independent central bank). In my opnion, the issue is not denial, but rather more of an intellectual failure, because policymakers keep relying on measures that have not worked in other contexts. Only after a policy fails in Brazil itself does pragmatism re-assert itself, and then only gradually.

Policy confusion. The recent reduction in energy taxes is a great example of policy bungling. In itself, this was a sound move for a country with low investment. However, parallel suasion on the energy companies to fully pass any benefits on to consumers undermines the superficially positive step.

Less fiscal discipline? Although it is denied, I sensed a greater willingness to let fiscal policy drive future growth. For the record, officials reiterated their commitment to long-standing (and achieved) primary balance targets. However, the focus was clearly on growth, and one can read between-the-lines a growing openness to discuss more aggressive fiscal policy, to stimulate growth. If this materializes, it weakens one of the pillars (in my opinion, the key pillar) of Brazil's positive tendencies over the past decade.

Credit growth stabilizing. In recent years, credit-based consumption has driven Brazil's GDP growth. For example, from 2003 to 2012, Brazil's ratio of credit/GDP increased from about 25% to around 50%. In the future, credit growth is likely to stabilize. The development of using credit for housing purchases, though, has produced an enduring change in demand, which could have positive economic implications going forward.

Inflation is not a concern. Inflation will be kept under 6% in 2013 for purposes of window-dressing the 2014 elections. It's not a broad concern at the moment.

Focus on jobs. Jobs are the key focus, and the impact on inflation was downplayed, despite inflation memory and the fact that investment is the key blockage for solid longer-term growth.

An unanswered question on inflation risks. It's a given in Brazil that: policymakers want a weak exchange rate, spare capacity is low, labor is tight, inflation memory exists, GDP is barely growing and interest rate cuts are viewed as politically motivated. The question was: "Doesn't all this mean that if your terms of trade improve or deteriorate, either result would be a negative development?" In other words, if the balance of payments accounts improve via higher commodity prices and global demand, FX won't be allowed to appreciate, and rates will be kept low, raising inflation risks. If the balance of payments accounts deteriorate, FX will depreciate, and rates will be kept low, raising inflation risks. It's hard to know whether policymakers didn't understand the question or didn't want to answer it.

Rate-cut bounty expected. Policymakers generally weren't worried about weak growth so far this year, as they see interest rate cuts as not being fully passed through to the economy. This is reducing pressure for more structural reforms.

Some populism. The popularity of policies, rather than its long-term effectiveness, seemed to be a bigger decision-driver than in the past. For example, payroll loans are very popular and do have positive near-term impact on an economy with low credit. Forcing interest rates lower on bank loans was a popular move, and the long-term policy risks were downplayed. The latest popular trend is new regulations and pressures on credit card companies. Brazil's populism is a a change from its recent past, in my opinion.

Love of industrial policy. Rightly or wrongly, President Dilma Rousseff views industrial and sector policies as the first solution to problems. The impact of government intervention, distortion of prices and incentives, and other unforeseen consequences do not seem to play a large role in her calculations. Import substitution – replacing imports with domestic production – is another example of policy that had been widely rejected globally, but still has a place in Brazil.

Policy progress? Brazil remains a country in which adverse economic outcomes are blamed on the policymakers responsible. The President appears sensitive to this reality and pragmatic in heeding it. One area to watch is the concessions for two airports, in preparation for the 2014 World Cup and 2016 Summer Olympics. The first attempt to award these contracts was a failure. The next attempts will show whether pragmatism and common sense will prevail. We also heard debates on whether President Rousseff's team, on which she depends for policy guidance, will be changed for the better.

A muddle and then inflation? The bottom line, in my opinion, is that Brazil will muddle along, and that inflation will become a greater risk over the coming year or two. Sound policies could make a big difference, though, as always.

Venezuela

Debt. Most of the country's debt is domestic, and the authorities went out of their way to emphasize that President Chavez paid the external/hard-currency debt, even with oil at $10/barrell. Central bank reserves are audited, and combined with other funds they equal more than the total amount of external debt. The exact amount of resources at these funds, though, is unclear. I find it promising that 80% of central bank reserves reportedly are held in gold inside Venezuela.

Maxi devaluations. Given the debt profile (more domestic than external), and investment constraints, devaluations will be a regular feature of Venezuelan policy, and post-election is the time to implement these with the least political impact.

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