Brazil – in search of the next growth engine

No. 14, 13 December 2016

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Economic situation	The recession has bottomed out
Real growth Private consumption (yoy) Inflation rate	The deep recession of the last two years has probably bottomed out and GDP is expected to grow with a small positive rate in real terms in 2017. Inflation is decreasing slowly, easing the pressure on real incomes. The inflation rate had previously acce-lerated, particularly as a result of the currency depreciation and higher administrative prices. The decline in inflation is a good thing, because the era of credit-driven consumption growth has ended for now.
Growth financing	**The situation of public finances allows no cyclical impetus**
Budget balance to GDP Current account balance / GDP Credit to the private sector / GDP	Consolidating public finances is one of the main projects of the new government, which is facing a budget deficit of 10 % of GDP. The current account deficit had eased in the wake of the real effective depreciation and resulting export increases. The appreciation since the beginning of the year, however, has reduced this advantage again. As lending to the private sector had grown strongly until the end of 2015, the banking sector should now be watched closely.
Growth resources	**More investment is needed to bolster productivity**
Investment ratio Share of manufacturing Real effective exchange rate	Investment had fallen disproportionately during the recession, plunging 14 % year-on-year in 2015; the investment ratio has dropped. Along with the comparatively low and diminishing share of manufacturing in output, this clearly illustrates the weakness of the growth model. The strong real effective appreciation since the beginning of the year is undermining the country's international competitive position again.
Economic relations with Germany	**Intensive economic relations with Germany**
Germany's share of exports Germany's share of imports FDI inflows from Germany	The mere size of its economy makes Brazil an important destination of German direct investment and exports. Germany exports mostly machinery as well as chemical and pharmaceutical products, while Brazil's exports to Germany are primarily coffee, pepper and other agricultural commodities, as well as minerals such as ores. Despite its declining share, Germany is Brazil's fifth most important export market.

Legend (see p. 5 for detailed explanation of methodology) very good good neutral poor very poor

Investment climate – assessment by our local experts

Even if the fundamental strengths of the Brazilian economy, especially the large domestic market, remain intact, the inherited burdens and structural weaknesses – bureaucracy, corruption and indebtedness – will prevent a rapid economic recovery. The new government has made a new attempt at mitigating the infrastructure problems and is relying on private investment, including from abroad. However, building a more resilient and more productive economy through increased competition will take some time. And time is something the current government has too little of, as the presidential election campaign is set to begin next year. It will therefore be crucial for this and the next government to stay the pro-business course and implement changes consistently.

Continued on p. 2

Focal theme: more competition, more investment

The deep recession has brutally exposed the weaknesses of the Brazilian growth model. Even if it was primarily demand-side factors that have driven the downturn, the legacy of the 2000s such as high private and public-sector debt levels will likely prevent a quick and strong recovery of comsumption. Hopes are therefore being placed on investment. The opportunity is also there to make the economy more flexible, more open and more friendly to competition and investment. After all, a dynamic economy that is capable of learning and innovating will manage structural changes as well as cyclical fluctuations more effectively.

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Investment climate – assessment by our local experts

The recession should have bottomed out by now, but the steps to recovery remain fragile. In particular, high unemployment and high debt levels of private households are putting a damper on consumption, while corporate indebtedness is hampering investment. At the same time, Brazil remains interesting for investors and exporters for its large domestic market and geographic location as a gateway to the region. Local and international enterprises have definitely been initiating investment projects again since the start of the year and the end of the political uncertainty caused by the impeachment of the former president.

The new government under Michel Temer is being expected to pursue business-friendly policies and put the necessary economic policy reforms in place. But it has little time because the campaign for the 2018 presidential elections is set to begin next year, restricting the scope for compromise. The government has addressed two fundamental problems: limiting public spending and improving infrastructure. Setting these priorities has given infrastructure-relevant industries and the energy sector a positive outlook on the future. The latter also includes renewables, especially solar energy. The improved cyclical outlook also improves opportunities for medical technology and the storage and logistics sectors.

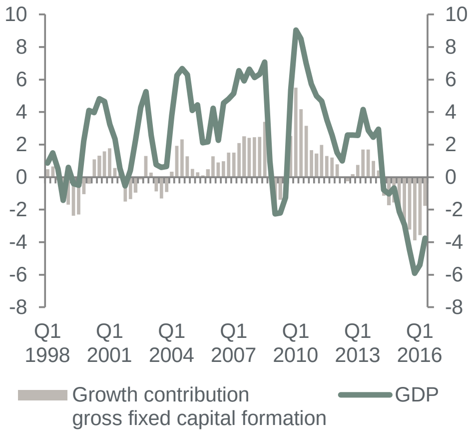
Opening the economy and enhancing competition would generally be a desirable way to challenge the sluggish industrial sector to increase productivity. This presupposes an environment that allows businesses to engage in competitive behaviour. Less bureaucracy and simplified tax legislation as well as better skilled workers would be a step in the right direction. Also necessary are international agreements that facilitate economic relations with other countries. For example, an agreement to prevent double taxation between Brazil and Germany has not been in place since 2005.

Solar energy, which is still in its infancy in Brazil, and other sectors would receive a boost if financing models could also be made attractive to international investors. International financing schemes are announced be made easier, at least for the privatisations and concessions included in the Investment Partnership Programme (IPP). The coming tenders will bring clarity in this regard. However, modifications for more competition and openness that affect the entire economy will take more time and require the willingness to effectively implement them.

Based on an interview conducted with Mariana Bormann (DEG Mercosur Office Director) on 14 November 2016. ■

Figure 1: Significance of investment for economic growth

(GDP in per cent, growth contribution in percentage points)



Sources: OECD, own calculations

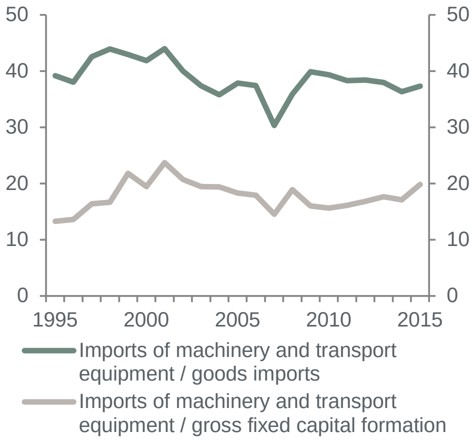
Focal theme: more competition, more investment

The deep recession of the past two years has bottomed out. The slump in economic output of the years 2015/2016 was caused by an interplay of various factors. Commodity prices dropped, fiscal policy was undisciplined, private sector lending reached unhealthy levels and was mainly driven by state-supported loans. This situation was compounded by the corruption scandal surrounding the Petrobras oil conglomerate and the impeachment of the president, which paralysed the government's economic policy in the recession as well. The central bank was forced to fight inflation which stubbornly remained on and above the upper limit of the target range, preventing it from providing economic stimulus.

The prospects for investment are brightening and will probably bolster the recovery. However, investment also accounted for a large share of the decline in real gross domestic product (Figure 1). Stronger investment growth beyond the cyclical aspect would also strengthen potential growth. For one thing, the country needs investment in infrastructure, which receives notoriously poor ratings. For another, the investment ratio is low overall and is now down to a mere 17 % of GDP.

Figure 2: The significance of capital goods imports

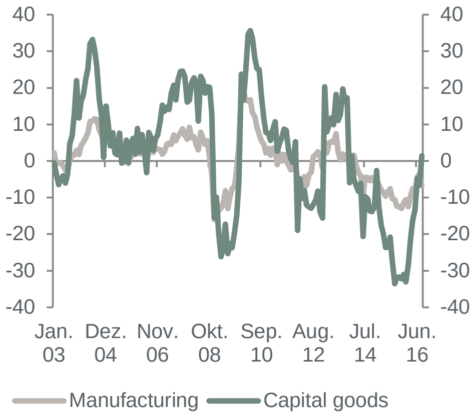
In per cent



Sources: UNCTAD, WDI; own calculations.

Figure 3: Production volume

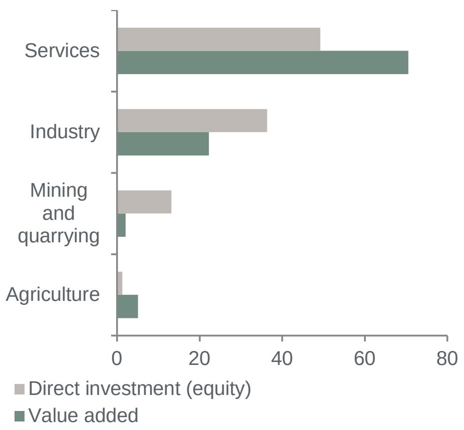
Variation on the same month in the previous year, in per cent



Sources: Thomson Reuters Datastream; IBGE; own calculations.

Figure 4: Value creation and direct investment by sector

Shares in per cent



Sources: Banco Central do Brasil; Thomson Reuters Datastream; own calculations.

Brazil imports significantly more capital goods than it exports. The decline in commodity prices has worsened the trading ratio of exports to imports, including for capital goods, which Brazil relies on. Imports of machinery and transport equipment account for around 37 % of Brazilian imports and around one fifth of gross fixed capital formation (Figure 2). Overall, however, the economy tends to be rather closed. The manufacturing sector, in particular, is scarcely oriented towards exports and has a relatively low integration into international value chains, even in the regional Mercosul context. The importance of the extractive sector and agriculture necessarily accounts for a very high share of domestic value added in exports, the highest in the group of BRIICS and G7 combined, according to the OECD. Almost half of exports contain domestic services, which underscores the economic importance of the service sector.

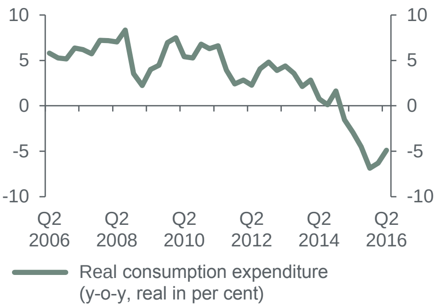
Domestic capital goods production grew at disproportionately high levels in the 2000s, but has suffered more in the current crisis than the manufacturing sector overall (Figure 3). In addition, Brazil has experienced premature de-industrialisation – as have Latin American countries as a whole. In the process, the share of manufacturing in employment and value added reached its highest level at a significantly lower per capita income and, hence, stage of development than was the case in today's industrialised countries. And even the actual highest share is lower. Thus, the proportion of manufacturing in nominal value added in Brazil is only around 11 % today, whereas it was still around 30 % in the 1970s.

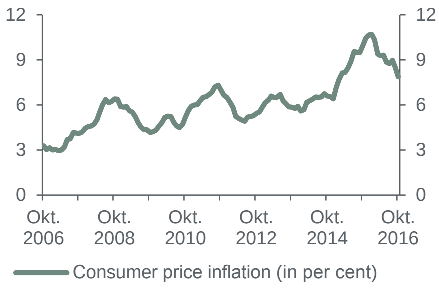
Brazil's industrial and trade policy is rather protectionist but has not been able to stop the decline of the manufacturing sector either. The protectionist measures tend to weaken competition, removing an important driver of efficiency improvements, innovation and customer orientation. The IMF and the OECD therefore see the need to open the economy, for example by gradually reducing tariffs and non-tariff trade barriers. The effective average import tariff on industrial goods is 11 %, higher than in the other South American countries (between 1.2 % in Chile and 10 % in Argentina), not to mention the EU (2 %). In public procurement procedures, bidders that produce their goods in Brazil can be up to 25 % more expensive, depending on the sector, without being disadvantaged by their higher price. The regulations on domestic content in public procurement and financing as well as tax reliefs are also in need of amendment. These affect the oil and gas industry and wind energy, among others. Overall, manufacturing and mining receive disproportionately high levels of foreign direct investment compared with their share of value added (Figure 4).

A significant part of the current Investment Partnership Programme (*Programa de Parcerias de Investimentos*) aims to boost investment. Under its Project Growth (*Plano Crescer*), privatisations will be conducted and concessions issued in the areas of transport infrastructure, energy generation, minerals extraction and water and wastewater management up until 2018 in order to stimulate private investment in infrastructure. A simplified and more transparent procurement procedure is designed to improve the chances of success compared with the preceding round of privatisation. The idea is to substitute the usual combination of bridging and long-term loans with financing models based on e.g. bank guarantees and securities. These laudable approaches must now find a reflection in the tendering procedures. A generally lower level of bureaucracy and more simplified tax legislation would benefit both domestic and international businesses. ■

Charts

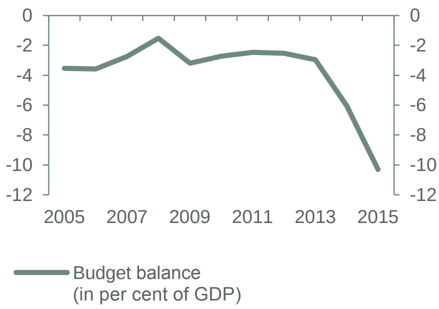
Economic situation

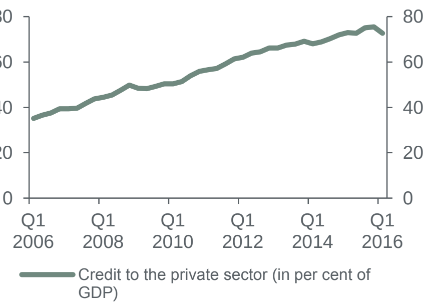




Sources: Thomson Reuters Datastream; IBGE, IMF; own calculations

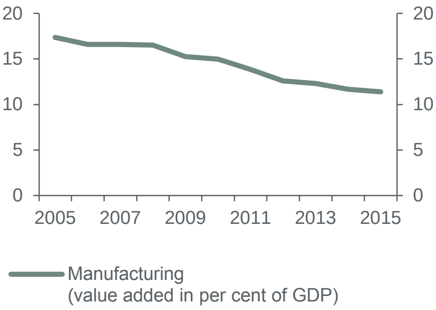
Growth financing





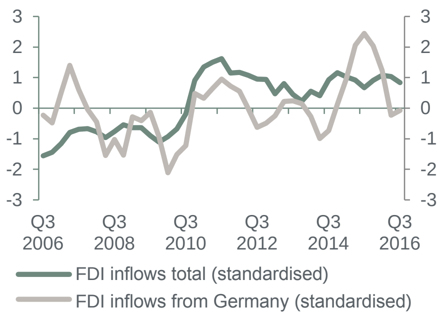
Current account balance in per cent of GDP as a moving average over four quarters.
Sources: Thomson Reuters Datastream; IMF, Banco Central do Brasil, Bank for International Settlements; own calculations.

Growth resources



Gross fixed capital formation in per cent of GDP as a moving average over four quarters.
Sources: Thomson Reuters Datastream; IBGE, World Bank, Bank for International Settlements; own calculations.

Economic relations with Germany



Moving average over four quarters.
Sources: Deutsche Bundesbank; Thomson Reuters Datastream; IMF; European Central Bank; own calculations.

Methodology

In the Emerging Markets Spotlight, a selected country is analysed based on various macroeconomic indicators. These indicators are grouped into four categories: economic situation, growth financing, growth resources and economic relations with Germany.

- Quintile 1
- Quintile 2
- Quintile 3
- Quintile 4
- Quintile 5

The indicators are used to compare the country's situation with its peers. The group comprises Brazil, China, India, Indonesia, Mexico, Russia, South Africa and Turkey. The comparison is based on a quintile ranking in five categories, which are labelled in different colours (see chart):

The country is assigned to a quintile of the country group for each indicator analysed. The best quintile may be different for each indicator. For example, higher growth rates are better, so here the upper quintile is coloured dark green, but higher debt rates are a negative factor, so here the upper quintile is coloured dark red.

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