BRAZILIAN
ECONOMIC OUTLOOK
4th quarter 2017

Overview

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This *Brazilian Economic Outlook* explains that there are three basic sources for the current economic recovery. First, there has been an inventory buildup for three quarters in a row up to the second quarter, following a long period of negative contributions to GDP growth. The second contribution to the rebound in the economy came from the fact that the federal government recently released BRL 42 billion in forced savings accounts. The third source of the current recovery is a significant fall in consumer inflation, which is expected to continue to spur growth in the near future. The low inflation and the subdued inflation expectations led to the lowest expected real interest rates ever in a context of controlled inflation, as the interest rate term structure projects a 3.2% real interest rate on a 12 months horizon. The international scenario has also been very benign, which helps to ensure capital flows into emerging markets in general and, more specifically, into Brazil.

The Brazilian GDP made an unexpected move and grew 0.3% Year-over-Year (YoY) in the second quarter of 2017, the first positive print in 12 quarters. This induced an upward review in economic forecasts for 2017 and 2018 GDP growth. For 2017, the Institute for Applied Economic Research (Ipea) forecasts a 0.7% annual growth and an acceleration to 2.6% in 2018.

The next session presents a short review of the economy in recent months. It is followed by a brief discussion of the fiscal challenges and a description of the scenario underlying Ipea's forecasts for 2017 and 2018.

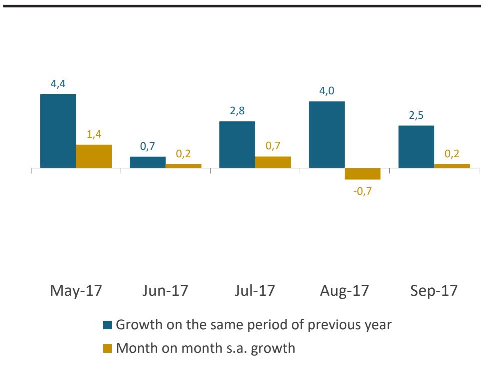
Cyclical Reversion

As mentioned, the GDP result for the second quarter was better than expected. Forecasts pointed to a seasonally adjusted contraction of 0.2% Quarter-over-Quarter (QoQ), 0.4 p.p. worse than the actual figure. The most surprising rebounds in the supply side were in the industrial and the services sectors. On the demand side, household consumption also presented a significant rise.

The available third quarter data suggest the continuity of second quarter's positive performance. After falling slightly in August, the industrial production recovered the upward trend in September increasing 0,2% MoM, and 2,5% YoY (see graphs 1 to 4 below).

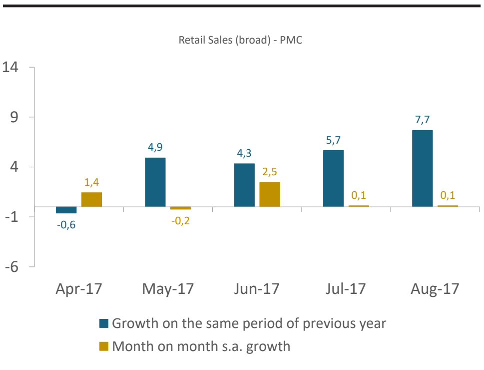
Investment, on the other hand, didn't perform well in the second quarter, declining 0,7% QoQ. After increasing 1.3% in July, Ipea's Gross Capital Formation Monthly Index stood still in August, showing a slightly decrease (-0,1%). Such outcome could have been better, were it not for the fall reported in the construction sector (-2.3%), while the apparent consumption of capital goods rouse 1.8% against July.

GRAPH 1
General Industry - PIM-PF.
(%)



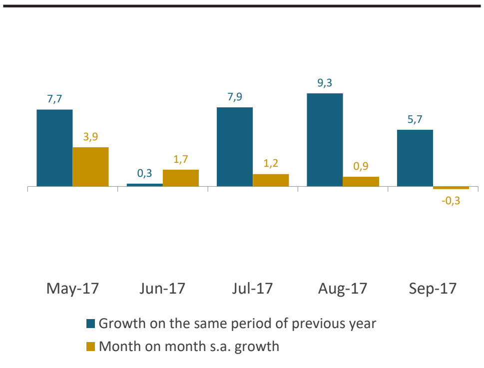
Source: IBGE.

GRAPH 2
Retail Sales (Broad) - PMC.
(%)



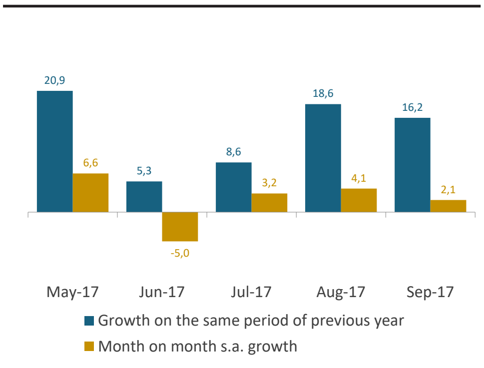
Source: IBGE.

GRAPH 3
Capital Goods - PIM-PF.
(%)



Source: IBGE.

GRAPH 4
Durables - PIM-PF.
(%)



Source: IBGE.

There are three basic sources for the current economic recovery. First, there has been an inventory buildup for three quarters in a row up to the second quarter following a long period of negative contributions to GDP growth. The inventory indices calculated by the National Industry Confederation (CNI) and the Getúlio Vargas Foundation (FGV) show that the percentage of business managers that consider their inventory levels as excessive has fallen markedly from the second half of 2015 to the end of 2016, stabilizing over 2017.The second contribution to the rebound in the economy has come from the fact that the federal government released BRL 42 billion in forced savings accounts, known as FGTS[1] , so that workers were able to withdraw funds that are usually frozen, except for specific circumstances related to job losses or retirement. This extra money was mostly employed to repay debt, but also for increasing consumption. Thus, this fact may have stimulated, at least partially, the rebound in retail sales growth.

The third source of the current recovery is a decisive fall in consumer inflation (Graph 5), which is expected to continue to spur growth in the near future. In fact, food prices are falling, having registered a deflation of 2% in August, on a yearly basis. One year earlier, the same figure was an inflation of 14%. Inflation on the services sector fell as well, from 7.4% YoY in August 2016 to 4.8% YoY in August 2017.

These positive developments on the inflation front and the vastly improved credibility of the Central Bank, which tamed expectations bringing them close to the inflation targets, has allowed an aggressive cut of the basic interest rate, from 14.25% in August 2016 to 8.25% in the same month this year.

The low inflation and the subdued inflation expectations led to the lowest expected real interest rates ever in the context of controlled inflation, as the interest rate term structure projects a 3.2% real interest rate on a 12 months horizon (Graph 6).

The international scenario has also been very benign, combining a synchronized rebound in growth of industrialized countries and China and an environment of high liquidity and financial stability which helps to ensure capital flows into emerging markets in general and, more specifically, into Brazil.

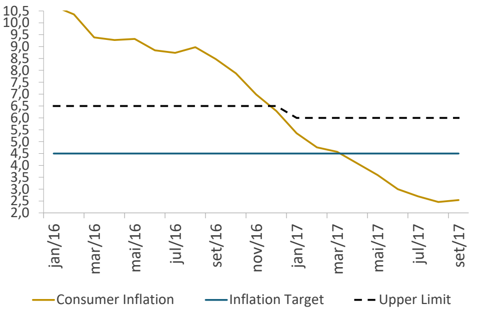
The labor market is also reinforcing the economic activity trends, as average real labor income has made a comeback and, along with the slightly reduced unemployment and increased participation rate, it helped to increase the total real labor income. This increased participation rate derive from a reversal of the discouraged-worker effect, leading to a reduction of the percentage of adults out of the economically active population from 47.2% in the first quarter to 44.7% in the second. The average labor income has been growing for three quarters in a row and has grown 3% in the second quarter, when compared to the previous year's. The unemployment rate, though, persists at a high level – 12.9% in the second quarter, with seasonal adjustment – in spite of a slight reversal of 0.3 p.p. when compared to the first quarter. [2]

Investments have shown some recovery at the margin too (Table 1). However, the poor performance in 2017 is mainly due to the still low levels of capacity utilization (74.1%) that remain well below the usual average (80.7%).[3] Also, even though entrepreneurial confidence indexes have been recovering from the lows seen in 2016,

1 Fundo de Garantia por Tempo de Serviço – a severance insurance fund.
2 Data from Continuous National Household Sample Survey of the Brazilian Institute of Geography and Statistics (IBGE).
3 Data from FGV.

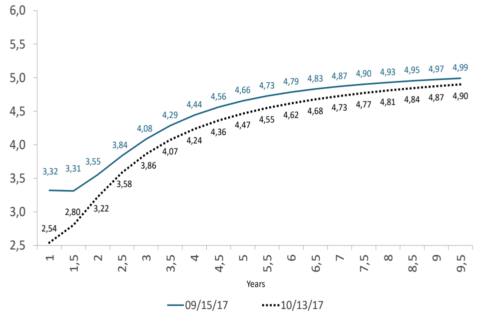
they still remain below the threshold that separates pessimism from optimism. There is still too much uncertainty, including the political landscape, to allow for confidence and investments to be fully reestablished (graphs 7 and 8).

GRAPH 5
Consumer Inflation.
(%)



Source: IBGE.

GRAPH 6
Interest Rates Structure.
(%)



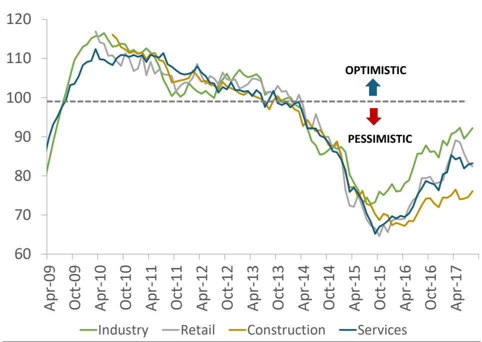
Source: Anbima.

TABLE 1
Ipea Gross Formation of Fixed Capital Indicator Growth Rates
(%)

	Compared to the previous period, seasonally adjusted				Compared to same period in previous year				Cumulative	
	May 17	Jun 17	Jul 17	Quarter	May 17	Jun 17	Jul 17	Quarter	On the year	12 months
Gross Fixed Capital Formation	-0.1	0.7	1.3	-0.1	-2.3	-10.2	-1.6	-4.8	-4.6	-5.4
Machinery	2.6	1.2	-1.2	2.9	9.9	-16.2	2.3	-2.4	-1.3	-2.7
Construction	-1.4	2.4	1.4	-0.7	-8.4	-6.2	-3.7	-6.1	-6.4	-6.7

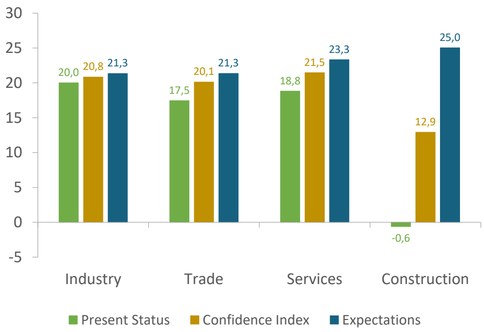
Source: Ipea/Dimac. Seasonally Adjusted by the X-13 method.

GRAPH 7
Confidence indicators
(index = 100 when neutral)



Source: FGV.

GRAPH 8
Confidence Indicators
(%)



Source: FGV.

The Fiscal Disequilibrium

In spite of the recovery of several macroeconomic indicators, the structural fiscal imbalance remains a major threat to the sustainability of public debt and to the economy's recovery path over the medium term.

Despite some effort to limit the government deficit, many variables are not under direct government control, like the demographic dynamics and the legislation that determines the value of social security benefits. Both affect social security expenses, one of the major components driving the fiscal imbalance.

Adding to that, government revenues have been disappointing when compared to the performance of the economy. The sectoral composition of GDP growth, which has been gradually moving to the services sector – where the tax levy is comparatively lower – and the tax amnesty programs, which reduce the incentive to comply with tax obligations, are to blame.

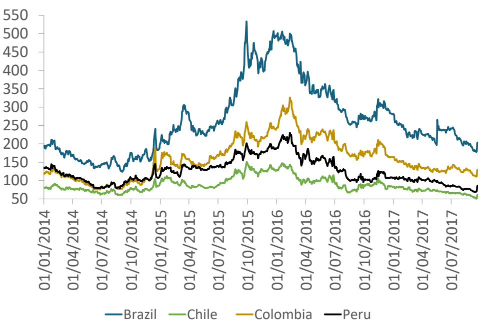
As the expenditure ceiling approved in Congress by the end of 2016 is expected to impact the gross public debt only from the mid-2020s onwards, the long-term growth prospects, the political landscape and the implementation of structural reforms become key to determine the scope of short term growth.

In that regard, the government newfound emphasis on privatization and infrastructure concessions to the private sector – which should bring better resource allocation and some extra government revenues – has been a source of some optimism.

Nevertheless, the government dependency on extraordinary revenues to keep debt in check makes the structural adjustment a vital issue that must be dealt with. As it is becoming increasingly clearer, the key to this is the Social Security reform, which is an issue also in the sub-national level, as many states are also facing severe fiscal imbalances.

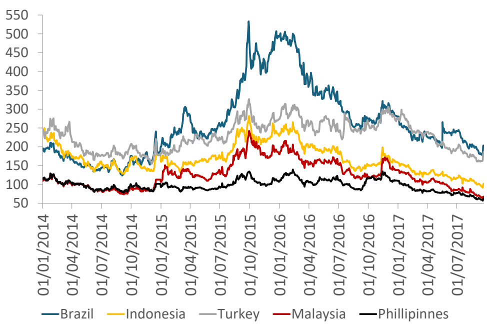
Although there is uncertainty about the social security reform, the country risk, measured by the Credit Default Swap (CDS) has recovered (Graphs 8 and 9). This benign risk perception is contributing to the macroeconomic recovery and seems to rely on the expectation that the necessary reforms are going to happen in the near future, in spite of the fact that they are mostly stalled at the moment. It should be clear, however, that the longer it takes for the social security reform to be approved, the harsher the necessary adjustment will have to be.

GRAPH 9
CDS – Selected Countries
(Last Update: 09/22/2017)



Source: Bloomberg.

GRAPH 10
CDS – Selected Countries
(Last Update: 09/22/2017)



Source: Bloomberg.

Macroeconomic Forecasts for 2017/18

Assuming that the perception of risk remains low, that there are no further relevant shocks and that the belief in the future approval of the reforms remains in place, Ipea has produced forecasts for the Brazilian economy in 2017 and 2018.

For the third quarter of 2017, most aggregate supply components are expected to grow, relatively to the same quarter of 2016. Industry should grow 1.4%, the services sector 0.5% and agriculture 11.1%. In seasonally adjusted terms, the agricultural sector is expected to contract with respect to the second quarter, but the other broad two sectors are expected to maintain growth.

Considering aggregate demand, household consumption is expected to grow by 1.4% in comparison to the third quarter of 2016, and exports should expand by 9.6%, 4.7 p.p. more than imports, so that net exports are expected to provide a positive contribution to GDP annual growth. Government consumption and aggregate investment, on the other hand, are expected to decrease. In a seasonally adjusted QoQ comparison, all components are expected to grow, except for government consumption.

GDP thus should expand by 1.2% compared to the third quarter of 2016 and 0.4% on the comparison with the second quarter, after seasonal adjustment. For the whole year of 2017, GDP is expected to increase by 0.7%. Next year, the pace of growth is expected to accelerate to 2.6% (Table 2).

Most of the growth in 2017 is related to household consumption hike and to net exports. Also, the agricultural sector performance will be the main contributor on the supply side.

TABLE 2
Gross Domestic Product (GDP) Forecast

	Actual		Forecast					
	2015	2016	2017-Q1 Same quarter of Previous Year	2017-Q2 Same quarter of Previous Year	2017-Q3 Same quarter of Previous Year	2017-Q3 QoQ Seasonally Adjusted	2017	2018
GDP (growth (%) on previous year)	**-3,8**	**-3,6**	**-0,4**	**0,3**	**1,2**	**0,4**	**0,7**	**2,6**
GDP - Industry (% growth over previous period)	-6,3	-6,3	-1,1	-2,1	1,4	1,6	0,5	3,4
GDP - Services (% growth over previous period)	-2,7	-2,7	-1,7	-0,3	0,5	0,4	0,1	2,2
GDP - Agriculture (% growth over previous period)	3,6	-6,6	15,2	14,9	11,1	-2,4	12,5	3,5
Consumption – Households (% growth over previous period)	-3,9	-4,2	-1,9	0,7	1,4	0,5	0,8	2,7
Consuptio - Government (% growth over previous period)	-1,1	-0,6	-1,3	-2,4	-1,6	-0,2	-1,9	-0,2
GFCG (var.% sobre período anterior)	-13,9	-10,2	-3,7	-6,5	-1,5	1,6	-2,5	4,2
Exports (% growth over previous period)	6,3	1,9	1,9	2,5	9,6	4,8	5,6	4,1
Imports (% growth over previous period)	-14,1	-10,3	9,8	-3,3	4,9	5,1	3,6	5,1

Source: Ipea/Dimac

In 2018, all aggregate supply components are expected to grow, while on the demand side both consumption and investment are to expand.

One of the main drivers of growth is going to be the monetary impulse. It is expected that the Central Bank will uphold its easing stance, slashing the basic interest rate to 7% p.a. at the end of 2017, keeping it at that level for 2018.

This interest rate trim is expected to cut the real interest rates down to the lowest level since the Real Plan took place (around 3% p.a.), as the expected inflation in 2017 and 2018 will be lower (2.9% and 4.2%, respectively) than the inflation target of 4.5% (Table 3). This tends to trigger consumption and investment.

TABLE 3
Inflation, Interest Rates and Exchange Rates Forecasts

	Actual		Forrecast	
	2015	2016	2017	2018
Inflation - IPCA (% per year)	10.7	6.3	2.9	4.2
SELIC Interest Rates (% p.a. end of period)	14.25	13.75	7.00	7.00
Exchange Rate R$/US$ (end of period)	3.90	3.26	3.15	3.30

Source: Ipea.

Institute for Applied Economic Research (Ipea)

The Institute for Applied Economic Research (Ipea) is a federal public foundation linked to the Ministry of Planning, Development and Management. It provides technical and institutional support to government actions – enabling the formulation and reformulation of public policies and Brazilian development programs. Its work is made available to society through numerous regular publications and seminars.

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