Country Views

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Brazil: Lower growth, lower inflation, and an election

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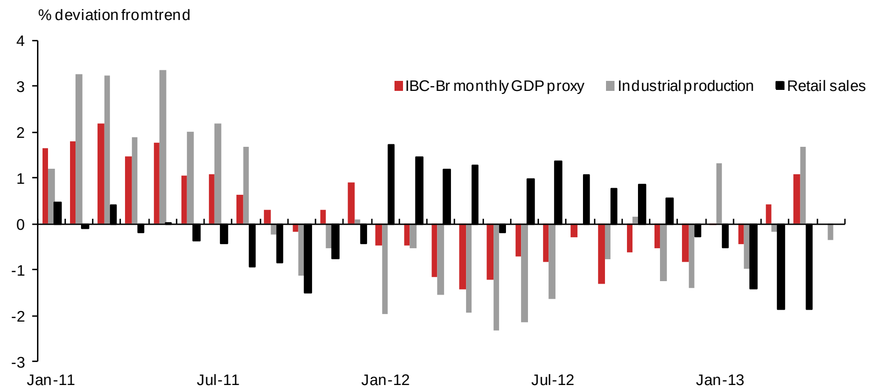
We change our growth and inflation forecasts, taking into account the recent tightening of financial conditions. We now expect growth to fall below 2% for both 2013 and 2014, together with a steady fall in inflation towards the 5% region. A fall in the Selic policy rate will depend on changes to fiscal policy.

As we have highlighted recently, changes in financial markets brought about by the prospect of normalization in U.S. monetary policy will have profound and long-lasting impact on emerging markets (see "EM Special Report - Back to the future: 1994"). Recent price action seems to validate our analysis: like in 1994, higher market rates in the U.S. have neither dented the economic recovery (as seen in the latest non-farm payroll numbers), nor knocked down prices of growth-sensitive assets such as equities, which have almost rallied back to recent highs. Meanwhile, emerging market interest and exchange rates have not seen a meaningful retracement after recent losses, and it is likely that emerging economies will have to learn to live in a world of scarcer, more expensive capital.

The transmission channel of this global shock is primarily through tighter domestic financial conditions. As each country's financial systems function differently, we have, in the case of Latin America, calculated Financial Conditions Indices (FCI) for each major economy in an attempt to measure the impact on growth. In the case of Brazil, a regression of growth against changes in the real Selic policy rate and the first principal component of 10 financial variables indicated a material negative impact on economic growth, which could become negative in year-over-year terms (see "When prices determine fundamentals").

Fig. 1: Brazil economic indicators – deviations from trend



Source: Nomura, IBGE, BCB

The Brazilian economy has entered this turbulent period in an already weakened state, with retail sales growing consistently below trend even as industrial production shows some resilience (Figure 1). When we take into account the impact of recent tightening of financial conditions on investments and consumption, we expect both to fall. In the case of investments, we were expecting a very robust 9% y-o-y rise in Q4 2013, and now we see this falling to 3.5% y-o-y, and then negative growth of -0.5% in Q1 2014. For consumption, we see growth falling to 0.6% in Q4 2013 from our previous forecast of 1.0%. **Given these changes, we now expect growth of 1.6% in 2013, down from 2.5%.**

Things are not likely to get much better in 2014: though we are not assuming a further tightening in financial conditions (a risk when the Federal Reserve actually begins to taper bond purchases), growth will probably rebound slowly. **Specifically, we now expect growth of 1.8% in 2014, down from 2.3% previously.** In part this is due to the negative effects of lower growth in China, which we expect to drive **commodity prices lower by around 20% from current levels**, something that negatively affects net exports and investments (Table 1).

Table 1: Brazil GDP, inflation, policy rate and exchange rate forecasts (% y-o-y unless otherwise noted)

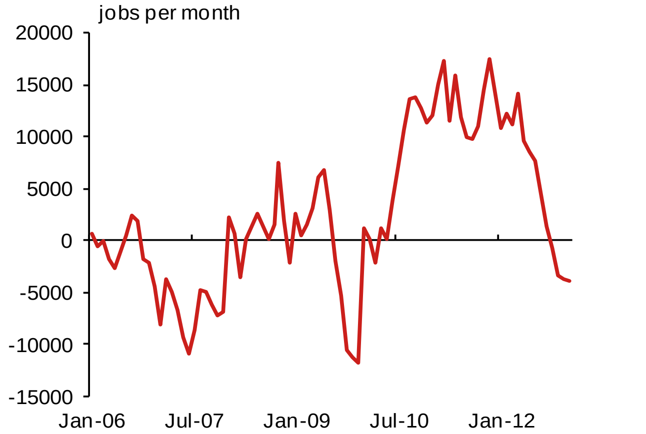
	GDP	Consumption	Investments	IPCA-Headline	Tradables	Non-tradables	Regulated	Selic (%)	USDBRL
1Q 2013	**1.9**	**2.1**	**3.0**	**6.6**	**6.9**	**9.3**	**1.6**	**7.25**	**2.02**
2Q 2013	2.2	1.6	6.2	**6.7**	**6.8**	**9.4**	**1.8**	**8.00**	**2.23**
3Q 2013	2.7	2.3	7.5	6.4	5.6	9.5	2.2	9.00	2.20
4Q 2013	-0.4	0.6	3.5	5.8	4.7	8.9	2.2	9.25	2.20
1Q 2014	1.0	2.6	-0.5	5.1	3.8	7.8	2.5	9.25	2.23
2Q 2014	1.2	2.1	1.9	5.2	4.2	7.3	3.0	9.25	2.26
3Q 2014	1.0	2.6	2.7	5.4	4.7	7.1	3.5	9.25	2.28
4Q 2014	3.7	2.9	2.1	5.2	4.1	6.9	4.2	9.25	2.30

Note: Bolds are actual values, others forecasts. Source: Nomura

How will these changes affect inflation? On one hand, they should contribute to higher inflation due to a weaker BRL, on the other hand, while the output gap will likely widen and the unemployment rate rise. **We now expect BRL to close this year at 2.20, from 2.00 previously, which will drive inflation to 5.8% in 2013 against a previously expected 5.7%.**

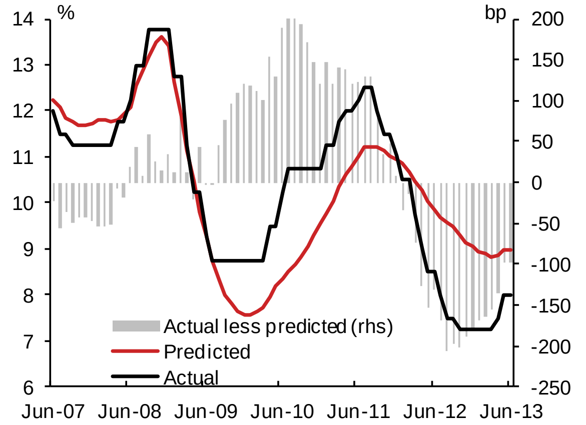
The impact on inflation from lower growth will likely kick in by 2014, the main channel being higher unemployment impacting non-tradable prices. Specifically, we see unemployment rising from 5.4% to 7.3% by the end of 2014, helping drive non-tradable inflation from 9.8% now to 6.9% by the end of 2014. Higher unemployment will be driven by both lower growth and a cooling off of the service sector, something already being seen in the CAGED payroll data (Figure 2). **This will help drive inflation lower to 5.2% in 2014, from 5.4% previously expected.** We also now expect BRL to close 2014 at 2.30.

Fig. 2: Brazil – Excessive job growth in service sectors



Note: The graph shows monthly service job creations in excess of total job creations. Source: Nomura, IBGE.

Fig. 3: Nominal Selic estimates based on Taylor rule



Source: Nomura.

Will lower growth and inflation allow the Central Bank of Brazil (BCB) to lower the Selic policy rate after the end of the current tightening cycle, which we expect at 9.25%? We would first note that hiking Selic is presently the correct policy response in order to minimize the inflationary impact of a weaker BRL, which also has the additional benefit of generating a much-needed fall in the real exchange rate, a key factor in reducing local labor costs (see "Want growth to return, call the IMF"). But afterwards, we see two conflicting forces. On the one hand, persistently low growth and inflation slowly falling back to the center of the target band argues for a lower policy rate. **Nonetheless, the rise in U.S. rates will likely lead to a higher level of neutral rates for all emerging economies, including Brazil.** With U.S. market rates trending higher, we think it will be difficult for Brazil to sustain real policy rates below 4%, which gives us a nominal Selic of around 9%. We would note this level is also suggested by our current Taylor Rule (Figure 3).

There is, however, one factor that could change much of the above: the 2014 election. We see upside risks for the economy for two reasons. First, if the results of the election point to improved business confidence, which has been a very negative factor for growth since 2012, financial conditions could improve in anticipation of that and boost growth in 2014. Second, **an improvement in fiscal policy would counteract the impact on neutral rate from external factors, allowing the BCB to cut rates in 2014 as inflation slowly falls back towards target.** Unfortunately, so far recent political developments have led to prospects of more government spending in response to street protests, as well as greater political uncertainty as the Rousseff administration tries to push through a controversial proposal of political reform.

What are the market implications? First, we think **the DI interest rate curve is too steep**, with Selic projected to rise towards 11% region by end-2014. This is not surprising given the recent rise in uncertainty that demands a substantially higher term-premium. **We would not expect any significant fall in the back-end until portfolio positions are more balanced and signs of lower inflation and lower growth are more concrete, something we think will only happen towards year-end** when we will likely see growth fall into negative territory in year-over-year terms. We would expect a substantial amount of curve flattening to occur at this point. The major risk to our forecast is that the beginning of tapering by the Fed leads to another round of liquidation in emerging markets and so even tighter financial conditions. In this case, the economy could see an outright recession.

Disclosure Appendix A-1

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