What to expect next year

IBRE staff and experts from various sectors of the Brazilian economy see a year clouded by uncertainties.

Solange Monteiro *and*
Claudio Accioli, *Rio de Janeiro*

IN DECEMBER 2011, most of the analysts interviewed by *The Brazilian Economy* did not hesitate to say that 2012 would be similar to 2011—that is, somewhat predictable and uneventful. And, in fact, there was no *major* turbulence in the domestic economy in 2012. But the year now ending did produce at least two surprises. The first is that estimates of gross domestic product (GDP) growth have been heading steadily downward and it is expected to hit only 1%—just a third of what even the most conservative projections expected early in the year. The second is the fact that economic activity has not responded to any of the government's efforts at stimulus, including investment packages, sectoral tax exemptions, and an unprecedented reduction in the central bank policy interest rate.

To try to cure the economic anemia, earlier this month the government ended the year as it began, by announcing yet another tax exemption initiative, this one for the construction industry, and a new US$50 billion package to stimulate investments. However, with inflation close to the official target ceiling (between 2.5 and 6.5), gross investment having declined for five consecutive quarters, and a very uncertain external environment, projecting scenarios for 2013 is a highly risky business.

IBRE BASELINE SCENARIO

The Brazilian Institute of Economics of the Getulio Vargas Foundation (IBRE-FGV) announced its scenarios during a recent seminar on Perspectives for the Brazilian Economy in 2013. Speakers were economists Regis Bonelli, Silvia Matos,

and Samuel Pessoa, all from IBRE; José Júlio Senna, managing partner of MCM Consultants and member of the FGV Board, and Affonso Celso Pastore, former governor of the Central Bank.

With regard to growth, the most sensitive point for current economic policy, the assessment of IBRE researchers is that, although the second half of 2012 performed slightly better than the first—despite the disappointing GDP results of only 0.6% for the third quarter—the recovery of economic activity is not enough to ensure growth of more than 1% for this year. For 2013, the forecast is 3.2% growth. Thus average growth in the first three years of President Dilma Rousseff's term would be 2.3%. "It's a significant drop compared to the eight years of President Lula, whose average was 4%. Of course the world is also growing less, but there is evidence that domestic factors have been more important in explaining the slowdown," said Silvia Matos, coordinator of the IBRE *Economic Outlook*.

Among those domestic factors is the plunge in gross investment, which should end the year with a cumulative decline of 3%. "This is a key variable that is very worrisome, because it puts at risk the country's growth potential not only in 2013 but also beyond," Matos said. For the next year, given the reduced real interest rate and other favorable factors, the IBRE researchers project a recovery in gross investment of 8.6%, but the risks to this projection are significant.

Given the projections for this year and next, the comparison again looks bad for the current administration compared to the previous one: average annual growth in gross investment would reach 3.4% for the Rousseff administration, compared to 8.9% in Lula's administration. "This difference is crucial to explain the deceleration of growth in Brazil," according to Matos.

Taking into account factors like productivity, hours worked, and capital stock used by the economy, IBRE researchers estimate potential 2013 GDP growth (growth capacity without increasing inflation) of 3.0% to 3.5%, primarily due to the lower rates of investment

Brazil
IBRE baseline scenario. 2009-2013

	2009	2010	2011	2012 Proj.	2013 Proj.
Real GDP growth (% change)	-0.3	7.5	2.7	0.9	2.9
Inflation (% change)	4.3	5.9	6.5	5.6	5.7
Central Bank policy rate (end-period, %)	8.75	10.75	11.00	7.25	7.25
Exchange rate (average, reais per U.S. dollar)	2.0	1.8	1.7	1.9	2.1
Budget primary surplus (% of GDP) 1/	2.1	1.9	3.2	2.3	2.6
External current account balance (% of GDP)	-1.5	-2.3	-2.1	-2.2	-2.5
Trade balance (US$ billions)	25	20	30	18	16
Export (US$ billions)	153	202	256	244	268

Source: Brazilian Institute of Geography and Statistics. Central Bank of Brazil. IBRE staff projections.

1/ Excludes interest payments on public debt

Economic activity has not responded to any of the government's efforts at stimulus, including investment packages, sectoral tax exemptions, and an unprecedented reduction in the central bank policy interest rate.

and productivity observed during the current administration compared to its predecessor. "We have lived in a very different period since the onset of the global crisis. It seems difficult to achieve the much-desired growth rate of 4% or 4.5%," said Matos.

IBRE researchers estimate that inflation was 5.4% for 2012 and will be 5.7% in 2013—less than in 2011, which hit the target ceiling (6.5%) but still far from the target mid-point of 4.5%. In 2012, the main factors contributing to inflation were the service sector, at 8.2%, and food inflation, at 9.1%; in 2013, the first of these is projected to go up slightly, to 8.5%, and the latter to drop to 6.5%. Despite the expected decline due to a positive external supply shock, Matos emphasized that food inflation will still be high enough to make it hard to bring headline inflation to the 4.5% mid-point target. Also, administered prices were not raised in 2012 because it

was a local elections year, and some prices, like that of gasoline, will be adjusted. Matos emphasized that "Projections for 2013 are a worrying combination of lower growth and higher inflation."

Despite the risk of higher inflation, Matos believes that the central bank will use macroprudential measures to curb inflation, holding its policy interest rate at the current 7.25% a year. "In a way, the central bank is accepting higher inflation as long as it does not exceed the target ceiling [6.5%]," Matos observed. "If there is a stronger recovery of the world and the Brazilian economies, it will certainly be necessary to adjust the policy rate. But as this is not likely, inflation is expected to remain reasonably controlled in 2013, making it unnecessary to tighten monetary policy."

Another important variable to contain inflation of tradable goods, according to Matos, is the exchange rate: "If the exchange rate had appreciated freely, without central bank intervention, the negative effects on domestic inflation from external shock would have been mitigated." IBRE researchers project an exchange rate at 2 reais per U.S. dollar by the end of 2013.

PUBLIC BUDGET

Missing the budget primary surplus target (budget balance excluding interest payments) of 3.2% of GDP was not surprising, but the result of only 2.3% was certainly disappointing. IBRE projects a primary surplus of 2.6% of GDP for 2013. The shrinking surplus is mainly due to the combination of the steep drop in tax revenue, whose real growth fell from

> **"[Investment growth] is a key variable that is very worrisome, because it puts at risk the country's growth potential not only in 2013 but also beyond."**
>
> *Silvia Matos*

12.2% in January-September 2011 to 1.5% in January-September 2012, and public spending, which for the same period rose from 3% in 2011 to 6.2%.

Revenues shrank not only because of the economic downturn but also because of the tax exemptions the government granted to revive the economy. The increase in spending, according to Matos, was mostly due to the rise in the minimum wage. "The main thing is the quality of the surplus," she noted. "This year, the federal government contributed 1.5% of GDP to the total primary budget surplus, and regional governments, because of the elections, contributed less. Next year, we expect regional governments will contribute 1% and the federal government 1.6%. Once again, it is unlikely that the government will meet its primary surplus target. However, if the 2.6% is achieved in a context of increased investment, it will not be so bad."

EXTERNAL SECTOR

IBRE researchers estimate a trade balance of US$19 billion for 2012 and US$16 billion for 2013: notably below the US$30

billion recorded in 2011. The value of exports contracted slightly, from US$256 billion in 2011 to US$245 billion in 2012, while imports held steady at US$226 billion—which may indicate a retraction of investments.

"Imports depend on the exchange rate and the strength of the economy, for which investment is vital," Matos explained. An appreciated exchange rate encourages imports of machinery and equipment, which would be beneficial for the Brazilian economy. However, the current depreciated exchange rate does not encourage imports of machinery and equipment, although it does help to improve industry's export competitiveness. IBRE researchers estimate that the current account deficit for 2012 will be 2.2% of GDP, almost the same as in 2011, and in 2013 will go up slightly to 2.6%.

The current depreciated exchange rate does not encourage imports of machinery and equipment, although it does help to improve industry's export competitiveness.

What is expected in agriculture, industry, trade, construction, and energy sectors of the Brazilian economy is forecast separately in the articles that follow.