Brazil's Macroeconomic Performance: 3Q 2016 GDP and Current Monthly Indicators

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Overview

Brazil economy continues to struggle, and economic indicators suggest that the economy will remain on weak footing. Economic activity contracted by 2.9% in the third quarter of 2016 compared to the same period in 2015. On the production side, most of components of the domestic demand had a downturn with the exception of the utilities sector, real state and education. Household consumption contracted by 3.4%, a reflection of a deteriorated labor market and an unemployment rate that has doubled from 5.4% in 2012 to 11.8% in October 2016.

Another factor that shows that the economic performance is failing to regain traction is the drop of 8.4% YoY in Gross Fixed Capital Formation (GFCF) in Q3 2016 that is being affected by weaker domestic demand as firms still are cutting capital expenditures and limiting their production capacity. Exports experienced a small increase of 0.2% YoY in Q3 2016, however, respect to the previous quarter, exports dropped by 2.8% and this was mainly driven by a contraction of some primary products exports, such as soybeans.

IMF estimates that Brazil will end 2016 with a contraction of 3.3% in its GDP. For 2017, it is expected Brazil will grow at 0.5%. Ultimately, growth in Brazil in 2017 is highly susceptible to external events (risks), such as an extended period of slower growth in emerging economies, further declines in export commodity prices and tighter financial conditions, and the risk of failing to deliver a fiscal consolidation strategy and pension reform.

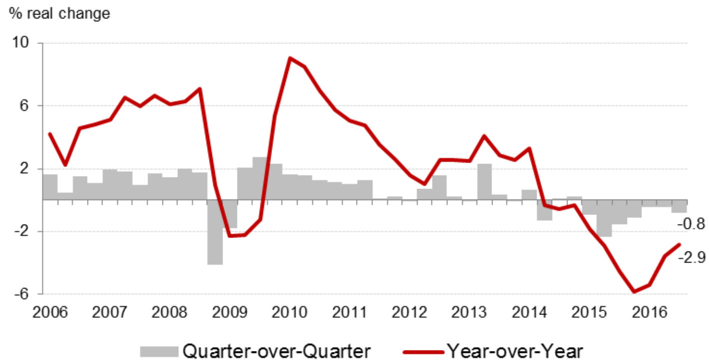
On December 13th, Brazil passed a 20 years public spending ceiling to control a ballooning budget deficit. This ceiling only allows the budget to increase by the rate of inflation in the previous year, a crucial step in an austerity drive to rescue Brazil's stalled economy. The pension reform, another unpopular measure, is planned for 2017 in order to further restore the fiscal balance.

Brazil is currently under stagflation, with inflation standing at 6.9% YoY in November. The inflation rate is considerably lower than in 2015, leading the Central Bank to cut the SELIC twice in the last two months, after almost four years of increasing it. Low interest rates are essential for easing the fiscal strain and promoting economic growth.

1. GDP, Economic activity

Brazil economy continues to struggle, and economic indicators suggest that the economy will remain on weak footing, at least in the short-term. Economic activity contracted by 2.9% in the third quarter of 2016 compared to the same period in 2015 (Figure 1), this was the smallest fall in over one year. Quarter-over-Quarter GDP shrank 0.8%, making the third quarter of 2016 the seventh consecutive quarter of contraction. The signs of recovery remain feeble and any lasting improvement is not expected in the near term.

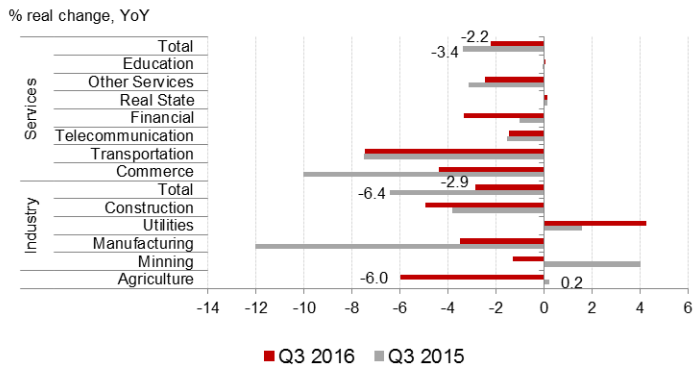
Figure 1: GDP Growth



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

On the production side, most of components of domestic demand suffered a contraction, although this drop was smaller than in Q3 2015 (Figure 2). The contraction in industrial output improved to 2.9% YoY in the third quarter of 2016, compared to a contraction of 6.4% in Q3 2015. Utilities was one of the few sectors that experienced growth in the third quarter (4.3% YoY), principally due the lifting of water restrictions that were imposed in 2015. The manufacturing sector although still negative (-3.5% YoY), showed signs of recovering when compared with Q3 2015, when it contracted by 12.0%. The service sector shrank 2.2%, a little less than in the previous period (-3.2%) because commerce, although still negative, showed an improvement, recovering from a contraction of 10.0% in Q3 2015 to only further decline by 4.4% in Q3 2016. Finally, the agriculture sector shrank 6.0% YoY in the third quarter due to a massive drought that affected many regions, making this the third consecutive quarter of contraction during 2016.

Figure 2: GDP by Sector

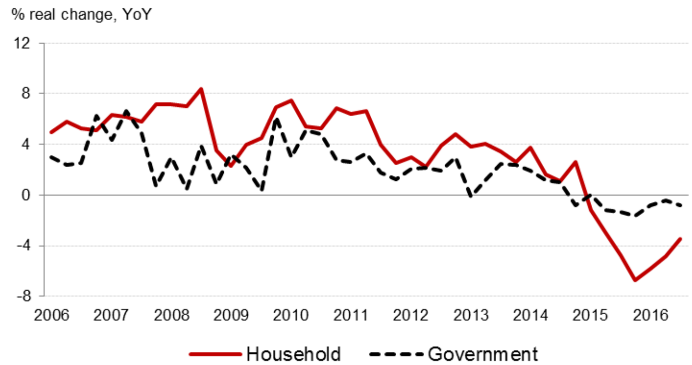


Source: IBGE, MUFG

Household consumption contracted by 3.4% YoY in Q3 2016 (Figure 3), the smallest contraction so far in 2016. Despite some signs of the recession coming to an end, the labor market continues to deteriorate, with unemployment rates having doubled from 5.4% in 2012 to 11.8% in October 2016. The severe recession and the political uncertainty have caused consumer confidence indicator to drop from 80.9 in November to 75.6 in December, the lowest since last June (Figure 4). The move was influenced mainly by the component of expectations, and it confirms that consumers are dissatisfied with the present situation and pessimistic about the coming months. The labor market is in its worst shape over the last 10 years, and high inflation and household indebtedness make this scenario even more challenging. Compounding these already difficult circumstances is the current political and economic uncertainty. This fall not only ended a cycle of improvements in consumer and business confidence, but also showed that the country's economic performance failed to regain traction.

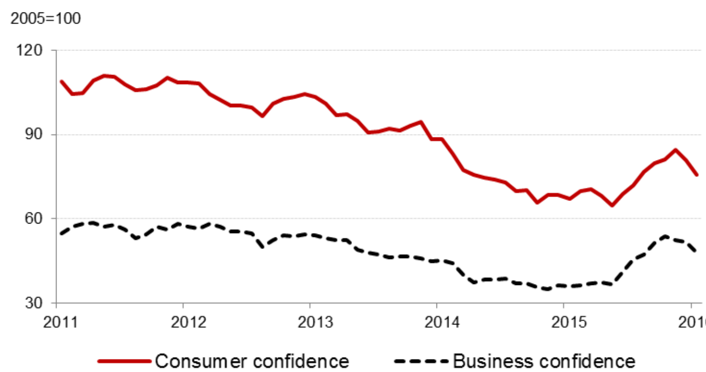
Another complicating factor in the inability for the economy to regain traction is the drop of 8.4% YoY in Gross Fixed Capital Formation (GFCF) in Q3 2016 (Figure 5). GFCF is being affected by weaker domestic demand as firms continue to cut capital expenditures and limit production.

Figure 3: Consumption



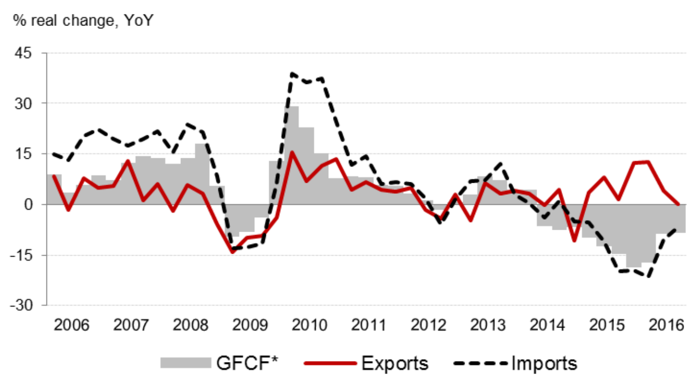
Source: IBGE, MUFG

Figure 4: Confidence indicators



Source: Getulio Vargas Foundation (FGV), MUFG

Figure 5: Investment, Exports and Imports

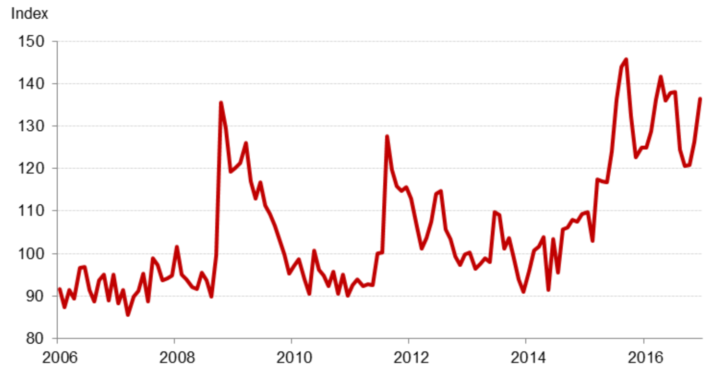


* Gross Fixed Capital Formation
Source: IBGE, MUFG

Exports experienced a small increase of 0.2% YoY in Q3 2016, however, respect to the previous quarter, exports dropped by 2.8% and this was mainly driven by a contraction of some primary products exports, such as soybeans.

The Economic Uncertainty Indicator[1] increased in December by 10 points (Figure 6). This reversed a downward trend that was observed from July to October and may signal a return of greater economic uncertainty in Brazil. This indicator is quite volatile and highly influenced by political events. Political uncertainty continued to increase as the result of additional corruption scandals, and although the announcement of fiscal austerity measures and pension plan reform are policies that are highly necessary for the country to return to the economic path of growth, they seem to be extremely unpopular among the Brazilian population. These factors have caused President Temer's popularity to continue its fall, with 46% of the population considering Temer's government as bad or terrible[2].

Figure 6: Economic Uncertainty Indicator



Source: FGV, MUFG

IMF estimates that Brazil will end 2016 with a contraction of 3.3% in its GDP. For 2017, the IMF forecasts Brazil to grow by 0.5% while Consensus Forecast is more positive, forecasting growth of 0.8%. Ultimately, growth in Brazil in 2017 is highly susceptible to external events (risks), such as an extended period of slower growth in emerging economies, especially China, further declines in export commodity prices and tighter financial conditions. Additional downside risks for Brazilian growth in 2017 include the risk of failing to deliver a fiscal consolidation strategy and reforming the pension system, as well as a risk of continued political instability. If these downside risk factors become reality, Brazilian GDP growth will suffer and any positive momentum Brazil may have gained in late 2016 and possibly early 2017 would erode.

[1] The Economy Uncertainty Indicator is comprised of three measures: i) the first one, IIE-Br- Media, is based on the frequency of news that mention uncertainty; ii) the second one, IIE-Br-Expectation, is constructed from the dispersions of business forecasts for the exchange rate and for the IPCA; and iii) the last component is based on the volatility of the financial market, the IIE-Br Market. These three measures, together, minimize the impacts that each factor singly can have on the final indicator. The consolidation of the IIE-Br results is based on the weighting of its three component indicators. Getulio Vargas Foundation. Dec 2016.

[2] MDA Poll. Approval Ratings.

2. Fiscal Policy

During the first 11 months of 2016, the Central Government expirienced a total deficit of almost 95 billion Brazilian Reals. This fiscal deficit stood at 1.6% of GDP, a deterioration when compared to the same period in 2015 (1.0%). The government expects this deficit to increase by 73 billion[3] in December, with a total fiscal deficit for 2016 of over 160 billion, an increase of over 40% when compared to 2015.

Public debt has increased around 20% from 61.2% of GDP in 2011 to 73.7% in 2015. The increase in both the public debt and fiscal deficit are the result of weak revenues over the past two years and Brazil's generous pension program [4].

On December 13th, Brazil passed a 20 years public spending ceiling to control a ballooning budget deficit. This ceiling only allows the budget to increase by the rate of inflation in the previous year, a crucial step to improve the government's balance sheet. This specific reform will apply only to the central government, so provinces would still have leeway to budget how they saw fit based on the local realities.

The IMF has written that fiscal consolidation based solely on the spending cap would take several years to stabilize public debt. In such a scenario, public debt as a ratio of GDP will continue to grow for several years before peaking and beginning to decline gradually. The overall deficit would also remain high for a period during which the government would continue to crowd out private agents from scarce funding. In order for these fiscal consolidation measures to actually lead to economic recovery in Brazil, the country will need for this fiscal cap to be only a first step in a procession of economic adjustments. For example, Brazil's pension system is very generous and is a key drain on government revenues. It is expected that in 2017 Brazil will try to reform its pension system, which would reduce the benefits paid to current and future retirees, this would be a key piece in restoring the fiscal balance of the country. However this reform will most likely face strong opposition as unemployment rises and the country remains far from regaining economic stability.

Brazil may also consider further opening its economy by reducing both tariff and non-tariffs barriers and pursuing free-trade negotiations outside Mercosur. Any move towards increased trade openness will help to boost competitiveness, increase efficiency, and ultimately lead to increase economic growth over the medium term. This policy will also enable Brazil to expand their exports into additional markets and to not be so dependent on the economic success/failure of a few countries (namely China).

[3] The government expects the deficit to expand by this amount, due mainly to expenses related to the social security system.
[4] Refer to Box 2.

3. Monetary Policy and Financial Markets

Brazil is currently experiencing stagflation, with inflation standing at 6.9% YoY in November (Figure 7 and 8).

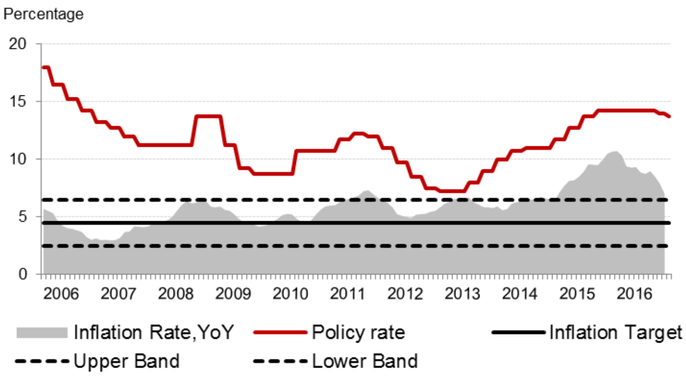
Brazilian consumer prices increased 0.18% in November over the previous month, which was below October's 0.26% rise. The rise in consumer prices was driven by higher prices for housing, clothing, transport personal expenses and healthcare, while the price of food and drink fell, although the YoY inflation rate by sector were lower than in November 2015 (with exception to health care).

The overall inflation rate on a YoY basis is considerably lower than in 2015, leading the Central Bank to cut the SELIC (monetary policy rate) twice in the last two months. These cuts were the first in almost four years, as the Central Bank had been consistently increasing rates to combat inflation. A reduction in these rates will help to ease the fiscal strain on the government and also to promote economic growth.

Inflation still remains above the Central Bank's target band of 2.5%-6.5%, with forecasters expecting inflation to close 2016 at around 6.9%. Forecasters expect inflation to further decline in 2017 and fall within the Central Bank's target band, with forecast inflation for 2016 at 5.0%.

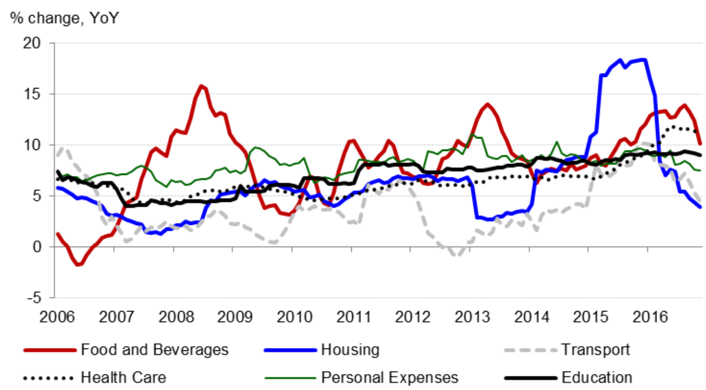
Although the Brazilian economy has not performed well in 2016, Brazil had experienced a constant appreciation of its currency (Figure 9). Given the current state of the economy, this currency appreciation is not a positive, at least not for exports. There could be several reasons for this appreciation: first, the growing signs of a bottoming out

Figure 7: Inflation and Policy Rate



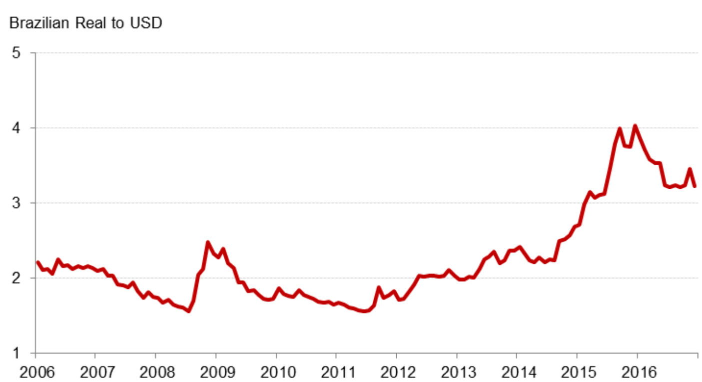
Source: Central Bank of Brazil, IBGE, MUFG

Figure 8: Inflation by Sector



Source: Central Bank of Brazil, Thomson Reuters DataStream, MUFG

Figure 9: Exchange Rate



Source: Central Bank of Brazil, Thomson Reuters DataStream, MUFG in commodities prices; second, expectations of a more moderate rate rise cycle than the Federal Reserve envisaged have caused several emerging market currencies to appreciate, including the Brazilian Real; and third, some investors may view the new government as having more credibility and foresee the end of the corruption scandals that have plagued Brazil.

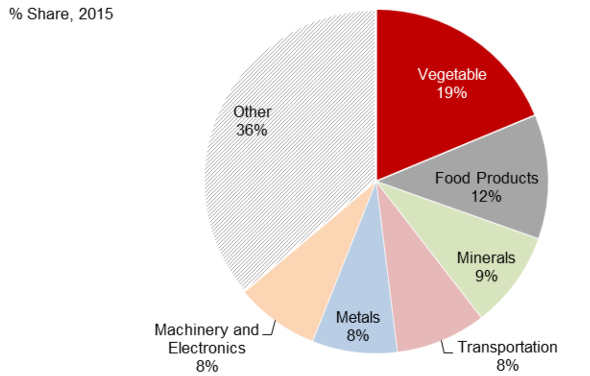
Box 1. Brazil's Exports Profile

Many factors have played a key role in determining Brazil's economic scenario. Among them is that Brazilian economy is highly dependent on commodities, such as soybeans, crude oil and iron ore (Figure 10). With the prices of such commodities low during 2015, exports fell.

China is Brazil's largest export market; almost 20% of total Brazilian exports went to China in 2015 (Figure 11). A slower demand from China has exacerbated the negative effects from the low commodity prices.

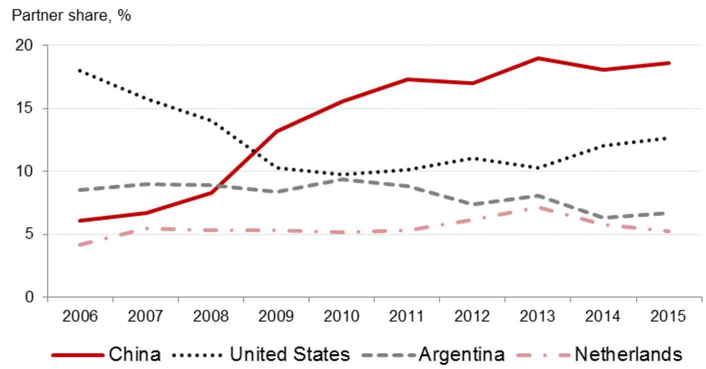
The Dutch disease is no stranger in Brazil, considering how highly dependent Brazil is on commodities. As figure 12 shows, raw material are the largest category of Brazilian exports and these exports have grown faster than total exports over the last 10 years and accounted for over 40% of total exports in 2015. The opposite happened with capital goods as their contribution to total exports has decreased over time, and in 2015 they accounted for less than 15% of total exports. The lack of investment in the manufacturing sector and its heavy reliance on commodities has created significant challenges that threaten the economy's medium and long term prospects.

Figure 10: Brazil's Exports by Products



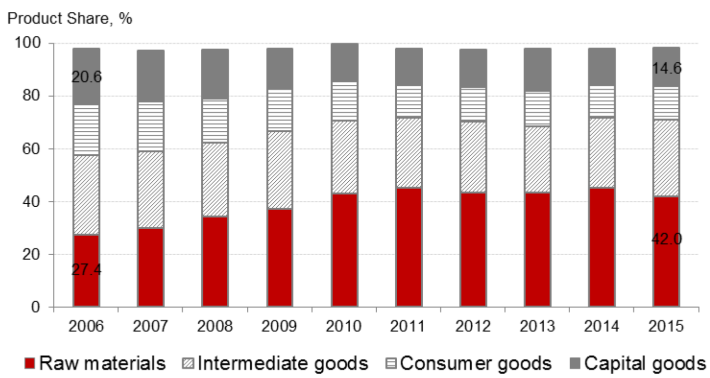
Source: World Bank-World Integrated Trade Solution, MUFG

Figure 11: Top 4 Export Partners



Source: World Bank-World Integrated Trade Solution, MUFG

Figure 12: Brazil's Exports by Product Groups



Source: World Bank-World Integrated Trade Solution, MUFG

There is nothing inherently wrong with relying on the production of raw materials as a main driver of economic growth, in fact, over the past decade Brazil has benefited from the rise in commodities prices, and the related increases in its output. However, there is a concern about the economic volatility that comes with commodity wealth. The risks of commodity dependence go beyond the possibility of lost exports revenues, driving up the value of the currency, making other parts of the economy less competitive, and leading to a current account deficit and an even greater dependence on commodities.

Box 2. Brazil's pension system

With an ageing population that is expected to surge by 2050 (almost 40% of total population will be 65 years or older in 2050)[5] and with pension costs already high (8% of GDP), pension payments are expected to more than double by 2060 (17% of the GDP). A more serious debate among government and civil society is required in order to try to address the high forecasted pension payments and to ensure future retirees receive their benefits.

Brazil's Current Pension System Structure as follow:

	General Social Security Regime (RGPS)-Pay-as-you-go (PAYG) system	The Pension Regimes for Government Workers (RPPS)	The Private Pension Regime (RPC)
Beneficiary	- Private sector employed workers - Self-employed professionals - Elected civil servants	Public-sector employees	Occupational and personal pensions are provided on a voluntary basis
Monthly Pension	Monthly pension is calculated based on the mean of the salaries registered from July 1994 to the date of retirement (excluding the lowest 20% of salaries during that period). This value is inflation adjusted and multiplied by a factor that considers the age, life expectancy and the years of contribution of the retiree. The value of the monthly pension cannot be lower than the minimum wage 880 Brazilian Reals or higher than the ceiling of 5,189.82 Brazilian Reals[6].	The monthly benefit calculation is the same as for the RGPS. In addition, public sector employees have a complementary pension made up of voluntary contributions (Under the Complementary Fund for Civil Workers- Funpresp, approved since 2003).	
Financed by	- Payroll taxes - Revenues from sales taxes - Federal transfers that cover shortfalls of the system	Pay-as-you-go basis with the employee paying a percentage of their salary	
Age of retirement	**Urban Areas** - Full retirement - at least 15 years (Y) of contributions – 65 Y-Men, 60Y-Women. - Full retirement after 35 Y of contribution irrespective of the retiree's age (55Y-Men, 50Y-Women). **Rural Areas** - Eligible for pension (without having contributed to the system) People aged over 60Y and poor citizens over 65Y.	- Full retirement (Members who joined after 2003) - 10Y of work within the government are required 60Y – Men, 55Y - Women. - Full retirement (Members who were already employed in the public sector) Men- 53Y, Women -48Y.	
Other benefits	Families inherit pensions in their entirety Paid maternity leave benefits, sickness benefits, unemployment insurance and disability pension, among other.		

Brazil's Pension Reform Plan includes the following[7]:

- Set a minimum age of retirement at 65 years, for both men and women.
- For rural areas, the minimum age to apply for the benefit will increase to 70 years.
- Raise social security contributions by civil servants. Require a minimum of 25 years of contributions in order to qualify for pension benefits.
- Reduce death pension benefits. These will be reduced to 50%, plus 10% per dependent. In addition, it will be disconnected from the minimum wage readjustment, which currently allows for real gains in pension payments.

[5] Bloomberg, based on Brazil's Finance Ministry
[6] The minimum wage is around 252USD and the ceiling is around 1,487USD (both figures are calculated using 2016 annual average exchange rate). These numbers are based on the latest publication of ABRAPP (Brazilian Association of Complementary Pension Plans Entities).
[7] Based on PEC 55 (a proposed constitutional amendment)