The Central Bank, once again in a tight spot

The Brazilian economy is doing well. And the recovery is surprisingly vigorous, judging from the levels of activity seen since the national accounts for the second quarter were published and from the signs coming from industry in the third quarter. Yet the life of economists could not be harder: predicting GDP for the next year with even minimal precision has never been so challenging. And because projecting economic activity is difficult, so is anticipating how inflation will behave at this delicate political-electoral moment. The Central Bank is entering into a phase that is as challenging as all the successive phases since inflation targets were introduced in 1999. One can only hope that it will come out of it as well as it has in the past.

There is no doubt that Brazil will grow at a good rate in 2010; the extent of next year's growth, however, may vary widely — from 4.5% to 7% is within the bounds of possibility. This broad range is justified by the fact that, for various reasons, as the country comes out of this crisis it is sailing into completely uncharted waters: First, the nature of the turbulence that has affected the global economy since the bankruptcy of Lehman Brothers in September 2008 has nothing in common with previous experiences of world deceleration. Moreover, unlike all previous crises since it defaulted on its foreign debt in the early 1980s, this time Brazil has been successful in using both monetary and fiscal countercyclical tools. How the effects of those policies, as adjusted by the administration, will play out is practically impossible to predict. There are simply no similar past experiences to compare them with.

Recovery — For these reasons, even if the scenario may seem overly positive, 7% growth is by no means inconceivable. Using the current market language, this would be a "V"-shaped process, where the intensity of the recovery equals that of the contraction in late 2008 and early 2009.

There are several signs that the Brazilian economy is racing back at full speed to its precrisis exuberance. Second-quarter seasonally adjusted GDP growth of 1.9% is much higher than market projections. Industry, in fact, has already recovered about half of its 20% loss in production from the precrisis peak to the lowest point.

The behavior of the labor market has also been a positive surprise for a significant number of economic analysts. According to the Institute of Geography and Statistics monthly employment survey (PME), the 8.1% jobless rate in August is close to the figure for August 2008 — and the net creation of 242,126 jobs announced by the General Registry of Employed and Unemployed Persons (Caged) in August is slightly higher than the number of jobs created a year ago.

The PME and Caged statistics reinforce the argument that the crisis may have been

a severe shock to industry demand that pushed down employment in the sector but it has failed to infect the rest of the economy. The crisis was contained through both monetary and fiscal countercyclical policies, such as reduction of the Central Bank policy rate, a cut in commercial bank reserve requirements, more lending by the BNDES (National Bank for Economic and Social Development), and tax breaks for the purchase of cars, home appliances, and construction materials.

The government also introduced two other countercyclical measures that have had powerful effects: the increase in the minimum wage and the adjustment of civil servant pay. Because of their effects on the permanent income of beneficiaries, those two measures facilitated the rebound of the economy by promoting higher household consumption. Thus, after falling investor confidence triggered the abrupt drop in stock prices in the last quarter of 2008 and the first quarter of 2009, the economy, supported by sound macroeconomic and financial foundations that were essentially spared by the crisis, may again find its previous pace.

China — Two other factors will help shape the pace of economic recovery in 2010: the recovery of both manufacturing exports and investment. In the first case, South America is the preferential destination for Brazilian manufacturing exports, so we depend on China to "restart" the region's economy — in other words, the expectation is that Chinese demand for commodities from our South American partners will boost their income and hence their demand so that they again buy Brazilian products in large quantities. Unfortunately, associated with that opportunity is the risk that Brazilian exports will come under increasing competition from the expansion of Chinese manufacturing exports to our trading partners.

Recovery of investment, on the other hand, is more complex. It is associated with the confidence of businesses. This variable is always difficult to predict and often fluctuates considerably. In this case the recovery of the capital markets, based on the perception that Brazil was one of the first emerging countries to come out of the crisis, and in good shape, is promising. It means that the confidence of the business community in the country may be quickly coming back — a trend that Moody's new investment grade rating for Brazilian bonds reinforces.

What is certain is that Brazil will grow at a good rate in 2010; the final results of next year's growth, however, may vary widely, from 4.5% to 7%.

Indeed, however much effort goes into trying to contain optimism, it is hard to justify any projection that 2010 growth will be less than 4.5%. Considering the country's trajectory over the past decade, this is a conservative estimate, particularly after a recession, which amplifies the effects of a turnaround. Furthermore, it is necessary to take into account the spillover effect of GDP from one year to the next, which in this case will be about 2.5%. Thus 4.5% growth in 2010 would represent in effect only a 2% expansion of GDP.

From the perspective of the Central Bank, such a range of GDP projections must certainly be uncomfortable to work with, because growth of 4.5% means that

the output gap will hold at current levels for a long time, perhaps even into 2011. If so, there would be no reason for the Central Bank to be haunted by the ghost of inflationary pressure, so it could keep its policy rate at 8.75% for a long time to come. In that case, the Bank would not have to worry about the timing of the withdrawal of the countercyclical fiscal stimulus.

Pressure — All the previous observations change, however, if growth in 2010 comes close to 7%. Then there would be no doubt that the economy's production capacity would come under pressure, and the Central Bank would face the uncomfortable job of having to slam on the monetary policy brake during an electoral campaign. Such a scenario becomes more plausible, however, when one assesses the powerful stimulus to demand created by the government, the management of which may not be immune from the political-electoral influences of 2010. For example, the minimum wage increase will be significantly higher than inflation next year.

International trade is still under the braking effect of the slow and painful recovery of the economy in the developed as well as in some emerging countries.

According to the current informal rule (it is still awaiting formal approval by Congress), the increase in the minimum wage incorporates the inflation rate for the year plus GDP growth in 2007. According to Ministry of Planning data, the increase would thus be about 8.8%, pushing the minimum monthly wage up to R$505.90 (US$253). In the labor market, moreover, some collective bargaining agreements have increased salary adjustment above inflation.

An analysis of utilization of industrial capacity, the NUCI index formulated by IBRE–FGV, shows that inflationary pressures are not yet evident. After falling to 77.6% in February 2009, at the height of the crisis, the index has already seen a recovery to 81.9% in September, though this is still well below its recent peak of 86.7% in June 2008 and below the average since 2003 of 83%. When analyzing the data, however, caution is advisable. First of all, as we know, this has essentially been an industrial crisis. Also, in analyzing the NUCI index by industrial sector, it becomes clear that the slack is unevenly distributed; in some of the major industrial segments, capacity utilization has been increasing in recent months. For example, in the case of semi-manufactured goods, which are important in determining inflationary pressure, there was a steep fall from a peak NUCI index of 87.9% in June 2008 to 77.1% in February 2009. This September, it was back at 83.3%, having jumped 3 percentage points in just three months. That is still below the 86% post-1994 average, but if the recent recovery rate is maintained, pressures will rise in the not-too-distant future.

Even in durable consumer goods and building materials — the two segments most influenced by the government's countercyclical measures — the NUCI index is, respectively, 88.9% and 89.3% — not too distant from the pre-crisis peaks of 91.7% and 91.3%. Even in the capital goods sector, the one most affected by the crisis, the recovery of investment now shows signs of accelerating. After having peaking

at 89.1% in July 2008, the NUCI index for capital goods sank to 73.1% in February 2009 and held there until July. In August, however, it jumped almost 5 percentage points, to 77.7%, and then stabilized at 77.3% in September.

Exports — A comforting factor for the Central Bank in terms of the inflation outlook, however, is external demand, which seems to be returning to a trend of moderate and gradual recovery. International trade is still slowed by the braking effect of the sluggish and painful recovery of economies in the developed world and in some emerging countries (in Eastern Europe, for example), which have been much more debilitated by the turbulence than countries in South America or East Asia. Loose world demand thus benefits Brazil, where domestic demand slack is tightening fast — it may not do much for the growth side, but it certainly offsets inflation.

On the other hand, there are signs that the global deflationary pressure is behind us. Commodities prices have been rising in the last few months; industrial commodities have already registered 50% average growth this year, which affects the metal and petrochemical sectors in Brazil. There are even some extreme cases, such as the 100% increase in copper prices. Oil is now almost half the price registered at its peak in 2008, when the barrel was negotiated at US$140 before crumbling to US$40. There is also pressure on agricultural commodities, for example sugar and alcohol. All those movements, incidentally, have been picked up by the US Producer Price Index, which has recently risen after a period of deflationary risk.

It would be a mistake, however, to consider that inflation will return revivified to the global scenario — at least not within the next year. Indeed, during the crisis, commodity prices that had been showing a trend of consistent increase simply collapsed. It can be expected that once the worst is over, they could recover vigorously. Perhaps the most sensible attitude for the moment as far as world prices are concerned is not to bet on a severe inflationary risk — but also not to put all the chips on the assumption that the world is on the eve of an inflationary spiral.

In the months ahead, in successive meetings of the Monetary Policy Committee the Central Bank will have to face many of the difficult issues reviewed here. The Bank team will have to handle a very wide range of macroeconomic projections — including scenarios that may or may not include all the relevant inflationary risks — and will also need to work on premises about how the world will come out of an absolutely unique crisis. The political heat of the electoral season and the doubts related to the permanence of the current Central Bank governor, the successful Henrique Meirelles, will certainly not help the Bank's job in the next year. In fact, even facing the possibility (though not the certainty) that 2010 will see an exceptionally hot economy, it is still too early to guarantee that inflationary pressures are returning. On the other hand, it is no longer admissible to ignore the risk.

It is still too early to guarantee that inflationary pressures are on their way back. But it is no longer admissible, on the other hand, to ignore this risk.