# BTMU LATIN AMERICA TOPICS

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## BRAZIL: PROSPECTS FOR LOW GROWTH AND HIGH INFLATION IN THE ELECTION YEAR

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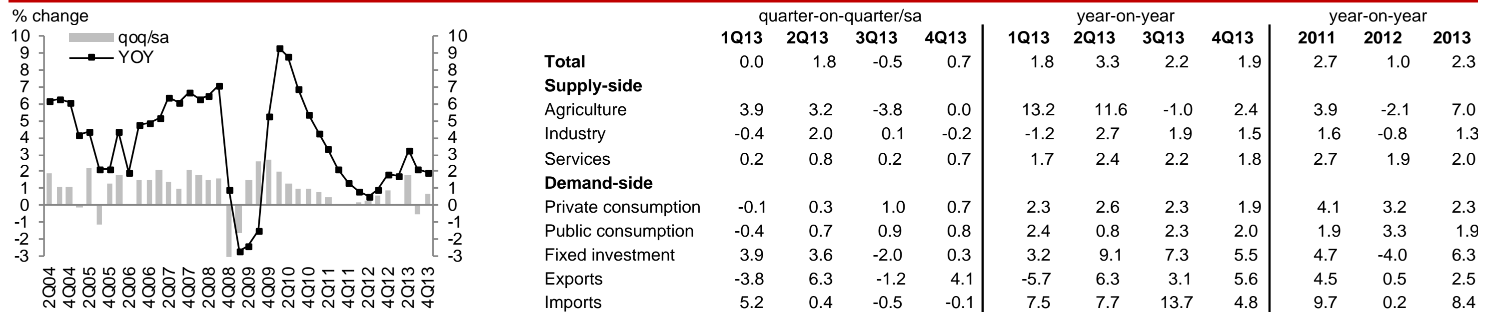
### GDP grew 0.7% qoq/sa in 4Q and 2.3% yoy in 2013

Real GDP growth rose 0.7% quarter-on-quarter (qoq/sa) in 4Q13, recovering from -0.5% qoq/sa in 3Q. (Figure 1.) With the result, the economy grew 2.3% in 2013. This is better than 2012's growth of 1.0%, but the outlook is for the economy to continue to expand below its potential of 3.5%. Growth drivers remain unbalanced: private consumption is slowing and investment continues to disappoint. This is occurring in the context of global financial market uncertainty and lower commodity prices.

Resilient private consumption—which accounts for two-thirds of GDP—grew 2.3% in 2013 and is the main growth driver of the economy. Yet, it is expanding at a weaker pace than in previous years, having slowed from 3.2% in 2012 and 4.1% in 2011. Indeed, as we have been noting, the moderation of credit growth and deceleration of real wage growth are important factors weighing on private consumption going forward. (See *Brazil: The Outlook for Consumption*, December 2013.)

Private fixed investment rose 0.3% qoq/sa in 4Q, but is still struggling to sustain growth amid weak industrial output, high inflation, and lack of policy clarity. It has declined in year-on-year terms over the last three quarters, and its growth prospects for 2014 may be thwarted by market uncertainty and strains on the electricity sector resulting from the drought. The fixed investment/GDP ratio is just 18.4%, near 2009 levels. A stronger economic recovery still requires higher investment.

Figure 1: Real GDP growth




| | quarter-on-quarter/sa | | | | year-on-year | | | | year-on-year | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1Q13 | 2Q13 | 3Q13 | 4Q13 | 1Q13 | 2Q13 | 3Q13 | 4Q13 | 2011 | 2012 | 2013 |
| **Total** | 0.0 | 1.8 | -0.5 | 0.7 | 1.8 | 3.3 | 2.2 | 1.9 | 2.7 | 1.0 | 2.3 |
| **Supply-side** | | | | | | | | | | | |
| Agriculture | 3.9 | 3.2 | -3.8 | 0.0 | 13.2 | 11.6 | -1.0 | 2.4 | 3.9 | -2.1 | 7.0 |
| Industry | -0.4 | 2.0 | 0.1 | -0.2 | -1.2 | 2.7 | 1.9 | 1.5 | 1.6 | -0.8 | 1.3 |
| Services | 0.2 | 0.8 | 0.2 | 0.7 | 1.7 | 2.4 | 2.2 | 1.8 | 2.7 | 1.9 | 2.0 |
| **Demand-side** | | | | | | | | | | | |
| Private consumption | -0.1 | 0.3 | 1.0 | 0.7 | 2.3 | 2.6 | 2.3 | 1.9 | 4.1 | 3.2 | 2.3 |
| Public consumption | -0.4 | 0.7 | 0.9 | 0.8 | 2.4 | 0.8 | 2.3 | 2.0 | 1.9 | 3.3 | 1.9 |
| Fixed investment | 3.9 | 3.6 | -2.0 | 0.3 | 3.2 | 9.1 | 7.3 | 5.5 | 4.7 | -4.0 | 6.3 |
| Exports | -3.8 | 6.3 | -1.2 | 4.1 | -5.7 | 6.3 | 3.1 | 5.6 | 4.5 | 0.5 | 2.5 |
| Imports | 5.2 | 0.4 | -0.5 | -0.1 | 7.5 | 7.7 | 13.7 | 4.8 | 9.7 | 0.2 | 8.4 |

Source: IBGE; BTMU Economic Research (NY).

### Below-potential GDP growth and high inflation present policy challenges in the election year, but adjustments are likely to be postponed

The low growth—high inflation dynamic is on track to persist for the fourth consecutive year in 2014, an election year. The government's growth forecast is 2.5%, which appears high, while the market consensus expects 1.7%. Inflation is expected at 6% at year-end, in the upper range of the Central Bank's 4.5% +/- 2% target.

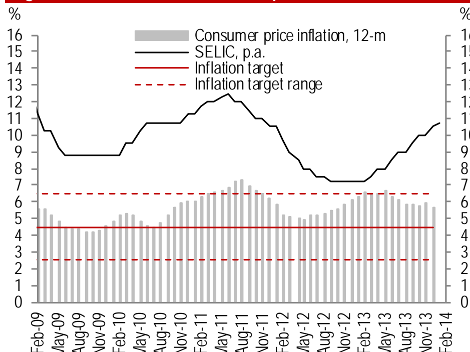
High inflation remains a risk despite GDP low growth, the Central Bank's monetary tightening cycle, and the government's suppression of monitored prices. Consumer price inflation (IPCA) decelerated to 0.55% month-on-month (mom) in January, from 0.92% mom in December, to lower the 12-month rate to 5.59%. The average core inflation measure, at 5.95% yoy in January, remains above the target midpoint. Moreover, the sizable suppression of inflation through price controls will be difficult to maintain. Free-market price inflation was 7.2% yoy, while monitored price inflation (for electricity tariffs, gasoline, and public transportation) was 2.2% yoy in the 12-months through January. (Figures 2 and 3). Pending price increases for electricity tariffs and gasoline risk generating higher inflation pressures by 2015.

The Central Bank's Monetary Policy Committee (COPOM) raised the policy interest rate (SELIC) by 25bp on Wednesday, February 26th, to 10.75% per year in a unanimous decision. The move slowed the tightening pace from 50bp delivered at the previous six meetings. COPOM has now raised the SELIC by a combined 350bp since last April. (Figure 2.) It did not clearly signal the end of the tightening cycle in its accompanying statement. We are of view that the BCB will hold at its next meeting on April 2nd, but will stay in data-dependent mode and keep the door open for more tightening sooner rather than later. If this hike was not the last one, we may see one more 25bp increase depending on inflation and BRL dynamics. More tightening would resume after the October election. Unless the BCB takes a firmer stance to lower inflation to the target midpoint, which seems unlikely in the context of weak growth and an election year, inflation will remain uncomfortably high in 2014.

It appears that the BCB will consider the government's adjusted fiscal surplus target of 1.9% for 2014 to be an adequate-enough effort to contain the growth of public spending. We note, however, that fiscal policy remains expansionary and counter to the monetary tightening effort. Further fiscal expansion is limited by the risk of a credit downgrade, and attaining the 1.9% surplus target could be difficult without resorting to one-off revenues, creative accounting, or cutting investment. (Figure 4.)

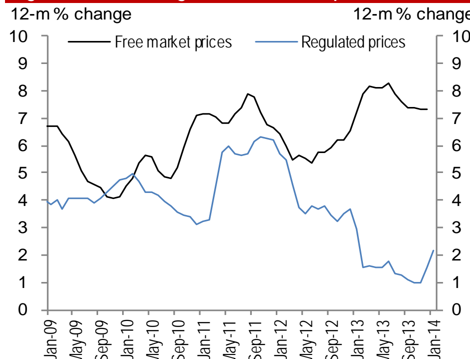
With President Rousseff still the favorite to win the October election, key policy adjustments are unlikely until 2015. Meanwhile, the government will try to get by as is.

Figure 2: SELIC and consumer price inflation



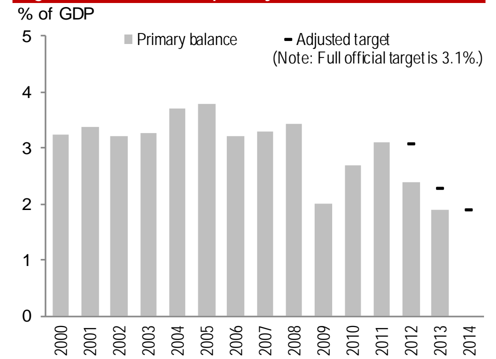

Source: Central Bank; IBGE; BTMU Economic Research.

Figure 3: Free vs. regulated consumer price inflation




Source: IBGE; BTMU Economic Research.

Figure 4: Public sector primary results




Source: Ministry of Finance; BTMU Economic Research.

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