BRAZILIAN
ECONOMIC OUTLOOK
Institute for Applied Economic Research
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Overview

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The Brazilian economy maintained its growth recovery through the end of 2017 and beginning of 2018, as shown, among other data, by the upward trajectory of industrial production and by the declining trajectory of unemployment rates.

Thus, in spite of the fact that the process has lost some momentum, the data still point to a positive scenario for this year. The Ipea Indicator for the output gap is at 4.4%, suggesting that there still is spare capacity in the economy and that monetary policy can remain stimulative without the risk of stoking back inflation.

In fact, a positive surprise in the early months of 2018 came precisely from the inflation scenario: in the first bimester, recorded inflation for the period was the lowest in a long time. This benign behavior of inflation ratifies the widespread expectation that monetary policy will remain in expansionary mode throughout 2018 and that it shall be the main driver of economic recovery. Among our new forecasts for 2018, the numbers for inflation were the ones that changed the most. The remaining indicators are mostly unaltered, when compared to the Ipea Economic Outlook of January 2018.

Also on the positive side, the Brazilian current account has shown surprisingly low deficits, mainly due to the strongly positive trade balance, while inward foreign direct investment remains very high. One reason for such a performance is the favorable international background, which has featured synchronized growth among the major economies and a recovery of international trade. Even if recent data indicate some global deceleration in economic activity, and in spite of the outburst of volatility early in February, international liquidity remains high and global inflation, low. Even in the economies that are more advanced in their economic cycles, as the USA, there are little signs of price acceleration. Therefore, the trend is one of a gradual normalization of their monetary policies.

On the negative side, the suspension of the vote concerning the pensions reforms in Congress was a source of frustration. The adverse implications for the sustainability of the public debt led to a further downgrade of the Brazilian debt rating by one of the major rating agencies. However, markets' response to the vote postponement was mute, maybe due to a consensus that the next administration will have to push the reforms forward, no matter who wins this year's elections. Also, some positive indicators revealing a small short term relief in the public deficit may have contributed to reduce the financial markets volatility. The primary deficit was below the target in 2017 and government revenues were higher than expected in the beginning of 2018. Both point to the attainment of the fiscal goal for this year, though the real challenge in 2018 should be to trim the primary deficit as a proportion to GDP with respect to 2017.

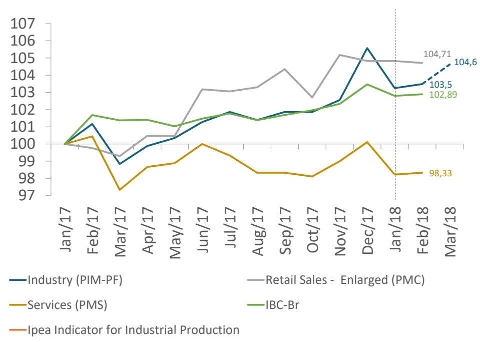
In the face of such a scenario, Ipea's macroeconomic forecasts for 2018 are mostly unaltered relative to January. GDP is expected to grow by 3%, with private consumption expanding 3.4% and investment increasing 4.5%. We estimate that government consumption is to remain stable, and that net exports are to decrease, as imports tend to grow faster than exports, by 7.5% and 6.2%, respectively. On the supply side, we expect industrial production to expand 3.6% this year and the services sector to grow 2.9%. They are expected to offset a 2.2% fall in agricultural production. Assuming that the next administration will engage in the pension's reform, we expect GDP to grow 3% once more in 2019.

1 Recent Data Analysis

Most economic activity indicators are displaying a clear recovery trend since the first quarter of 2017. Nevertheless, in the beginning of this year, there were signs of a deceleration. Although industrial production grew energetically in December, gaining 2.9% month on month, seasonally adjusted (momsa), it contracted strongly in January by 2.2% momsa. In February it has resumed growth but at a very slow pace (0.2%). These fluctuations notwithstanding, when compared to February 2017 the industrial production expanded 2.8% year over year (yoy), while manufacturing increased by 3.9% yoy. Due to the severity of the recession, there is still significant spare capacity: capacity utilization, measured by FGV, was at 74.7%, below the historic average of 80.4%.

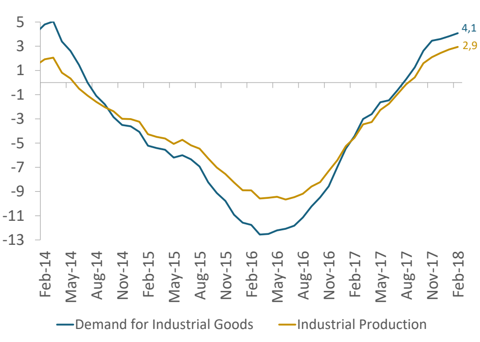
Consumer durables and capital goods led the expansion on an annual basis in February, with the former growing 15.6% yoy and the latter 7.7% yoy. Semi-durables output is on a slow growth trend, as its rate of increase decelerated to 1.6% while Intermediate goods and have trailed behind, with an expansion of 1.4%.

GRAPH 1
Selected Activity Indicators
(Seasonally Adjusted Index (Jan 2017 = 100))



Source: IBGE Ipea and Brazilian Central Bank.
Compilation: Ipea/DIMAC.

GRAPH 2
Demand for Industrial Goods versus Industrial Production
(12 Month Cumulative Growth Rates (%))



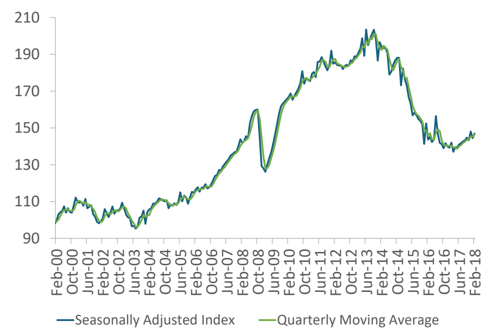
Source: Ipea and IBGE.
Compilation: Ipea/DIMAC.

The Ipea Indicator of Apparent Consumption of Industrial Goods reports better results than the production figures. In spite of a seasonally adjusted fallback in January and in February, this demand indicator registered a 4.5% growth when compared to February 2017 (Graph 2).

Aggregate investment expanded by 3.8% in the last quarter of 2017, the first annual increase after 14 consecutive contractions. On the seasonally adjusted quarter over quarter (qoq) basis, growth was positive since the second quarter of 2017, recording an increase of 2% last quarter.

On a monthly basis, Gross Fixed Capital Formation (GFCF) increased by 1.7% in February when compared to the previous month. This result partially reverses the decline of 2.4% in January. Considering the 3 month moving average, the period ending in February showed a 1.9% hike, when compared to the same period ending in November 2017. The machinery and equipment component of gross capital formation increased by 1.4% in this comparison, while construction rose by 1.2% – a positive development as this sector acted as a drag for investment performance over most of 2017.

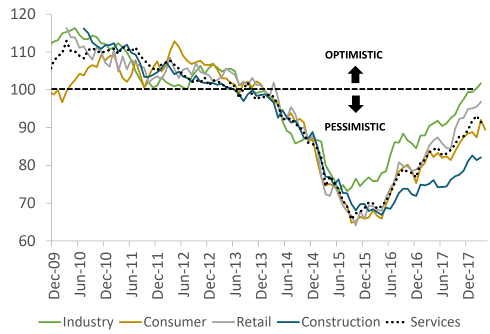
GRAPH 3
Monthly Ipea Indicator of GFCF
(Index 1995 = 100)



Source and Compilation: Ipea/DIMAC.

The recovery in output and investment is connected to an improvement in the business sentiment, as most confidence indicators improved. In spite of a small retreat in construction and consumer confidence numbers in February, the uprising trend is clear. In February, the indicator for industry broke the 100-points threshold for the first time since September 2013, denoting optimism (graph 4).

GRAPH 4
Confidence Indicators
(Index. Neutral = 100)



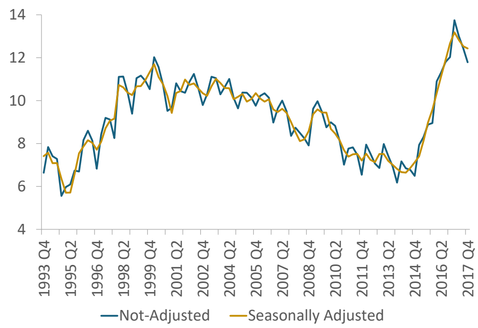
Source: IBRE/FGV.
Compilation: Ipea/DIMAC.

The retail sector confidence index is trailing the industry's one. Recent IBGE data show that retail sales volume decreased by 0.2% momsa in February, and expanded by 1.3% when compared to the same month in 2017.

Domestic consumption was the main propeller of growth in 2017, expanding by 1% over the year, even if contracting slightly in the fourth quarter. Nevertheless, it is expected that it will continue to be a source of growth this year. The explanation for last quarter's loss of impetus is the waning of the effects of the release of FGTS funds that happened earlier in the second and third quarters. Still, there are many elements that point to the acceleration of demand, like low inflation, decreasing interest rates, low household debt and the recovery of the labor market.

Employment has increased 2% in the moving quarter ended in February when compared to the same period of 2017. On the same basis, average income has grown 2.1% and the payroll value expanded 4.1%. The unemployment rate was 12.6%, 0.6 percentage points (p.p.) lower than a year earlier, and the participation rate increased by 0.2 p.p. in the same interval (Graph 5).

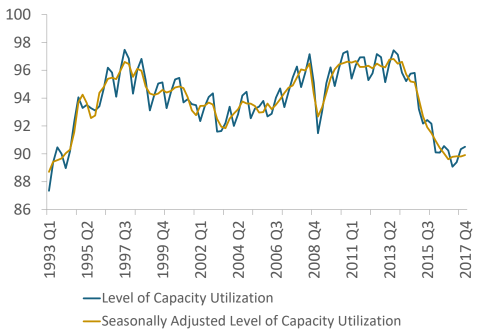
GRAPH 5
Chained Unemployment Rates - 1993–2017
(In, %)



Source: IBGE and IPEA.
Compilation: Ipea/DIMAC.

Household credit grew 2.9% yoy in February 2018. Yet, debt-to-income ratio is still falling, reaching 41% in January, from a high of 46.4% in April 2015. The debt service-to-income ratio has also decreased, to 19.9%, from 22% in mid-2016. In contrast, credit to businesses collapsed by 9.3%.

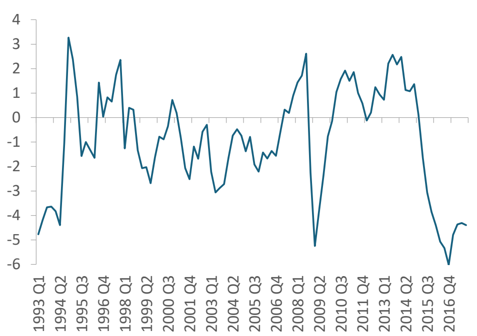
GRAPH 6
Ipea Indicator of the Capacity Utilization Level (Average) – (1993–2017)
(In, %)



Source and Compilation: Ipea/DIMAC.

Low inflationary expectations have been the backbone of the recovery, as shown by Central Bank's Focus weekly survey, which reveals expectations of a CPI inflation of 3.6% this year and 4.2% in the next. Hence, it is expected that interest rates will remain low along 2018. The ex-ante real interest rate in March was 2.4%, the lowest ever in a period of controlled inflation. These minor real interest rates are not expected to accelerate inflation for some time, as mentioned before, as there is considerable spare capacity (Graph 6). The Ipea Indicator for Output Gap suggests that effective GDP is 4.4% below the potential level (Graph 7).

GRAPH 7
Output Gap (%) – (1993-2007)
(In, %)



Source and Compilation: Ipea/DIMAC.

This positive scenario for inflation and interest rates also draws on favorable international conditions, as the world economy has been showing relatively strong growth and subdued inflation. IMF forecasts point to a 3.9% growth in 2018 and 2019, whereas international trade seems to have revived, with a 4,7% growth in volume in 2017, as compared to 2,6% in 2016. Forecasts point to a continuity of this pace in the coming years, but the recent decision by the US to impose tariffs on steel and aluminum imports threatens such a picture to the extent that it may evolve into a trade war.

Commodity prices have been high and, in the case of those related to energy and metals, on a rising path. This has positively affected the Brazilian trade balance, which recorded a surplus of US$ 18.6 billion in the first three months of the year, US$ 8 billion above the balance in the same period of 2017. Nonetheless, that surplus is expected to shrink, as exports' growth up to March of 7.8% per year is being surpassed by that of imports, which surged by 12.1%.

In the face of a still abundant global liquidity, capital flows to emerging markets tend to remain high. This fosters exchange rate stability and tends to boost domestic asset prices which in turn stimulate investment. Besides, FDI flows into Brazil totaled US$ 70,3 billion in 2017, and the Brazilian Central Bank forecasts, for 2018, a net inflow of US$ 80 billion.

To sum it up, in spite of a slowdown in economic activity in the last quarter of 2017 and first month of 2018, the general picture remains favorable. Obviously, electoral uncertainty weighs on the economy, particularly on investment decisions that could lead to an acceleration of growth. Underlying such uncertainty are the prospects of the reform agenda and its implementation under a new government, as it is generally agreed that they are crucial to put public finances back on a sustainable track, as well as to promote efficiency and increase productivity.

2 Macroeconomic Forecasts for 2018/2019

The perspectives for the Brazilian economy remain positive, although subject to uncertainty. The subdued reaction of the financial markets to the interruption of the Social Security reform in Congress seems to corroborate the impression that agents believe that: (i) structural fiscal reforms are going to be addressed in the medium term; and (ii) international markets will keep providing liquidity over the transition period until the reforms take effect.

If this is true and in the absence of further instabilities, it is expected that the economy will keep the recovery trend. It is expected that in the first quarter of 2018, GDP will grow by 1.9% yoy. When compared to the last quarter of 2017, Ipea forecasts a seasonally adjusted expansion of 1%.

On the supply side, this growth will result from a 2.6% increase in industrial production on a yearly basis (1.8% qoq, seasonally adjusted) and on a hike of 2.4% in services (0.8% qoq). These expansions are expected to offset a projected slump in Agricultural production of 7.1% and 2.6%, respectively.

On the demand side, household consumption is expected to increase by 3.4% in comparison to the first quarter of 2017 and aggregate investment is to grow 4.3% on the same basis. Notwithstanding, Government consumption (-0.4%) and net exports are expected to fall.

For the remainder of the year, the outlook points to continued growth of the private consumption and investment, leading to 3.4% and 4.5% growth rates, respectively, for the year as a whole. Considering this, the GDP is expected to grow 3% in 2018. On the supply side, industry (3.6%) and services (2,9%) growth are forecasted to offset the plunge in agriculture (-2,2%).

For 2019, the basic assumption is that the next administration will carry on with the fiscal and pensions reforms, in order to ensure the sustainability of public finances. Assuming this, we expect the Brazilian GDP to increase by an additional 3%. Differently from forecasts for 2018, though, growth in 2019 is expected to be more widespread across sectors than this year's.

Projections for 2018 indicate that the Brazilian GDP will remain below potential output by the end of 2018. The output gap is expected to be close to zero in 2019, albeit this entails some uncertainty.

TABLE 1
Forecasts: GDP and Its Components Growth
(%)

	Actual			Forecast			
				2018-Q1			
	2015	2016	2017	Previous Year.	Quarter, Seasonally Adjusted.(*)	2018	2019
GDP (var.% on previous period)	**-3,5**	**-3,5**	**1,0**	**1,9**	**1,0**	**3,0**	**3,0**
PIB - Industry (var.% on previous period)	-5,8	-4,0	0,0	2,6	1,8	3,6	3,1
PIB - Services (var.% on previous period)	-2,7	-2,6	0,3	2,4	0,8	2,9	3,0
PIB - Agriculture (var.% on previous period)	3,3	-4,3	13,0	-7,1	-2,6	-2,2	3,5
Consumption - Households (var.% on previous period)	-3,2	-4,3	1,0	3,4	1,0	3,4	2,8
Consumption - Government (var.% on previous period)	-1,4	-0,1	-0,6	-0,4	-0,2	0,0	0,5
GFCF (var.% on previous period)	-13,9	-10,3	-1,8	4,3	0,1	4,5	6,0
Exports (var.% on previous period)	6,8	1,9	5,2	6,5	3,5	6,2	5,8
Imports (var.% on previous period)	-14,2	-10,2	5,0	7,9	2,4	7,5	5,5

Note: *First Release of Seasonally Adjusted Series.
Source: IBGE and Ipea.
Compilation: Ipea/DIMAC.

TABLE 2
Forecasts: Selected Macroeconomic Variables
(%)

	Actual		Forecast	
	2016	2017	2018	2019
Inflation - IPCA (%)	6,29	2,95	3,60	4,25
SELIC Interest Rate (% p.a. - End of period)	13,75	7,00	6,25	7,00
Exchange rate R$/US$ (End of period)	3,26	3,29	3,40	3,45

Source: IBGE and Ipea.
Compilation: Ipea/DIMAC

Institute for Applied Economic Research (Ipea)

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