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BRAZIL: TANGLED UP IN THE CHALLENGES OF LOW SAVINGS AND INVESTMENT **January 16th 2013**

LOW GROWTH WITH HIGH INFLATION

While the Brazilian economy will see gradual growth acceleration in 2013, the pace of expansion will be mediocre and rising inflation will prolong the recovery. The latest consensus forecasts place growth at 3.3% for 2013. This is below both the potential growth rate of 3.5%-4.0% and the annual average of 3.6% over the last ten years. Although the weak global economy can partly explain Brazil's extended underperformance, growth has also been held back by internal limitations arising from the country's unbalanced growth dynamics. The ongoing combination of strong consumption and weak investment has led to supply-side constraints that have slowed economic growth while pressuring inflation above the target mid-point.

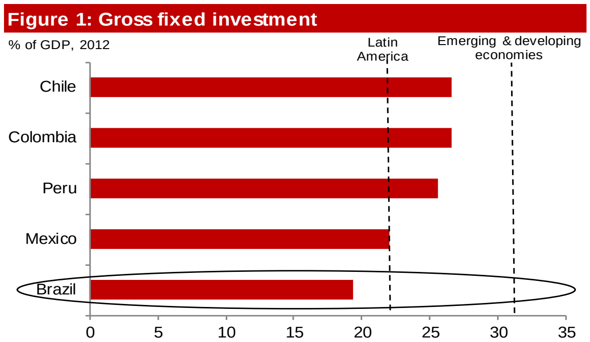
As long as Brazil saves little, fixed investment will be weak and pro-cyclical; and, when fixed investment does rise, it will be accompanied by inflationary pressures and increased reliance on foreign borrowing. A key, unaddressed weakness in Brazil's consumption-led, investment-deficient growth model remains the low savings and investment of the public sector (Figures 1 and 2). At the same time, the declining trend of investment has exposed the pro-cyclicality of spending with commodity prices; the obstructed credit market; and business environment uncertainty pertaining to the struggling industrial sector and increasing frequency of government interventions.

UNBALANCED GROWTH DYNAMICS: DECLINING FIXED INVESTMENT HAS BEEN HOLDING BACK GROWTH

Investment in fixed assets contracted in real terms by 5.6% yoy and 2.0% qoq/sa in 3Q12, marking its fifth straight quarter of negative growth on a sequential basis. This declining trend is worrisome because a sustained increase in economic growth cannot come without fixed investment and capital accumulation. As it is, Brazil's already low investment-to-GDP ratio has fallen below 19%. It continues to trail the average for the Latin America region, which in itself is below the average for emerging and developing economies (Figure 1).

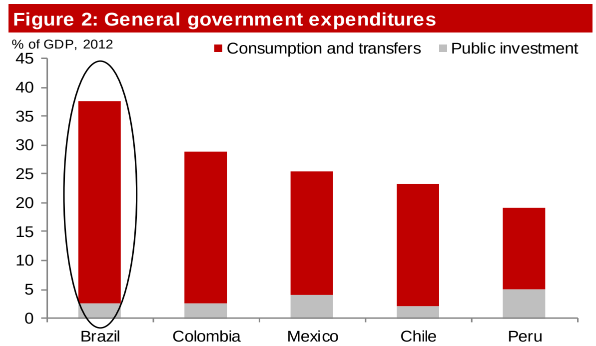
Certainly, investments have been cut back worldwide amid the period of uncertainty in the global economy. Yet Brazilian investment growth has been unremarkable since before the 2008/09 crisis and, post-crisis, it is falling behind Chile, Colombia, and Peru (Latin American countries that have similar macroeconomic policies and are net commodity exporters with growing ties to China). (Figure 1.)

Figure 1: Gross fixed investment



Source: IBGE; IADB; BTMU Economic Research.

Figure 2: General government expenditures



Source: IMF; World Bank; National sources; BTMU Economic Research.

WHY IS FIXED INVESTMENT SPENDING LOW?

Brazil has a savings shortfall.

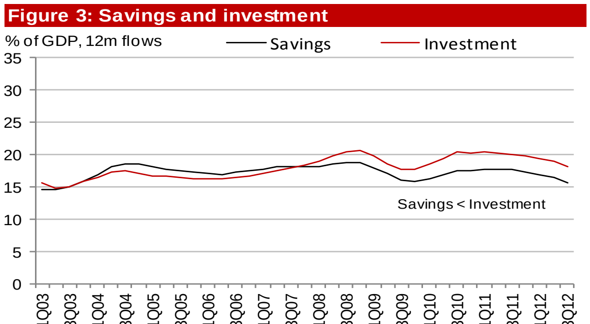
To begin, Brazil's low gross domestic savings are a structural impediment to higher investment (Figure 3). Typically, higher domestic savings are associated with elevated economic growth, as savings work through higher productive investments.

Brazil's gross savings account for just 16% of GDP, less than the regional average of 21%. The public sector is not saving; its net borrowing requirement is at 2.8% of GDP. The government's sizeable fixed expenditures on consumption and transfers come at the expense of higher investment (Figure 2). Moreover, large expenditures cut into public sector savings, in effect reinforcing the pro-cyclicality of fiscal spending and challenging the inflation-targeting Central Bank's ability to keep rates low. Meanwhile, private sector savings are limited by high tax rates and the elevated household debt burden. It is also dis-incentivized by a generous pension program.

To finance the growing shortfall between domestic savings and investment, particularly of the public sector, Brazil relies on foreign savings. In fact, it has increased its borrowing from abroad to finance investment and, accordingly, its current account balance has reverted from surpluses held in 2003-06 to a widening deficit reaching 2.2% of GDP in 2012 (Figure 4).

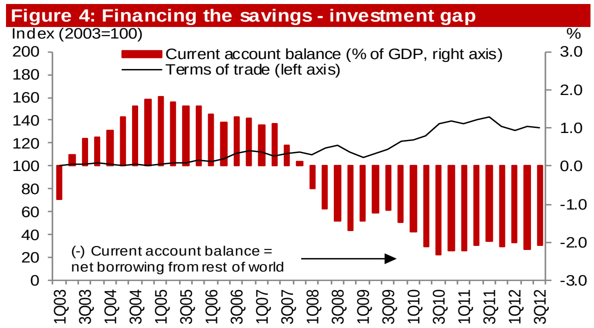
Brazil's foreign borrowing has increased despite higher commodity price inflows, meaning that Brazil's substantial gains in its terms of trade (the price of its commodity exports relative to its capital goods imports) have already been expended and, thus, not saved. Rather, the 35% improvement in terms of trade from 2003 through 2012 has assisted in containing the widening of the current account deficit.

Figure 3: Savings and investment



Source: IBGE; BTMU Economic Research.

Figure 4: Financing the savings - investment gap



Source: Central Bank; Funcex; BTMU Economic Research.

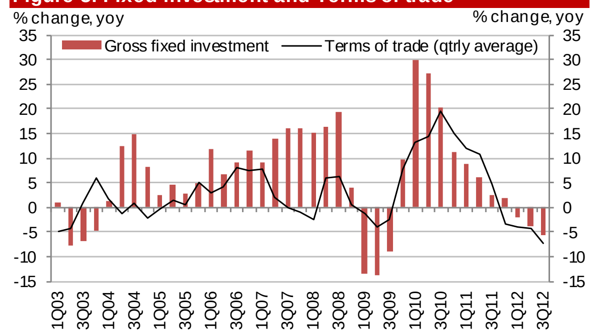
Fixed investment is strongly pro-cyclical with commodity prices.

What's more, Brazilian fixed investment spending is pro-cyclical, and it is especially correlated with commodity prices. Interestingly, investment spending moves closely with terms of trade despite Brazil being a relatively closed economy. As a matter of fact, fixed investment and terms of trade have moved together closely since 2009, while domestic savings have remained low, reflecting the intensification of the Brazil-China link through the expansionary effects of higher commodity prices on Brazilian demand. (Figure 5.)

This strong correlation between fixed investment and terms of trade is largely a result of low domestic savings and the government's pro-cyclical spending policies, which constrain its ability to smooth spending over periods of growth fluctuations.

Brazil has registered strong gains in its terms of trade over the last decade; but, given that another commodity price supercycle as was seen in 2003-08 is not on the near-term horizon, it can no longer rely on abundant improvements in the external environment to finance higher investment spending.

Figure 5: Fixed investment and Terms of trade



Source: IBGE; Funcex; BTMU Economic Research.

Weak link: The public sector is a big spender, but not on investment.

On the fiscal side, serious constraints limit the growth of the government's investment spending. First, the government is already large, and it is a big spender. Despite its high tax intake of 35% of GDP (which is high for emerging markets), it is dis-saving. The public sector's savings-investment gap has particularly widened (Figure 6).

Second, there is limited flexibility in the government's expenditures. Most of its fixed spending is tied up in recurring consumption expenditures, transfers to states and municipalities, and pension benefits. Thus, the government still invests very little. Public investments account for less than 2.5% of GDP (Figure 7).

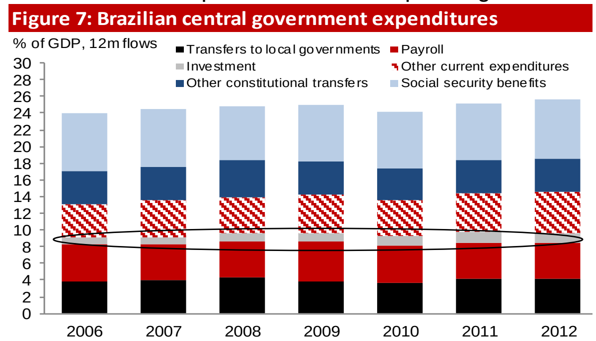
Brazil needs to raise public investment through larger public savings, not additional borrowing. Why? Larger public sector savings would assist the Central Bank in meeting its inflation target and keeping rates low, thus opening space for higher private sector investment at lower interest rates. The government could also maintain current spending levels, but shift the share of total spending towards investment and away from consumption and transfers. Both ways, the government's ability to tackle this key issue is rooted in undertaking important fiscal and pension system reforms that boost government savings and free up resources for elevated public investment spending.

Figure 6: Savings and investment balance, % of GDP

	2007	2008	2009	2010	2011	2012
Savings	18.4	19.0	16.3	18.0	18.5	18.6
Private	15.2	17.6	17.1	18.6	18.9	18.0
Public	3.2	1.4	-0.8	-0.6	-0.4	0.6
Investment	18.3	20.7	17.8	20.2	20.6	21.2
Private	16.6	18.5	15.7	17.8	18.4	18.8
Public	1.7	2.2	2.1	2.4	2.2	2.4
S-I balance	0.1	-1.7	-1.5	-2.2	-2.1	-2.6
Private	-1.4	-0.9	1.4	0.8	0.5	-0.8
Public	1.5	-0.8	-2.9	-3.0	-2.6	-1.8

Note: 2012 figures are forecasts as of July 2012.
Source: IMF; BTMU Economic Research.

Figure 7: Brazilian central government expenditures



Source: National Treasury; Central Bank; BTMU Economic Research.

RE-BALANCING GROWTH DRIVERS THROUGH HIGHER SAVINGS AND INVESTMENT

Brazil has stronger growth potential that is still bounded by its unbalanced growth dynamics. The challenge, which is endogeneous and is not new, is to balance its growth dynamics through higher savings and investment. The limitations of the consumption-led, investment-deficient growth model are now at the forefront.

Strong consumption, combined with low savings and investment, are pressuring inflation upwards and widening the current account deficit despite the weak pace of economic growth. The 12-month consumer price inflation (IPCA) rate rose to 5.84% in December. For the third consecutive time since 2010, it once again ended the year in the upper range of the inflation target. And, while this current account deficit is still moderate, foreign savings are a less favorable financing source than domestic savings since the former incur the risk of volatility in flows and fluctuations in cost during times of market stress.

The government has, so far, sought to stimulate the economy through low rates, a weaker BRL, and measures to support already-robust private consumption. But raising economic growth through fixed investment will require a longer-term, larger savings effort—which should be led by the government—as well as tax and capital market reforms to facilitate medium-to-long-term private sector investments; more productive investments to enhance competitiveness; and less interventionist government policies.

For historical data and commentary following BTMU's Economic News Releases, see our website at: https://reports.us.bk.mufg.jp/portal/site.