Brazil and South Africa: Two Continental Giants with Feet of Clay

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Following heavy public spending during the pandemic, Brazil’s and South Africa’s government debt has surged over the past year, exacerbating the already sizable fiscal problems both countries were facing before the onset of COVID-19. Moreover, both are now struggling in the aftermath of their largest ever economic slowdowns and contending with slower-than-expected vaccine rollouts. While both countries face significant hurdles in the years ahead and share several common economic features, we believe the outlook for South Africa is more favourable. Accordingly, given its more supportive macro and political backdrop, credible central bank, and deep domestic financing sector, we expect South Africa’s local bonds to outperform relative to Brazil’s going forward.

Brazil and South Africa are among the largest emerging market (EM) economies and local bond markets for foreign investors.¹ Both economies, however, share the dubious distinction of growing well below the EM complex over the past 15 years. Not only have they underperformed regional peers, albeit by different margins (Figure 1A), but the countries’ growth rates had been declining well before the onset of the pandemic (Figure 1B). The two also share several common economic features: both are large commodity exporters, have large public sectors and state-owned enterprises, and their fiscal situations and outlooks have deteriorated markedly. These raise concerns over debt sustainability and the performance of local assets, given that public debt is mostly in local currency (Figure 2).

¹ Brazil’s weight in JPM’s GBI-EM Global Diversified Index is 8.27% while South Africa’s is 7.56%, as of February 2021.
Figure 1A: Average Real GDP Growth, 2005-2020

Figure 1B: Real GDP Growth (% Year-over-Year)

Note: The aggregate EM average annual rate of growth was 5%, as of December 2020. Sources: National sources, IMF, Haver, PGIM Fixed Income

Figure 2: Domestic and Foreign Public Debt


A Path to Debt Sustainability

To ease their debt burden without resorting to inflationary taxation, Brazil and South Africa need sustained economic growth and fiscal discipline. To assess the former, we examined the structural conditions for self-sustained growth by comparing 28 emerging markets along a range of growth-enhancing structural metrics, including institutional quality, trade openness, human capital, demographics, productivity growth, and investment as a condition to boost future productive capacity (Figure 3). While neither country scored particularly well relative to peers, based on these indicators South Africa is generally better equipped than Brazil to attain a superior growth trajectory.²

² South Africa and Brazil were also highlighted as highly vulnerable countries in a panel of 25 EMs. See Sheets, N., Hepworth, C., Jiranek, G.; The Prospects of the Emerging Markets – Looking Beyond the storm, July 2020; https://www.pgim.com/pgim-japan/article/pgim-fixed-income-prospects-for-the-emerging-markets
To analyse the prospects for fiscal correction, we then compared both countries across various metrics capturing debt-sustainability risks and prospects for meaningful fiscal adjustments. The verdict here is mixed. While Brazil starts with a heavier debt burden (88.8% of GDP versus South Africa’s 79.3%), its debt-accumulation dynamics are more favourable given the primary fiscal balance forecasted this year and average interest rate-growth differential projected for the next five years. However, Brazil’s spending profile is more rigid, with the interest cost taking a larger share of revenues. Both countries have limited leeway to raise revenue.

### Large Financing Needs in 2021

Addressing growth and fiscal shortcomings in both countries should be part of a multi-year adjustment and reform effort. Of more immediate concern, however, is each country’s ability to meet its large financing requirements in 2021. In South Africa, these amount to about $37 billion, or about 10% of GDP, while in Brazil these amount to about $305 billion, or about 22% of GDP.
A fairly large menu of options is available to both countries to meet their financing needs, namely: i) external debt issuance, enabled by both countries’ low external debt levels and large reserve buffers, though higher global yields would render this alternative more expensive;3 ii) limits on foreign investments by local investors (e.g., South Africa Regulation 28) or other capital controls, but this option could well backfire; iii) deficit monetization or bond purchases by central banks (QE), which also seems unlikely as both countries rely on independent central banks, with Brazil’s needing to reassert itself after its autonomy was recently enshrined in the Constitution; iv) tapping fiscal buffers; v) further reliance on local markets, the path of least resistance, in our view.

The risks of relying on local markets appears lower for South Africa than for Brazil. First, the difference in magnitude of financing needs favours South Africa. Second, the domestic financial sector is very deep in South Africa, which should contribute to a better financing environment.4 Third, debt rollover pressure should be lower in South Africa as the average maturity of South African local debt is 11.9 years, whereas the average maturity of Brazilian local debt is 3.4 years.

**A More Credible Monetary Policy**

Moreover, the South African central bank has strong credibility and pursues relatively orthodox monetary policy, whereas the Brazilian central bank has yet to establish its reputation as a properly independent central bank—especially with foreign investors and against a challenging fiscal backdrop (Figure 5). Yet both central banks have been relative laggards among EM inflation-targeting central banks, failing to establish a track-record of meeting targets and smoothing inflation gyrations (Figure 6). Ideally, a country should experience very low inflation volatility while meeting its inflation target. Figure 6 shows that over the last two decades, average annual inflation in both countries has overshot central targets, with Brazil underperforming South Africa. We’d note that inflation volatility has been similar between the pair but has been relatively high compared to the broader cohort.

Partly owing to their respective track records, we expect Brazil’s and South Africa’s monetary authorities to follow different paths in the coming months. While we expect the South African Reserve Bank to remain on hold this year, we expect Banco Central do Brasil to continue the policy normalization process it initiated at its March policy meeting, with the pace and length largely determined by the inflation outlook and fiscal policy.

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3 In both Brazil and South Africa, FX reserves are more than double the outstanding foreign government debt.
4 Total assets held by institutional investors, excluding banks, amount to 142% of GDP, while these assets total about 82% of GDP in Brazil, as of March 2021. Source: Haver.
The combination of a more credible monetary policy and a more supportive backdrop for local debt has also attracted a higher participation of foreign investors in South Africa, with the country’s downgrade to sub-investment grade not appearing to significantly deter foreign investment (Figure 7)—though the double-edged-sword nature of high foreign holdings of local debt may become more salient during risk-off episodes.
Conclusion

While both Brazil and South Africa have been on disappointing growth and fiscal paths in recent years and face severe challenges in the years ahead, we currently prefer exposure to South Africa’s local bonds versus Brazil’s. Both have accumulated large government debts and Brazil is seemingly in a better situation in terms of debt sustainability. However, the unabated spread of COVID-19 and ensuing risks to Brazil’s growth and fiscal outlook, coupled with the resurgence of political risk, intensify the headwinds faced by Brazil through next year. Moreover, South Africa seems better positioned to reach a stronger growth path and meet its financing needs domestically, owing to the depth of the local investor base, strength of institutions, and lower short-term financing needs. Foreign participation is also higher in South Africa than in Brazil, contributing to an overall better financing environment. We believe this combination of a more favourable economic and political backdrop, more credible central bank, and more robust financing environment should be supportive of South Africa’s local bonds relative to Brazil’s local bonds going forward.
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