Brazil's Macroeconomic Performance: 4Q 2016 GDP and Current Monthly Indicators

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Overview

Brazil's economic activity contracted by 2.5% YoY in the fourth quarter of 2016 and closed the year with an annual contraction of 3.6%.

Most of the components of domestic demand suffered a downturn in Q4 2016, although this was smaller than in Q3. Household consumption contracted by 2.9%. Gross Fixed Capital Formation (GFCF) contracted once again in Q4 2016 (-5.4% YoY), making this the 11th consecutive quarter of contraction.

Brazil's economy is expected to recover in 2017 due to an improvement in commodity prices, a decline in the inflation rate, and lower interest rates. The recovery will be slow and it is still highly susceptible to external and internal events (risks), such as an extended period of slower growth in emerging economies, especially China, tighter financial conditions, and the possibility that negotiations stall on the reform of the pension system as well as that political instability in Brazil continues.

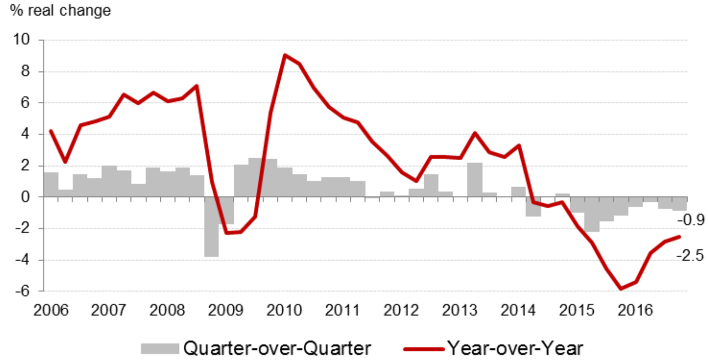
The primary balance for 2016 stood at -2.5% of GDP, a deterioration from 2015 (-1.8%). Although the government is expecting the fiscal deficit to reduce this year thanks to the fiscal consolidation, this reduction is highly dependent on pension reform being approved by congress. The first six months of this year will be crucial for Brazil, as congress will likely decide whether or not to approve this reform during this time period.

Finally, Brazil's inflation rate stood at 5.3% YoY in January 2017, and it is expected to continue its decline during 2017. This favorable situation led the Central Bank to cut the SELIC twice so far in 2017, which will help to promote economic growth.

1. GDP, Economic activity

Brazil's economy has seen its growth rate moderate from a contraction of 2.9% YoY in Q3 2016 to 2.5% YoY in Q4 2016 (Figure 1). This result from Q4 was the smallest rate of contraction over the past six quarters. From a prior quarter, GDP shrank 0.9%, making the fourth quarter of 2016 the eighth consecutive quarter of contraction.

Figure 1: GDP Growth

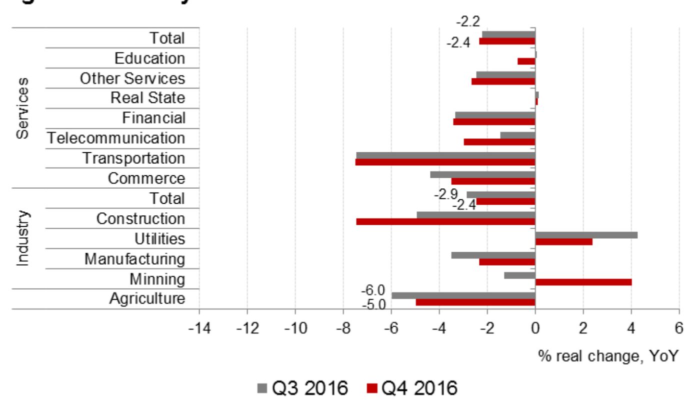


Source: Instituto Brasileiro de Geografia e Estatistica (IBGE), MUFG

GDP by Sector

On the production side, most of sectors suffered a contraction, although this drop was smaller than in Q3 2016 (Figure 2). The contraction in industrial sector lessened to 2.4% YoY in the fourth quarter of 2016, compared to a contraction of 2.9% in Q3 2016. The mining sub-sector was one of the few that experienced growth in the fourth quarter (4.0% YoY), due to the recovery of commodity prices. Construction, on the other hand, was the sector that contracted the most in Q4 of 2016 (7.5% YoY), representing the eleventh consecutive quarter this sector suffered a contraction. The service sector shrank 2.4% YoY, a little more than in the previous quarter (2.2% YoY) because of a slowdown in the education, telecommunications and transportation sub-sectors. Finally, the agriculture sector shrank 5.0% YoY in Q4 due to the massive drought that affected many regions, making this the fourth consecutive quarter of contraction.

Figure 2: GDP by Sector

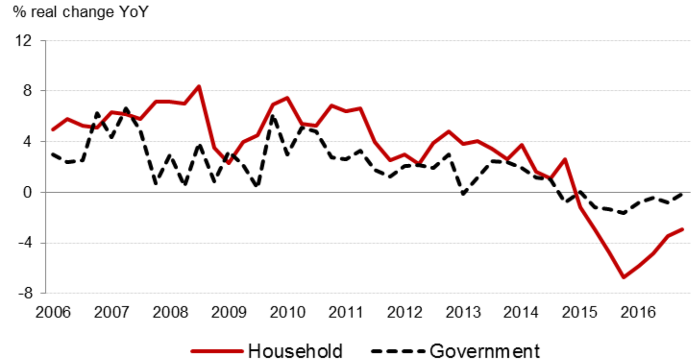


Source: IBGE, MUFG

Consumption

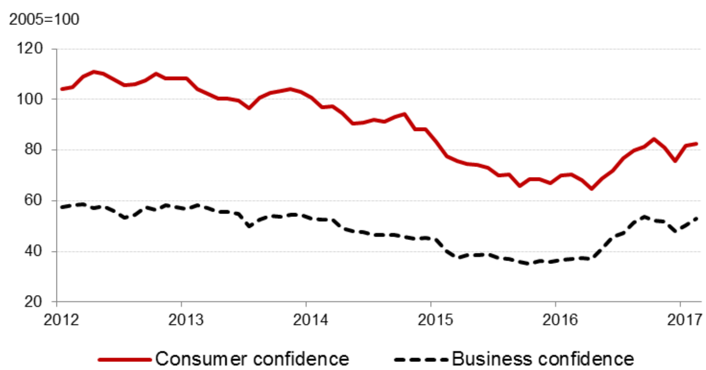
Household consumption continued its decline (falling by 2.9% YoY in Q4 2016) (Figure 3). However, this was the smallest contraction in a year and half due to the decrease in inflation that reduced the pressure on household income. The labor market continues to deteriorate, with the unemployment rate reaching 12.0% in December 2016, the highest rate that Brazil has registered since the 2003. Consumer confidence showed some signs of recovering during the first two months of 2017, with the index increasing to 81.8 in February from 77.9 in December (Figure 4). However, these values are still far below their historical averages, showing that households remain pessimistic about the future.

Figure 3: Consumption



Source: IBGE, MUFG

Figure 4: Confidence Indicators

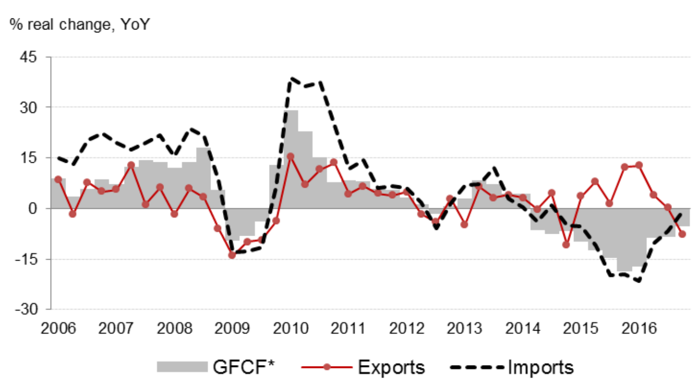


Source: Getulio Vargas Foundation (FGV), MUFG

Investment, Exports and Imports

Gross Fixed Capital Formation (GFCF) contracted once again in Q4 2016 (-5.4% YoY), making this the 11th quarter of contraction (Figure 5). Although this result was expected due to the economic conditions in 2016, as 2017 progresses, there are positive expectations for a return to growth due to likely monetary easing, an increase in business confidence, and general improvements in overall economic conditions. These factors will likely result in a modest increase in GCFC during 2017.

Figure 5: Investment, Exports and Imports



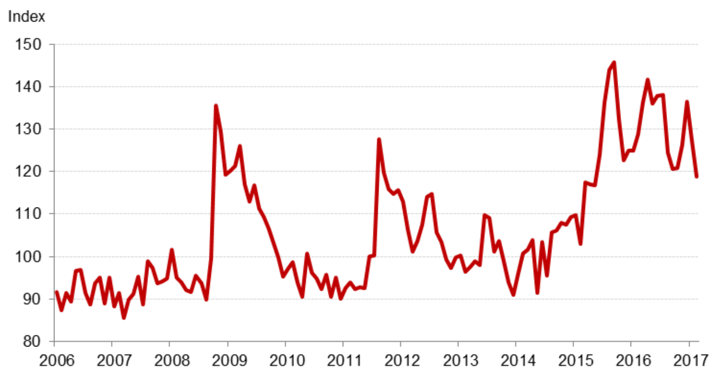
* Gross Fixed Capital Formation
Source: IBGE, MUFG

Exports plunged in Q4 2016 (-7.6% YoY), after increasing 0.2% YoY in Q3. A strong Brazilian real has hurt export sales whose performance was further exacerbated by low commodity prices. Imports saw a modest improvement during Q4 2016 (although they still contracted by 1.1% YoY) due to a strong Brazilian real and some improvements in the domestic demand. This was the smallest contraction since last quarter of 2014.

Economic Uncertainty

The Economic Uncertainty Indicator decreased by 8.5 points in February 2017 (Figure 6), the lowest level since May 2015. This downward trend is a reflection of the reduction of inflation and reductions in interest rates. This indicator, as explained in our previous report, is quite volatile and highly influenced by political events. Any improvements in this indicator should be taken with caution since the Lava Jato Operation[1] is still in progress, so more political corruption scandals could arise. In addition, if there are any setbacks during the negotiations on Social Security reform, this could reverse the fall in economic uncertainty very quickly.

Figure 6: Economic Uncertainty Indicator



Source: FGV, MUFG

Outlook

For 2017, Brazil will likely escape the recession that has plagued the country in recent years. This recession originated from external shocks, such as the fall of commodity prices and external financial volatility, and was exacerbated by internal turmoil due to one of the biggest corruption scandals in Brazil's history.

The recovery will be slow and it is still highly susceptible to external and internal events (risks), such as an extended period of slower growth in emerging economies, especially China, tighter financial conditions, and the possibility that negotiations stall on the reform of the pension system, as well as that political instability in Brazil continues. If these downside risk factors become reality, Brazilian GDP growth will suffer and any positive momentum Brazil may have gained would quickly erode.

[1] Lava Jato Operation started out as an investigation in 2014 carried out by the Federal Police of Brazil against suspected cases of money laundering, and it has expanded to cover allegations of corruption at the state-controlled oil company Petrobras, where executives allegedly accepted bribes in return for awarding contracts to construction firms at inflated prices.

2. Fiscal Policy

The Central Government primary balance[2] for 2016 stood at -2.5% of GDP, a deterioration from 2015 (-1.8%). The overall budget deficit, which includes interest payments was 8.9% of GDP.

Net debt[3] rose to 45.9% of GDP in 2016, from 35.6% of GDP in 2015. The increase in both the public debt and fiscal deficit are the result of weak revenues over the past two years and outlays to Brazil's pension program.

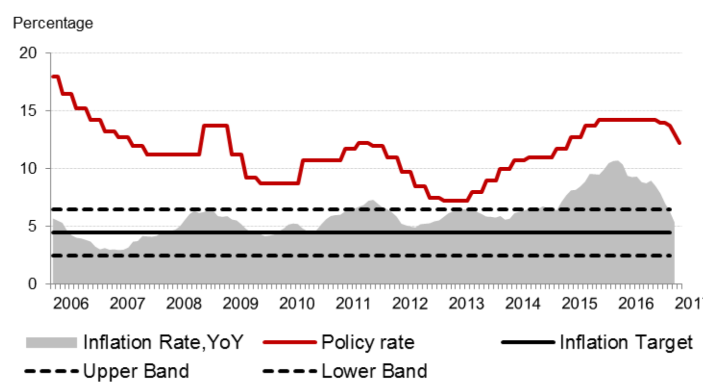
For 2017, the government is expected to reduce its deficit. Signs of this are already visible as in January the Central Government primary balance was 19 billion of Brazilian reals, compared to 14.8 billion of Brazilian reals in January 2016.

The previous numbers show a slight improvement in Brazil's public finances, but there is still some uncertainty about the pension reform. As explained in our previous report, this reform, if it happens, will greatly help in restoring the fiscal balance of the country. News about how the Brazilian congress expects to approach this reform and its possible approval will likely occur during the first half of 2017.

3. Monetary Policy and Financial Markets

Brazil closed the year with an inflation rate within the target band and inflation continued decreasing in January (where it fell to 5.3%) (Figure 7). The decrease in inflation could be attributed to currency appreciation and the general decrease of economic uncertainty. The Central Bank expects that inflation will further decline in 2017 and be around the inflation target of 4.5%.

Figure 7: Inflation and Policy Rate

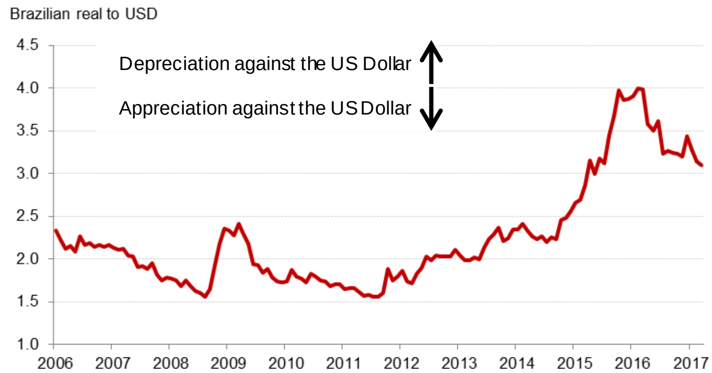


The moderate inflation in Brazil is allowing the Central Bank to continue cutting the SELIC (monetary policy rate), this time by 0.75 percentage points in February 2017 to 12.25%. A reduction in these rates will help to promote economic growth.

[2] The primary balance is the budget result prior to the interest debt payments.
[3] Net debt is calculated as gross debt minus financial assets corresponding to debt instruments.

The Brazilian real has been appreciating since the beginning of 2016 and has reached 3.15 Brazilian reals per USD (February 2017), the strongest the currency has been since July 2015 (Figure 8). The reasons for this appreciation are the increase of commodity prices and the fall of perceived risk during the last months of 2016 and the first months of 2017. This continuous appreciation, given the current state of the economy, could alter the Central Bank's monetary policy regarding the easing cycle. A possibility of depreciation also should be considered in case the government fails to approve the pension system reform. This failure would lead to more political instability that could raise the perceived risk from investors. Finally, if the Federal Reserve increases interest rates, this could also lead to a weakening of the Brazilian real.

Figure 8: Exchange Rate



Source: Central Bank of Brazil, IBGE, MUFG