Recession and recovery: The worst of the crisis

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That the credit crunch and loss of confidence triggered by the financial crisis in the United States have precipitated a recession in the Brazilian economy is officially confirmed by data published by FGV. Because GDP fell so steeply in the last quarter of 2008 and the first quarter of 2009, the economy's performance for the year has been compromised—growth will probably be negative by about 1%. Unlike the United States, Europe, and Japan, where recovery is not in sight, however, in Brazil the most recent indicators point to a clear economic recovery from the contraction on the supply side that started at the end of September 2008. The worst consequence of the crisis was not the cyclical fall in GDP and higher unemployment; it was the interruption of a process of rising growth of the Brazilian economy over the course of the past few years. The fall of potential GDP has major consequences for recovery and the eventual resumption of growth.

First, it is important to remember that it is too early to be optimistic about the recovery of economic activity. The recovery is so far more vigorous in sectors supported by the government's fiscal policy, particularly the automotive industry and some other durable consumer goods and construction segments. Thus, fiscal measures prevented the worst and are supporting the recovery. However, it was the contraction of domestic credit in the banking system, nervous about the global confidence crisis triggered by the bankruptcy of Lehman Brothers, that brought about the supply side contraction that started at the end of September 2008. Had the Central Bank reacted swiftly, with more daring interest rate cuts and an injection of liquidity into the system, the domestic crisis might have been milder. The consequences of the crisis on the demand side have recently been reflected in the drop in exports, particularly of manufactured goods.

Because of the elevated interest rates and the appreciation of the exchange rate, the most adequate response to the crisis would have been a more vigorous and faster Central Bank response — particularly because at that point inflationary pressure had disappeared completely and the appreciation of the exchange rate was creating an explosive increase in the current account deficit. That is why the excessive expansion of demand should have been controlled by fiscal policy, with cuts in public spending, not by a monetary policy of increased interest rates, which worsened the deficit in current transactions and the appreciation of the exchange rate.

Risk to the future — The government has resorted to fiscal policy to avoid the worst, and it is precisely this policy that is responsible for promoting the economic recovery. The most important aspect is that an abrupt contraction of credit has led to a substantial drop in investment, which will jeopardize growth of the Brazilian economy in the next few years. Clearly, the reduction of reserve requirements, the cuts in interest rates, and the measures introduced by the official banks are slowly bringing the credit situation back to normal. However, those measures have not been sufficient to trigger the resumption of investment, nor to accelerate recovery of the economy generally.

The worst consequence of the recession and the contraction of investment is that we put the future at risk. As a rule, recession tends to destroy productive capacity as

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factories shut down and businesses go bankrupt. Potential Brazilian GDP, which had been rising over the last few years, was definitely making it possible for the Brazilian economy to grow at a rate of 5% a year without creating inflationary pressures or problems in the balance of payments. After the recession, potential GDP will decline for a few years, for a variety of reasons. The investment rate, which was recovering and had reached 18% of GDP, has been drastically reduced, and it will take several years to return to previous levels. In the meantime, we will not be able to expand our productive capacity, which means a GDP loss during this period.

In times of recession, businesses also suffer losses and accumulate debt, which compromises their investment potential. Businesses that shut down or go bankrupt also help to destroy potential GDP. This would be the most serious consequence of the effective reduction in Brazil's production capacity.

It is no longer possible to extrapolate potential GDP as projected before the crisis into the after-crisis period. In the best scenario, if we return to the pre-crisis situation by 2011, with 5% to 6% growth of the Brazilian economy, the trajectory of potential GDP shifts downward, resulting in losses that may easily reach 20% of GDP.

Consequences — The fall in potential GDP has other, perhaps more serious, consequences — fiscal consequences, for example. The structural deficit, calculated on the basis of potential GDP, should be zero when effective production equals potential production; it increases with the drop in potential GDP because tax revenues fall while costs remain fixed. This means that post-crisis the government will have to make an additional fiscal effort to restore the previous scenario, by either cutting spending or raising taxes — either of which would have perverse consequences for the economy. Furthermore, a recessive period increases both the deficit and public debt, which in turn demands that the government at some point make an additional fiscal effort.

Also, growth is a process that can positively affect what happens next and that generates a virtuous cycle. For instance, when in 2004 the economy started growing due to external stimulus (an increase in exports), investments increased, promoting growth that in turn generated positive feedback in terms of investment. Once this virtuous cycle is broken, it may become a vicious cycle, and restoring the previous situation would not be easy. Likewise, lower unemployment was affecting salaries positively, which expanded demand for consumer goods; the higher salaries in turn led businesses to introduce innovations to increase productivity to contain unit labor costs and sustain profit margins. This is yet another virtuous cycle. Increased unemployment also breaks this virtuous cycle that we have been building on for years.

The worst consequence of the crisis was the interruption of the process of rising potential growth of the Brazilian economy.

In conclusion, the recovery of the Brazilian economy is underway, but one must be cautious in making extrapolations. One must also bear in mind that higher unemployment has already affected increases in salaries, which are no longer real increases, and that in turn affects aggregate demand. The reduction of the industrial products tax (IPI) and record sales of automobiles and other durable goods in the first half of the year have an expectation component. When the IPI tax reduction is lifted, sales will fall more than proportionately. The increase in idle capacity may also have two adverse effects: on one side a fall in productivity and benefits, and on the other, postponement and reduction of investment.