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Ipea Economic Outlook

José Ronaldo de Castro Souza Júnior
Director of Macroeconomic Studies at Ipea.

ronaldo.souza@ipea.gov.br

Paulo Mansur Levy
Researcher at the Directorate for Macroeconomic Studies (Dimac) at Ipea.

paulo.levy@ipea.gov.br

Marco Antônio F. de H. Cavalcanti
Deputy Director of Macroeconomic Studies at Ipea.

marco.cavalcanti@ipea.gov.br

Christian Vonbun
Researcher at the Directorate for Macroeconomic Studies (Dimac) at Ipea.

christian.vonbun@ipea.gov.br

Summary

The performance of the Brazilian economy in the third quarter of 2018 was affected by an increasing instability in the financial markets, combined with a sluggish recovery in economic activity. The forecast of GDP growth accelerated to 1.1% qoqsa, but it must be taken into account that it happened immediately after a severe supply shock due to the truck drivers' strike, making the basis of comparison a weak one.

The increasing instability is due to several domestic and external motives. On the external front, the economic landscape is becoming less favorable to emerging economies, mainly due to United States' monetary policy normalization, as well as to devaluation episodes in Argentina and Turkey, increasing the perception of risk in the international markets.

On the domestic front, electoral uncertainties and the deeply unbalanced fiscal stance is spurring heightened risk premia and stark financial conditions. This is negatively affecting consumption and investment decisions by economic agents.

The modest economic growth expectation for 2018, which IPEA forecasts at 1.6%, and the high macroeconomic volatility are both rooted in the very same structural fragilities: stalled productivity and fiscal imbalances.

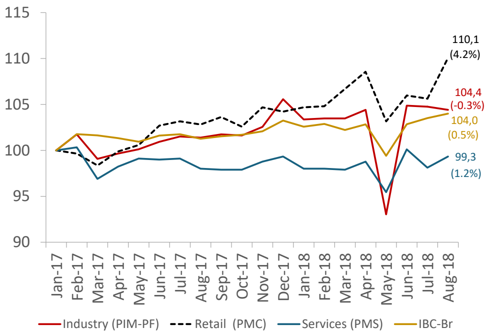
In the short term, the adverse effect of the slow productivity growth upon trend output growth rates tends to be compensated by the high spare capacity in the economy as a whole, as the output gap is estimated to still be at 3.7%. Thus, there is still room for an economic rebound in the near future, without inflationary pressures.

Nevertheless, the fiscal imbalance is leading the public debt into an unsustainable growth path, generating uncertainties that increase financial risks and undermine consumption and investment. This is, by far, the most important risk factor affecting the economy.

1 Recent Trend Analysis

The fact that the real GDP is still 6% lower than the pre-crisis level and that the unemployment rate remains very high, around 12.5%, contributes to a widespread perception that the economy is stagnant. This fact is reinforced by the falling growth forecasts for 2018, which shrank from 2.7% as of the end of 2017 to 1.4% last September.

GRAPH 1
Selected Indicators of Economic Activity (Jan./ 2017-Ago./2018)
(Seasonally Adjusted, base: Jan./2017 = 100)



Source: IBGE, Banco Central do Brasil (BCB) and Ipea.

The industrial production fell in 0.3% momsa in August, but increased by 2% yoy. The year to date growth up to August is 2.5%. The best performances came from the capital and durables goods sectors (9% and 13.8% growth, respectively). After a poor performancein July, both showed expansion on the margin in August (5.3% and 1.2% respectively), reflecting the macroeconomic instabilities that affect investment and consumption.

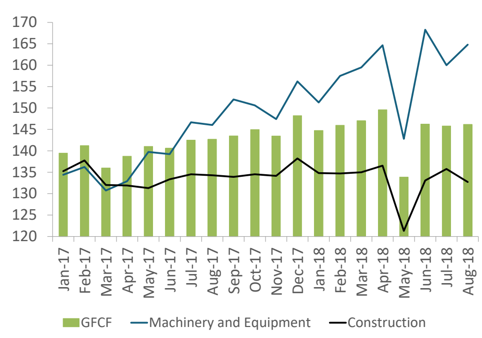
The recovery from the truckers' strike in May led Ipea's Fixed Capital Formation Index to grow in June (9.2%). Since then, the indicator has shown some small fluctuations during the following two periods (-0.3% and +0.3%, respectively).

The services sector activity increased in August (1.2% momsa and 1.5% yoy). Despite this, the sector is not on a recovery track yet, being mostly flat in the post-recession period.

The labor market is also in a lethargic recovery path, and even though employment has been growing, the unemployment rate remains very high, above 12% and almost double the pre-crisis level.

Considering all sectors, the fact is that the recovery lost steam since the beginning of this year, although there are signs of a dismal GDP growth. The three-month period from May to July 2018 has shown a decrease of the unemployment rate of 0.5 percentage point, when compared to the same period of 2017. This reflects a 1.1% increase in the occupation rate and a decrease in the participation rate, from 61.7% to 61.5% in that period. According to the PNAD/IBGE survey, most of the increased occupation is taking place in the informal sector. Also

GRAPH 2
Ipea Monthly Indicator of GFCF and its components
(Indexes 1995 = 100, Seasonally Adjusted)



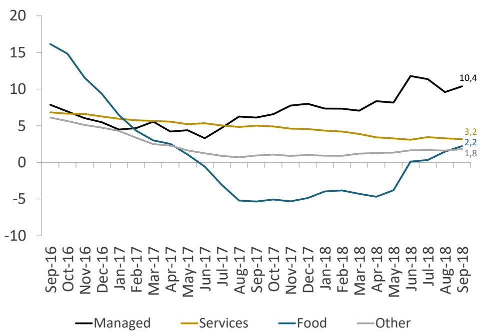
Source: DIMAC/Ipea.

corroborating the weak recovery, the rate of discouraged workers over this period also increased, from 2.4% to 2.8%.

Real income in the second quarter improved by 0.8% on a yearly basis, a clear deceleration from the 2.7% growth seen in the year 2017 as a whole.

Inflation remains tame, in spite of the exogenous shocks from the truck drivers' strike and from the exchange rate depreciation. Most of the effects of the strike, especially on foodstuff prices, proved to be temporary and have already reversed. Nevertheless, the devaluation of 32% of the exchange rate is being felt strongly in wholesale prices, which accelerated sharply. By the end of 2017, industrial and agricultural wholesale prices' annual change were 1.2% and -12.3%, respectively. In August 2018, they accelerated to 11.6% and 13%. The impact of those changes are expected to gradually affect inflation of consumer prices (Graph 3).

GRAPH 3
CPI Inflation: IPCA by category
(Growth rates cumulative in 12 months, %)



Source: IBGE.

Nonetheless, expectations, as per Central Bank's weekly survey, are that consumers' inflation rate will remain under control to the extent that the passthrough is slowed down by the still high levels of spare capacity, as shown by Ipea's indicator of economy's capacity utilization (Graph 4).

Two main factors have contributed to the economy's loss of steam: tighter international financial conditions – mostly due to the rate hikes in the U.S. and capital outflows from emerging markets – and falling confidence levels.

Regarding the first factor, Brazil's risk was affected by a global increase in risk perception due, among other things, to heightened trade disputes between U.S. and China and by the crises in Argentina and Turkey. Domestically, issues related to the uncertainties of reforms, and their impact on public finance and public debt trajectory, also played a role. The CDS increased from 150 b.p. to 300 b.p. from April to August. Ipea estimates that 40% of this increase is due to idiosyncratic factors.

2 The Fiscal Stance

Brazil is on a 'Fiscal Trap' and this fact is a determinant cause of the drag that is dampening the economic recovery. The fiscal balance plunged from a surplus 2.9% of GDP in 2011 to a 2.5% deficit in 2016. The general government gross debt soared from 51.3% of GDP in 2013 to 77.3% of GDP last August.

In the end of 2016, the Congress passed a Constitutional Bill (EC95) to limit the growth of the federal government expenditures to the previous year inflation. However, the budget includes major categories of mandatory expenditures, like social security transfers or the government's payroll, whose growth is determined by predetermined rules (as in the case of previously negotiated wage increases, or the volume of subsidies, which depends on the behavior of market interest rates) or by an exogenous dynamics (like demographic trends in the case of the number of people entitled to social security benefits). That limits the scope for expenditure control as the effort falls upon an ever smaller share of discretionary expenditures whose cuts threaten the very functioning of the government eventually leading to a shutdown. Thus, there will be increasing difficulties to control expenditures in order to meet the ceiling and reverse the current trend of public debt rapid growth.

It is important to have in mind that the approval of the expenditure ceiling law has had an important positive impact on expectations which helped to spur confidence and thus economic recovery from recession. Currently, the expenditure ceiling law is the only anchor regarding expectations of the debt trajectory, its abandonment should be seen with extreme caution. Instead, as it was clear from the beginning, its maintenance requires further measures, above all a Social Security reform.

Simulations of this gradualist fiscal consolidation show that only in 2023 the primary fiscal budget would swing back into positive territory and that only a year later would the debt-to-GDP ratio begin to shrink from its peak, above 80% of GDP. When the expenditure ceiling comes under attack, it is important to have in mind that such a gradualist approach avoids heavy tax hikes or abrupt expenditures cuts. In that sense, it contrasts with those fiscal consolidation processes implemented in several European countries between 2012-2015 which entailed sharp tax increases and expenditure cuts. However, a gradualist approach alsohas its risks, as it depends on the maintenance of fiscal credibility for long periods.

Continuous fiscal adjustment remains the main challenge for the next government and one that holds a decisive weight upon the Brazilian economy's recovery path in the next years.

3 Macroeconomic Forecasts

Economic recovery, which has been slower than expected, was dampened in the second quarter by a truck drivers' strike that caused a significant negative supply shock to the economy, leading to price increases and production losses.

Nevertheless, available indicators for the third quarter suggest that those effects were temporary and that the economy is returning to its previous recovery path. In addition, we forecast that the inflation rate will remain under control for the rest of the year.

We also forecast a relatively strong GDP growth in the third quarter, both in seasonally adjusted terms (1.1% over the second quarter) and in annual terms

(1.8%). The former reflects the rebound from the strike as the basis of comparison was artificially depressed.

On the supply side, all sectors are expected to raise activity: industry is expected to expand by 2.1% qoqsa, services are expected to grow by 0.9% and agriculture by 1.1%. In annual terms, those figures are 2.4%, 1.5% and 2.5%, respectively.

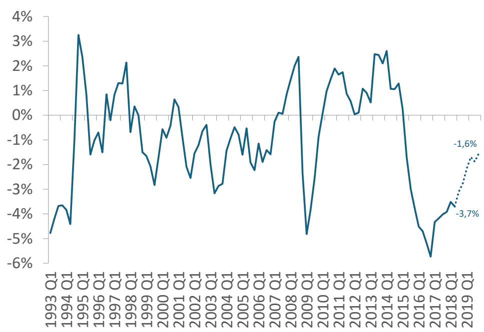
On the expenditure side, almost all components should also grow. The exception is the government spending, which expected to decline 0.1% yoy and 0,4% qoqsa. Household consumption is forecast to expand by 1.2% yoy and 0.8% qoq; aggregate investment should increase by 2.9% yoy and 2.1% qoq; exports are expected to soar by 8.2% yoy and 13.5% qoq and imports 11% yoy and 10.4% qoq.

The recovery pace will not be stronger due to the uncertainties surrounding the country and the all-important structural budget imbalance. It is also necessary to implement regulatory reforms in order to enable capital investment in infrastructure projects.

After the electoral process, it is expected that those uncertainties will fade – as the new government will announce its team and measures – which could re-start the cyclical recovery. Ipea forecasts the GDP growth in 2018 to be 1.6% and 2.8% in 2019.

Graph 4 indicates that even with a stronger growth there should not be any significant inflationary pressure in 2019. Nevertheless, the output gap is expected to shrink steadily along next year, thus limiting the space for the maintenance of low interest rates. Besides, the severe depreciation of the Brazilian currency that took place recently may spur some inflationary effects this year and the next. This shall lead the Central Bank to increase the interest rates, expected to end 2019 at 8% p.a. The expected inflation for 2019 is 4%. In 2020 and in 2021 inflation is expected to converge to the new target, attaining 4% in 2020 and 3.75% in 2021.

GRAPH 4
Output Gap (1993 – 2018T2) and forecast up to 2019
(%)



Source: Ipea.

Obviously, those forecasts depend on the fiscal stance, the resumption of reforms' debates in Congress and on the international environment, which is expected to provide adequate liquidity while the reforms are yet taking place.

TABLE 1
Forecasts: GDP growth rates and its components
(%)

	Actual		Forecast	
	2016	2017	2018	2019
Consumer Inflation - IPCA (% p.a.)	6,3	3,0	4,2	4,2
SELIC Interest Rates (% p.a. end of period)	13,8	7,0	6,5	8,0
Exchange Rate R$/US$ (end of period)	3,3	3,3	4,0	3,8

Source: Ipea.

TABLE 2
Forecasts: Selected Macroeconomic variables
(Em %)

	Actual				Forecast			
	2016	2017	2018-Q1	2018-Q2	2018-Q3		2018	2019
			YOY	YOY	YOY	qoq		
GDP	-3,5	1	1,2	1	1,8	1,1	1,6	2,9
Industry	-4	0	1,6	1,2	2,4	2,1	1,8	2,8
Services	-2,6	0,3	1,5	1,2	1,5	0,9	1,6	2,9
Agriculture	-4,3	13	-2,6	-0,4	2,5	1,1	-0,5	3,6
Household Consumption	-4,3	1	2,8	1,7	1,2	0,8	2	3
Government Consuption	-0,1	-0,6	-0,8	0,1	-0,1	-0,4	-0,2	0,5
GFCF	-10,3	-1,8	3,5	3,7	2,9	2,1	3,3	4,6
Exports	1,9	5,2	6	-2,9	8,2	13,5	4,2	6
Imports	-10,2	5	7,7	6,8	11	10,4	8,5	6,8

Source: Ipea.

Grupo de Conjuntura

Equipe Técnica:

Christian Vonbun
Estêvão Kopschitz Xavier Bastos
Leonardo Mello de Carvalho
Marcelo Nonnenberg
Maria Andréia Parente Lameiras
Mônica Mora Y Araujo de Couto e Silva Pessoa
Paulo Mansur Levy
Vinicius dos Santos Cerqueira
Sandro Sacchet de Carvalho

Equipe de Assistentes:

Ana Cecília Kreter
Augusto Lopes dos Santos Borges
Felipe dos Santos Martins
Felipe Simplicio Ferreira
Janine Pessanha de Carvalho
Leonardo Simão Lago Alvite
Matheus Rabelo de Souza
Monyk Brites Alves Cardoso
Pedro Mendes Garcia
Renata Santos de Mello Franco
Victor Henrique Farias Mamede