Gloomy prospects for the economy

IBRE staff discusses prospects for the Brazilian economy in a time of transition.

Solange Monteiro

Several economic indicators worsened in the third quarter, as did the confidence of entrepreneurs and consumers in the economy. That will no doubt heighten the challenges for the president who is sworn in early next year. In the Economic Analysis Seminar organized by the Brazilian Institute of Economics (IBRE) in mid-September, IBRE researchers expressed considerable concern about the current situation of the economy. "There was some expectation of economic recovery after the World Cup, but pessimistic expectations proved to be stronger, "said Samuel Pessôa. "The difference is that now there is no global crisis to justify our internal crisis," commented Armando Castelar

Other indicators reinforce the pessimism. "In the second quarter the service sector, for example, contracted by 0.5%. This has only happened twice in the last eleven years," Regis Bonelli said. Domestic savings have been declining since 2011 and are now down to 13% of GDP from 19% of GDP in 2011. The savings drop and a fall in investment by 5.3% in the same period confirms the severity of the country's financing needs. Silvia Matos explained that "Our projection is that fixed investment will fall by 7.9% in 2014. Surveys show that the manufacturing sector intends to invest little in the next 12 months, and the scenario for the construction sector is critical"; she said IBRE is projecting that fixed investment in Brazil will end the year at 17% of GDP compared to 20% of GDP in 2011.

Aloisio Campelo affirmed that certain sectors of the economy had seen some improvement in activity in the third quarter. But, he warned, "This seems more related to the normalization of working days, after the period of the World Cup holiday." Consumers were concerned with uncertainty about employment considering how few jobs were created. Castelar pointed out that reduced credit implied a decline in activity in such labor-intensive sectors as construction, commerce, and financial intermediation, which should affect employment heavily.

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>
> ***Armando Castelar***

Castelar also identified a fall in confidence in both public and private banks: "In the last 12 months, private bank credit adjusted for inflation declined, as was seen at the height of the crisis in 2009." He believes that in order to ensure GDP growth in 2015, whoever is elected president will have to win back the credibility of both consumers and markets. "Today we are growing as little as in 2009, but with much higher inflation and external current account deficit. This implies a non-trivial cyclical adjustment."



As for monetary policy, José Julio Senna signaled concern about market expectations that the presidential candidates will not raise interest rates. "I think the market is buying the presidential candidates' speeches," Senna said, indicating that usually a new administration would do the opposite. "There is no way out given that Brazil has a flexible exchange rate. That was the case with Arminio Fraga in 1999, when he raised interest rates from 39% to 45%; Antonio Palocci and Henrique Meirelles in 2002 raised interest rates twice; and Alexandre Tombini increased interest rates from 10.75% to 12.5%," he said.

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Silvia Matos

Nelson Barbosa argued for caution on interventions to contain depreciation of the real. In his view, Central Bank interventions in the exchange market have been higher than would be desirable and somewhat precipitate. Based on the nominal exchange rate since the beginning of the Real Plan in

1994, Barbosa estimates that the long-term average exchange rate at 2.50 reais per U.S. dollar, adding, "This means that the Central Bank sold 25% of Brazil's international reserves in the form of swap operations, but the exchange rate did nothing more than return to its long-term average."

On the fiscal side, economists pointed to the problem of maintaining government consumption when there is no room in the budget. From January to July, the primary surplus was R$24.7 billion, the lowest since the Fiscal Responsibility Law was enacted in 2000. "On the one hand, the voter wants more consumption and more public spending. On the other, it is hard to think how rising spending can continue," Barbosa said. "We cannot deny that there has been some control of administrative and personnel expenses. However, we have a complicated political economy and the fact is that over the past three years the fiscal primary surplus has deteriorated," Pessôa noted.

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Nelson Barbosa

IBRE estimates that the 2014 primary surplus will be 0.2% of GDP—far below the government target of 1.9%. What is the actual margin for fiscal adjustment is an issue that generates controversy and will certainly depend on the preferences of the president elected. Between reducing subsidies, eliminating tax exemptions, and greater fiscal effort, IBRE researchers estimate that a primary surplus of 1.1% in 2015 is possible. "If we do everything right we will work with lower interest rates and this will give us a chance to improve domestic savings and seek an adjustment of the economy that leads us to another period of growth," Pessôa concluded.



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