Insight

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Foreign gyrations and economic deceleration in Brazil

Brazil's real GDP growth slowed sharply in the third quarter, preliminary data showing stagnation over the previous three months, seasonally adjusted, and a slim 2.1% increase over a year ago, according to the official bureau of statistics (IBGE). These readings should be taken with a grain a salt, for IBGE also revised the time series of national accounts dating back to 2009 and is very likely to do the same when the information concerning the fourth quarter is released.

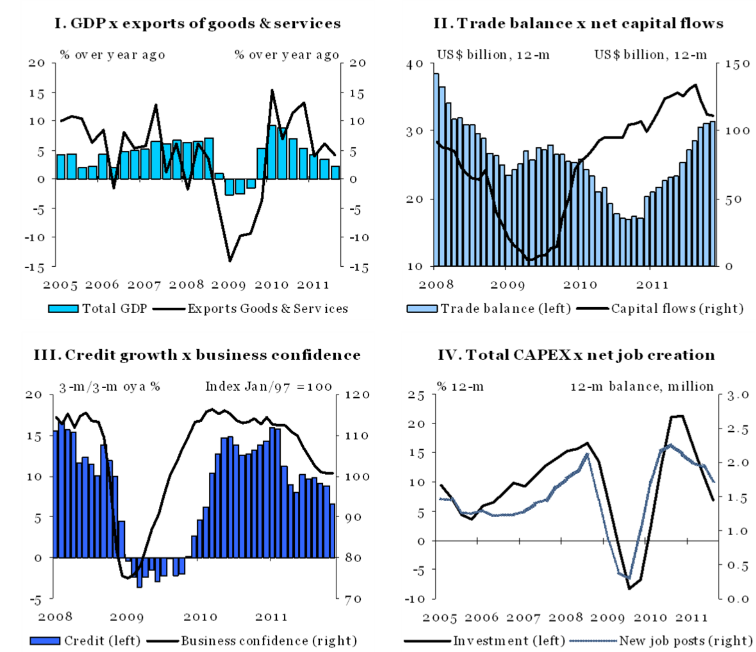
It is therefore advisable to be careful while drawing inferences from economic data, especially high frequency series. Yet there is convincing evidence that the usual transmission channels of a negative external shock to domestic activity are not playing a major role at this stage. The deterioration in global sentiment has not hurt merchandise trade and exports are merely expanding a slower pace (although twice as fast as total GDP, as can be seen in Chart I).

Moreover, net capital inflows, notably foreign direct investment, remain close to record levels (Chart II). As a result, Brazil's balance of payments is in a more solid footing now than in it was when European jitters began to jolt markets worldwide. This picture is a stark contrast to that observed in late 2008, early 2009, when foreign gyrations had a palpable impact on the economy through a steep decline in the trade balance mixed with large capital outflows and significant currency depreciation.

This time the transmission belt seems to be of a different nature. One of the most revealing microeconomic evidences of the past months is the rapid deceleration of credit concession in Brazil. By the end of the first half of 2011 credit growth was running above 10% over-year-ago and five months later the rate decreased to less than 7%, the marginal decline being driven by financing facilities provided to firms, which pace slowed to around 5% (Chart III). Foreign banks, notably European institutions, have been actively deleveraging and therefore trimming their exposure to the country. Interbank and merchandise lines have been particularly affected. This contraction indeed magnified the impact of measures formerly adopted by the Central Bank, which aimed at tightening monetary and credit conditions to fight rising inflation.

Credit scarcity combined with deteriorating global mood dented business confidence and prompted companies to downsize or altogether halt their capital expenditure plans. This abrupt response to perceived unfriendly conditions is typical of Brazil's investment spending and since stabilization in the mid-90's the country posted a very volatile but modest median gross fixed capital formation of 17% of GDP. The comparable metrics for emerging markets during the same period is 26% of GDP. It is worth stressing that the present slowdown is not only a story of CAPEX retrenchment. Insecure entrepreneurs scale down hiring (Chart IV) and this stance negatively affects one of the pillars of long term growth in the country, which is steady net job creation lifting domestic consumption, alongside higher disposable income.

Since August the government has been working to mitigate the forces dampening GDP growth. The Central Bank switched to easing tone and is lowering the policy Selic rate (currently at 11% p.a.) despite the fact that CPI readings are far away from the center of the inflation target: 6.6% up to November versus 4.5%, respectively. Credit restrictions are being dismantled and the federal administration will attempt to speed up investment programs to compensate for private sector's reluctance to deploy capital.



Sources: IBGE, Central Bank of Brazil, Fundação Getulio Vargas and Ministry of Labor and Employment.

Economic activity is expected to bounce back from the last quarter of 2011 onwards and the measures aiming at preventing a credit crunch are likely to prove the most effective. Save for another comprehensive revision of national accounts data, 3% seems to be a ceiling for real growth this year. The country should then gradually converge to its long term expansion path over the next quarters and GDP is preliminarily estimated to advance around 3.5% in 2012 and 4% in 2013.

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