Measured optimism

Aside from the impact of the American attack on Iran on the financial markets, which was brief and transient, as predicted, the external situation began the year relatively favorably. There are clearer signs of stabilization in world economic activity, after months of deceleration, with most economic indicators signaling a reduction in the risk of a global recession in 2020.

The situation is therefore better than in 2019, a year that was marked by different sources of international tension, viewed as potential triggers of a possible (and feared) recession. The industrial sector, which was the most affected by the reduction in world trade, has shown a slight recovery in Europe and most Asian countries. In the United States, the data still indicates weakness in this sector. However, the service sector remains very resilient. In fact, in the vast majority of countries, there is a mismatch not just between the industrial sector and service sector, but also between investment and household consumption. The latter is sustained by a labor market that remains quite favorable.

Considering that a significant part of the deterioration in the global economy in 2019 was due to uncertainties arising from tensions between the United States and China, the signing of Phase 1 of their trade agreement represents an important step toward reducing global risks. After 18 months of progress and setbacks in negotiations and many tariff retaliations on both sides, disrupting supply chains, the agreement provides for China to buy an extra US$200 billion of agricultural products and other goods and services from the U.S. over the course of two years, compared to a baseline figure of US$186 billion in 2017.

However, this relatively promising international situation is not without risks for Brazil. First, the agreement will have negative impacts on our exports, according to the analysis shown in the External Sector section of this bulletin. Second, an upsurge in geopolitical conflicts, such as tensions between the U.S. and Iran, could affect markets on a global scale.

Given the reduction in external tensions, including the weakening of protests in Latin America, at least for the moment, and a certain normalization observed in Argentina, attention has returned to the domestic situation, in which optimism also prevails. A narrative of “finally it’s time for the economy to recover” is set to strengthen in the coming months, not least because everyone wants this to happen.

However, in recent weeks, despite market optimism regarding the economic recovery, economic indicators have shown a very modest pace of growth. Despite excellent performance in terms of household consumption in the fourth quarter of last year, other indicators have been frustrating. Manufacturing has performed poorly, especially the auto and capital goods sectors. Following the disclosure of figures for November and estimates for December, we revised our projection for GDP growth in the fourth quarter, in relation to the third, down from 0.8% to 0.6%, while maintaining our forecast for whole-year growth at 1.2%.

Signs of weakness in some economic indicators in the fourth quarter reinforce FGV IBRE’s expectations of still-modest growth at the start of this year. As discussed in previous editions of FGV IBRE’s Macro Bulletin, the positive result in the fourth quarter was related to the performance of household consumption, which looks set to have increased 1.1% in relation to
the previous quarter. At the same time, investment dropped an estimated 0.2%. On the supply side, we estimate that manufacturing grew just 0.1% in the quarter. This was not enough to offset the 1% decline in the previous quarter. Meanwhile, we estimate that the service sector’s pace of growth accelerated between the quarters, from 0.4% to 0.6%.

In the first quarter of 2020, we expect a slowdown in all sectors of the economy and GDP growth of just 0.2%. This deceleration is expected due to the reduction in the effects on consumption of the release of resources from the Government Severance Indemnity Fund (FGTS) and the pickup in inflation observed since December 2019. Inflation is likely to remain high in the first few months of the year, therefore reducing families’ purchasing power. In the three following quarters, we expect growth of around 0.5% per quarter, on average, resulting in annual GDP growth of 2.2%.

Despite the increase in the minimum salary to R$1,045 a month, higher labor market informality will tend to reduce the impact of the nominal increase in minimum salary on average labor income. This is one of the highlights of the Labor Market section of this bulletin. As of mid-2020, we expect inflation to settle, before ending the year at 3.7%, down from 4.3% in 2019. In addition, we expect faster growth in formal employment in the second half of 2020, which should also contribute to a gradual recovery of real income.

Consumer surveys also reinforce this scenario of moderation in household consumption at the beginning of the year. As highlighted in the section on Business People’s and Consumers’ Expectations, financial stress indicators show that family budgets are still tight.

It is also important to moderate our optimism so that we do not neglect the government’s reforms, which continue to be highly necessary. In fact, it is important to emphasize that within Brazil, the main risk is that the sense of urgency may lessen in this second year of the Bolsonaro administration. As stressed in the previous edition of this bulletin, the tendency to delay the adoption of solutions to Brazil’s structural problems exists, and this may increase as the economy’s cyclical recovery advances.

In short, this edition of FGV IBRE’s Macro Bulletin includes the following highlights:

1. The section on Economic Activity states that the fourth quarter of last year began well. In October, there was positive growth in all the main sectors of the economy. For this reason, there were high expectations for November, but the results of monthly surveys by the national statistics agency, IBGE, were disappointing. On the other hand, the Brazilian Central Bank’s activity indicator, IBC-Br, found that the economy was up 1.1% at the end of November compared to 12 months earlier, and up 0.2% from October. This result contradicted IBGE’s surveys, but it was in line with a scenario of accelerating activity in November, as we expected. In view of the data for October and November and our expectations for December, our projection for GDP growth is 0.6% on a quarterly basis (1.8% year-over-year) in the fourth quarter. For the year 2019, our current baseline scenario is growth of 1.2%. For 2020, we expect growth to accelerate to 2.2%. (Section 1)

2. In the section on Business People’s and Consumers’ Expectations, the theme is renewed confidence. In the business world, confidence is approaching a neutral level, and in particular,
the Construction sector’s recovery seemed to gain impetus in the fourth quarter. Among consumers, there has been a gradual return of optimism, but a more consistent recovery of family confidence will continue to depend on an acceleration of the labor market. Considering the better prospects for employment in 2020, the chance that the present upward trend will continue is high. The winds of economic recovery are starting to blow harder.  (Section 2)

3. The Labor Market section states that due to the slowdown in the decline in the economically inactive population, the reduction in the unemployment rate gained momentum in the last moving quarter, to November, from 11.6% to 11.2% in relation to the same period of the previous year. This move, in contrast to the last two moving quarters (when there was a drop in the economically inactive population and unemployment virtually stagnated), suggests that the pace of reduction in the unemployment rate in 2020 will be mainly determined by the rhythm of the return of economically inactive people to the labor force. General Employment Registry (CAGED) figures for November show a strong acceleration in formal job creation, with 99,200 new jobs. For December, the projection is a reduction of 305,000 jobs. This will mean that in 2019, nearly 562,000 jobs were created (not including those outside this timeframe), up around 140,000 from 2018. With regard to income, the federal government established a nominal adjustment in the minimum salary, marginally higher than the rate previously decided. However, due to the recent pickup in inflation and increase in job market informality, which should only start to recede in the second half of 2020, real income is unlikely to grow in the first quarter of the year. (Section 3)

4. Regarding inflation, after a meteoric acceleration in the last quarter of 2019, the 12-month Extended Consumer Price Index (IPCA) result ought to remain stable in the first quarter of 2020, despite the expected slowdown in the index’s monthly rates. The sharp acceleration in the prices of proteins, especially beef, made the 12-month figure leap from 2.54% in October 2019 to 4.31% in December 2019. Part of this acceleration may gradually reverse in the first quarter, but without greatly altering the accumulated 12-month number. We expect the first quarter of 2020 to repeat the good behavior seen in the same period of 2019. This will keep the 12-month figure stable in this period. With the dissipation of supply shocks that influenced IPCA in 2019, inflation should continue to behave well throughout the year, leading IPCA to end 2020 with a 3.7% rise, comfortably below this year’s 4% inflation target. (Section 4)

5. In the Monetary Policy section, our analyst states that inflation observed in 2019 practically hit the target (4.31% against 4.25%). Interestingly, during the year and a half until the end of 2019, the Brazilian Central Bank’s official projections indicated inflation below the target. The expectations revealed by the Focus survey were also lower than the target. Our analyst argues that this turned out to be useful, as the price shocks of November and December, mainly involving meat, came as a major surprise, taking the final inflation figure to 4.31%. This result – inflation ending the year practically on target, despite strong shocks – may be seen as very helpful in keeping inflation expectations anchored over the next few years, favoring convergence of inflation to lower levels. (Section 5)

6. The Fiscal Policy section states that expectations of real growth in the federal government’s tax revenue in 2019 were dashed early in the year. Despite this, revenue recovered and ended the year in positive territory. Between January and December 2019, the federal government’s
tax revenue is estimated to have grown 1.7% in real terms in relation to the same period of 2018. This variation was due to factors beyond the recovery in economic activity. One-off impacts involving atypical events had a big impact on the year’s result. (Section 6)

7. With regard to the external sector, our analyst says that the factors that explain the reduction in the trade surplus between 2018 and 2019 will remain present and they are likely to contribute to another drop in the trade surplus in 2020. However, there is also a possibility of new facts. In the case of commodities, the U.S.-China trade deal may cause losses for Brazil and there is a small chance it will raise raw material prices. The conflict between the United States and Iran may escalate (although this is unlikely), but the effects in terms of higher oil prices would be offset by uncertainties that will prevail in relation to future global economic growth. This section highlights the trade balance in industrial products, from the perspective of Foreign Trade Secretariat (SECEX) and Foreign Trade Indicator (FGV/ICOMEX) figures. From both angles, a trend for a deterioration in the deficit is recorded. An increase in Brazil’s GDP growth should lead to higher imports, but there are no signs of improvement in exports of manufactured goods. (Section 7)

8. The International Panorama section says that the Federal Reserve has been conducting a tricky fine-tuning operation to achieve a soft landing for the American economy in 2020, stabilizing GDP growth just above the potential growth rate. There are risks and the possibility of producing a sharper economic slowdown, but everything indicates that the Fed’s operation will be successful. The current fragility of the U.S. economy is of a different nature from the fragility seen in 2007. It is about the growth of corporate indebtedness. The risk is that a strong economic slowdown could hit corporate results and help increase risks, worsening many companies’ credit ratings. This in turn could spark a wave of corporate bankruptcies, aggravating the crisis. To combat this risk, the Fed carried out a “mid-cycle” adjustment in 2019, aimed at avoiding a repetition of 2007. It would seem that the American Central Bank was successful and managed to avoid a sharper economic slowdown. For 2020, the baseline scenario is a soft landing. (Section 8)

9. Finally, the In Focus section, written by researchers Fernando Veloso, Silvia Matos and Paulo Peruchetti, is about labor productivity – the long-term driver of economic growth. (Section 9)

Armando Castelar Pinheiro and Silvia Matos
1. Economic Activity

Economic activity disappoints in November, but trend of gradual acceleration remains

The fourth quarter of last year started well. In October, there was positive growth in all the main sectors of the economy. For this reason, there were high expectations for November, but the results of monthly surveys by the national statistics agency, IBGE, were disappointing. Manufacturing continued to experience difficulties due to declining foreign demand. In November, there was a 1.3% drop from October. The wider retail sector expanded just 3.8% year-over-year and it shrank 0.6% compared to October, despite optimism related to Black Friday. In turn, the Monthly Services Survey (PMS) indicator fell 0.1% in November compared to the previous month.

On the other hand, the Brazilian Central Bank’s activity indicator, IBC-Br, found that the economy was up 1.1% at the end of November compared to 12 months earlier, and up 0.2% from October. This result contradicted IBGE’s surveys, but it was in line with a scenario of accelerating activity in November, as we expected.

In view of the data for October and November and our expectations for December, we have revised our projection for GDP growth to 0.6% on a quarterly basis (1.8% year-over-year) in the fourth quarter. For the year 2019, our current baseline scenario is growth of 1.2%. For 2020, we expect growth to accelerate to 2.2%.

In relation to the fourth quarter, on the supply side, we have cut our forecast for manufacturing growth to 0.7% year-over-year (0.1% quarter-over-quarter). This revision was due to the weak result in November, dragged down by a drop in auto and food product output, as well as less optimistic projections for December in the industrial sector. Slower growth in manufacturing had indirect effects on some service activities, such as trade and transportation, besides dampening tax revenues. As a result, we revised our fourth-quarter GDP forecast from 2.1% year-over-year (0.8% quarter-over-quarter) to 1.8% (0.6%). Even so, our expectation for GDP growth in 2019 remains 1.2%.

<table>
<thead>
<tr>
<th>Activities</th>
<th>2019.IV (QoQ)</th>
<th>2019.IV (YoY)</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Household Consumption</td>
<td>1.1%</td>
<td>1.8%</td>
<td>2.0%</td>
<td>2.6%</td>
</tr>
<tr>
<td>Government Consumption</td>
<td>0.5%</td>
<td>0.4%</td>
<td>-0.4%</td>
<td>0.1%</td>
</tr>
<tr>
<td>Investment</td>
<td>-0.2%</td>
<td>4.3%</td>
<td>3.4%</td>
<td>4.4%</td>
</tr>
<tr>
<td>Exports</td>
<td>3.6%</td>
<td>-4.5%</td>
<td>-2.7%</td>
<td>4.3%</td>
</tr>
<tr>
<td>Imports/GDP</td>
<td>-2.1%</td>
<td>2.3%</td>
<td>1.3%</td>
<td>4.1%</td>
</tr>
<tr>
<td>Agriculture</td>
<td>1.4%</td>
<td>3.7%</td>
<td>1.8%</td>
<td>4.0%</td>
</tr>
<tr>
<td>Industry</td>
<td>0.6%</td>
<td>2.0%</td>
<td>0.6%</td>
<td>3.1%</td>
</tr>
<tr>
<td>Extractive</td>
<td>-1.6%</td>
<td>0.0%</td>
<td>-2.0%</td>
<td>8.5%</td>
</tr>
<tr>
<td>Processing</td>
<td>0.1%</td>
<td>0.7%</td>
<td>0.0%</td>
<td>1.3%</td>
</tr>
<tr>
<td>Construction</td>
<td>0.6%</td>
<td>5.0%</td>
<td>2.5%</td>
<td>4.0%</td>
</tr>
<tr>
<td>Electricity and Other</td>
<td>2.9%</td>
<td>2.5%</td>
<td>2.8%</td>
<td>3.5%</td>
</tr>
<tr>
<td>Services</td>
<td>0.6%</td>
<td>1.5%</td>
<td>1.2%</td>
<td>1.7%</td>
</tr>
</tbody>
</table>

Source and produced by: FGV IBRE
On the demand side, household consumption increased an estimated 2.8% year-over-year (1.1% quarter-over-quarter) in the last three months of 2019, and we project full-year growth of 2.0% in 2019. Higher available income arising from extra withdrawals from the Government Severance Indemnity Fund (FGTS), expanding credit operations and marginal improvements in the labor market explain this acceleration in consumption at the end of last year. In the fourth quarter, investment rose an estimated 4.3% in relation to the same period of 2018. At the margin, however, we project a slight decline of 0.2%.

Accordingly, we project investment growth of 3.4% in 2019 and 4.4% in 2020. Stripping out imports of oil platforms, this figure would be unchanged in 2019 and 4.9% in 2020.

Despite the equal investment growth with and without oil platforms in 2019, the dynamics over the course of the year were different, as shown in Graph 1. These dynamics are explained by sudden changes in the comparison baseline for 2018. It should be noted that imports of oil platforms that year were mainly concentrated in the second half. As a result, there is an inversion in Graph 1, when investment without oil platforms exceeds investment with oil platforms. In 2020, we do not project any more imports of old oil platforms, so the investment metric that excludes this product should record stronger growth than the metric that includes it.

Despite the slowdown at the end, the economic activity data continued on its recovery path in relation to the previous year. Therefore, the acceleration trend is still in place. In any case, the latest results pose a warning that the ongoing cyclical recovery is still fragile and challenges for the acceleration of growth remain. As a result, structural reforms and further fiscal adjustment must be prioritized.

Silvia Matos and Luana Miranda
2. Business People’s and Consumers’ Expectations

Improvement

Our confidence indexes ended 2019 on a high. The Business Confidence Index (ICE) rose 1.5 points to 97.1 points, the highest level since March 2014, and the Consumer Confidence Index (ICC) went up 2.7 points to 91.6 points.

In the corporate world, business people’s perceptions of the current situation have improved for five consecutive months, while expectations remain relatively stable around the level of neutrality.

Among the sectors that make up ICE, the recent highlight has been construction. Although the sector’s level of confidence is still the lowest out of four major sectors, the difference between the Construction Confidence Index and the average rate for the other ones (Industry, Services and Trade) dropped 5.6 points in December – the smallest difference since May 2016, when it was 4.7. This result was mainly influenced by expectations, which in December reached the highest level since June 2013 (102.6 points).

When it comes to industry, although the sector’s survey recorded a decline in the average level of capacity utilization in the fourth quarter – a sign of weak productive performance – confidence reacted in the period, driven by improved expectations, and it ended the year in the neutrality zone once again. This result suggests confidence about recovery in the domestic market, although we judge that external risks will tend to curb optimism a little in the coming months.
Confidence in the trade sector remained on an upward trend during the second half of 2019, led by expectations of the release of resources from the Government Severance Indemnity Fund (FGTS). However, the year ended with a slight decrease, possibly influenced by consumers’ relative pessimism for much of 2019. Apparently, a more consistent improvement in consumer confidence is linked to perceptions of improved employment and a lower level of financial stress.

In terms of consumers, the good news is the return of expectations to the level of neutrality. This may be a favorable sign for 2020, if the trend is sustained in the first quarter. Even so, despite perceptions of a slight improvement in the current situation in recent months, confidence remains at a low level in historical terms and a more consistent recovery will tend to continue to depend on a recovery of the labor market.

One of the signs that household consumption impetus and capacity require a faster labor market improvement can be seen in the relationship between consumers’ perceptions of the labor market and one of the indicators in our Consumer Survey. This indicator is constructed as the sum of the relative frequencies of people who say they have been forced to tap savings to cover everyday expenses or have been led to get into debt. This “financial stress indicator” declined after reaching a peak in 2016, until mid-2018, but since then it has remained above the historical average. A similar and even less favorable movement can be observed in the indicator that measures consumers’ perceptions regarding ease of getting a job at the moment. After leaving rock bottom, this indicator is still close to the all-time low. The correlation between these two variables is nearly 0.9.

In short, the results for December show that companies and consumers are once more moving steadily in a positive direction. From a business perspective, the continuity of the recovery is linked to a continuation in the upward trend in demand. At this moment, this seems more likely at home than abroad, especially following the outbreak of a dangerous conflict between the United States and Iran in January. Considering the impact of better business prospects for employment in 2020, there is a good chance that household confidence will also continue to improve. The winds of economic recovery are blowing harder.

Aloisio Campelo Jr. and Viviane Seda Bittencourt
3. Labor Market

Unemployment rate falls at a strong pace, as the decline in the economically inactive population slows, while inflation and informality tend to weaken average income

According to the National Household Sampling Survey (PNADC), the unemployment rate in the quarter ending in November 2019 was 11.2%, down 0.4 percentage points from the same moving quarter of the previous year. This indicator was below the projection by FGV IBRE and it was also less than analysts’ median forecast.

This result was recorded at the same time as a strong slowdown in the decline in the economically inactive population (-0.1%) and stable growth in the economically active population. The combination of these two movements suggests that the dynamic of economically inactive people’s entry into the labor market may largely determine the speed of unemployment decline.

In turn, the General Employment Registry (CAGED) points to an acceleration in net vacancies in November in relation to October, from around 69,000 to 83,000 in seasonally adjusted terms. Without seasonal adjustments, the result for November was a net gain of 99,200 jobs, beating the projection by FGV IBRE (60,000) as well as market forecasts. In December, we expect a slight marginal deceleration, with a net negative result (as is usual in CAGED figures for...
December) of 305,000. In seasonally adjusted terms, this equates to 68,000 extra formal jobs in the month.

In light of higher inflation projections, mainly driven by the recent food price shock, the federal government decided to raise the minimum salary to R$1,045 per month, up R$6 from the previously agreed amount of R$1,039, and R$14 above the R$1,031 sum established in the first version of the federal budget. In fact, because of the price shock of recent months, if nominal increases remain at the previous rhythm, we expect a negative real variation in labor income in the first moving quarters in the 2020 Continuous PNAD survey, as shown in Graph 7.

In addition to the recent pickup in inflation, higher labor market informality will tend to reduce the impact of the nominal increase in minimum salary on average labor income. Graph 8 shows the increase in informality in the country in recent years. In 2020, we expect formal jobs to grow faster than informal jobs only in the second half of the year, so a further reduction in the formal employment rate will be observed in the first two quarters.

Graph 9 shows that, in fact, in 2019 there was an unprecedented convergence between the formal and informal sectors in terms of the percentage of workers whose income was close to the minimum salary (3% above or below). However, this movement was only due to the proximity between the value of the 2019 minimum salary (R$998) and the rounded value of
R$1,000, since it is well documented that there is a peak in the frequency of workers who claim to have monthly earnings in rounded amounts. Historically, even among workers with salaries close to the minimum salary, informal workers tend to register, as expected, a smaller proportion (30% to 40%) of annual adjustments close to the value stipulated by the government, in relation to formal ones (50% to 60%), as shown in Graph 10.

In other words, even with an equivalent proportion of workers receiving the minimum salary, sensitivity to government adjustments is significantly higher among those in the formal sector. Thus, in view of the recent increase in inflation and growth in informality in the last few years, no major effects on the wage bill are expected from the increase in the minimum salary to R$1,045 in 2020.

Daniel Duque

4. Inflation

Inflation may repeat the good behavior seen in the first quarter of 2019

Inflation in December, as measured by the Extended Consumer Price Index (IPCA), was 1.15%, exceeding median market expectations of around 1.09%. Because of this result, the 12-month inflation rate rose to 4.31%, above the 4.25% inflation target set for 2019, but within the range of tolerance of plus or minus 1.5 percentage points.

IPCA suddenly accelerated in the last quarter of 2019. In October, the 12-month number was 2.54%, 1.77 percentage points below the result at the end of 2019.

The main reason for this acceleration was the jump in beef prices. A sudden increase in the volume of exports to China, due to swine flu, caused prices to rise nearly 30% on average in the fourth quarter. Almost all the price increase observed for meat in 2019 took place in the last quarter, leading to an accumulated rise for the whole year of 32.4%. Give the size of this price rise, the meat item alone accounted for 20% of accumulated inflation in 2019.

The peak of meat price inflation was reached in December, when prices rose 18%. Following this acceleration, we may wonder when these prices may start to decline in 2020.

The first estimates for inflation in January 2020 indicate that the pace of acceleration is falling rapidly. According to the Inflation Monitor, it will not take long for consumer price indexes to record meat price declines. Preliminary results for the Extended Consumer Price Index (IPCA) have shown negative results since January 8, and since then the price declines have deepened.

In the Broad Producer Price Index (IPA-DI) for December, the prices of beef products went up 7.85%, less than the 15.63% rise seen in November. This slowdown has continued with the prices in the January statistics. The next editions of IPA should show declining variations for beef-related items, and this movement, as indicated in the statistics in the Inflation Monitor, has already reached the retail market.

IBGE’s next inflation results will be January’s IPCA-15. The Inflation Monitor indicates a decline from December’s figure of 1.05% to 0.70% in January. This edition of IPCA-15 will also use an old weighting, but a preliminary result for January’s IPCA will be considered, based on a new
weighting. The behavior of IPCA-15, even using the old weighting, indicates a slowdown in inflation.

According to the Inflation Monitor, in January – with the weighting structure updated in line with the 2017/2018 Household Budget Survey – IPCA is expected to increase by close to 0.4%, representing a sharp slowdown from December, when it rose 1.15%. This downward contribution arising from the weighting update is modest compared to the slowdown recorded in the prices of items that drove inflation in December, such as meat, fuel and lottery tickets. Our estimate for IPCA in January would be nearer 0.5% if the weightings were not updated.

The contribution to the deceleration in the index will mainly come from the Food and Drinks group, for which we expect a variation of around 1%, down from 3.38% in December. Major contributions will also come from Transportation (1.54% to 0.26%) and Personal Expenses (0.92% to 0.25%), which should show a decline in their rates of change.

Thus, despite the meteoric acceleration in the last quarter of 2019, the 12-month IPCA rate should remain stable. We expect a slowdown in the monthly figures in the first quarter of 2020.

The sharp acceleration in the prices of protein, which made the 12-month number leap from 2.54% in October 2019 to 4.31% in December 2019, may gradually reverse in the first quarter, but without significantly altering the accumulated 12-month rate. We expect the first quarter of 2020 to repeat the good behavior seen in 2019. With the dissipation of supply shocks that influenced IPCA in 2019, inflation should continue to behave well throughout the year, leading IPCA to end 2020 with a 3.7% rise, comfortably below this year’s 4% inflation target.

5. Monetary Policy

Inflation on target

Inflation observed in 2019 practically hit the target. In fact, in the year as a whole, the average pace of growth in consumer prices, measured by IPCA, was 4.31%, very close to the official target of 4.25%.

Looking at estimates in statements issued after each meeting of the Brazilian Central Bank’s Monetary Policy Committee, we can see that since mid-2018, the Central Bank’s official projections generally suggested that 2019 would end with an observed inflation rate below the target, as occurred in 2017 and 2018. The expectations in Focus studies indicated the same thing.

Certainly, there was no shortage of people criticizing the monetary authorities for not reacting to these results. They argued that in the circumstances, the Central Bank ought to resume the cycle of reductions in the benchmark Selic interest rate, which was halted in May 2018. Between October 2016 and March 2018, the benchmark rate was cut 12 consecutive times, in doses ranging between 25 and 100 basis points, from 14.25% to 6.5% per year.
At the beginning of the second half of 2019, the Central Bank understood that there was room to resume cutting Selic without threatening the achievement of the inflation target. In July, Selic was lowered 50 points. Three more cuts of the same size took the base rate to its present level of 4.5%.

Table 2 shows the official inflation forecasts (in line with different criteria), the expectations in Focus reports and inflation observed in the 12 months ended in the month before the respective meeting of the Brazilian Central Bank’s Monetary Policy Committee, since mid-2018. The 4.25% target for 2019 appears in the far-right column.

![Table 2: Central Bank’s Forecasts and Focus Report Estimates for Inflation in 2019*](image)

Although the Central Bank resumed the process of cutting interest rates, many people argued that the pace wasn’t fast enough. They said that the Central Bank ought to be more aggressive and make deeper cuts in Selic.

In discussions of this kind, we should remember that monetary policy decisions are not based solely on official inflation forecasts in the respective time horizon. They usually also take into account a “balance of risks,” which merely means the Central Bank’s vision of the risks involving the baseline scenario outlined by it.

But that is not the point we wish to draw attention to in this section. For some time now, we have highlighted the fact that Brazil does not yet have a stable inflation target. Since the introduction of the inflation targeting regime, we have had a target for all calendar years, always...
established in advance, but the official objective continues to change. According to the existing schedule, the target for 2020 is 4.0%, while the targets for 2021 and 2022 are 3.75% and 3.5%, respectively.

As a result, our inflation target has been falling over time. And the monetary authorities should not ignore that. In general, countries that adopt stable inflation targets treat them with due symmetry. That is, they try to avoid breaching the target both up and down, giving equal weight to both types of deviation.

The following question arises here: given a falling inflation target trajectory, does it really make sense to work with the idea of symmetry? Wouldn’t it be more sensible to be more concerned about a possible upward breach than a downward one? It should be noted that any downward deviation would help the process of anchoring expectations for the following years. Any upward deviation would surely bring more risk to this anchoring.

Accordingly, it is quite possible that such an issue has somehow influenced the conduct of monetary policy in the past two years. As shown in Table 2, in December 2019, the Central Bank projected 4.0% inflation for the year as a whole. Following the shocks observed in November and December, mainly involving the price of meat, the final inflation figure was 4.31%, practically on target. This achievement of the target in 2019 is certainly of great relevance to keep inflation expectations anchored in the coming years.

José Júlio Senna

6. Fiscal Policy

Prospects for federal tax revenue in 2019

Expectations of real growth in the federal government’s tax revenue in 2019 were dashed early in the year. Although some recovery was observed, tax revenue ended 2019 well below the forecasts at the start of the year, both those made initially in the federal budget (Budget Guidelines Law and Annual Budget Law) and initial market projections (Prisma Fiscal). Despite this, the balance for the year was positive and several factors contributed to expansion of federal revenues faster than growth in economic activity. These factors will be analyzed in this section.

The following analysis is based on federal tax revenue reported in the Brazilian Federal Revenue Service’s reports from January to November 2019 and preliminary results for December.¹ This analysis is in constant terms, adjusted by IPCA at December 2019 prices.

Between January and December 2019, it is estimated that total federal revenue increased 1.7% in real terms in relation to the same period of 2018. This performance reflects expansion of

¹ The official data on federal revenue in December had not been released by the date this bulletin was written. Our preliminary estimates are based on information taken from the “Tesouro Gerencial” platform, which is managed by the National Treasury Secretariat.
revenues administered by the Federal Revenue Service (+1.7% in real terms) and those administered by other organizations (+1.1% in real terms).

These positive variations were due to factors beyond the recovery in economic activity. One-off impacts involving atypical events had a big impact on the year’s results.

Regarding revenues collected by the Federal Revenue Service Secretariat, the performance of Corporate Income Tax (IRPJ) and Social Contribution on Net Earnings (CSLL) stands out. Both taxes are levied on profits and it is estimated that the amount raised grew 12.7% and 8.1% in real terms, respectively. The justifications for such high growth are the recent improvement in corporate performance and one-off revenues in 2019 due to the sale of equity stakes by some companies. The 2019 result was also influenced by changes to tax offsetting rules arising from Law 13,670 of 2018.

Taxes on income from work also showed more favorable results than those observed in 2018. The reason was the improvement in the labor market and the increase in pension contributions in the public and private sectors (income tax withheld at source on employment income).

Thus, considering our estimates that federal tax revenue grew 1.7% in real terms and the economy expanded 1.2% in 2019, we can see that tax revenue outpaced economic activity. However, when we look at the composition and origin of growth, we note that not all factors are due to economic activity, and it is necessary to break down tax revenue to verify how it has actually been performing in relation to GDP.

Vilma Pinto

7. External Sector

Risks to the trade balance in 2020: what does 2019 teach us?

Between 2018 and 2019, the trade surplus fell from US$58 billion to US$46.7 billion. This is explained by the fact that exports fell more than imports in value terms (6.4% versus 2.1%). Prices decreased for both flows, but in terms of volume, exports went down 1.8% and imports went up 2.4% (Graph 11).

The deterioration in export performance affected all industrial sectors (Graph 11). In agriculture, growth went from positive (18.8% between 2017 and 2018) to negative (-8.3% between 2018 and 2019) in value terms. The 0.9% increase in volume was not enough to offset an average price decline of 8.8%. Soybeans, Brazil’s largest export product, had benefited in 2018 and early 2019 from the trade war between China and the United States, but in 2019, sales shrank 21% due to lower demand from China, which absorbs 78% of all Brazilian soy exports.

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2 FGV IBRE’s forecasts.
Swine flu, which decimated much of the Chinese herd, and the country’s lower growth in 2019 explain the worsening in sales of soy, which is used for feed. In 2020, improvements in this area are not expected, and the situation may in fact become even more unfavorable due to the agreement between China and the United States.

Under this agreement, announced on January 15, China has pledged to purchase US$40 billion worth of agricultural products from the U.S. in each of the next two years. Until now, the highest annual value of agricultural exports from the U.S. to China was US$29 billion in 2013. Additionally, it is not clear that American farmers want to divert their sales from other markets to China, which creates an uncertain situation. In 2019, China purchased US$26 billion of soy from Brazil and US$4.5 billion of meat. There may be losses for soy exports, but China will continue to depend on Brazil to meet its demand. The greatest risk would be the loss of increased potential exports of meat and other agricultural products to the Chinese market. The agreement explicitly mentions measures to facilitate phytosanitary rules governing Chinese imports of beef, pork and chicken.

In 2019, the extractive sector recorded a 0.6% increase in value, 1.7% increase in volume and 0.6% decrease in prices. Iron ore exports expanded US$2 billion, while crude oil exports fell US$1.2 billion. In the case of iron ore, volumes declined but prices rose. The opposite happened to oil.

In 2020, we are unlikely to see a similar increase in iron ore export prices (+25.7%) and the exportable supply is still not fully back to normal following the accident in Brumadinho. In the case of oil, fears of a sharp rise in prices as the consequence of conflict between Iran and the United States are not entirely off the radar screen, although so far, the signs point to attempts to stop the conflict from escalating. Nevertheless, surprises have become part of the international agenda in recent years.

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Manufacturing exports decreased in value (-8.5%), volume (-3.4%) and price (-5.3%) in 2019. Slower global economic growth and the crisis in Argentina, the main purchaser of Brazilian auto products, contributed to this result. However, the agenda for increasing exports of manufactured products raises some questions that go beyond cyclical factors. As we often emphasize, exports in this sector depend on improvements in factors that affect competitiveness and productivity. Items such as tax reform, investments in infrastructure, trade facilitation measures, and access to lower import tariffs for inputs and capital goods help, but the effects will only be felt in the medium and long term.

In the December issue of FGV IBRE’s Macro Bulletin, researcher Livio Ribeiro noted that, in a scenario of high international liquidity, even with occasional turbulence, Brazil is unlikely to face difficulties in financing its current account, despite a projected 3.5% current account deficit / GDP ratio in 2020. In addition, if the government succeeds in advancing the concession and privatization agenda, and if domestic political and economic conditions are favorable to business, a new wave of foreign investment is possible. The trade balance is the only item in surplus in the current account, apart from secondary income, which often records small positive balances (below US$5 billion). Thus, the performance of this indicator is significant.

In 2019, the trade surplus recorded surpluses in agriculture (US$36.4 billion) and the extractive industries (US$35.3 billion). On the other hand, there was a deficit of US$25.6 billion in manufacturing. Between 2018 and 2019, manufacturing exports fell 8.5% while imports fell 1.8% in value terms.

Graph 13 shows the trade balance in industrial products from three perspectives. First, there are manufactured products, in line with the definition used in Brazil since the 1970s. The second perspective is based on the methodology used by IBGE for classifying processing industries in the national accounts. This definition is also used to calculate the Foreign Trade Indicator (FGV/ICOMEX). The third perspective, used by the Foreign Trade Secretariat (SECEX), is based on the United Nations International Standard Industrial Classification (ISIC). The trends are the same, and differences are explained by the scope of the definition of industrial products.

The deficit increased between 2017 and 2018. GDP growth was the same both years, while the Brazilian real fell 10% in real terms. Data from processing industries shows that between 2017 and 2018, exports increased 3.9% while imports soared 20%, in value terms. However, the import figures are overestimates, reflecting changes in the REPETRO regime (related to oil platforms). In volume terms, processing industry imports grew 11.6%, or 6.0% without oil platforms. Nevertheless, the fact remains that imports increased despite an exchange rate devaluation, while GDP growth was the same in both years (2017 and 2018).

In 2019, the trade deficit increased, while it is projected that GDP expanded slightly less than in 2018 (1.2%) and the Brazilian real gained 0.3% between 2018 and last year. The main cause of this deterioration in value terms was the decline in exports, as already observed, together with a small decrease in the value of imports but increase in volume. If the Brazilian economy grows around 2% to 2.5% in 2020, as some forecasts suggest, while international conditions are not very favorable for the agricultural and extractive industries (as higher oil prices arising from
conflicts cause uncertainty in the markets), and as the processing sector’s deficit rises (as the data indicates), the trade surplus in 2020 will be lower. The increase in oil prices may boost extractive industry exports, but a climate of tensions caused by an intensification of geopolitical conflicts will have a negative impact on global economic growth.

Macroeconomic equilibrium is unlikely to be affected by any balance of payments constraint, but we still have the challenge of ensuring better manufacturing performance.

Lia Baker Valls Pereira

8. International Panorama

American economy: the path to a soft landing

The Federal Reserve has been conducting a tricky fine-tuning operation to achieve a soft landing for the American economy in 2020, stabilizing GDP growth just above the potential growth rate of around 1.6% to 1.8%.

The risk is that the Fed will make mistakes in this operation and produce a sharper economic slowdown. This risk was greatest at the end of 2018, but since then, the Fed has reversed the direction of its monetary policy. In 2019, there were three 0.25 percentage-point reductions in the federal funds benchmark interest rate. All the signs indicate, as I have written previously in this space, that the Fed will be successful. At the end of the year, the federal funds rate will be at the same level as today and the economy will be growing at an annualized rate of 2%, or slightly less.
To understand the risks, just look at the previous cycle, which ended with the mortgage crisis and bankruptcy of Lehman Brothers in September 2008.

Graph 14 presents the main variables. The red dashed line and the left-hand scale show the trajectory of real GDP at 2012 prices, seasonally adjusted. The figures are quarterly. All the other curves on the graph refer to growth rates and they are measured on the right-hand scale.

The blue line shows the inflation rate measured by the national accounts consumption deflator, PCE. The blue dashed line shows the core PCE rate. The gray line shows the federal funds rate, while the red line shows accumulated four-quarter real GDP growth. The gray rectangular areas indicate crises in the U.S. economy, as dated by the American Bureau of Economic Research (NBER).

As the graph makes clear, in the third quarter of 2004, a cycle of increases in the benchmark interest rate began, starting from the very low level of 1.01%. The federal funds rate went up to 5.25% in the third quarter of 2006 and then remained the same until the second quarter of 2007.

The curious thing, from today’s perspective, is that this entire cycle of rising base interest rates occurred while core PCE remained all the time under 2.5%, at 2.2% on average – just 0.2 percentage points above the Fed’s current target of 2.0% for core PCE. During this period, full
inflation measured by PCE rose due to the commodities boom and strong Chinese growth after the country joined the World Trade Organization in 2002.

Simultaneously, there was a continuous deceleration in annual economic growth, which fell from 4.1% in the first quarter of 2004 to 2.0% in the fourth quarter of 2007, when the crisis began, according to NBER records, and to 1.1% in the third quarter of 2008, when the economic crisis worsened due to the bankruptcy of Lehman Brothers.

There was weakness in the credit market, but this weakness did not spread as long as the country’s average real estate prices increased. Financial assets continued to grow in value, on average, mixing the roles of different regions of countries. The economic slowdown changed the average behavior of house prices and caused the financial sector to collapse.

Once again, from today’s perspective, the cycle of interest rate increases was very steep. Probably, due to regulatory problems and enormous risk exposure assumed by the American and European financial sectors, the crisis would have happened sooner or later. Nevertheless, we can say that the increase in interest rates precipitated the process.

The fragility of the American economy today is of a different nature. It is about the growth of corporate debt. Based on perceptions of lower long-term interest rates and permanently lower capital costs of business operations, a change in the capital structure of companies has been under way. Companies have taken on debt to buy back shares. The share of third-party capital in companies’ liabilities has grown, given the perception that this capital is cheaper, and the share of internal capital has fallen. Since 2010, American companies’ debts have expanded 120%, from US$3.8 trillion to US$8.5 trillion. Over the same period, GDP grew 33%, from US$15 trillion to US$20 trillion.

The risk is that a strong economic slowdown could hit corporate results and help increase risks, worsening many companies’ credit ratings. This in turn could spark a wave of corporate bankruptcies, aggravating the crisis. The capacity of the non-financial sector’s indebtedness to generate a systemic crisis is not clear, but this is certainly a risk.

To combat this risk, the Fed carried out a “mid-cycle” adjustment in 2019, aimed at avoiding a repetition of 2007. It would seem that the American Central Bank was successful and managed to avoid a sharper economic slowdown. For 2020, the baseline scenario is a soft landing.

Samuel Pessôa

9. In Focus: Labor productivity – the long-term engine of economic growth

FGV IBRE has chosen productivity as one of the core concerns of its institutional mission to contribute to debate on Brazil’s economic development. Given the importance of this subject, FGV IBRE recently launched the Productivity Observatory website, which features an extensive database on the productivity of the Brazilian economy, as well as studies and analyses, with the
aim of supplying information to help people understand the topic and contribute to the formulation of public policies that can increase productivity and economic growth.4

One of the reasons for the intensification of studies related to this subject is the Brazilian economy’s loss of dynamism in recent years, exacerbated by the country’s severe recession between the second quarter of 2014 and the fourth quarter of 2016 – one of the longest and deepest in history. Furthermore, the subsequent economic recovery has been very weak. After growing 1.3% in 2017 and 2018, it is estimated that GDP maintained the same pace of expansion in 2019.

As revealed by FGV IBRE’s quarterly productivity indicators, available on the Productivity Observatory website, the slow recovery in growth since the end of the recession may be associated with the negative performance of labor productivity, which was stagnant in 2018 and dropped in the first three quarters of 2019.5

Give the importance of this topic, the aim of this section is to analyze the evolution of Brazilian per capita income since the early 1980s and its relationship with productivity growth in this period, to contribute to a better understanding of its future trajectory.6

Graph 15 presents the evolution of per capita income and productivity per hour worked between 1981 and 2018.7

Graph 15 shows that although the behavior of per capita income is correlated with the dynamics of productivity per hour worked, per capita income grew more than productivity between 1981

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4 This website, at https://ibre.fgv.br/observatorio-produtividade, was launched on December 4, 2019 during the First Seminar on Productivity and Reforms.
5 A report showing the recent decline in quarterly labor productivity is available at http://ibre.fgv.br/observatorio-produtividade/artigos/produtividade-do-trabalho-apresenta-queda-de-07-no-terceiro.
6 In recent years, several researchers have examined the determinants of Brazil’s low productivity and pointed out its major effect on economic growth. Part of his work can be found in a book titled “Anatomia da Produtividade no Brasil” (Elsevier, FGV IBRE, 2017), one of several books to which he contributed articles to help readers better understand the topic.
7 In this text, we define per capita income as the ratio between value added obtained from the national accounts and the country’s population. We chose to use value added information to make our analysis compatible with calculations of productivity per hour worked, which also consider value added information (VA divided by total hours worked extracted from the Continuous PNAD and PNAD surveys). Value added data differs from GDP in that it is equivalent to the sum of value added plus taxes (net of subsidies) on products.
and 2018. To better understand the reasons for this difference, in Table 3 we present a breakdown of per capita income growth in selected periods since the 1980s. 

### Table 3: Breakdown of Growth in per Capita Income (% per year), Brazil, selected periods

<table>
<thead>
<tr>
<th>Periods</th>
<th>VA/POP</th>
<th>VA/HOURS</th>
<th>HOURS/EW</th>
<th>EW/EAP</th>
<th>EAP/WAP</th>
<th>WAP/POP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981-1990</td>
<td>0.3%</td>
<td>-0.6%</td>
<td>-0.5%</td>
<td>0.1%</td>
<td>0.9%</td>
<td>0.4%</td>
</tr>
<tr>
<td>1990-2000</td>
<td>1.0%</td>
<td>0.2%</td>
<td>-0.4%</td>
<td>-0.7%</td>
<td>1.1%</td>
<td>0.7%</td>
</tr>
<tr>
<td>2000-2010</td>
<td>2.3%</td>
<td>1.6%</td>
<td>-0.4%</td>
<td>0.2%</td>
<td>0.4%</td>
<td>0.5%</td>
</tr>
<tr>
<td>2010-2014</td>
<td>-0.2%</td>
<td>0.5%</td>
<td>-0.5%</td>
<td>-0.5%</td>
<td>0.0%</td>
<td>0.3%</td>
</tr>
<tr>
<td>2014-2018</td>
<td>1.3%</td>
<td>1.5%</td>
<td>-0.6%</td>
<td>0.5%</td>
<td>-0.6%</td>
<td>0.4%</td>
</tr>
<tr>
<td>1981-2018</td>
<td>0.9%</td>
<td>0.4%</td>
<td>-0.4%</td>
<td>-0.2%</td>
<td>0.6%</td>
<td>0.5%</td>
</tr>
</tbody>
</table>

Source: Produced by FGV IBRE, based on national accounts. PNAD and Continuous PNAD – IBGE.

In addition to growth in productivity per hour worked, growth in per capita income depends on average working hours, which is equivalent to average hours per employed worker (HOURS/EW). Another relevant factor is the economic activity rate, which corresponds to the proportion of employed workers in relation to the economically active population (EW/EAP). A third determinant is the labor force participation rate, characterized by the ratio between the economically active population and the working age population (EAP/WAP). Finally, the ratio between the working age population and total population (WAP/POP) is a measure of the demographic dividend’s contribution to per capita income growth.

Between 1981 and 2018, per capita income and productivity per hour worked increased 0.9% per year and 0.4% per year, respectively. The figures in Table 3 show that low productivity growth was offset by rapid growth of the working age population in relation to the population (demographic dividend), which increased by 0.5% per year in the period. Another positive contribution to per capita income growth between 1981 and 2018 was growth in the participation rate (EAP/WAP), at a rate of 0.6% per year, reflecting the incorporation of more people into economic activity. However, the drop in average working hours (-0.4% per year)

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8 In Table 3, the first year of each period refers to the baseline year of analysis.
9 The working age population (WAP) comprises people aged between 15 and 64 who are able to exercise some economic activity. The economically active population (EAP) comprises employed workers (EW) and people who do not work, but are looking for employment. The terms VA/POP and VA/HOURS are equivalent to per capita income and productivity per hour worked, respectively.
and reduction in labor force participation rate (-0.2% per year) acted to reduce per capita income over the period.

Although the participation rate contributed positively to per capita income growth until 2010, since then it has fluctuated. It fell between 2010 and 2014, before increasing between 2014 and 2018, probably associated with cyclical factors. Throughout the analyzed period, the average number of working hours per employed worker showed negative growth rates, reflecting a reduction in the average workday that tends to occur throughout the development process. In turn, although the labor force participation rate fell 0.2% per year between 1981 and 2018, it tended to mainly vary in line with the economic cycle. This is illustrated by the increase of 0.5% per year between 2010 and 2014, and the subsequent decrease of 1.5% per year between 2014 and 2018.

Another interesting fact is that, in periods of higher per capita income growth, there were significant increases in productivity per hour worked. Between 2000 and 2010, for example, per capita income went up 2.3% per year, and productivity per hour worked grew around 1.6% per year, after a modest expansion of 0.2% per year between 1990 and 2000.

More recently, between 2014 and 2018, per capita income dropped 1.7% per year, due to the combination of a reduction in productivity of 0.4% per year, a 1.5% per year decline in the labor force participation rate and a 0.5% reduction in working hours. Recent per capita income performance has suffered from the end of the demographic dividend, whose growth was just 0.1% per year between 2014 and 2018.

Graph 16, which presents the growth differential between the working age population and total population, shows that the demographic dividend ended in 2018, when this difference entered negative territory for the first time. The graph also shows that in the coming years, the demographic dividend will turn into a demographic burden, as the working age population grows slower than the population.

The data reveals that the factors that allowed per capita income to outpace productivity since the early 1980s will no longer have a positive contribution in future. On the other hand, determinants that had a negative effect will probably continue to exert themselves.

In particular, working hours will probably continue to fall, as in recent decades, in line with the trend observed in other countries. The labor force
participation rate, due to its cyclical nature, will also not offer a positive contribution in the long term. As we noted earlier, the participation rate has not increased since 2010. Finally, with the end of the demographic dividend, the working age population will expand slower than the population as a whole.

Given this situation, the only way to increase per capita income and generate sustainable growth in Brazil in the next few decades will be to raise workers’ productivity. This, in turn, will only be possible if Brazil persists in advancing the reform agenda.

_Fernando Veloso, Silvia Matos and Paulo Peruchetti_

_Editorial Revision of FGV IBRE’s Macro Bulletin: Fernando Dantas_