IBRE Outlook 2010

THE BEST PERFORMANCE OF THE DECADE

Liliana Lavoratti, from Rio de Janeiro

After a near miss by the storm that triggered the recent major global recession, Brazil has everything in place to return to the growth path it embarked on at the turn of the millennium. In 2010, after nine years of progressively better gross domestic product (GDP), GDP growth will achieve 6% — the best performance of the decade. The only deviation from the growth path was 2009, when growth decreased slightly by about 0.47%.

However favorable this scenario, though, the country will have to deal with risks from the side effects of the economic stimulus that was used to vaccinate us from the global financial contagion. The government's expansionary fiscal and monetary policies — the increase in government consumption and the reduction of interest rates — together with the resumption of investment and the prospect of presidential elections next October, raise the possibility that rapid growth will have an unwelcome companion: high inflation, and with it the rollback of the lowest interest rate in Brazil's history (an annualized 8.75% last December).

"We are beginning to reap the fruits of 16 years of stable government led by Fernando Henrique Cardoso and Luiz Inácio Lula da Silva. This favors sustainable growth. A step back now would have a very high cost for all Brazilians," says Fernando de Holanda Barbosa Filho, a researcher at the Center for Economic Growth of the Brazilian Institute of Economics of Getulio Vargas Foundation (IBRE-FGV) in Rio de Janeiro.

Brazil is returning to the levels of GDP it had reached before the global crisis but no one knows how far it can grow without inflation again threatening. "The uncertainty around the potential growth of the economy at this stage leaves some questions unanswered as this year begins," says the economist Samuel Pessôa, coordinator of the IBRE Center for Economic Development. Forecasting how the strength of economic activity will affect prices, he says, is the real art of monetary policy in a country that has only had reliable data on economic indicators for a relatively short time, since the

economic stabilization in 1994.

It is particularly difficult to predict the trajectory of interest rates and the primary surplus of the public sector in an election year. In October voters will choose not only the president, but also senators, congressmen, and state governors. Would the government have the courage to raise the interest policy rate back to 13.75%, as in January 2009? "The Central Bank's position in trying to anticipate the market is at the very least delicate," says Pessôa. In an election year it is easier to justify increasing the interest rate once there are clear signs of increasing inflation, rather than increasing rates preemptively. In the opinion of Salomão Quadros, head of price studies for IBRE, Brazil's economy can grow 6% in 2010 without missing the 4.5% official inflation target.

Revenue and expenses

The government has stated several times that it does not intend to expand the tax incentives granted to the economy last year to heat up the domestic market and diminish the effects of the global crisis on Brazil. But it has signaled it will not remove the tax incentives until the time is right. That clouds the future of the primary surplus — revenues less expenditure, excluding the payment of interest on debt.

The primary surplus was 3.92% of GDP in 2007 and 4.07% in 2008. The Central Bank estimates that the consolidated public sector closed 2009 with a primary surplus of 2.5% — excluding 0.5% of GDP in public investment in the Acceleration Growth Program (PAC) and Pilot Program Investment (PPI). The Finance Minister Guido Mantega is confident that the government does not need to use investment exclusions to achieve a primary surplus of 3.3% of GDP in 2010.

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	Weights	12-month change		
		2008	2009	2010
Headline official inflation (IPCA)	100%	5,9	4,3	4,5
Food	20%	11,12	3,29	4,5
Consumer goods	25%	4,26	2,72	3,5
Services	25%	6,38	6,42	6,5
Utilities	30%	3,28	4,51	3,5

Sources: Brazilian Institute of Geography and Statistics (IBGE) and IBRE-FGV.

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For Pessôa, it is not yet clear whether the fall in revenue in 2009 is a purely cyclical phenomenon resulting from the tax cuts to support domestic demand, or whether there is a permanent decline in revenues. Will the resumption of growth bring tax revenues back to the levels of 2007 and 2008? "There are many open questions," he says.

The specialist in public finance, Amir Kahir, believes the federal government's loss of revenue in 2009 must have reduced the tax-to-GDP ratio to 34.5%, compared to 35.8% in 2008 and 37.3% in 2007.

It remains to be seen whether the primary surplus of 3.3% of GDP can be reached without major sacrifices. "Most likely the task of building a bigger primary surplus in 2011 will be left to the next government. It is less difficult for a government to face this kind of problem at the beginning of its term than at the end," says Barbosa Filho. The next president may be helped by the minimum wage policy that will see the end in 2011 of consecutive years of increases in the minimum wage above inflation; thereafter increases will simply replace inflation. "Without doubt, this rule will support the new government's program of fiscal adjustment," he added. In recent years, according to the Ministry of Finance, the increase in recurrent spending (salaries of civil servants and income transfers) raised total central government spending from 15.71% of GDP in 2002 to 18.72% in 2009.

We must pay attention to what happens from now on, Barbosa Filho observes. The latest Central Bank projections are that net public debt increased from 39.1% of GDP in 2008 to 43% in 2009 but should fall to 41% in 2010. At the same time, the consolidated public sector nominal deficit (including interest payments) was 4.14% of GDP in the 12 months to November 2009. This nominal deficit — double the 2008 deficit — makes the government's claim that it will reach the end of 2010 with a zero nominal deficit something of a stretch. That would mean taking in enough revenues to pay for all public expenditure, including interest payments. Barbosa Filho thinks that "much of the increase in spending came to stay, such as wage increases, assistance benefits, and the public works of the PAC."

Engines of growth

GDP growth of around 6% in 2010 will continue to be fueled by public and private consumption but from now on will also count heavily on larger investments. "A panoramic look indicates that the industry will continue to react well, as will trade," says IBRE economic researcher Regis Bonelli. "Data from the third quarter of 2009 compared with the previous quarter show positive developments in both production and final demand, except for agriculture." He says that uninterrupted future growth also depends on permanent recovery of investment, which has been becoming stronger since the last quarter of 2009, according to IBRE statistical models. The decrease in real interest rates and the firming

up of the intermediate and capital goods sectors will push industrial capacity utilization to about 86%, which is above its historical average. In November it had already reached 83%, the average for the last ten years.

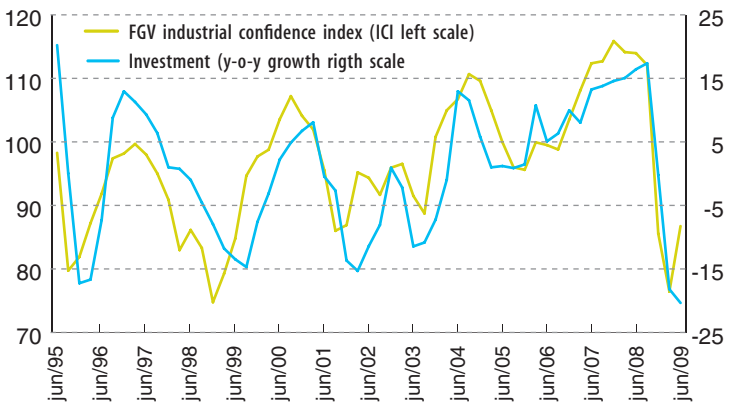
According to the coordinator of the IBRE Center of Methodology and Solutions, Silvia Maria Matos, the investment-to-GDP ratio will return to the 2008 level of about 19% of GDP by the end of 2010. If that is to happen, investment growth will have to be 15% to 20% in 2010 — higher than the 13.4% in 2008. Even if companies recently restarted projects postponed at the beginning of the crisis, investments in 2009 will be about 10% less than in 2008. "Even with all the progress expected, investments will still be below what is considered ideal to support solid accelerated growth," Matos points out. For an economy like Brazil, investments should be about 22% of GDP. Matos adds that both investment and GDP growth rates in 2010 will be distorted because the low 2009 base of comparison tends to magnify growth rates.

IBRE is forecasting that investments in manufacturing should soar, with growth of 8.3% this year compared with 5.1% for agriculture and 5.9% for services. In December the FGV

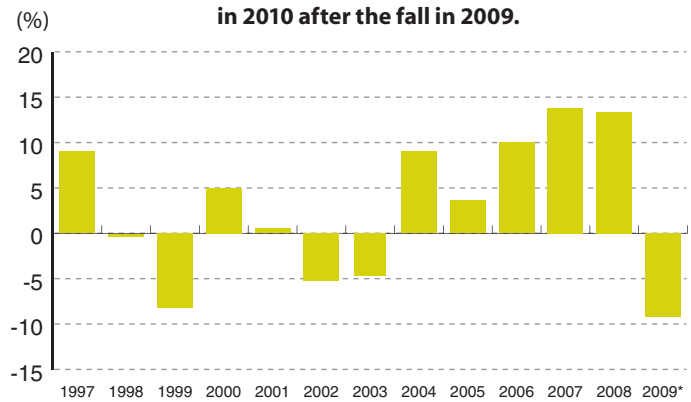
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The latest FGV survey shows industrial businesses are more optimistic about the coming months...



... as a result investments in manufacturing should soar in 2010 after the fall in 2009.



Sources: IBGE and IBRE-FGV . * Estimate

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Confidence Index of Industry (ICI, seasonally adjusted data) grew 3.5% — a return to pre-crisis levels. "Industrial businessmen are more optimistic about the coming months," says Jorge Ferreira Braga, head of economic cycles for IBRE. Of 1,110 companies surveyed, 46.9% said they had plans to expand between December and February, only a 2.8% reduction from the previous year. Another positive finding is that utilization of installed capacity in December had its ninth consecutive increase, highlighting the progress in the second half of 2009 from 79.9% in July to 83.8% in December. At same time, utilization in the capital goods sector increased from 77.9% to 80.9%.

Household consumption completes the positive outlook of the economy for 2010. Low unemployment and more formal jobs will expand salaries and thus incomes. From January to October last year 1.2 million new jobs were created – 2.1 million less than in the same period of 2008 but nevertheless a good sign given the global economy. "The fast recovery of formal employment means sustained income and ultimately economic growth," Bonelli says. He adds that part of the consumption increase is related to income transfers from the federal government.

According to the Central Bank this process will also be encouraged by a 20% expansion in credit this year, well above the 16% in 2009. Thus, total credit should increase to 48% of GDP in 2010, compared to 45.3% in 2009 and 41.1% in 2008. Increased credit, domestic and external, will have a positive effect on, for example, vehicle production, which is expected to rise 11% above last year, reaching 3.5 million units.

In this favorable moment, nobody is talking about structural reforms. "The adjustments to improve the current model and help make development sustainable will not depend on half a dozen cautious economists but on the political process," says Samuel Pessôa. "Voters do not vote for 15 or 20 years in the future. They vote for now." For him, tax, Social Security and labor law reforms will come only when the Brazilian state can no longer afford all its commitments.

As the last issue of *The Brazilian Economy* emphasized, low domestic savings, public and private, mean that foreign savings will be required to finance investments. The external current account deficit is expected to rise from 1.3% of GDP in 2009 to 2%. As long as Brazil remains a safe haven for investors' profits, foreign capital will continue to offset external current account deficits.

"The current model, resulting from 16 years of stability, is creating the conditions for Brazil to grow at 6% a year," notes Barbosa Filho. "With structural reforms, our potential could skyrocket. But among the presidential candidates there is no one who would be prepared to make changes of the necessary magnitude."