Is the worst over?

The cumulative drop in GDP of 7.1% in the eight quarters since the beginning of the current recession—from the second quarter of 2014 to the first quarter of 2016—shows a serious GDP loss in a short time, but it does not say much about how long the fall in GDP will continue and how severe it will be. How much more serious can this become? And how long will the slide last? These are recurring questions for those who analyze the Brazilian economy.

Like other analysts, our estimates of the Brazilian economy indicate that GDP was increasing at least until the April-June quarter of 2014. Besides, all projections point to lower GDP this year than last, and the recent analyses reviewed suggest that decreases will gradually lessen.

Projections for 2017 are more optimistic, although they still imply that growth would be close to zero. Other analysts are more positive. The IMF expects 0.5% growth. The average increase, according to the Focus Bulletin, is 1.1%. Other forecasts are even more optimistic.

Such relatively optimistic expectations are based on the assumption that Brazil has already reached the bottom, and there will be light at the end of the tunnel in the near future. Different market and media segments share this opinion, believing that the predominantly negative expectations have begun to change.

Although we agree that expectations have changed, we should perhaps reconsider the idea that the worst is over, for a number of reasons:

1. The projections reviewed have been heavily influenced by the performance of the manufacturing industry in the second quarter of 2016, though that was not sufficient to suggest that there will be a significant change in the economy in the short run. This is not only because industry has relatively little impact on GDP but also because (1) the resumption of industrial activity is focused in only a few areas—and the nondurable goods category, particularly food and drink for domestic consumption, is the only area where recovery has been consistent; and (2) the major currency exchange devaluation in 2015—which has contributed to the resumption of industrial activity—has been partially reversed this year.

2. It is not clear how sustainable the better business confidence indicators are, since they have been boosted by higher expectations. Because they are so subjective, expectations may have been encouraged more by the reforms and changes in economic policy that the government has announced than by effective results in terms of balanced public accounts.

3. The performance of the labor market continues to be weak and the current level of activity will face impacts the moment the situation gets better. New job opportunities, for example, will be made available when companies are convinced that recovery will be sustainable for the long run. Until then, neither payroll nor family consumption will grow. High inflation also makes it difficult for real incomes to recover—and it is hard to imagine there will be a more significant increase in consumption unless they do.
4. Interest rates are still too high to stimulate fixed investments, so because of the high inflation it is too soon to infer when they will effectively go down. Credit on offer is still low and expensive, and that is not likely to change as long as default is high. Moreover, public spending on consumption and investment will be restrained for some time.

Taking all these factors into consideration, it would be premature to assume that the worst in the Brazilian economy is over, or even close to being over. As in previous issues of this Bulletin, our analysts are careful about making forecasts: the fall in GDP this year will be only marginally less severe than last year. It will be followed by a slow recovery that will begin as 2016 moves into 2017. Clearly, this does not confirm the highly optimistic views of some analysts, who might have subjective reasons to estimate significant growth in GDP per capita in 2017.

Here are other highlights in this issue of IBRE’s Macro Bulletin:

1. In terms of level of activity, our previous forecast holds: a drop in GDP of 0.5% in the second quarter from the first quarter of this year and of 3.7% from the second quarter of 2015. The less negative results of quarter-based rates compared to last year will not prevent a 3.5% drop in GDP for this year. Extreme GDP growth is not expected in 2017 because the export pace that had resumed will fall back; domestic demand, particularly family consumption, will be very slow; and imports will increase. Next year the economy as a whole, especially industry, will again have to deal with an unfavorable scenario.

2. Higher expectations have been pushing up business confidence indicators after their downward slide of more than two years. The recent increases are minimal in historical terms and can be explained by the long-lasting recession and Brazil’s worsened economic fundamentals. Remedies for current problems, and others likely to come, are difficult and carry great risks. Therefore, whether a resumption of growth is sustainable will depend on whether the upward trend of the indicators is confirmed in the next few months.

3. Several analysts have discerned some pleasant surprises, such as a possible start to a recovery of the labor market, that raise doubts about the negative forecasts for this market through the end of 2017. Is the current slight deceleration in the number of people being fired seasonal—as usually happens in May and June—in which case the situation will worsen again in July? Or is the number of jobs really as low as it can go, in which case job offers should resume in the remainder of 2016? Our analysts are still skeptical that unemployment will decrease this year, saying “Signs of resumed job offers are not on the horizon yet, taking into consideration not only the number of employed persons based on continuous PNAD but also the most recent data from Caged, which has recorded net layoffs of 72,000—the second worst result for May since 1997.”

4. The highlight of the inflation analysis is the deceleration of consumer inflation in June, according to the results released by the Central Bank for four areas: lows were between 0.30 and 0.54 of a percentage point, cumulative for the 12 months through June compared to May. Again, consumer inflation was mostly influenced by administered prices, which recorded a 0.97 percent drop in June for the previous 12 months. Our analysts expect that “consumer inflation will continue to go down in the next months toward 7.1% in December. Another 2.6% will be required for the Central Bank to achieve its 4.5% target in one year, which according to the market is unlikely.”
Our monetary policy analyst addresses two options that the new Central Bank Board of Directors had before it made its first public statement: recognize how difficult it will be to reach the inflation target in 2017 and then make adjustments for next year; or recognize these difficulties but at the same time indicate that reaching 4.5% in 2017 would not be so hard if fiscal policy is favorable. The decision was for the second, which our analyst views as correct based on fiscal policy measures. He concludes that “To accomplish this, the Selic rate must be invariable for some time. Basic interest rates are likely to be stable through the next two Copom meetings.”

With regard to the fiscal environment, the main concern continues to be the possibility of a change in the trend of growth in the primary deficit, considering the non-significant revenue results impacted by that cycle and spending controls. Based on the behavior of different ranges of federal tax collections, our analyst investigates whether the downward trend in revenues is likely to continue and if there are signs of different results for some types of taxes. The analysis looks at taxes on salaries, profit, revenue, production, import, financial operations, and trade.

Analysis of the external sector highlights the trade balance surplus in January-June of 2016 as the highest in the historical series for the first semester. Imports have been the main influence for months; this year, they are down 28% compared to the same semester in 2015. On the other side, exports have dropped only 4% because commodities prices are lower. According to our analyst, in the second semester the fast revaluation of the real exchange rate is a threat to this trend.

In the International Panorama section our analyst addresses the BREXIT as a structural problem indicating that some people see globalization as a loss, which has probably influenced the referendum result, and as a reaction to the trends of higher income concentration in developed countries. He adds that the income imbalance also affects the political balance. His conclusion is that “if the development model in rich countries is not upgraded and move toward solutions to such instabilities accumulated over the last three decades, new Brexits will occur.”

The Political Observatory, written by Prof. Octavio Amorim Neto, analyzes Interim President Temer’s performance in the little more than two months since he took over the administration. After emphasizing the positive and negative aspects of Temer’s journey to effectively become president, the question the author asks is how Congress will react to the strict adjustment measures to be put into force. He also speculates on a scenario where at some point this year the Interim is dropped from Temer’s title: “The first semester of 2017 will be a great opportunity for Temer to show his skills and make his way in the history of the Republic.”

The In Focus section, written by Vilma da Conceição Pinto and José Roberto Afonso, investigates the possibility that some state governments will become insolvent.