3 Brazil: stagflation

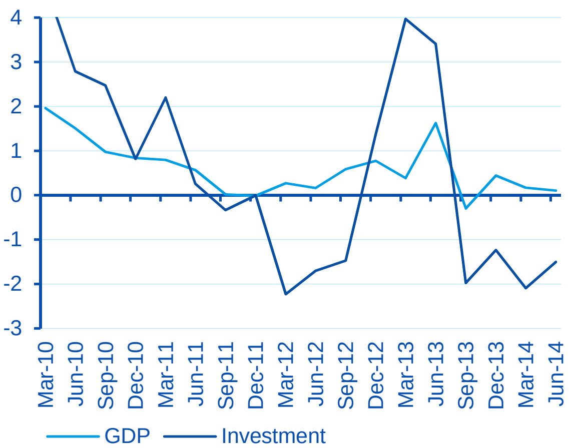
After further signs of weakness, we have revised our growth forecast to 1.3% in 2014. Nor is a significant recovery on the horizon for 2015, with the economy set to grow just 1.6%

Brazil's GDP only grew 0.2% QoQ in the first quarter, significantly below expectations. Evidence available for the second quarter suggests an additional moderation of economic activity over the period (Figure 3.1). Specifically, we expect growth of just 0.1% QoQ of GDP over the period, but a slight contraction would not be surprising either.

Activity has been weak across the board, but particularly so in the fixed capital investment component, which fell 2.1% QoQ in 1Q14 and we forecast that it will fall for the fourth consecutive quarter in 2Q14. In terms of the contribution to growth of consumption and net exports, we expect this to be more positive in 2Q14; in the case of net exports, this is mainly due to a moderation in imports.

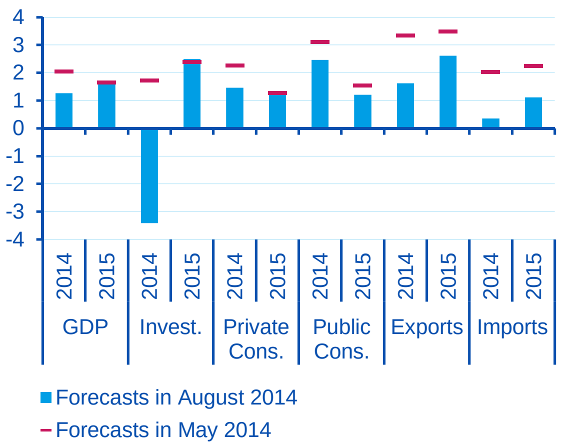
In view of the very low growth in the first half of the year and the lack of good reasons to expect a significant uptick in the remainder, we have revised our growth forecast for the Brazilian economy in 2014 from 2.0% to 1.3%. This downwards revision is particularly significant in the area of investment, which we now estimate will contract by around 3% this year. Despite the downwards revisions, consumption and exports will make a positive contribution to growth (Figure 3.2).

Figure 3.1
GDP and investment * (% QoQ)



* 2Q14 data are BBVA Research forecasts.
Source: IBGE and BBVA Research

Figure 3.2
GDP and demand components: forecasts (%)

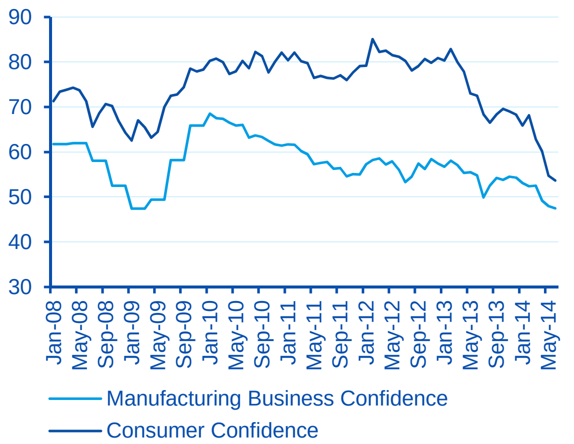


Source: BBVA Research

As well as a series of structural problems, such as, for example, the increasing loss of competitiveness in the economy (Box 3.3), activity - and investment in particular - is still suffering the negative impact of uncertainty about domestic government policy and economic developments in the future, to a certain degree because of the national and regional elections in October 2014. Another factor adding to uncertainty is the deterioration in the economy in the last few years, creating a negative cycle which is clearly unfavourable.

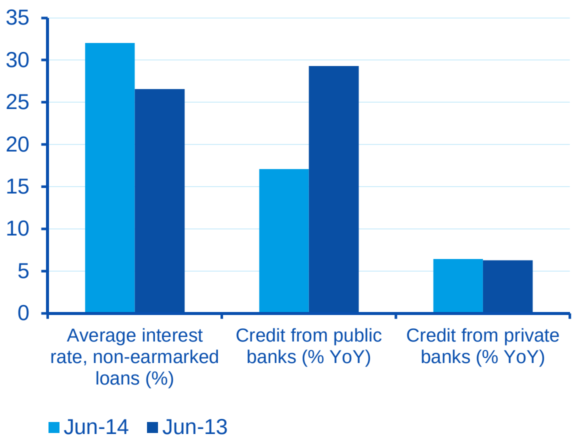
Reduced business and household confidence is a clear reflection of the current problems in the economy, especially the increased uncertainty mentioned above. The consumer confidence index has shown a strong downwards trend since the beginning of last year and is at significantly lower levels than during the 2009 crisis. The business confidence indicator, where the downwards trend started at the beginning of 2010, is currently very close to its 2009 lows (Figure 3.3).

Figure 3.3
Consumer and business confidence



* The consumer confidence indicator has been adjusted to the 0-100 range.
Source: Fecomercio, CNI and BBVA Research.

Figure 3.4
Credit markets



Source: BCB and BBVA Research

Recent fragility in economic growth is also related to the restrictive tone of monetary policy after the 375bp adjustment in the Selic rate between March 2013 and April 2014. This adjustment has contributed, among other things, to the recent appreciation in the exchange rate, with a negative impact on net exports, and to the increase in interest rates on bank loans. This last has contributed to a further moderation in the credit markets, in a context marked by a growth of only 13% YoY in credit stock (approximately 6% in real terms), in comparison with around 32% YoY (25% in real terms) in 2008, as a consequence of the recent slowdown in public loans and of the stagnation in loans made by private banks (Figure 3.4).

There were more factors contributing to moderate activity, especially through their impact on exports: the approximately 4% deterioration in the terms of trade in the first half of the year and the moderation of demand from Argentina, the traditional destination for around 8% of Brazilian exports (Figure 3.5). On that final point, there is a risk that Argentine demand for Brazilian exports will moderate even more because of the impact of the recent suspension of payments on the trade channel, (see Box 1 of our 1Q14 Brazil Outlook for more details on the impact on Latin American countries of a stress situation in Argentina).

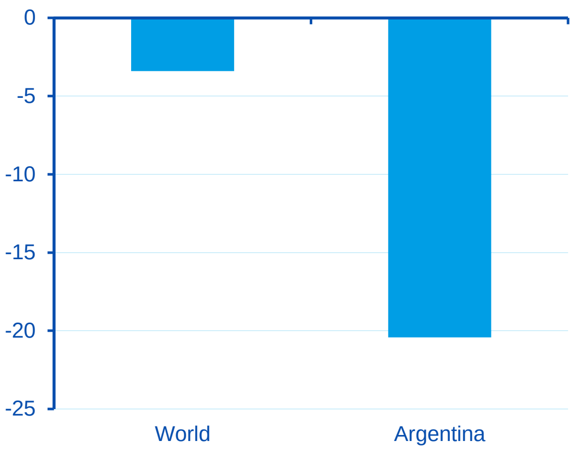
In line with expectations, preliminary evidence suggests that the recent Football World Cup had little positive impact on Brazil, restricted to a few services sectors. By contrast, the fewer working days as a result of the national holidays decreed during the event has exacerbated the negative trend in industry and other segments.

We expect the Brazilian economy to show some signs of recovery, after this particularly weak first half. This prognosis is based on the greater momentum expected in the global economy over the period and the impact - although a limited one - of some fiscal stimulus and macroprudential measures adopted recently by both the government and Brazil's central bank, the BCB (see later sections below for more information). These measures, notably the fiscal ones on the automotive sector, those supporting the export sector and capital markets and, in particular, the injection of liquidity via the reduction of reserve requirements, show that the further deterioration of economic activity has given the authorities a marginal bias in the direction of supporting growth instead of prioritising the fight against inflation.

Similarly, if this expected partial recovery does not materialise, growth this year will be around 0.5pp below our official forecast of 1.3% for this year.

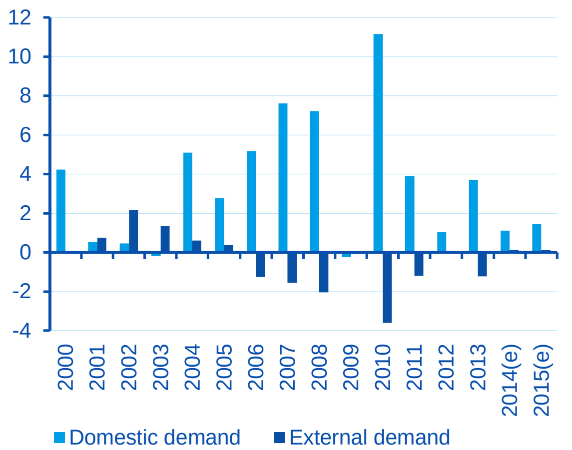
The general election in October 2014, which will, among other things, decide the President of Brazil between 2015 and 2018, increases the uncertainties about the economy's performance in the next few years. Recent surveys carried out after the Football World Cup show that, despite the increasing popularity of the opposition candidates, President Dilma Rousseff (from the *Partido dos Trabalhadores*, or Workers Party) is still the favourite in the battle against candidates Aecio Neves (of the PSDB party) and the late Eduardo Campos (PSB), both defenders of more orthodox economic policy management. In any event, even though Dilma Rousseff is the favourite, victory by one of the opposing candidates cannot be ruled out, especially Aecio Neves. This is particularly true given the desire for change revealed in recent surveys and the likely impact of the current economic scenario on voter decisions.

Figure 3.5
Goods exports, first half 2014 (% YoY)



Source: ALICEWEB and BBVA Research

Figure 3.6
Contribution of external and internal demand on GDP growth (pp)



Source: BCB and BBVA Research

Whatever the result of the general elections, we believe that 2015 will be a year of corrections, marked by the readjustment of regulated prices and a more restrictive tone in economic policies (see sections below for more detail). Without these adjustments, inflation expectations could deteriorate further, uncertainty and the lack of confidence could continue to prevent greater momentum in economic activity and doubts about public accounts could generate new downgrades in the country's credit rating[1].

In the short term, i.e. in 2015, these corrections mean that a solid recovery of economic activity is unlikely, despite greater growth in the global economy. More specifically, we believe that, after growing 1.3% in 2014, GDP will rise by 1.6% in 2015, which is the same as we were forecasting three months ago. In terms of demand components, investment and exports will contribute more to growth next year than this, because of reduced uncertainty about public policies and the expected depreciation of the real (Figure 3.2).

1: In March 2014, S&P downgraded Brazil's sovereign debt from BBB to BBB-.

Note the more positive contribution of external demand to GDP in both 2014 and 2015, compared with earlier years, which reflects in part a lower growth in imports, consequence of the moderation in internal demand (Figure 3.6). Similarly, as we have been pointing out in our reports, solid export growth, as well as investment, is a necessary condition if the country is to return to growth rates of around 3%, close to potential growth (Box 3.1). In order for exports to recover competitiveness momentum to increase, we consider that sharper currency depreciation is vital, since it is still trading at high levels, partly as a result of the central bank's exchange-rate interventions (see later sections for more details).

Box 1. The Brazilian economy's growth potential

We have updated our potential GDP growth forecasts for Brazil, incorporating real data from recent quarters in our estimation process, together with our forecasts for key variables over the coming years.

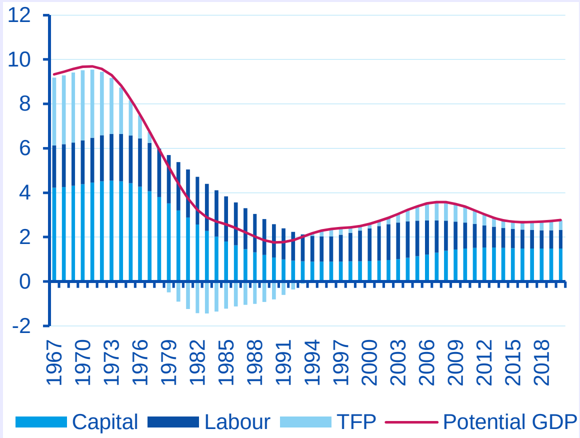
We estimate that the economy's growth potential is currently close to 2.8% and that it will stay at these levels over the next few years (Figure B.1.1).

The key contribution to this 2.8% growth comes - and will continue to come - from the capital factor, practically unchanged at 1.5pp. The labour factor and total factor productivity (TFP) currently contribute 0.9pp and 0.3pp, respectively. By 2020, the labour factor contribution will have softened very slightly, offset by the uptick in TFP. The former is partly due to a gradual reduction in the working-age population and the latter to an increase in TFP thanks to marginal positive progress in the institutional arena.

This growth rate is lower than in earlier years. Between 2007 and 2008, the potential growth rate, according to our current estimates, was close to 3.6%, thanks to higher contributions of the labour factor, helped at that point by more favourable demographic factors, and TFP.

The current potential growth rate, of 2.8%, is also lower than our 3.8% estimate a year ago (Figure B.1.2). This downward revision is due to the smaller contribution made by the capital factor, and, particularly, of TFP. In terms of the capital factor, this downwards revision is explained by the disappointing recent performance of investment (which have fallen as a proportion of GDP) and by the absence of indications of an uptick in the near future. On the other hand, we have cut our expectations for institutional progress and the business environment, partly because there is no sign of a reform agenda which would contribute to increase productivity. The deterioration of economic debate is an illustration of this, focused as it is more on macroeconomic policies than on reforms and productivity. These are the factors keeping down TFP's contribution to growth.

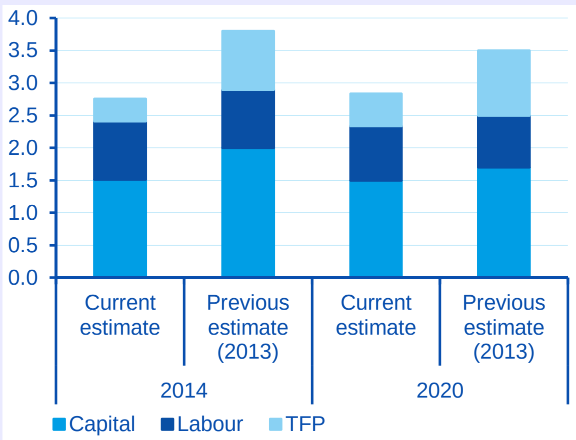
Figure B.1.1
Potential growth, by components, 1967-2020 (%)



Source: BBVA Research

Finally, bearing in mind our estimate of potential growth of close to 2.8%, we conclude that the economy's recent moderation is temporary and that activity should recover in the medium term. To be specific, we believe it will do so after the corrections we expect to be adopted once the elections have taken place, in 2015 (see earlier sections).

Figure B.1.2
Potential growth, by components, 2014 and 2020, current and previous estimate (2013)

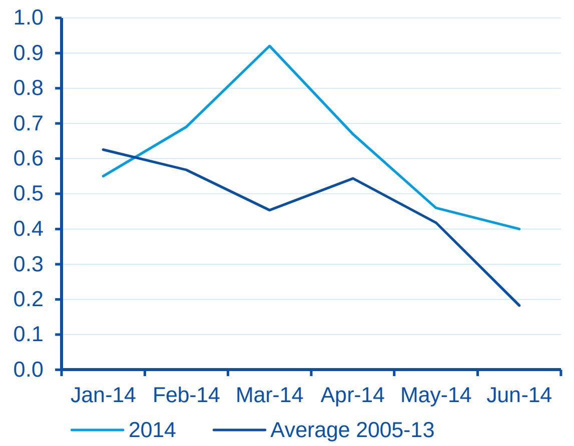


Source: BBVA Research

Inflation: above the target range and with no signs of a significant moderation resulting from any corrections to administered prices and to the exchange rate

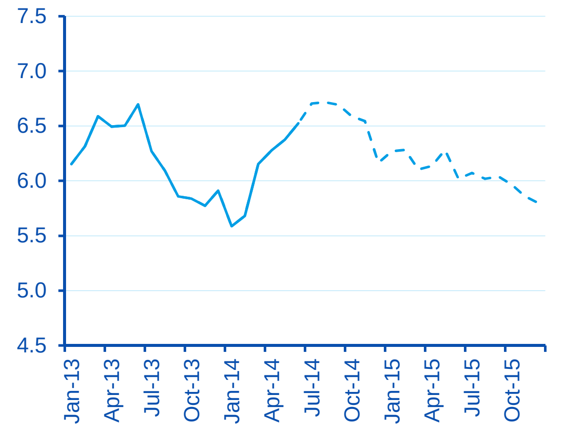
MoM inflation has been slowing every month since March, when it reached 0.92% MoM. The waning impact of the drought affecting the country earlier in the year has contributed to this downwards trend. In any event, this moderation of monthly inflation is due to a large degree to seasonal factors and has often occurred over the same period in earlier years (Figure 3.7).

Figure 3.7
Inflation (% MoM)



Source: IBGE and BBVA Research

Figure 3.8
Inflation (% YoY)



Source: IBGE and BBVA Research

Similarly, despite deceleration in monthly terms, annual inflation has risen continuously since the beginning of the year (Figure 3.7). The most recent rise, up to 6.5% YoY in June, has been affected by the heavy increase in the price of certain services, which enjoyed significantly increased demand as a result of the Football World Cup (hotels: 25% MoM, plane tickets: 22% MoM).

Although inflation will benefit in July and August from the fall in the prices of these same services which rose because of the World Cup, we forecast that in annual terms it will continue to rise over the next few months, remaining above the target ceiling of 6.5% YoY set by the central bank (Figure 3.8) until November, then slowing slightly in December, helped by a positive base effect, closing the year at 6.2% YoY, the same figure as we forecast three months ago.

As well as more structural factors, such as the economy being highly indexed, the still-significant increase in labour costs, together with the acceleration in inflation of administered products, are preventing the recent hike in interest rates and the slowdown in activity from bringing inflation down to any noticeable degree.

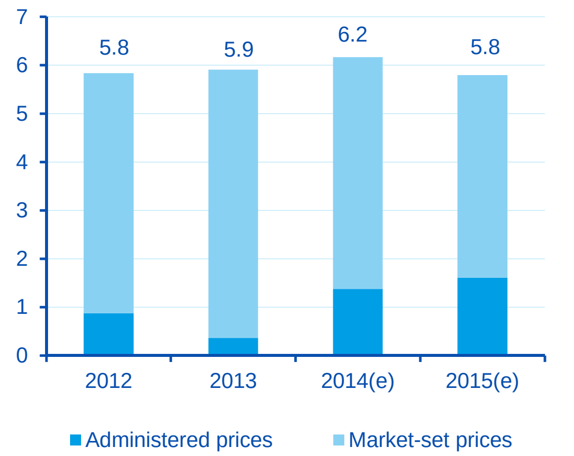
On labour costs, these are currently increasing at round 3% YoY in real terms (9% YoY in nominal terms), sustained by the very low level of unemployment (5.1%) and by the policy of raising the minimum wage, and in spite of the moderation in new job creation in the economy[2].

On the other hand, inflation of administered products is accelerating due to the lack of margin for retaining the subsidies that had been awarded in the past. Specifically, inflation of products supervised by the

2: Although new job creation in the economy has been slowing recently, the unemployment rate remains at particularly low levels because of the contraction in the workforce.

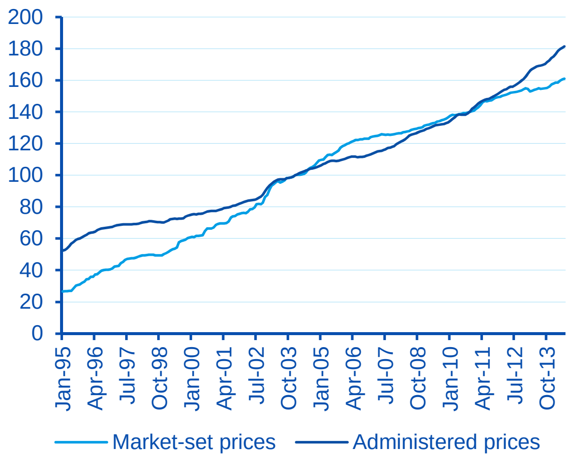
government, whose weighting in the IPCA basket of goods is around 24%, has risen from 1.5% YoY at the end of 2013 to 4.0% YoY in June 2014.

Figure 3.9
Contribution of regulated and free-market prices on annual inflation*



* The weighting of products regulated by the government in the HICP basked is about 24% in the period analysed.
Source: IBGE and BBVA Research

Figure 3.10
Free-market and regulated prices, index Jan 04=100



Source: Central bank and BBVA Research

The acceleration in inflation of products regulated by the government will continue for the next few months. We expect it to reach 6.0% YoY by the end of the year, as such contributing in a much more significant manner to inflation in 2014 than in past years (Figure 3.9).

The additional pressure expected on administered products in the coming year, when we forecast they will top 7% YoY, as well as the impact of the expected depreciation of the exchange rate, will not leave room for a reduction of any significance in inflation, even though slowing internal demand contains the upward pressures on market-set prices. The fact that long-term expectations, currently at around 6% YoY, are not anchored, is also a barrier to a sharper slowdown in inflation. In the light of all this, we forecast inflation to come in at an average of 6.1% YoY in 2015 (6.3% YoY in 2014) and to close next year at 5.8% YoY.

The convergence processes currently underway between administered and market-set prices, and between the current exchange rate and its equilibrium rate, and which the central bank has pointed up in its recent communication, should continue not only for the rest of 2014 and into 2015, but even beyond this period (see our section on the exchange rate for more details on the future outlook for the real).

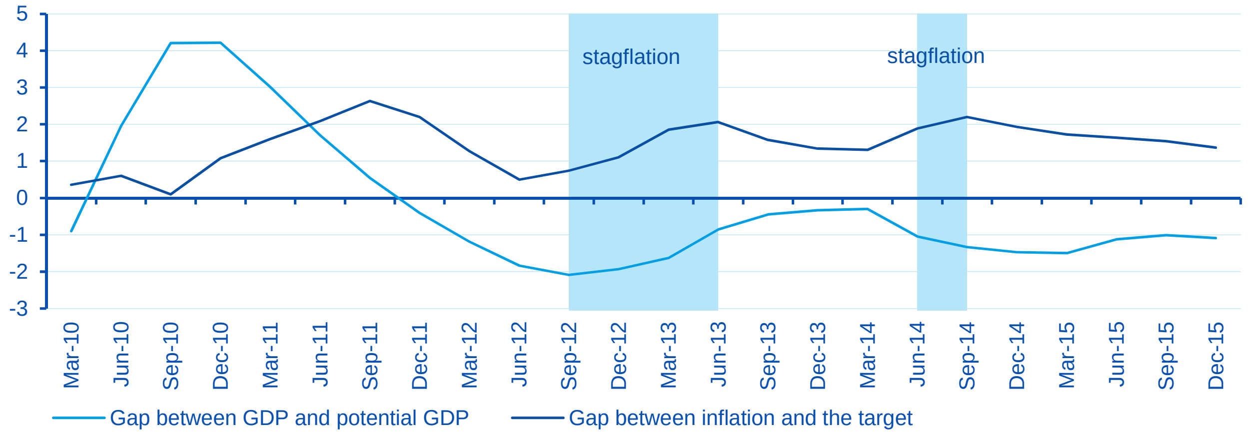
The gap between administered and market-set prices is about 13% (Figure 3.10). If we use our forecast figure for this year (inflation of market-set and administered products at 6.2% YoY and 6.0% YoY, respectively) and that of free prices for 2015 (5.5% YoY), closing the gap would require 19% inflation on administered products in 2015. However, in our opinion it is more likely that this correction will occur gradually over the next few years. In line with this view, our estimate is that administered prices will grow by 7.0% in 2015.

On the other hand, we estimate that the real is trading 10%-15% above its equilibrium rate. Convergence towards this point would have an impact of around 0.60pp-0.80pp on inflation.

The severe and persistent deterioration in economic activity and inflation rising beyond its target both signal that the economy is going through a period of stagflation

Recently observed data and our forecasts for economic activity and inflation indicate that the Brazilian economy is going through a period of stagflation in the second and third quarter of this year, in line with the identification method we have developed based on the literature on the subject (see Box 3.2).

Figure 3.11
Recent periods of stagflation (shaded areas)*



* See Box 3.2 for a precise definition of stagflation periods.
Source: BBVA Research

Put simply, our definition of stagflation is a situation in which growth remains persistently and significantly below potential GDP, at the same time as inflation rises above its target.

If we assume this methodology and our forecasts, the country will come out of stagflation in the fourth quarter and gradually distance itself from this situation in 2015 because of decelerating inflation, in spite of continuing above the central bank's 4.5% target and growth remaining noticeably below potential (Figure 3.11).

If we apply this methodology but use market consensus forecasts (inflation reaching 6.4% YoY by the end of the year) instead of our own (6.2% YoY), or if we consider the risks arising from a less gentle than expected closing of the gap between administered and market-set prices and between the current exchange rate and its equilibrium, it is not difficult to spot a risk that inflation may not decelerate and that, in this case, the economy could remain in stagflation beyond the third quarter of this year.

Finally, the high number of quarters in stagflation since the beginning of 2012 shows how weak the economy is at the moment (Figure 3.11). It also supports our analysis, above, that we cannot rule out the current stagflation period lasting beyond the third quarter, nor that other episodes such as this will occur again in the future, although at this point this is not our central scenario.

Box 2. Identifying periods of stagflation in Brazil

The dual concern about low growth and high inflation in Brazil, together with recent discussions as to whether the country is in stagflation or not, have led us to look to the economic literature for a method for identifying these situations.

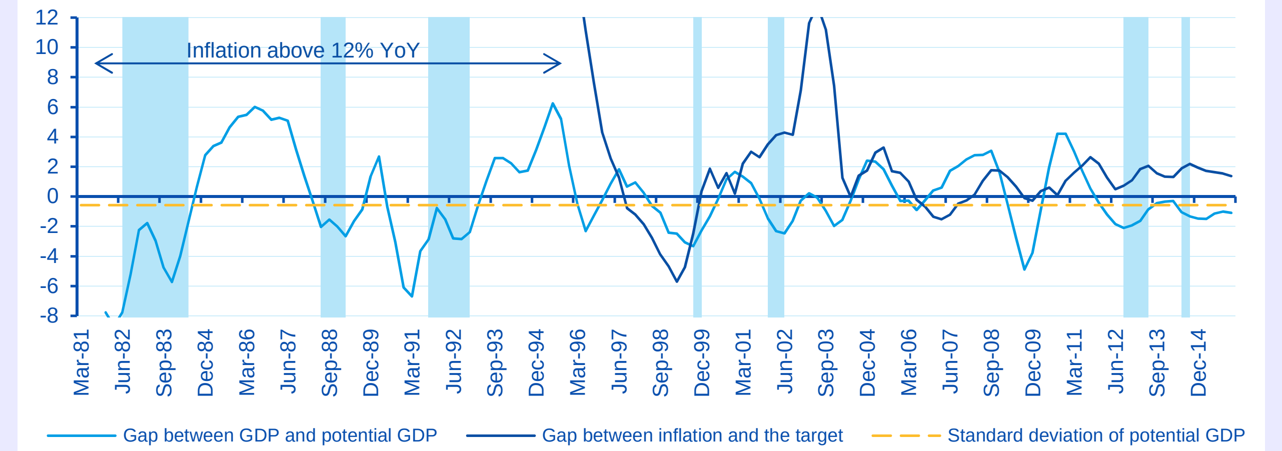
Based on the method proposed by Berthold and Grundler (2012)[3] and on an application created recently for the Chilean[4] economy, we have defined stagflation as a persistent period of below-potential growth, at least one standard deviation from the latter, at the same time as growing consumer inflation above the explicit inflation target (or of historic averages in periods before the target system was adopted).

For this identification exercise, we have employed the quarterly figures from 1981 to 2015, using our growth forecasts from 2Q14 onwards, and our inflation forecasts from 3Q14.

The GDP growth figures are the annual variation of the moving average in the last four quarters, which helps us to justify the use of the term "persistent" in our definition of stagflation. For potential GDP we have used our estimates (average potential GDP over the period being analysed: 2.72pp; standard deviation: 0.57pp). Finally, for inflation we have taken the quarterly average of the YoY inflation rate measured by the IPCA.

Figure B.2.1 shows us the periods of stagflation through which the country has passed since the early 80s and those on the forecast horizon, as far as 2015. They are as follows: 2Q82-2Q84 (the longest recession in the period under analysis), 2Q88-1Q89, 3Q89, 3Q91-4Q92, 3Q99-4Q99, 4Q01-2Q02, 3Q12-2Q13 and 2Q14-3Q14.

Figure B.2.1
Stagflation periods in Brazil (shaded areas)



Source: BBVA Research

3: Berthold, N. & Gründler, K. (2012): "Stagflation in the World Economy: A Revival?" Bayerische Julius-Maximilians-Universität, Würzburg (Germany), April 2012.
4: BBVA Research (2014):"Stagflation in Chile: More a myth than a reality", Chile Economic Watch.

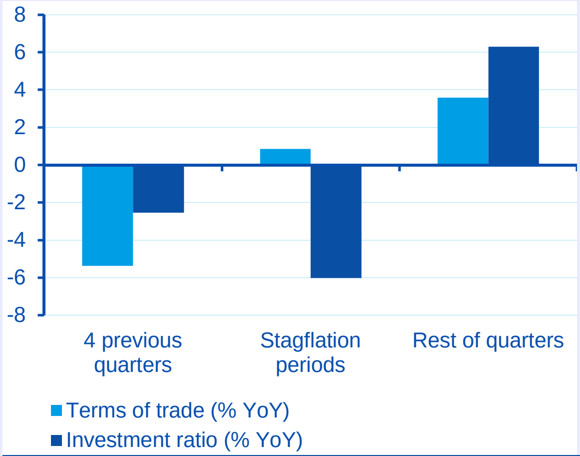
As well as confirming that Brazil is currently going through a (short) stagflation, these results show us that another situation of this type occurred recently, during the second half of 2012 and the first of 2013 and that, prior to this, the period between the second half of 2002 and the second half of 2012 was the longest the country has enjoyed without a stagflation episode since the beginning of the 80s.

Although the results vary slightly depending on the precise definition of stagflation, even if we were to take the ceiling of the inflation range (6.5% YoY) instead of the central target (4.5% YoY) as our parameter for defining whether inflation is high, or even if we were to take two standard deviations, instead of one, to establish whether GDP deviation from its potential is significant, we would still identify the second and third quarters of 2014 as stagflation periods.

Episodes of stagflation are generally linked to supply-side problems, but there are other interpretations, such as economic policy management[5], for example.

In the case of Brazil, among the variables that are potentially correlated with periods of stagflation, terms of trade and fixed capital investment (Figure B.2.2) are the most important. In particular, a fall in terms of trade tends to herald a period of stagflation[6] and a sharp fall in investment also tends to coincide with periods of stagflation[7].

Figure B.2.2
Change in terms of trade and investments in fixed capital (% YoY): during periods of stagflation, in the four preceding quarters and in other quarters



Source: IPEADATA, IBGE and BBVA Research

The present episode of stagflation in Brazil in the second and third quarter obeys the general rule: we estimate an average fall of 5.5% YoY in investment over the period and an average deterioration of 2.8% YoY in the terms of trade in the four previous quarters.

In the future, we expect a fall of approximately 3% YoY in the terms of trade and a recovery of investment in 2015. Our previous analysis recommended caution because of the deterioration in terms of trade. It also indicated that, should the expected uptick in investment go awry for some reason, the risk of the country having to face another stagflation period next year would increase.

5: For more on this subject, see: BBVA Research (2014):"Stagflation in Chile: More a myth than a reality", Chile Economic Watch".
6: In very few cases only, the period analysed, of a strong and persistent fall in the terms of trade was not followed by a period of stagflation. In addition, it is unusual for there to be stagflation without a fall in terms of exchange.
7: Investments may be falling during stagflations as a result of the latter. They are not necessarily a leading indicator, unlike terms of trade, which appears to be.

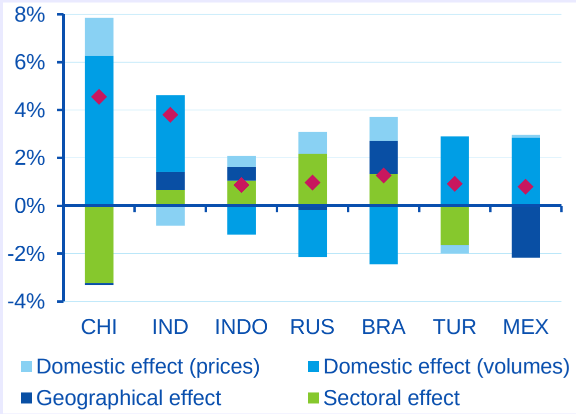
Box 3. More about the competitiveness of the Brazilian economy

A few months ago we published several studies showing, among other things, the loss of competitiveness in the manufacturing sector in Brazil over the last decade (see "Competitiveness in the Latin American manufacturing sector: trends and determinants" and the Brazil Economic Watch "The Brazilian manufacturing sector loses competitiveness").

We are returning to the subject because of its importance for the Brazilian economy and because of a new database on the competitiveness of exports, developed jointly by the World Bank and the French central bank, which breaks down the growth of a country's exports in an innovative manner into three separate elements: sector, geography and domestic effects[8].

The first two capture the effect of the composition of a country's export portfolio in terms of sector and geographical specialisation, while the third effect isolates the country's specific determinants[9]. This domestic effect can be used as a proxy for competitiveness if we consider that a country is becoming more competitive when its exports behave more favourably than those of countries whose exports have the same geographic and sector orientation. In other words, we can isolate the sector and geographical factors in an interesting an innovative way, to analyse export performance and, as such, competitiveness.

Figure B.3.1
EAGLEs: Differential between export growth in the country and in the world (YoY avg., 1Q06-1Q14, in values)



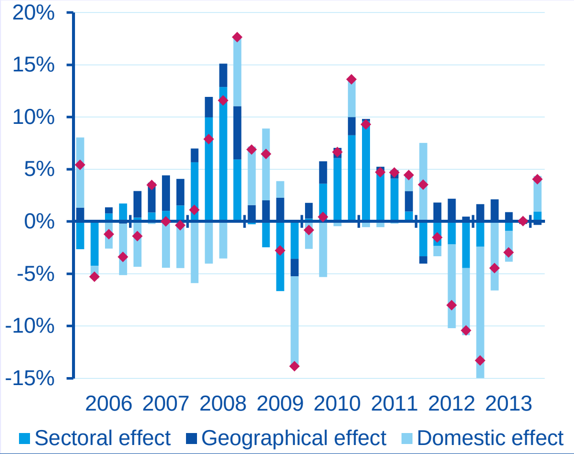
Source: World Bank, French central bank and BBVA Research

Brazilian exports grew at an annual rate of 7.4% between 1Q06 and 1Q14, compared to an average growth in global exports of 6.1%, implying a differential in Brazil's favour of 1.3pp, which, compared with other EAGLEs[10], is slightly higher than Russia, Turkey, Indonesia and Mexico, but well below China and India (Figure B.3.1).

If we break down this positive differential for Brazil and isolate the geographical and sectorial effects deriving from its export exports (+1.4pp and +1.3pp, respectively), the remaining domestic effect is negative (-1.5pp), meaning that Brazil would have lost share in global exports were it not favoured by the composition of its exports. Indeed, once the sector and geographic effects have been eliminated, Brazil is the worst-performing EAGLE member in terms of exports; and if we break down the domestic effect in terms of price (1.0pp) and quantity (-2.5pp) components, we see that Brazil's export performance is even worse.

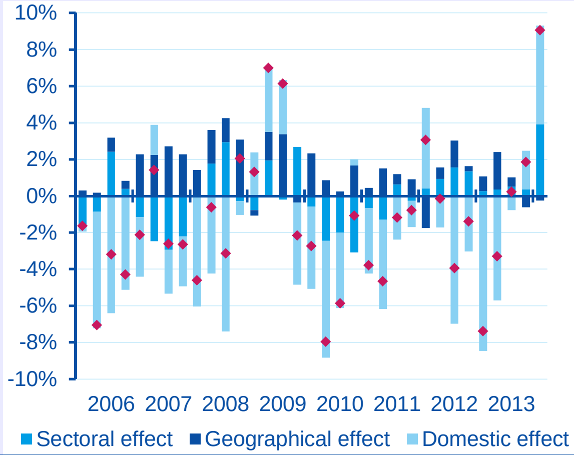
8: The data base, together with several computer graphics, is on http://ecd.bluetundra.com/.
9: For methodological details, see Working Paper "Market Shares In the Wake of the Global Crisis: The Quarterly Export Competitiveness Database" published by the Banque de France (BdF, the French central bank) and the World Bank in December 2013.
10: EAGLEs is the group of emerging economies which will contribute most to global GDP growth in the next 10 years. The group consists of China, India, Indonesia, Brazil, Russia, Turkey and Mexico.

Figure B.3.2
Differential between Brazil and global export growth (1Q06-1Q14, in values)



Source: World Bank, Banque de France (BdF, the French central bank) and BBVA Research

Figure B.3.3
Differential between Brazil and global export growth (1Q06-1Q14, in quantities)



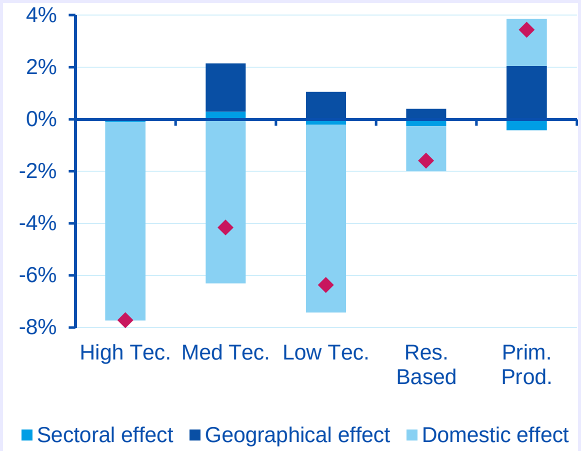
Source: World Bank, the BdF and BBVA Research

Brazilian exports performed better than the world average between 2008 and 2011 (except in the second half of 2009) and worse in 2012 and 2013 (Figure B.3.2). In any event, the domestic effect (the competitiveness proxy) was generally negative throughout the eight years analysed, with the drivers being the composition (geographical and sectorial) and price effects (Figure B.3.3).

The deterioration in Brazil's competitiveness between 2006 and 2013 was most notable in manufacturing of all kinds, whether high, medium or low technology. Gains were only made in the primary products segment (Figure B.3.4).

These results reveal new features in the process of the loss of competitiveness in the Brazilian economy in the last few years, very concentrated on the manufacturing sector, and these features support the conclusions of our earlier studies on the subject.

Figure B.3.4
Differential between Brazilian and global export growth by technological categories (annual average 1Q06-1Q14, in quantities)



Source: World Bank, the BdF and BBVA Research

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