2010-2013 : IS THE WORST OVER ?

RS 064 - March 2010

INTRODUCTION :

The core question : is the worst of the crisis over? The answers diverge. For the European region the crisis is not ended. While few countries are expecting to rely on exports to trigger economic growth, a recovery in domestic aggregate demand is deeply needed to prevent the turnaround from floundering. However this element is so far missing from countries such as Germany (until now not included in the critical area), Portugal, Italy, Ireland, Greece, Spain (the PIIGS group) and other economies that soon will join the distress club. In all these countries, families are concerned over joblessness and private consumption tends to stagnate.

Meanwhile, there are growing signs that the worst of the global financial crisis is behind in U.S. and U.K., but the pressing issue is how strong or weak the revival will be. All eyes and attention are on the 2010 outlook in order to assess how quickly the recovery will pick up pace. It is clear from the latest data presented by Consensus Forecasts that industrial production is driving growth in some countries. Japan is a good example: after suffering a sharp decline in output in 2008 and 2009, industrial production is expected to undergo a strong rebound, in good part due to the economic resilience of China to the financial crisis. But a strong industrial recovery is not so clear and for sure in other major economies. Euro zone indicators are not so strong, and domestic demand lacks momentum. Therefore domestic aggregate demand as the main determinant of the overall recovery faces serious downside pressures going forward. This fact is a somber and disappointing note for the expectations of a strong and sustained recovery in 2010.

Table 1 – World economic activity
Selected countries and regions

	Real GDP growth, %			Consumer prices, %			Current account, US$ billion		
	2009	2010	2011	2009	2010	2011	2009	2010	2011
United States	-2.5	2.9	3.1	-0.3	2.2	1.9	-430	-504	-568
Japan	-5.4	1.3	1.5	-1.3	-1.0	-0.3	143	172	174
Germany	-5.0	1.8	1.6	0.4	1.0	1.3	145	174	180
United Kingdom	-4.7	1.5	2.2	2.1	2.4	1.7	-37	-36	-33
France	-2.2	1.4	1.6	0.1	1.2	1.5	-57	-55	-55
Italy	-4.8	0.9	1.2	0.8	1.6	1.8	-66	-63	-55
Spain	-3.6	-0.4	1.2	-0.3	1.4	1.7	-85	-70	-62
North America[b]	-2.4	3.1	3.0	-0.2	2.1	2.0	-465	-533	-580
Western Europe[c]	-4.2	1.2	1.7	0.6	1.4	1.6	51	131	182
European Union[d]	-4.0	1.2	…	1.0	1.5	…	-193	-55	…
Euro zone[e]	-3.9	1.3	1.6	0.3	1.2	1.5	-86	-28	-7
Asia Pacific[f]	1.5	5.5	5.1	0.8	2.1	2.3	559	547	561
China	8.7	9.0	9.0	…	…	…	…	…	…
Eastern Europe[g]	-5.6	3.0	4.1	6.6	5.9	5.5	-2	12	1
Latin America	-2.3	4.0	3.7	5.5	7.5	6.8	-21	-47	-73
Brazil	**-0.2**	**6.4**[a]	**5.4**	**4.3**	**4.8**	**4.7**	**-24**	**-47**	**-63**
Argentina	-2.8	3.8	2.4	7.7	9.7	10.1	9	9	7
Other countries	0.9	3.7	4.5	7.1	6.2	6.1	30	62	77
Total	-2.2	3.0	…	1.4	2.6	…	…	…	…

Source : Consensus Forecasts. [a] SILCON. [b] US and Canada [c] Germany, France, UK, Italy, Austria, Belgium, Denmark, Finland, Greece, Ireland, Netherlands, Norway, Portugal, Spain, Sweden and Switzerland. [d] Euro Zone countries plus Denmark, Sweden, UK, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, and Bulgaria. [e] Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Spain, Slovakia and Slovenia. [f] China, Japan plus 15 other countries. [g] Czech Republic, Hungary, Poland, Russia, Turkey plus 19 other countries.

For 2011 and after, the key question is the performance of the PIIGS and the Euro Zone in adopting correct measures. And it is not healthful to forget that inflation may be the next dragon to slay. As we pointed out in the previous report, the lack of timely and decisive action will have serious detrimental effects for emerging markets and the global economy. Even with economic and financial conditions on the mend, soon or latter the policies will have to turn their attention to the legacy of the excessive stimulus during 2008 and 2009 to domestic consumption and how to prevent the unprecedented monetary and credit stimulus from becoming a destabilizing pressure on inflation. But, inflation is not restricted to West economies. Average inflation in Asia will climb to 6 % in 2010. India faces two digit inflation (16 % in annual basis last February). China will probably have 8-10 % in 2010 (by the way, inflation erodes the exchange rate in real terms and helps to control prices). Vietnam, Australia, and Malaysia follow the same path. No matter the inflation, later on, in 2011, this challenge will have to be faced by the major economies.

In Latin America, GDP declined on the average around 2.3 % in 2009, but the performance was not even. Some economies had a positive expansion in GDP: Bolivia grew 3.3 %, followed by Dominican Republic (2.5 %); Panama (2.4 %); Uruguay (1.9 %) and Peru (1 %), but most of the countries faced a recession. The major economies suffered from the international crisis: Mexico contracted 6.5 %; Argentina[1], 2.8 %; Chile, 1.7 %, and – in a not so bad picture – in Brazil the decline was null (-0.2 %). Average inflation measured by the consumer price index is estimated in 5.5 %, and current

[1] Official statistics are under distrust in Argentina. According to independent economists, government agencies and ministries continue to over-estimate GDP and under-report true inflation. The recent decision of government tapping US$ 6.6 billion of foreign reserves damages the authorities' credibility. The 2008 recession has hit the government's ability to pay down debt and there are increasing doubts about the Argentina capacity to honor their international and domestic debts. Another ongoing default ?

account had a deficit of US$ 20.6 billion, as measured by Consensus Forecasts.

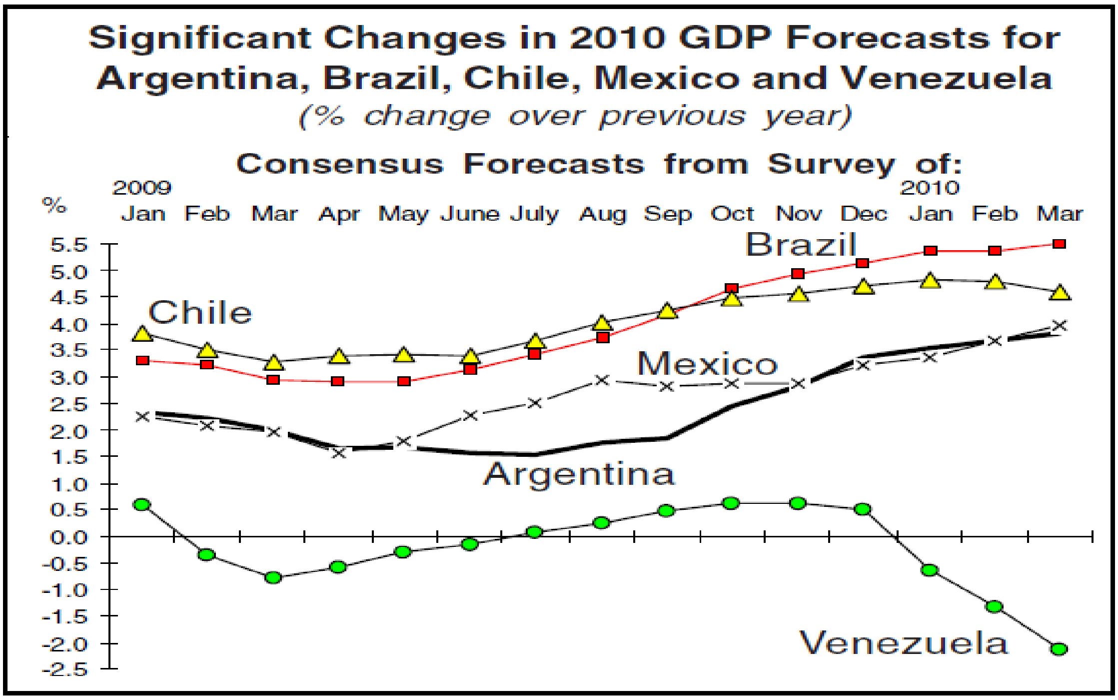

Figure 1 – Forecasts of GDP for the major Latin America countries. Source : Consensus Forecast

Table 1 presents forecasts of the economic activity of selected countries and regions. According to Consensus Forecasts estimates, global GDP will fall 2.2 % in 2009 and is expected to rebound to 3 % in 2010. The major expansion in 2010 is expected to occur, besides China and by consequence Asia Pacific, in Latin America and Eastern Europe. Europe keeps a slow recovery in 2010 and 2011.

II – DOMESTIC PERSPECTIVES

By the latest statistics of the Brazilian National Accounts, the GDP stagnated in 2009 (decline of 0.2 %). Agriculture product shrank 5.2 %; Industry, a fall of 5.5 %, and Services had an expansion of 2.6 % (Services product accounts for more than half of GDP). The pace of activity in last quarter of 2009 shows that the Brazilian economy entered in steady recovery that appears to be gaining traction. Economic activity was buoyed by a 6.6 % surge in capital spending and household consumption grew 1.9 %. Inflation measured by consumer prices (IPCA of IBGE) Dec/Dec was 4.3 % and diverges from the deflation of 1.4 % of the general price index (IGP-DI of Getulio Vargas Foundation). Going into 2010, the forecasts of GDP growth range into the interval of 6 to 6.5 %. The strong recovery is however generating inflationary pressures, and there is a fear that inflation exceeds the Central Bank target of 4.5 % (IPCA). Even considering the general elections of 2010, the current administration and board of the Central Bank will be prone to raise basic interest rate to curb inflation.

Foreign trade fared less well in 2009. Hit by lower commodity prices and smaller volume of sales, exports declined from almost US$ 200 billion in 2008 to US$ 152 billion in 2009. Imports also felt and amounted US$ 128 billion, a fall of 27 % over 2008. By the second successive year, the current account balance was negative (it means that Brazil imported external savings). Foreign currency reserves (excluding gold and SDRs) hit US$ 240 billion and it is a positive factor of international differentiation of the Brazilian economy. Table 2 depicts the historical data of the last three years.

Since the third quarter of 2009, most of these results were already signalized by the composite leading indicators of SILCON, and the final figures of 2009 just confirmed our previous forecasts. For 2010, GDP growth will keep in pace as shown in Figure 2. Composite leading indicators for GDP, consumption and capital formation forecast the phase of recovery. In all figures, the red line represents the observed growth rate and the blue line, the projection of the CLI.[2]

[2] CLIs of sales and production of several sectors and macroeconomic variables can be obtained from the site www.silcon.ecn.br, link “O que dizem os indicadores antecedentes”.

Table 2 – Economic activity of the Brazilian economy

	2007	**2008**	**2009[a]**
Gross Domestic Product:			
R$ billion	2.597,6	2.829,3	3.143,0
US$ billion	1.313,9	1.546,1	1.579,4
Real growth, %	6,1	5,1	-0,2
Inflation IGP/DI:			
Annual average, %	5,1	11,2	1,8
Dec/December, %	7,9	9,1	-1,4
Basic rate of interest, SELIC, %			
Nominal rate	11,9	12,3	9,9
Real rate (deflated by IGP/DI)	3,7	2,9	11,5
Exchange rate, R$/US$:			
Annual average	1,95	1,83	1,99
Nominal change, %	-10,4	-6,2	8,7
Real change (deflated by IGP/DI), %	-14,7	-15,6	6,8
Unemployment rate (annual average)	9,9	9,3	7,9
Balance of payments, US$ billion:			
Exports FOB	160,6	198,4	152,3
Imports FOB	120,6	175,5	127,6
Trade balance	40,0	22,9	24,6
External trade (exports+imports)	281,2	373,9	279,9
% of GDP	21,4	24,2	17,7
Current account balance	1,5	-30,0	-32,0
% of GDP	0,1	-1,9	-2,0
Foreign reserves (end of year)	179.4	192.8	239.1

Sources : IBGE, FGV, Central Bank. [a] Preliminary.

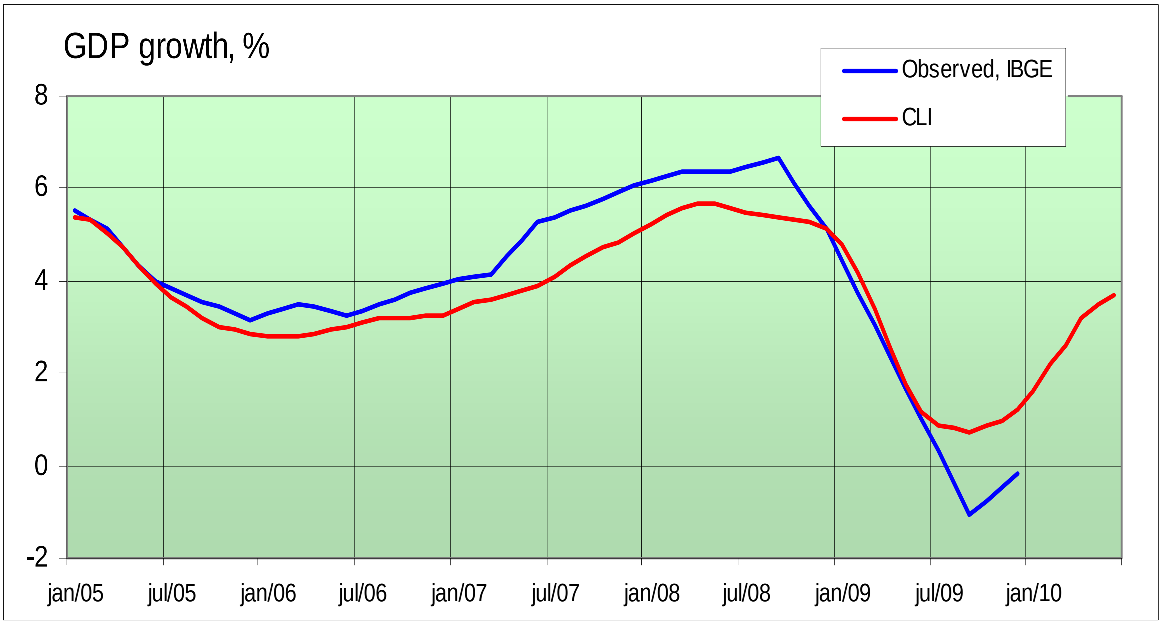

Figure 2 – Performance of the CLI for GDP growth.

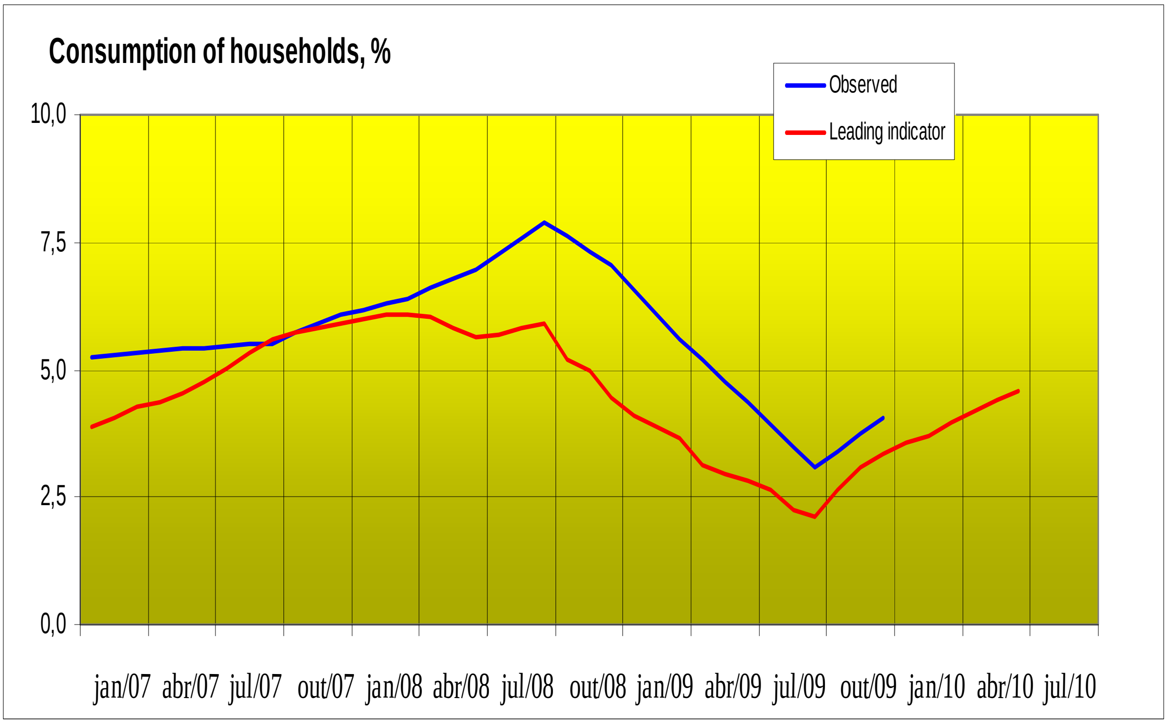

Figure 3 – Performance of the CLI for the growth of household consumption.

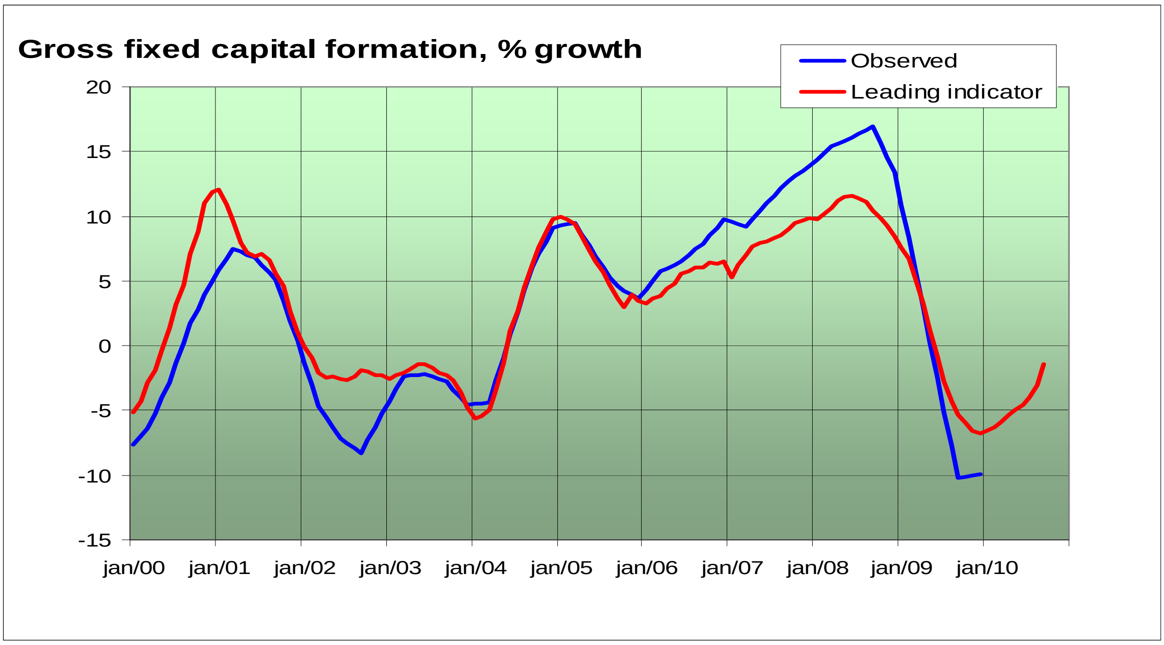

Figure 4 – Performance of the CLI for fixed investment growth.

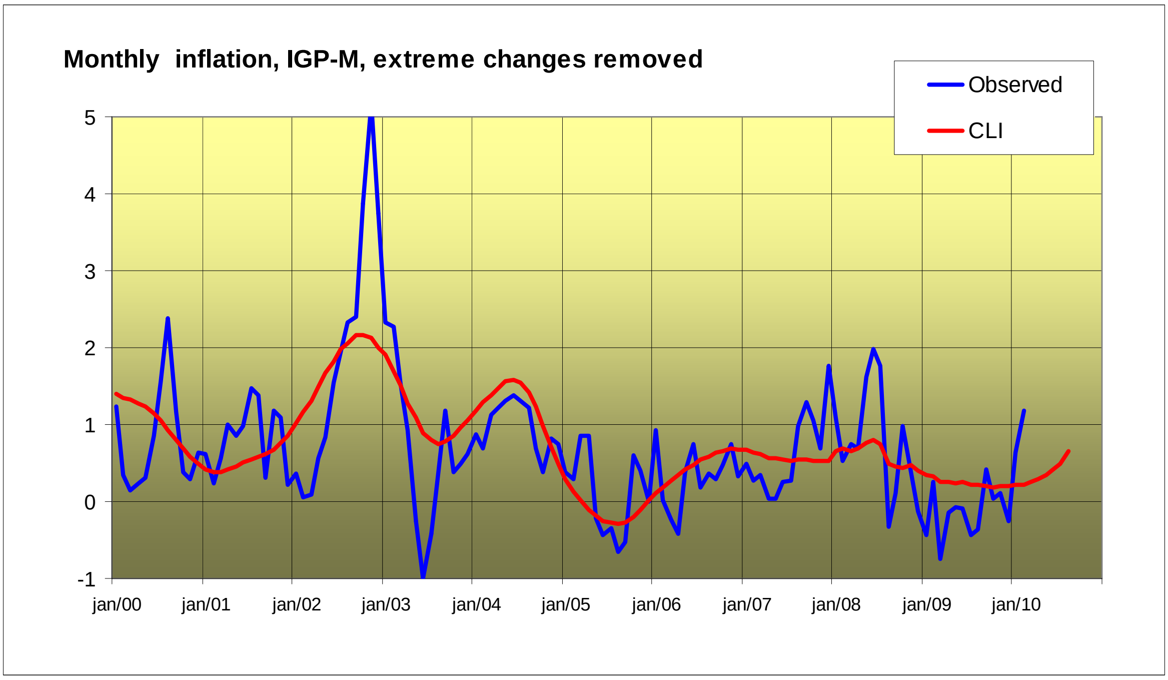

Figure 5 – Performance of the CLI for monthly inflation, IGP-M.

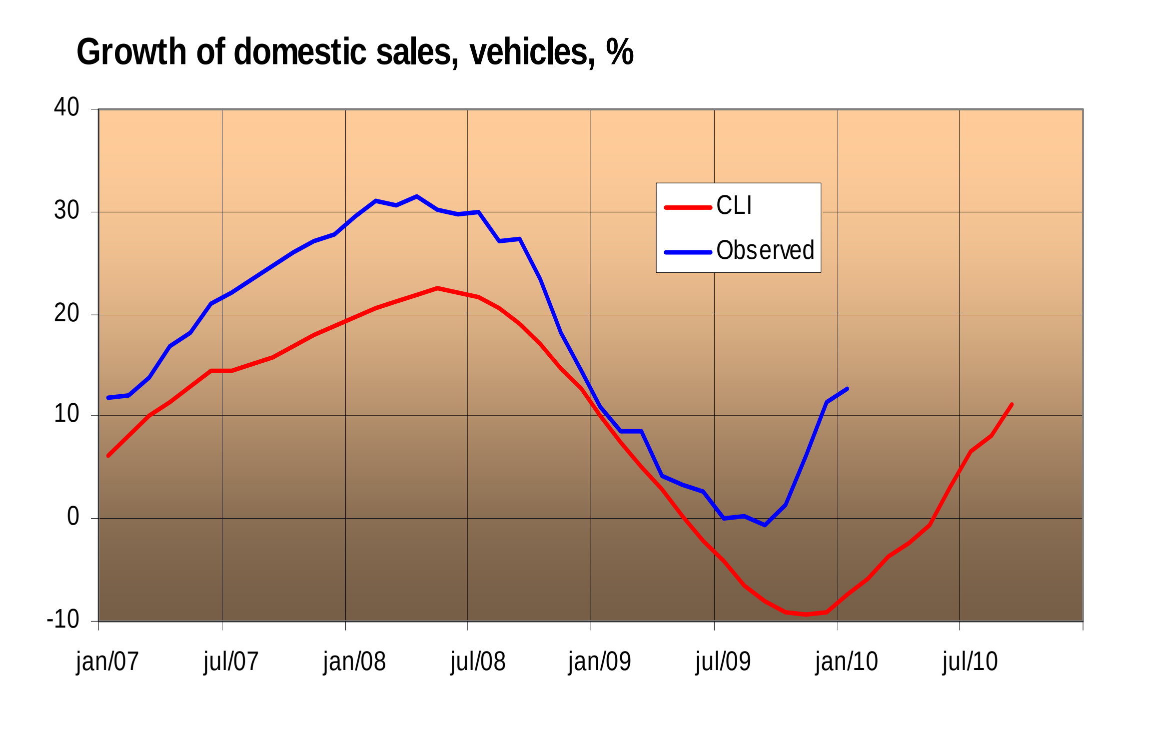

Figure 6 – Performance of the CLI for the growth of domestic sales of vehicles

III – UPDATED SCENARIOS FOR 2010-2013

The methodology used to simulate the outcome of the macroeconomic variables is based upon an econometric model of middle size, and considers trade-offs among the major macro variables, such as inflation, economic growth and employment, embodying a revised-expanded version of the Phillips Curve.[3] Three alternative scenarios are used; and each has different path for the macro variables, according to the economic policy adopted and to the expected constraints imposed by political events. Starting data and benchmark of the simulations are those conditions of 2009 in Table 2, represented by point t_o in Figure 7.

[3] Methodology and reasoning are found at Contador, C.R., "Inflation and recession : fate or political choice in Brazil today", The Brazilian economy in the eighties, Salazar-Carrillo, J. & Fendt, R., (editors), (New York, Pergamon Press, 1985), pp. 149-169, and "Comments by Samuel A. Morley", pp.167-169.

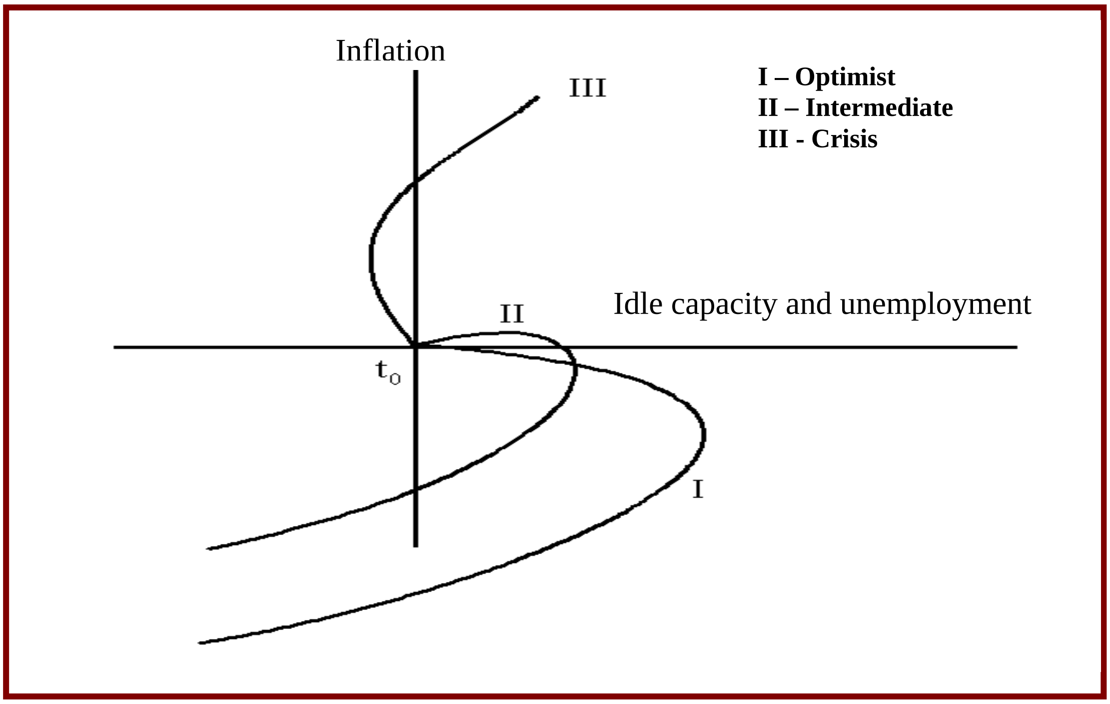

Figure 7 – Dynamic paths of alternative scenarios

- Scenario I (optimist) of correct adjustments and policies, in which the core of the economic policy is the control of inflation, the opening of trade and reform of the public sector and fiscal policy, even at the cost of higher unemployment and lower economic growth in the short-run.
- Scenario of crisis III (pessimist), with the fiscal, monetary and foreign trade dominated by the government's interventionist and unorthodox use of policy instruments. In the short-run, the expansive fiscal spending and monetary liquidity can buoy economic activity with inflationary build-up. However in the medium and long-run the economic conditions deteriorate and a political crisis arises.
- Scenario II – Intermediate that combines elements of the extreme scenarios.

Each scenario follows a specific path of inflation and economic activity, as shown in Figure 7. The origin of the axes t_o represents the average economic conditions of 2009, resumed in Table 2. The vertical axis displays the pressure on the rate of inflation relative to that of 2009, and the horizontal axis, the pressure on the unemployment and the manufacturing utilization rate, resumed on the GDP gap. Scenario I of Optimism is marked by a persistent decrease in the rate of inflation with rise in the unemployment and idle capacity in the short-run, but a sustained recovery in the economic activity and low inflation in the medium and long-run. Therefore the movement is first to the right and down and later to the left.

On the other hand, scenario III of crisis is the opposite, with a lowering of unemployment and idle capacity in the short-run along 2010 at a cost of rising inflation in the following years. This is the well-know prescription of populism with all the bad effects in the long-run: the inflation keeps rising and the economic activity ends up deteriorating. The path follows a movement to North-west from the origin and later on forward to right. Finally scenario II - Intermediate - combines the movements of the two extreme scenarios. In this scenario, the control of inflation is less rigorous in the short-run but the effects on unemployment and idle capacity are not as severe as in scenario I.

Actual data from the period 2003-2009 are reproduced in Figure 8, where the clockwise movement of inflation and idle capacity is observed. Inflation is measured by GDP deflator and idle capacity by GDP gap. From 2003 till 2007, the path is characteristic of the lagged effects of economic policy of previous years. After 2007 and on, inflation and idle capacity grew. Considering dynamics of the pressures, what should we expect for the next years ?

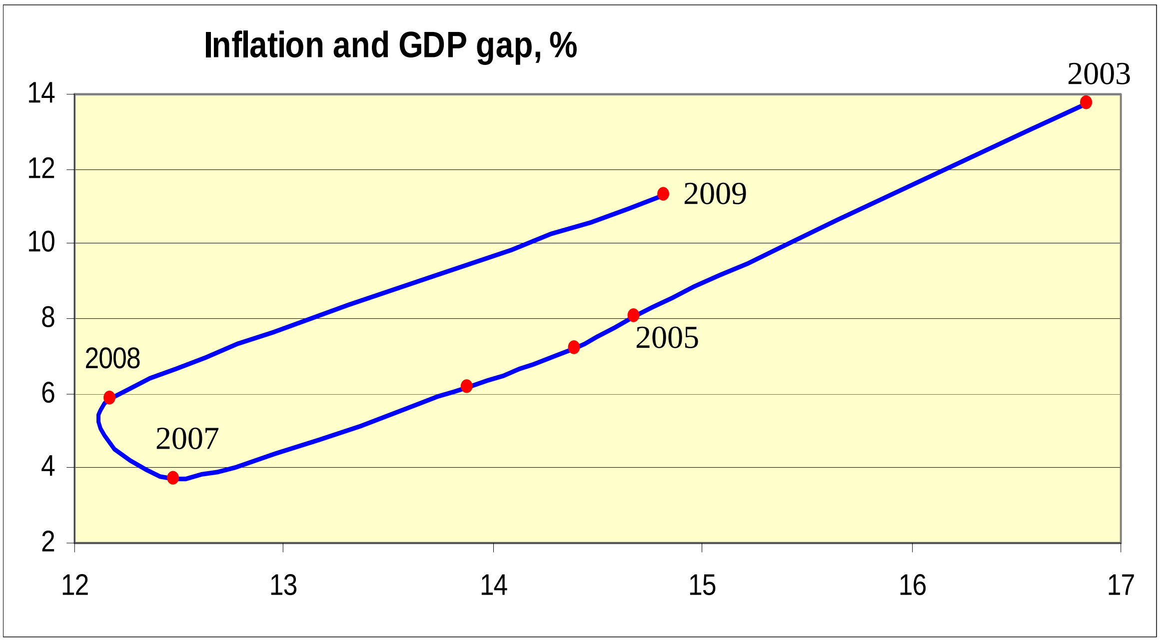

Figure 8 – The clockwise movement of inflation and GDP gap, 2003-2009

Table 4
Summary of macroeconomic scenarios, weighted averages

Weighted scenario[a]	2010	2011	2012	2013	Average
GDP, US$ billion	1,771.1	1,865.6	1,966.1	2,087.4	1,973.0
Real growth, %:	6.0	5.4	5.1	5.3	5.3
Inflation, IGP-DI, % :	1.9	5.1	4.5	3.5	4.4
Annual average	5.3	4.8	4.1	3.0	4.0
Dec/December	1.92	2.02	2.10	2.16	2.09
Exchange rate, R$/US$, avg	7.9	7.9	7.8	7.5	7.7
Unemployment rate	186.2	196.6	211.9	183.9	197.5
Exports FOB, US$ bn	166.8	182.1	199.3	168.2	183.2
Imports FOB, US$ bn	19.4	14.5	12.6	15.8	14.3
Trade balance, US$ bn	353.0	378.7	411.1	352.1	380.6
External trade, US$ bn	-32.8	-33.8	-32.8	-21.6	-29.4
Current account, US$ bn	19.9	20.3	20.9	16.9	19.3
Trade rate, % GDP	-1.9	-1.8	-1.7	-1.0	-1.5
Current account, % GDP	1,771.1	1,865.6	1,966.1	2,087.4	1,973.0

Source : SILCON. March 2010. [a] Weighted by the probability of occurrence, in Table 3.

Table 3 shows the details of the simulations from 2010 till 2013. The probability of each scenario is based upon a survey among the staff and associates of SILCON and reproduced in the table. The numbers of the simulations are summarized in Table 4 and Figures 9 to 13.

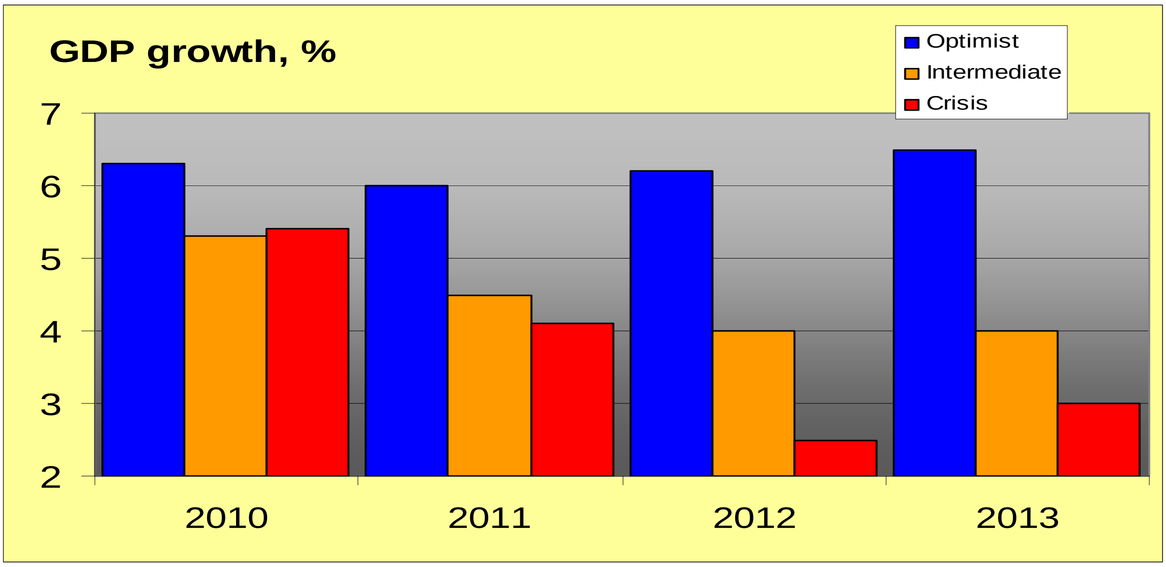

Figure 9 – Simulation for the GDP growth

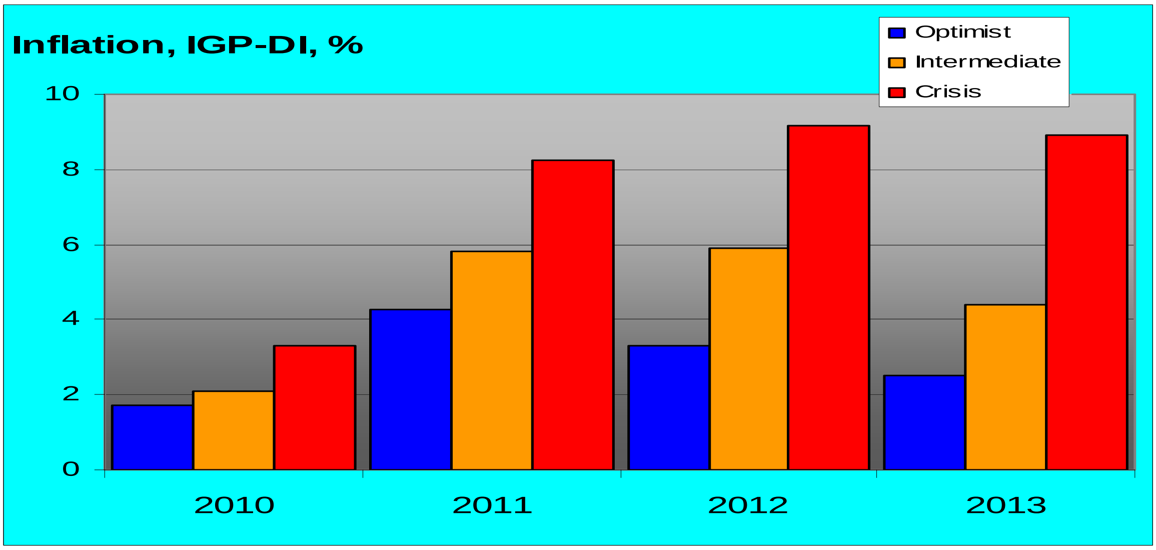

Figure 10 – Simulations for inflation, IGP-DI

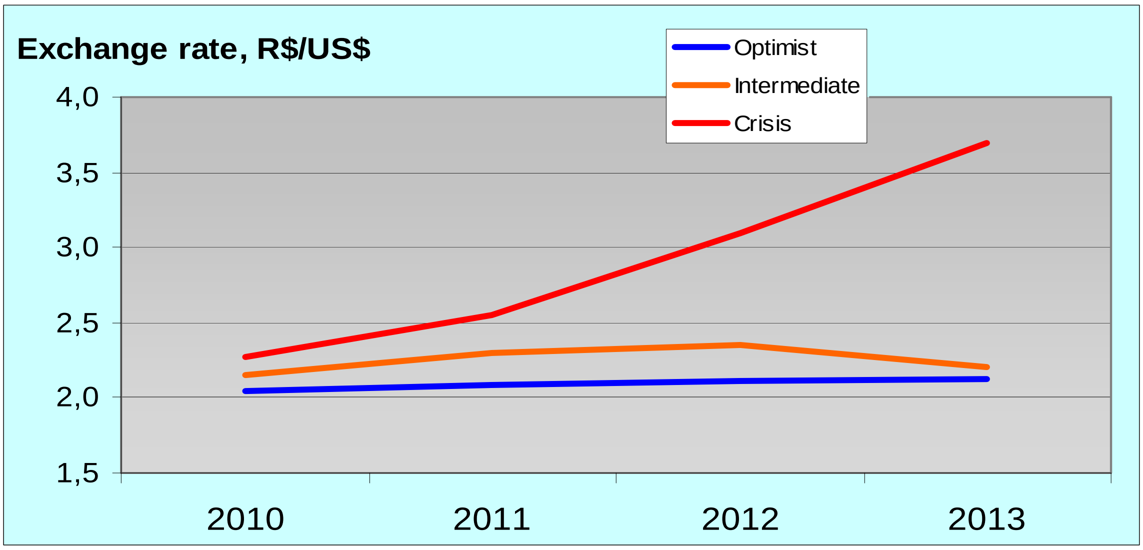

Figure 11 – Simulations for the exchange rate, annual average, R$/US$

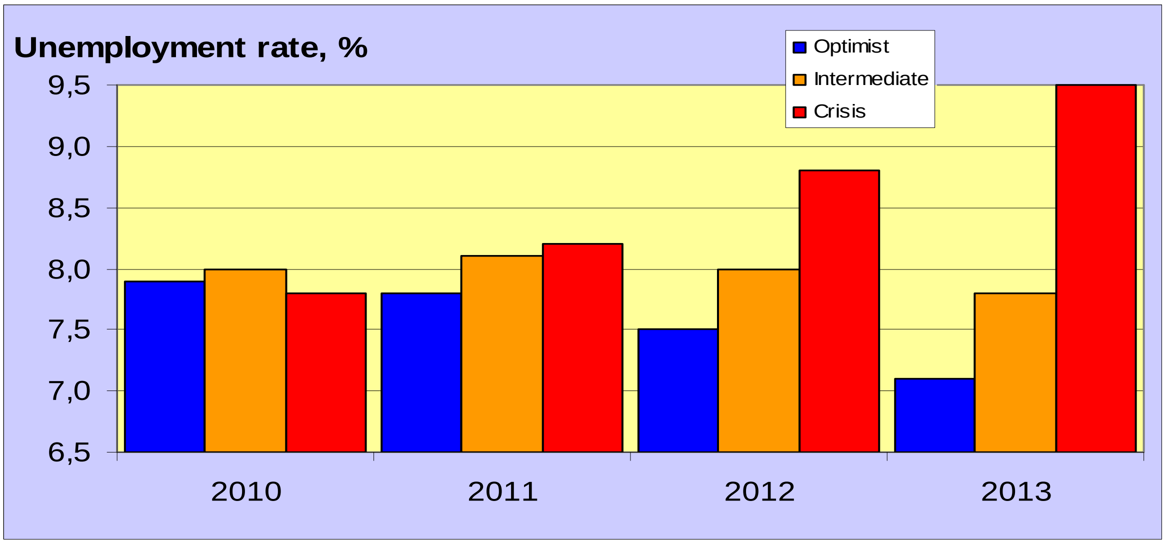

Figure 12 – Simulations for the unemployment rate, annual average

Figure 13 resumes the projections of the three scenarios for the period 2010-2013. According to Figure 7 and the methodology, the movements of inflation and idle capacity should follow a clockwise path. In fact, for the period 2010-2013 and the three scenarios considered, the simulations of macroeconomic scenarios confirm nicely the argument.

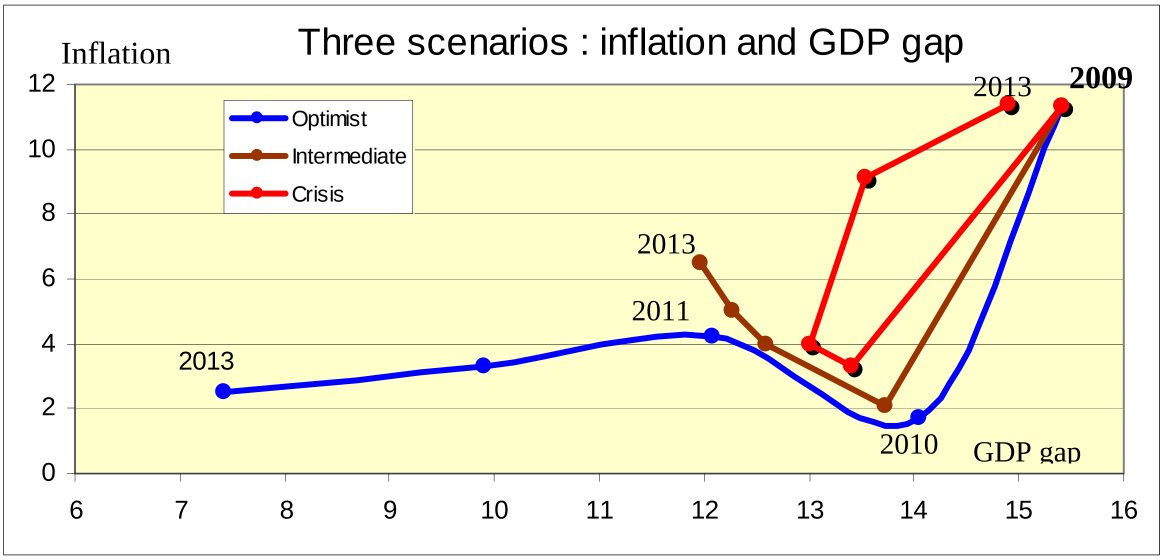

Figure 13 – Paths of three scenarios : 2010-2013

IV – CONCLUDING REMARKS

2010 will no doubt present a year of unique political and economic paths for the Brazilian economy. General election in next October poses the choice of the best strategy policy for the future, more than a single selection of presidency, governors and congressmen. The scenario of reforms is not the best one in the short-run in terms of unemployment and idle capacity. Unemployment falls less than alternative policies, but it is the best choice in the long run. On the other extreme, populist measures decrease unemployment more rapidly but create inflationary pressures that end up reverting unemployment.

Table 3

Macroeconomic scenarios : 2010-2013

	Observed		I - Optimist				II - Intermediate				III - Crisis			
	2008	2009[a]	2010	2011	2012	2013	2010	2011	2012	2013	2010	2011	2012	2013
Probability, %	...	...	65	60	55	55	30	30	40	40	5	10	5	5
Gross Domestic Product:														
R$ billion	2,829.3	3,143.0	3.399,0	3.756,0	4.120,5	4.498,1	3.378,6	3.735,4	4.098,5	4.456,8	3.421,5	3.855,7	4.313,7	4.728,0
US$ billion	1,546.07	1,579.4	1.808,0	1.926,2	2.050,0	2.183,5	1.715,0	1.787,3	1.862,9	1.972,0	1.629,3	1.736,8	1.867,4	1.953,7
Real growth, %	5.1	-0.2	6,3	6,0	6,2	6,5	5,3	4,5	4,0	4,0	5,4	4,1	2,5	3,0
Inflation IGP/DI:														
Annual average, %	11.2	1.8	1,7	4,3	3,3	2,5	2,1	5,8	5,5	4,0	3,3	8,3	9,2	11,4
Dec/December, %	9.1	-1.4	4,9	3,6	3,0	2,0	5,6	6,0	5,0	3,0	8,0	8,5	9,8	13,0
Basic rate interest, SELIC, %														
Nominal rate	12.3	9.9	8,5	8,0	7,2	6,0	9,0	9,5	9,5	9,5	9,0	11,0	12,0	13,0
Real rate (IGP/DI)	2.9	11.5	3,4	4,2	4,1	3,9	3,2	3,3	4,3	6,3	0,9	2,3	2,0	0,0
Exchange rate, R$/US$:														
Annual average	1.83	1.99	1,88	1,95	2,01	2,06	1,97	2,09	2,20	2,26	2,10	2,22	2,31	2,42
Nominal change, %	-6.2	8.7	-5,5	3,7	3,1	2,5	4,8	6,1	5,3	2,7	7,7	5,7	4,1	4,8
Real change (IGP/DI), %	-15.6	6.8	-9,9	0,1	0,1	0,5	-0,8	0,1	0,3	-0,3	-0,3	-2,6	-5,2	-7,3
Unemployment rate	9.3	7.9	7,9	7,8	7,5	7,1	8,0	8,1	8,0	7,8	7,8	8,2	8,8	9,5
Balance of payments, US$ bn														
Exports FOB	198.4	152.3	187,0	201,0	221,0	186,0	188,0	194,0	202,0	182,0	165,0	178,0	190,0	176,0
Imports FOB	175.5	127.6	167,0	183,0	204,0	172,0	170,0	186,0	195,0	163,0	145,0	165,0	181,0	167,0
Trade balance	22.9	24.6	20,0	18,0	17,0	14,0	18,0	8,0	7,0	19,0	20,0	13,0	9,0	9,0
External trade (exp.+imports)	373.9	279.9	354,0	384,0	425,0	358,0	358,0	380,0	397,0	345,0	310,0	343,0	371,0	343,0
% of GDP	24.2	17.7	19,6	19,9	20,7	16,4	20,9	21,3	21,3	17,5	19,0	19,7	19,9	17,6
Current account balance	-30.0	-32.0	-32,0	-33,0	-30,0	-20,0	-34,0	-34,0	-36,0	-22,0	-36,0	-38,0	-38,0	-36,0
% of GDP	-1.9	-2.0	-1,8	-1,7	-1,5	-0,9	-2,0	-1,9	-1,9	-1,1	-2,2	-2,2	-2,0	-1,8

Source : SILCON, March 2010. [a] Preliminary

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