2014.05.04 (No.21, 2014)

Newsletter

Institute for International Monetary Affairs
公益財団法人 国際通貨研究所

Brazil's Economy at a Critical Juncture

: Economic Policies of Next President Keenly Watched

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Summary

- Brazil's economy is now experiencing what can be called a stagflation with its growth rate slowing down to 2% level while inflation rate rising to the order of 6%. This is the direct result of its economic policies that tried to prolong the growth with stimulus measures on the demand side such as tax cuts and low interest rate loans through public finance without addressing the problems on the supply side (so-called Brazil cost problems).
- Those policies, however, are coming to a limit, with adverse effects other than inflation emerging in the expanding deficits of current account and budget balances.
- Brazil's economy is now standing at a critical juncture. What is required is not the policies directed on the demand stimulus but the strengthening of the supply side policies which address the reduction of so-called Brazil cost. Brazil cost refers not only to high tax rates and high unit labor costs but also to the high logistic costs due to the poor and inadequate infrastructures, high business costs associated with complex tax system, and high interest rates.
- In October 2014, a presidential election is to be held. When the reelection of the incumbent President Rousseff becomes more assured, there might be a case that the market deliver a

non-confidence vote in the form of financial turmoil. Whoever the next president may be, however, he or she will have to play a role to make the people swallow bitter medicine. The year 2015 will be a test year for Brazil.

Full Text

1. Prolonged Slow Growth and Sign of Decline in Property Price

In the first decade of the 21st century, Brazil posted a high economic growth of an average growth rate of 3.6%, while its economic scale expanding by 1.42 times. Since 2011, however, its growth rate has slowed down to around 2%. The outlook for 2014 is not a bright one either. On the external front, the Chinese economy is losing its momentum, which suggests less promising exports of Brazilian resources and agricultural products to China. Timing of the US interest rate hike has come to be discussed in the international financial circles, meaning continued outflow of capital from emerging market economies including Brazil with accompanying depreciation of their currencies. It is feared that these will induce slower growth and higher inflation. Domestically, the Soccer's World Cup slated for June will increase the consumption and tourism income on the one hand, there is a possibility of planned blackout from decreased storage capacity of dams due to drought on the other. Brazil relies on the hydropower generation for 80%of total electricity generation capacity. The stoppage of power supply would put a downward pressure on production. Private economists forecast an average growth of 1.7% for 2014 and 2.0% for 2015 (as of March 28) with every their revision downward.

Chart1. Real Economic Growth of Brazil (%)

	2011	2012	2013	13/1-3	4-6	7-9	10-12
Real GDP growth rate %	2.7	1.0	2.3	0.0 1.8	1.8 3.3	-0.5 2.2	0.7 1.9
Private Consumption	4.1	3.2	2.3	-0.1 2.3	0.3 2.6	1.0 2.3	0.7 1.9
Government Consumption	1.9	3.3	1.9	-0.4 2.4	0.7 0.8	0.9 2.3	0.8 2.0
Fixed Capital Formation	4.7	-4.0	6.3	3.9 3.2	3.6 9.1	-2.0 7.3	0.3 5.5
Exports	4.5	0.5	2.5	-3.8 -5.7	6.3 6.3	-1.2 3.1	4.1 5.6
Imports	9.7	0.2	8.4	5.2 7.5	0.4 7.7	-0.5 13.7	-0.1 4.8

(Source) Datastream (※) Upper: S.A.A.R. Lower: year on year growth rare

Even this low growth rate has actually been supported by fiscal policies. From the end of 2011 to the middle of 2013, the Brazilian government reduced tax rates and utility fees while it took a series of protective policies of domestic industries to promote economic growth. The expenditures were expanded by 151.6 billion real (approx. 6.8 trillion yen) during the three years, raising the growth rate for 2013 and 2014 by an estimated 1% strong.

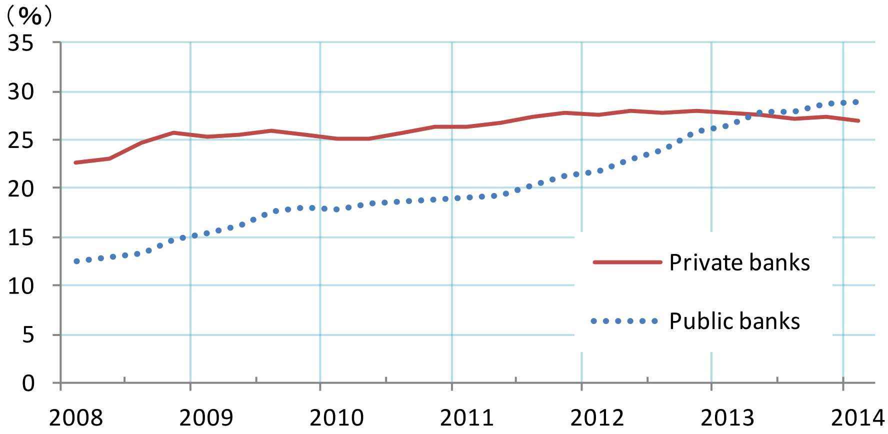
Chart 2. Fiscal Burdens of Stimulus Measures (Since 2011)

	2012	2013	2014
Fiscal cost (Billion Real)	25.9	58.9	66.8
Same as above (% to GDP)	0.6	1.2	1.3
Tax cut (% to GDP)	0.4	1.0	1.1

(Source) IMF Country Report, Brazil No.13/312 Oct. 2013

The government also provided loans actively through public banks to support the economic growth. Since 2012, the ratio of public financing to GDP has rapidly risen while that of the private loans has been falling, resulting in the reverse of the outstanding amounts with the public finance accounting for more than a half of the total. Public loans are provided at preference rates that are lower than the market rate, to a wide range of borrowers from big corporations to housing loans. But for these supporting measures, Brazil's economy would have fallen into a recession.

Chart 3. Bank Loans Outstanding (% of GDP)

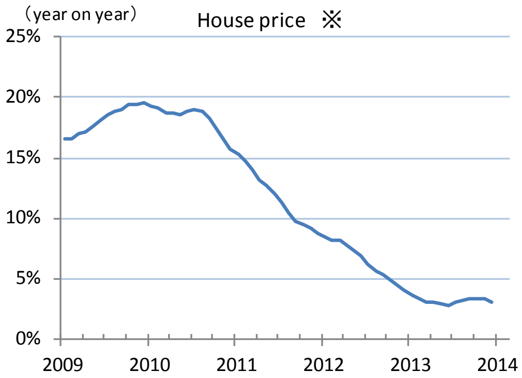


(Source) Datastream

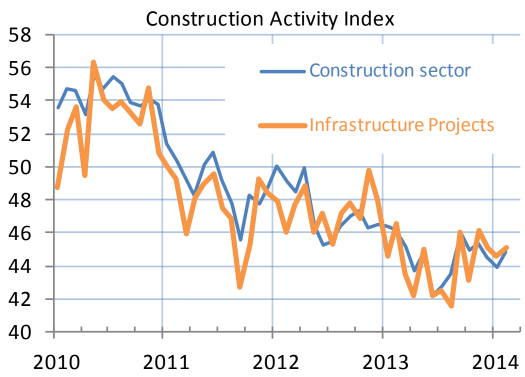
What needs to give attention as a new risk factor to the growth is the movement of real estate price. The housing price in Brazil (nationwide) is still rising by nearly 10% over the previous year, but after adjustment of inflation it falls down to the level of 3%. More worrisome is the property price for commercial use. According to a survey by a local real estate agency, the vacancy ratio of office buildings rose to 18% in 2013 (as compared 13% in 2012), marking the highest rise since 2005. Naturally the rental fees started to fall, by 15% in Sao Paulo and 10% in Rio de Janeiro in 2013. It is reported that excess supply has spread to shopping malls. Construction Index has shown a sluggish trend.

Although in the first half of 2014 some temporary stimulus effect can be expected from the soccer's World Cup, but caution should be taken for the risk that the repercussion of the event might be joined by a fall of the real estate price.

Chart 4. Housing Price and Construction Indices



(Source) Datastream ※Inflation adjusted



(Source) Datastream

2. Stimulus on Demand Faces the Supply-side Constraints

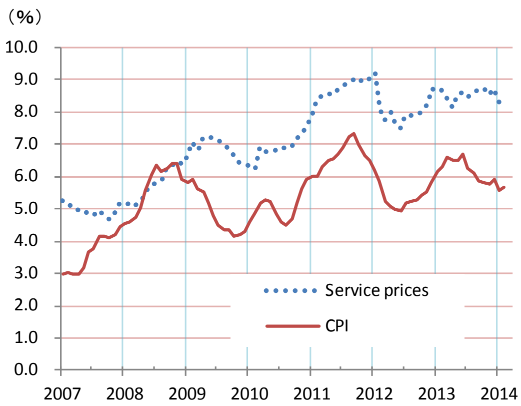
As the economy in Brazil has a high weight of consumption that is comparable to the advanced countries, economic stimulus measures tend to focus on the consumption side for its immediate effect. In fact the policies taken after 2012 included, among others, cut of consumption tax on home appliances, reduction of financial transaction tax on consumer loans, and later reduction of consumption tax on automobiles. They were followed by a reduction of income tax and social security taxes and lowering of interest rate for the loans by the government affiliated financial institutions. These were originally intended to be temporary measures, but eventually they were repeatedly extended in fear of negative repercussions.

However, the supply capacity of Brazil's economy is limited. Artificial creation of demand has led to an increased constraint of supply capacity, invoking a rise of inflation and worsening of current account balance.

Consumer prices in Brazil have been rising at a high rate of over 5 % since 2011, temporarily exceeding even the upper limit of inflation target range (4.5%±2%) set by the central bank. In this environment the Monetary Committee of the Central Bank(COPOM) started to raise its policy rate (Selic) in April 2013, and currently (as of April 2014) the target of the Selic interest rate is set at 11.0%. Inflation rate fell a bit in early 2014, but the service price still remains high at the level of 8%.

Continuing high inflation reflects tightness in the supply and demand balance of production factors, with both capacity utilization ratio and employment rate remaining high. Especially the unemployment rate is at the low half of 1% level, which is an extremely low level for Brazil[1] This is a twisted situation where the fiscal policy stimulates the economy while the monetary policy tries to tighten. In addition, the accelerating depreciation of the real has added to a rise of inflation expectations, strengthening the prospect that the Brazilian economy will fall into a stagflation (meaning slow growth accompanied by high inflation).

Chart 5.   Price Movements



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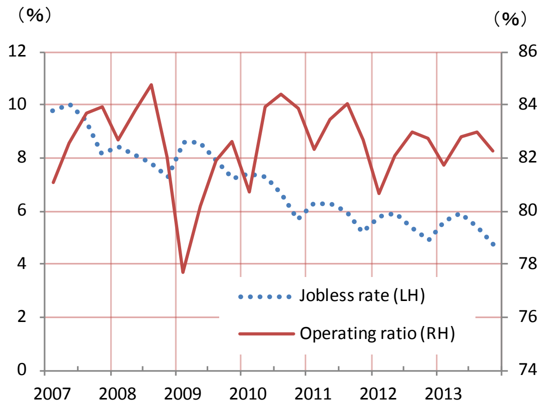
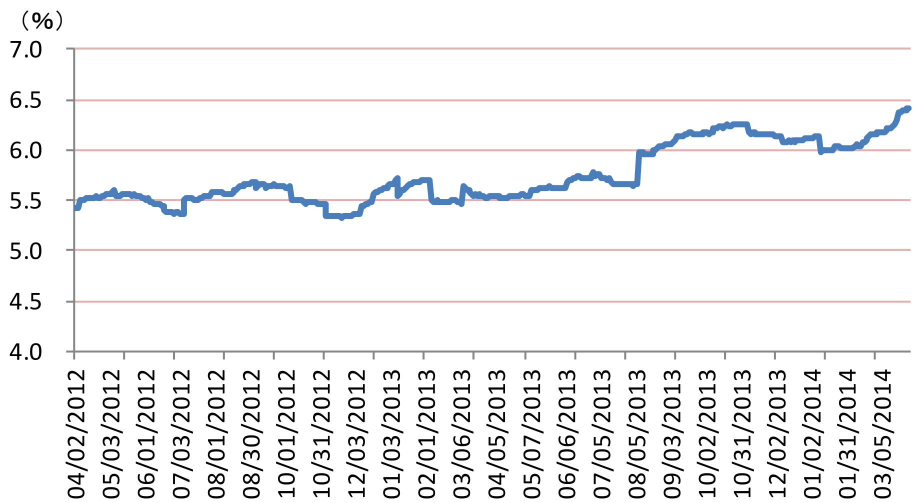


(Source) Datastream

[1] The IMF gives for this reason such factors as (i) that the growth of working age population has slowed since 2011, (ii) demand for labor is strong in service sector with low labor productivity, (iii) manufacturing industry tends to hoard workers because of high frictional cost including dismissal cost of workers and shortage of skilled workers are lacking, and (iv) reduced burdens for social security taxes have worked as an incentive to keep the workers. Country report on Brazil, No.13/312（2013）

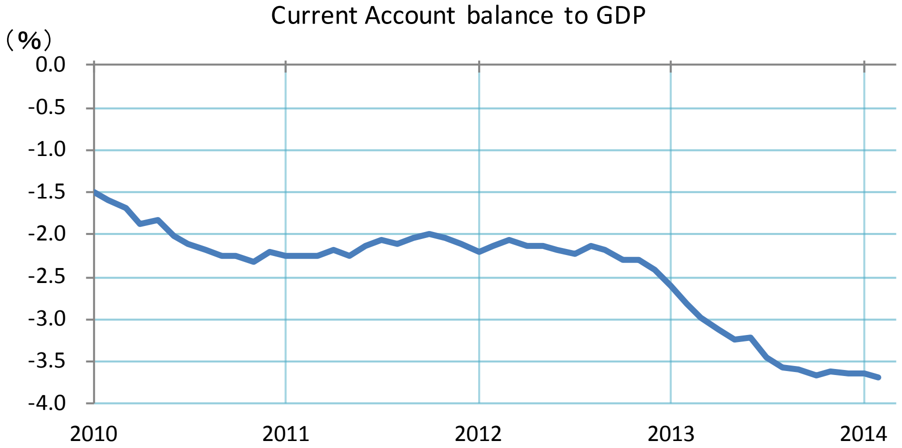
Chart 6.　Inflation Expectations (for one year ahead)



（Source）Banco Central do Brasil

Stimulating demands in the face of deepening supply constraints has triggered a deterioration of the current account deficit. Current account deficit gradually expanded from the latter half of 2012 and currently (first quarter of 2014) it registered -3.7% of GDP. Brazil has constantly had a current account deficit and in recent years it was more than financed by a large inflow of FDI which amounted to around $60 billion a year. However, in 2013 the current account deficit recorded $81.4 billion while the FDI inflow slowed down to $58 billion, the gap financed by other capital inflows such as portfolio investment and borrowings. These latter capitals are more volatile than FDI and actually at some times in 2013 the total capital outflow exceeded the total inflow of capital. As the US starts to tighten its monetary policy on a full scale, there will be a bigger change in the capital flow. This is a situation to be closely watched.

Chart 7. External Transactions in Brazil



(Source) Datastream

(Billion US$)

	Financial account, net	Direct Investment, net	Portfolio Investment, net	Other Investment, net	Current account, net
Q1 2012	23.0	20.4	1.9	0.8	−12.1
Q2 2012	22.2	14.4	0.5	7.3	−13.2
Q3 2012	13.2	14.5	3.3	−4.6	−8.9
Q4 2012	13.5	18.9	3.1	−8.5	−20.1
Q1 2013	30.9	10.2	7.5	13.2	−24.8
Q2 2013	19.4	27.1	4.9	−12.7	−18.5
Q3 2013	11.5	9.2	16.5	−14.3	−17.1
Q4 2013	11.7	21.1	−3.3	−6.2	−21.0
Q1 2014	21.4	9.7	6.2	5.5	−19.0

(Source) Datastream

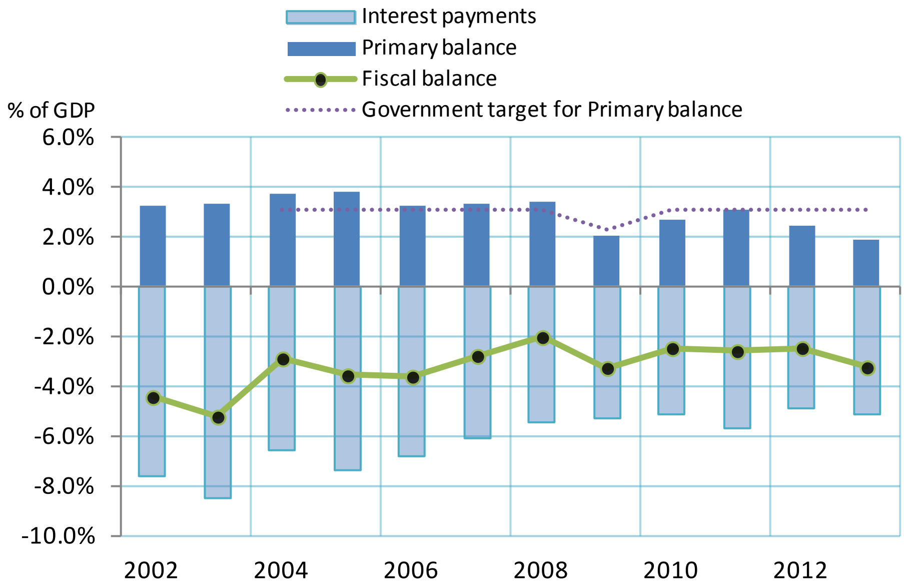
3. Uncertainties over the Fiscal Discipline

In order to conquer the hyperinflation and regain the trust of the market, the Brazilian government desperately needed to establish a firm fiscal discipline. In 2002 when President Lula of the left-wing came into power, it was afraid that the budget deficit might be increased, but contrally to expectations the Lula administration tried to turn the primary balance[2] into black and kept reducing the government debts. His government's success was partly assisted by the resource exploration boom, but his management of the budget administration based on the rules he set himself gave the impression at home and abroad of sustainability of his budgetary discipline. The government set the target of the primary balance at 3.1% of GDP in 2004 and

2 Refers to a basic budget balance that excludes debt servicing cost, which is the balance between general expenditures other than interest costs and redemptions and general revenues (tax revenues) that exclude the income from government bond issuance.

generally managed to keep the target until 2012 when the divergence from the target began to widen[3]. In 2013, the primary balance managed to keep 1.9% of GDP, but this figure is criticized as the one that was modified by many opaque accounting operations and also inflated by one time revenues such as from bidding for oil digging fields and others. The current government sets the primary balance target at 1.9% for 2014 but most of the private economists forecast that the downward shift is unavoidable.

Chart 8. Budget Balance（% of GDP, General Government）



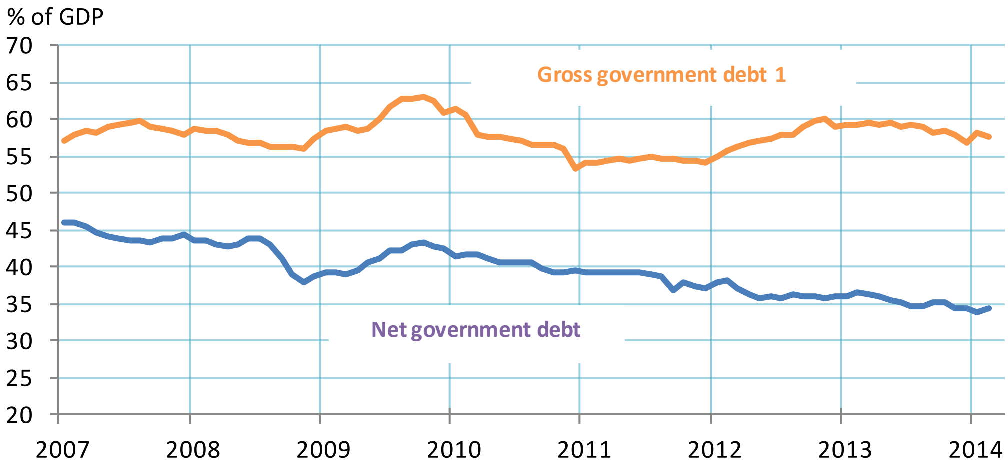
（Source）Datastream

Another factor of uncertainty in the fiscal policy of Brazil relates to the fact that, as is seen from Chart 3, the public banks are virtually playing a role of budgetary policy makers and therefore there is a concern that their loans may correspond to hidden debts of the government. Although the apparent outstanding ratio to GDP of the government debts is declining (net debt outstanding in Chart 9), actually since 2009 the government has switched the expenditures it should bear to the lending of National Bank for Economic and Social Development (BNDES). The outstanding adjusted for this shift shows no declining. So far the ratio of non-performing loans of public banks including the BNDES is low, but there is a possibility that the loans recently made by public banks, so to speak on behalf of private banks, might become non-performing if the slow growth is to be prolonged.

[3] In 2009, just after the global financial crisis, it was set at 2.3%. In 2013, it was originally set at 3.1% but later it was revised down to 2.3%.

Taking into account these situations, Standard and Poor's, a rating agency, lowered in March 2014 the Brazil's sovereign debt rating in foreign currency by one notch from BBB to BBB minus, the agency's lowest investment grade rating. The review had been warned previously so there was no surprise in the financial market by the downgrade. If other rating agencies join S&P's in downgrading of Brazil, there will be a contagious impact on the market.

Chart 9. Government Debts Outstanding (% of GDP)



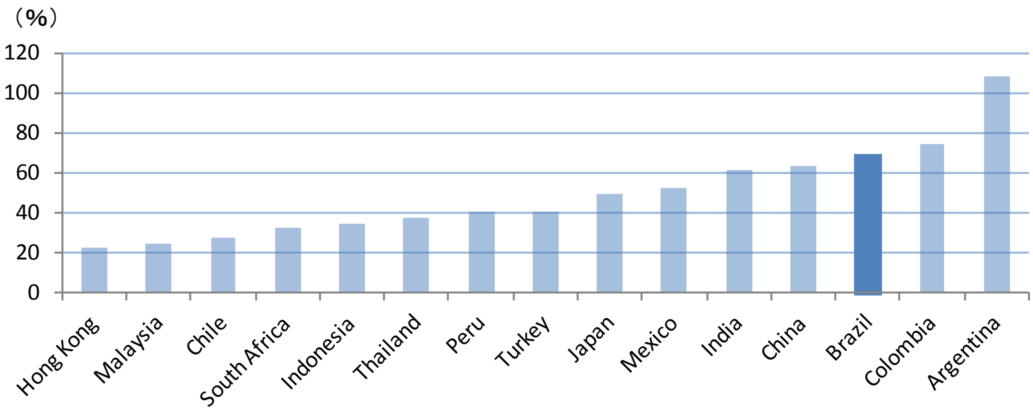
1. In this figure, general government gross debt does not include treasury bills on the central bank balance sheet not used under repurchase agreements.

（Source）Datastream

4. Brazil's Economy at Crossroads –Policy Change Required

Brazil's economy is standing at a critical juncture. Extension of the economic growth through stimulating demand is coming to a limit, given the magnitude of supply-side constraints and fiscal burdens so far injected. Tax increases might alleviate the fiscal constraints to some extent but it would be hard to implement them. The tax burden ratio of Brazil is already high at 35.9% (%of GDP, 2012), exceeding the average ratio of Latin American countries (excluding Brazil) by 16.7%. Tax is a big burden to corporate managers with tax rate on profit as high as 69%.

Chart 10. Taxation on Corporate Profits



（Source）OECD *http://dx.doi.org/10.1787/888932924400*

If the present policies are to be maintained in the future, there will be a forced termination by the market mechanism. It is a scenario that higher inflation and outflow of capital coupled with downgrading will trigger a plunge of exchange rate, leading the economy into a recession. To avoid this scenario, it is important to change the policies from stimulating consumption to promoting investment. More precisely, the government should start with scaling down tax cuts which stimulate consumption. At the same time, minimum wage indexation mechanism that has bloated social security burdens should be reviewed. It would be also desirable to review the rules themselves for raising minimum wage. Currently the wage is to be adjusted based on the nominal GDP growth rate for the past two years, but it should be limited to the inflation adjustment only.

Next, the composition of the government expenditures should be reviewed to increase the public investment, by which it should eliminate the bottlenecks in the economy. The expenditures of the federal government other than debt services amount to 19.02% of GDP (2013), out of which only 1.02% is spent on investment[4]. The government has released some of the infrastructure projects for private participation, but as is seen in Chart 4, there is no conspicuous move in the construction industry.

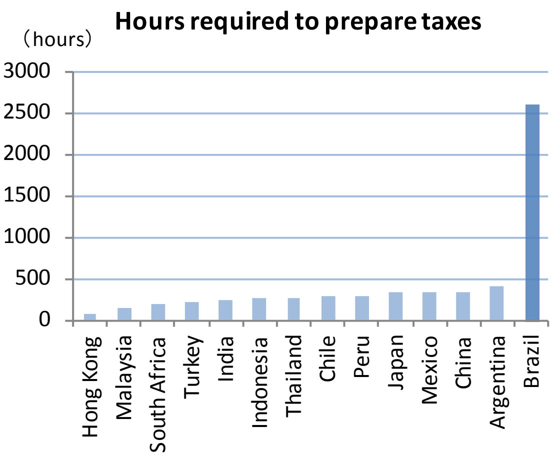
What are required further are the policies to reduce the so-called Brazil cost. This refers to not only high tax rate and high unit labor costs but also to the high logistic costs due to the poor and inadequate infrastructures, high business costs associated with complex tax system, high interest

[4] FGV IBRE “Adjusting Brazil’s Fiscal Policy: Necessary, but Tough” The Brazilian Economy , Vol.6 No.3 March 2014

rates, etc. To show some examples, tax rates in Brazil vary by state and various tax breaks make the tax system quite complicated. For this reason, companies have to spend 2500 hours annually to write the tax procedures. This is extremely long hours. Also the inadequate and underdeveloped infrastructure in Brazil is a “notorious” matter. Installation of logistics infrastructure and their quality are lagging far behind the rival emerging countries.

Despite the urgent need to reduce Brazil costs and to enhance the competitiveness of Brazil’s economy, the Rousseff administration is far from being active in addressing the problem. It has rather postponed the required reform on the supply side and relied on the demand stimulating measures to prolong the growth. This policy, however, has pushed the economy into a stagflation, and the lower interest rates, which was once regarded as an only successful measure of the government, did not continue for long with double digit policy rates coming back again.

Chart 11. Examples of Brazil Costs



（資料）*http://dx.doi.org/10.1787/888932924419*

Brazil’s infrastructure relative to its rival countries

	Brazil	Rival countries
Road quality	1.00	1.52
Rail quality	1.00	2.06
Port quality	1.00	1.62

（※） Ratio to Brazil

Rivals: Argentina, Chile, China and Mexico

(Source)*http://dx.doi.org.10.1787/888932924381*

In these circumstances, a presidential election is to be held in October 2014. Approval rate for President Rousseff is not so high[5] but as she has no strong rival candidate, her reelection is most certain. However, it seems that the financial market participants expect a change of the administration, given the fact that when her approval rate goes down the stock prices go up.

As the election day draws near and re-election of President Rousseff is more promising, the financial market may deliver non-confidence vote in the form of financial turmoil. On the other hand, when the possibility of political change becomes high, the market will be filled with expectation. But

[5] Her approval rate was 36% in March, 2014.

whoever is the next president, he or she will have to take policies to make the people swallow bitter medicines. The year 2015 when the next president starts to take power will most likely be a year of test for Brazil.

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