



Economic Premise

JUNE 2014 • Number 148

Three Perspectives on Brazilian Growth Pessimism

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Over the last few years, Brazil's growth has significantly decelerated. Accompanying this slowdown, a change in commentary on Brazil's economic future has emerged, and is reflected in a recent ratings downgrade of Brazilian sovereign paper and an overall much-bleaker growth outlook both for the near and medium term. This note examines three contributing factors to this change in sentiment: macroeconomic management, the external environment, and microeconomic fundamentals. Among these, this note argues that the relative lack of progress on the microeconomic reform agenda has been far more detrimental to the growth outlook than either the credibility cost of recent macroeconomic management or the negative influence of a less supportive external environment. Against this backdrop, the recent ratings downgrade is not inherently negative: while Brazil is not about to slide down a slippery slope of macroeconomic mismanagement or on the verge of an externally powered economic meltdown, the downgrade can serve as a call to action for government to enact the necessary structural reforms to energize and sustain productivity growth.

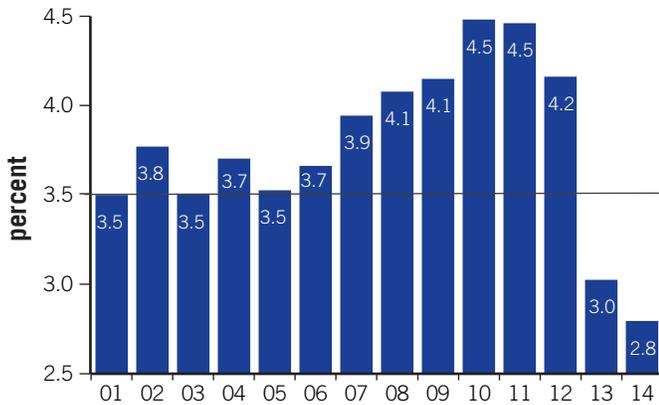
Slower Growth, Diminished Expectations

Brazil's postwar era was marked by a protracted boom period, followed by alternating episodes of macro instability and stabilization. Between 1947 and 1980, Brazil's national income grew at 7.5 percent per year, lifting the country into upper-middle-income status. Between 1981 and 2003 were two decades of instability and crisis management that reduced average growth to just 2 percent. A brief uptick occurred after inflation control imposed by the Real Plan in 1994, only to be interrupted by the currency crisis of 1999. Subsequently, Brazil introduced inflation targeting and strengthened its fiscal framework, efforts that laid the foundations for future growth. Aided by favorable external tailwinds, growth subsequently accelerated to 5 percent in the period 2004–8. Improved macropolicy fundamentals also resulted in resilience during the global financial crisis: following a dip of 0.3 percent in 2009, the economy grew 7.5 percent in 2010 and 2.7 percent in 2011.

It has become increasingly evident that Brazil's growth dynamism of the mid-to-late 2000s was a short-lived phenomenon and that the economy's growth engine has run out of steam over the last few years. Despite the country's resilience during the global financial crisis and seemingly quick recovery amid a difficult external environment, economic growth slowed to just 1 percent in 2012 and remained subpar in 2013, settling at an uninspiring rate of 2.5 percent. The most recent data available suggest that economic weakness persists: during the first quarter of 2014, the economy grew at an annual equivalent rate of just 0.6 percent. Looking ahead, little improvement is expected in the near term. Indeed, as of early June, the median forecaster predicted growth of 1.4 for 2014 and 1.8 percent for 2015. Looking even further ahead, a muted recovery is anticipated that would bring growth to 2.5 to 3 percent between 2016 and 2018.

The recent weak performance of the Brazilian economy and its subdued economic outlook are disappointing in at

Figure 1. How Growth Optimism Turned into Pessimism (daily median forecast of GDP two years later averaged over the year)



Source: Central Bank of Brazil; World Bank staff calculations.

least two respects. While not atypical for an advanced economy that has exhausted the benefits of catch-up growth, the slow growth observed in Brazil is neither typical nor desirable for an emerging market in need of further per capita income growth and shared prosperity. Recent growth rates also disappoint in comparison to recent economic history and, most notably, the 2004–8 period when growth, as noted, reached 5 percent; instead, the slow growth rates evoke memories of the earlier 1981–2003 period, when the economy grew at just 2 percent annually, even if the latter period is different in many other respects.

This disappointment has been accompanied by a significant degree of growth pessimism that appears to have sunk into the minds of analysts and observers of Brazil’s economy (figure 1). Market forecasts regarding Brazilian economic growth two years out have dropped considerably, with similar forecasts also at three years out. Remarkably, however, market forecasts have deteriorated not only relative to the zenith of 4.5 percent reached in 2010–11, but also relative to the estimates of 3.5 percent earlier in the last decade.

What Explains Growth Pessimism in Brazil?

The answers may be found in what underpinned the growth acceleration of the mid-to-late 2000s. That growth spurt was the result of delayed effects of reform efforts from the 1990s and the first half of the 2000s, when Brazil got its macroeconomic house in order and implemented reforms in the financial, trade, and social sectors (Ter-Minassian 2012; Canuto, Cavallari, and Reis 2013). Risk premiums on all Brazilian assets fell systematically after it became clear that commitment to fiscal discipline, inflation targeting, and flexible exchange rates would be preserved regardless of the political parties in government. In addition, favorable external conditions prior to the global financial crisis relaxed financial constraints and financed growth.

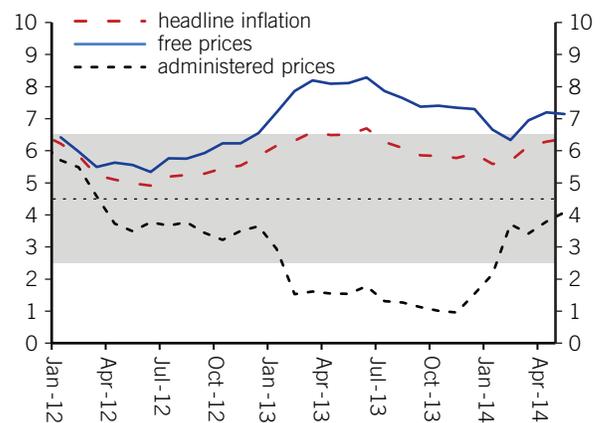
These same three factors once responsible for Brazil’s growth acceleration—the credibility of the macroeconomic policy framework, the support of the external environment, and the reform efforts on the microeconomic front—underpin the three strands of growth pessimism that have become prevalent in recent economic commentary on the future direction of Brazil. However, as will be argued below, the deterioration in sentiment appears to go beyond what is warranted by fundamentals and appears to reflect an excessive degree of pessimism about Brazil’s economic growth capacity—not unlike the earlier period of exuberance when expectations were equally distorted, although then on the upside.

Macroeconomic policy credibility

The first strand of growth pessimism espouses the view that recent macroeconomic management has eroded the hard-won credibility of a macroeconomic policy framework built on fiscal prudence, exchange rate flexibility, and inflation targeting. In response to slow growth coupled with high inflation, policy makers have relaxed fiscal policies, accommodated sticky inflation at the upper end of the target range, and introduced large currency market interventions to dampen exchange rate volatility (figures 2 and 3). Critics point to these developments—alongside interventions to control inflation with administered prices and support growth through less than fully transparent para-fiscal operations—as the beginning of a slide down a growth-reducing slippery slope (Wheatly 2014). These critics believe that the recent downgrade of Brazilian sovereign paper to just one notch above junk validates their claims of recent macroeconomic mismanagement.

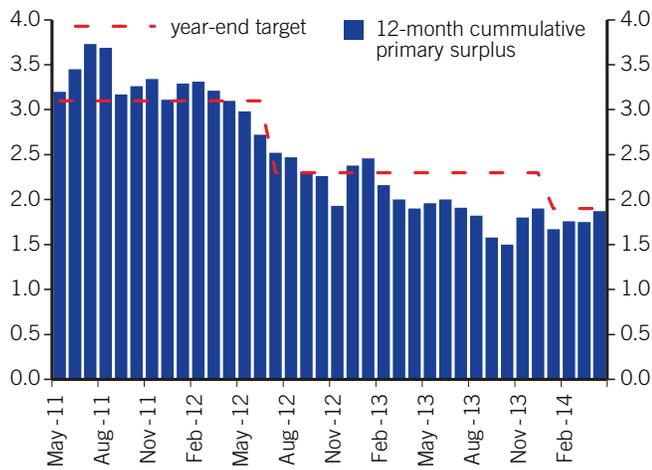
These factors however are unlikely to account for the moderation of growth forecasts observed in recent quarters. While a return to macro instability of the sort seen in Brazil’s pre-stabilization period can be discounted as a remote possibility, the policy framework did suffer a credibility loss as the authorities struggled to respond to the evolving macroeco-

Figure 2. Inflation Hovers at Upper End of Target (year-on-year, percentage change)



Source: Haver; World Bank staff calculations.

Figure 3. Primary Surplus Has Diminished (percent of GDP)



Source: Haver; World Bank staff calculations.

economic environment of slow growth and high inflation. But these interventions took place at a time when the flexibility implied by such actions was warranted to counter economic conditions and stabilize asset prices. Importantly, despite such interventions, the pillars of the macroeconomic framework have remained broadly intact and Brazil continues to enjoy large external buffers. While care will need to be taken to ensure that fiscal buffers are restored and inflation returns to the mid-point of the target range, the credibility losses incurred so far are unlikely to have been a driving factor in stalling growth or depressing expectations.

External support factors

The second strand of growth pessimism laments the lack of a supportive external environment. This view is intricately related to the hypothesis that the growth acceleration before the global financial crisis was largely the result of external rather than domestic factors. Rapid capital inflows, better terms of trade, and lower global interest rates all played to Brazil's favor when times were good. In turn, as conditions changed for the worse, so did Brazil's economic fortunes. Looking ahead, this view paints a depressing outlook for Brazil based on the extent to which its premier trading partner, China, continues to slow, major advanced economies remain stuck in the doldrums, and global capital becomes more expensive and less readily available, as the U.S. Federal Reserve tapers off its purchases of long-term securities. All of the above are thought to present a clear and present danger for Brazil (Wentzinger 2013).

While external factors continue to play a role in Brazil—both by affecting the real and financial side of the economy—they are all too often overplayed (World Bank 2014). Growth in Brazil is still largely made in Brazil, given the overwhelming share of its domestic market in GDP and its limited external orientation (figure 4). Brazil's external trade accounts also remain well diversified product-wise

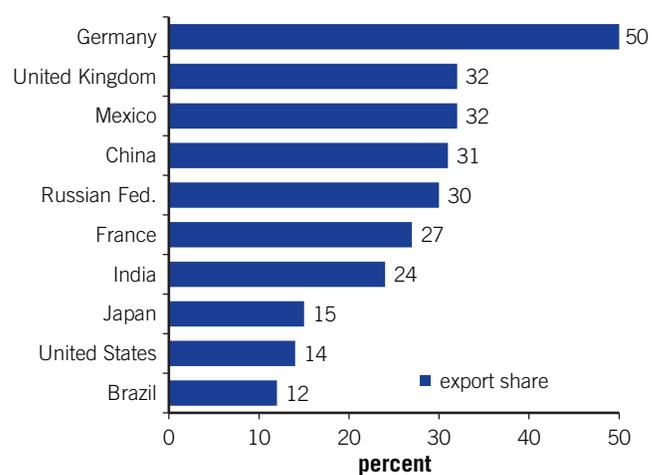
and geographically, both on the export and the import side. Furthermore, the role of the external environment in accelerating growth during 2004–8 must not be overstated. Important components of growth acceleration during that period were the delayed effects of earlier macro- and microeconomic reforms that produced stabilization gains and enhanced productivity (Canuto, Cavallari, and Reis 2013; Canuto 2013).

Microeconomic growth fundamentals

The third strand of growth pessimism concerns the lack of improvement in the microeconomic fundamentals for growth. This strand is of far greater concern than the credibility cost of recent macroeconomic management or the economic impact of the deterioration in the external environment. Indeed, the microeconomic environment is critical for growth, even more so today than in the past. This is because demographic dynamics have reduced the growth of Brazil's labor force. Higher growth therefore requires first and foremost increased worker productivity. But productivity growth remains constrained by a cumbersome business environment and a slow pace of physical and human capital accumulation (figures 5 and 6). For Brazil to energize and sustain productivity growth, it will need to enable the enabling environment and disable the disabling one.

Yet, during the recent period of slower growth, little progress was made in tackling long-standing structural bottlenecks, and therefore the structural reform agenda remains long and unfinished (Canuto 2014; World Bank 2014). Unsurprisingly, slow growth has, for that reason, primarily become a supply-side phenomenon of a structural nature. This is indicated by the fact that, despite slower growth, the output gap is as good as closed, inflationary pressures are pronounced,

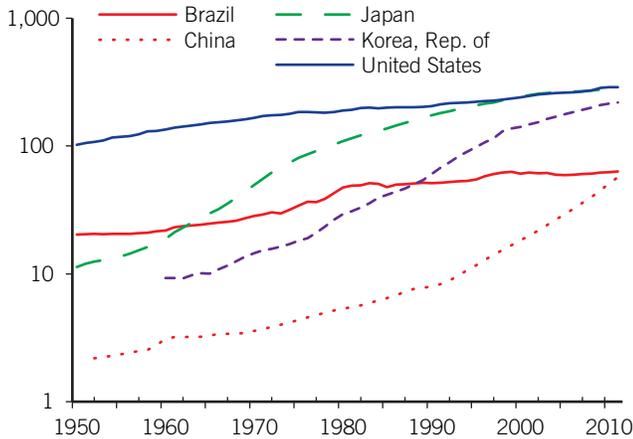
Figure 4. Brazil Ranks Lowest on Export Share of World's 10 Largest Economies (share of exports in GDP, 2011, percent)



Source: WDI; World Bank staff calculations.

Note: Largest 10 economies selected in terms of 2011 GDP (PPP-adjusted current international dollars).

Figure 5. Capital Accumulation Remains Slow (capital stock at constant 2005 national prices per worker, 2005 US\$ thousands)



Source: Penn World Tables version 8.0; Feenstra, Inklaar, and Timmer (2013); World Bank staff calculations.

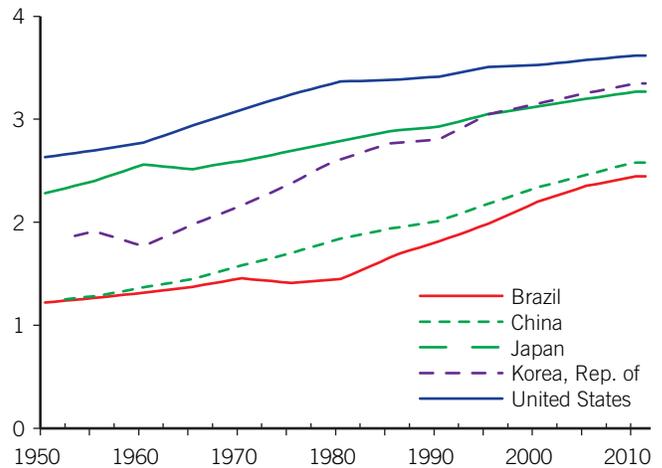
and the labor market is buoyant with unemployment at record lows.

The key challenge going forward is therefore to energize the momentum of progress on this agenda of structural reform. In this respect, the recent ratings downgrade is not unwelcome, nor is it a signal that Brazil is about to slide down the slippery slope of macroeconomic mismanagement, or on the verge of an externally-powered economic meltdown. Rather, it is a call for action on the structural reform front. For the main risk facing Brazil and its economy is the specter of mediocre growth over a protracted period against a counterfactual potential of opportunity. Such a scenario would not only exacerbate current concerns about macroeconomic vulnerability but also—and more importantly—imply that Brazil is unable to live up to its development potential.

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Figure 6. Human Capital per Person Improves, But Continues to Lag (index of human capital per person, based on years of schooling and returns to education)



Source: Penn World Tables version 8.0; Feenstra, Inklaar, and Timmer (2013); Barro and Lee (2012); Psacharopoulos (1994); World Bank staff calculations.

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