The GDP Contraction in the first quarter and the risk of recession in 2019

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- **Abstract**
- The risk of a recession in 2019 rose. The GDP drop in the first quarter demands a strong recovery in the following quarters so that market forecasts are achieved for the year-on-year GDP growth. As it has already been the case since 2014, it is unlikely that the market's GDP forecasts will be proven successful by the year´s end.
- The main reason for the GDP contraction is a demand-side slowdown. Household consumption keeps on slowing its pace quarter by quarter, under the weight of the increase in the unemployment rate, the deceleration in the supply of bank loans and the rise in bank´s interest rate spreads (regardless of the year-on-year decrease in the default rate).
- The exports of goods and services had a strong quarterly decline (-1.9%), reflecting the deceleration of the World Economy. Also, there was a significant contraction of Gross Fixed Capital Formation (GFCF) (-1.7%), despite the sharp increase of Business Confidence after Jair Bolsonaro´s presidential election.
- If the investment rate were determined by business confidence in the economic policy and the government, it would have shown a huge recovery instead of the significant decline in the first quarter.
- The domestic demand was negatively affected by the reinforcement of fiscal austerity in 2019. Although the promise of new public expenditure cuts strengthens business confidence, its impact on the aggregate demand preserves high levels of spare capacity and unemployment - which limits private investment and consumption.
- As we anticipated in July 2017, the economy which recovered from the greatest economic crisis in Brazilian history is less dynamic than the one that got into it, due to the new austere fiscal regime, the high level of spare capacity, the increase in inequality and the heightened uncertainty of the worker's income.

What does the first quarter´s GDP data shows?

The GDP result for the first quarter of 2019 is frustrating in all respects, considering that the median forecast for the financial market at the end of 2018 was an economic growth of 3% by 2019.

The 0.2% drop is small but disappoints not only the forecasts made in December 2018 but also in mid-May. In the Central Bank´s FOCUS report with financial institutions on May 24, the median of the forecasts of economic growth was 1.23% in 2019.

For this forecast to materialize, an average growth of 0.7% every quarter is required. Turning from a 0.2% contraction to a 0.7% growth in each of the next three quarters is unlikely for the reasons listed below.

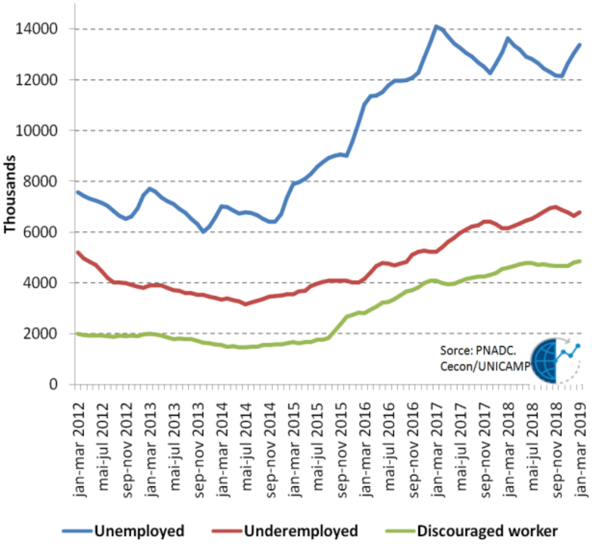
What is the main reason for the GDP contraction?

As Cecon-Unicamp has pointed out for many years, the systematic forecast error results from the underestimation of the importance of the effective demand and its cyclical dynamics.

Household consumption has slowed in the last two quarters. And in no time since 2017, it came close to the pre-crisis rates.

As we anticipated in 2017, the upturn in household consumption would be focused on replenishing depreciated inventories of durable consumer goods after households had deleveraged. However, it would be limited by the high unemployment rate, the small bounce-back in the average real income and by fears of losing formal employment contracts with the labor reform (according to surveys at the time).

Figure 1- Underutilization of the labor force



Household consumption is unlikely to accelerate at the pace required to meet the FOCUS forecast, given the increase in the unemployment rate and the inequality of labor income identified in the last surveys.

The slowdown in the supply of bank loans and the rise in banks' interest rate spreads (regardless of the year-on-year decrease in the default rate) will also limit growth in household consumption. Banks are unlikely

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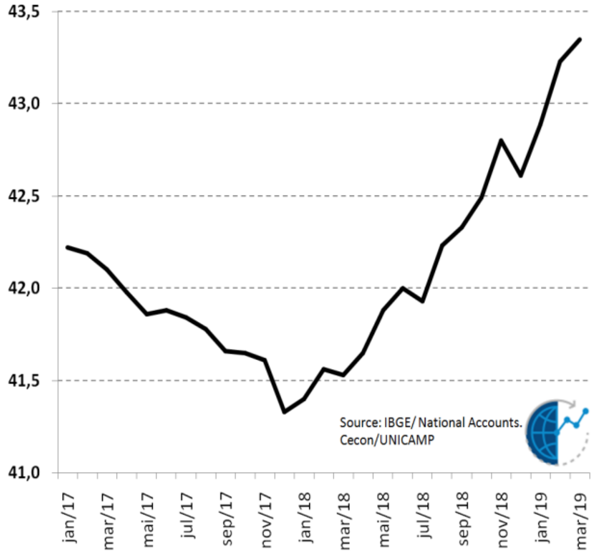
to reverse their cautious stance in the face of the recent unemployment rate, income inequality, and household indebtedness data.

Figure 2- Household indebtedness as a proportion of the accumulated income in the last twelve months



Exports were essential for the GDP recovery in 2017, given the weak domestic demand. In turn, its contraction in the first five months of 2019 contributes to the weakness of the domestic demand to bring about the quarterly GDP contraction.

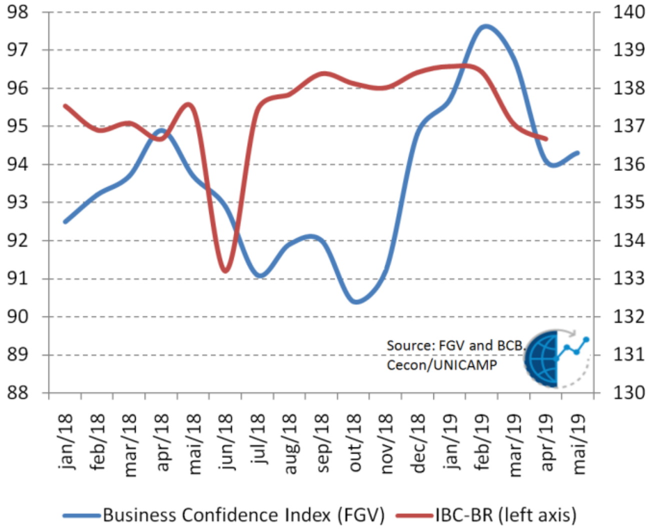
The strong quarterly decline in the net export of goods and services (-1.9%) reflects the global and regional deceleration. For this reason, it is unlikely that the external sector will save us from a tiny GDP growth or even a recession in 2019, given the slowdown of the developed economies and the uncertainties caused by Brexit and the US-China trade war.

Why didn't the increase in business confidence revive investment?

Jair Bolsonaro´s presidential election provoked a great increase in manufacturers confidence (20% between October and November), a boom in the share price of publicly traded companies (Ibovespa) and, shortly after that, great optimism about GDP growth in 2019. The optimism stemmed from the fact that Bolsonaro proposed extreme cuts in public spending, social security benefits (net of contributions), and formal employment protections.

The increase in optimism was even more surprising (given the contractionary impacts of austerity since 2015) because the effective demand dynamics did not justify the uptick in business confidence between October and November 2018. After all, demand slowed in the last quarter of 2018.

Figure 3 - Business Confidence Index (FGV) and IBC-BR.



That optimism with GDP growth in 2019 could only have resulted from the belief that an increase in private investment caused by the boom of business confidence would compensate for the negative effect of the proposed cuts on public demand and household consumption of salaried and retired employees.

However, the failure of "expansionary austerity" to revive private investment was again spectacular. Gross fixed capital formation fell sharply (-1.7%) in spite of business confidence. If investment were determined by business confidence in economic policy and government, it would have made a great recovery. After all, confidence only fell in the second quarter.

In any case, BTG Pactual's latest survey pointed out that, in the opinion of entrepreneurs, the weakness of demand is the main obstacle to investments, even above political uncertainty. This uncertainty is also not favored by the enormous difficulty of complying with the rigid rules of the new tax regime (as explained in Cecon, 2017) in a recessive economic environment and stagnant tax revenues.

Given significant levels of spare capacity, we would recommend that the economists consulted by the FOCUS report pay more attention to the dynamics of effective demand before making positive predictions about austerity. A policy that increases the confidence and the valuation of financial assets transacted in secondary markets can have opposite effects on the sales that determine the levels of spare capacity and the incentives for productive investment and hiring.

IBGE does not capture the impact of fiscal austerity on the GDP

For reasons beyond the scope of this note, IBGE's methodology measures the supply of public services better than the impact of public expenditure on aggregate demand.[1]

In this regard, it is better to use the sources that capture the evolution of public spending, that is, the National Treasury for the federal government and the Central Bank for the other public sector entities.

Fortunately, the data for the first quarter is already available. In March, federal spending (about 20% of GDP) plunged by 3.2% over the same month last year. In the first quarter (compared to the same quarter of the previous year), it fell by 1.2%, which subtracts GDP by about 0.24%.

The cut in regional government expenditures was strong according to the Central Bank, generating a primary fiscal surplus of about 1% of GDP. In this case, a R$10.5 billion deficit in the last quarter of 2018 (about 0.6% of quarterly GDP) was replaced by a R$17 billion surplus.

The announcement of the cuts has boosted both the confidence of financial managers and capital gains on stock and bond markets. It is important to recognize that the cost of this is paid by a loss of quality in public services and by the contraction of sales of goods and services from the private sector to the public sector, with a negative impact on economic growth and welfare.

As we anticipated in July 2017, the economy which recovered from the greatest economic crisis in Brazilian history is less dynamic than the one that got into it, due to the new austere fiscal regime, the high level of spare capacity, the increase in inequality and the heightened uncertainty of the worker's income.

Unless the world economy defies the expectations of a global slowdown and pulls Brazilian exports magnificently, the scenario for the domestic demand and therefore of GDP and employment is more of the same, especially if the government doubles down on its bet in “expansionary austerity.”

The economy kept on contracting at the beginning of the second quarter (updated on July 05th, 2019)

The processes that led to the GDP contraction in the first quarter don’t seem to have been reversed as we entered the second quarter. As of now, the only available statistic on macroeconomic performance is the monthly GDP proxy estimated by the Central Bank (IBC-Br). It depicted a 0.47% decline in April compared to March, reaching the lowest absolute level in the seasonally adjusted series since May 2018.

In the services sector, the IBGE´s survey (PMS) registered a fall of 0.7% in April when compared to April 2018. This fall marginally outdid even the pessimistic median market expectations (-0.6% YoY, according to Bloomberg). However, the MoM variation was slightly positive (0.3%). It doesn’t portend optimism because the uptick was led by information and communication services (0.7%), rebounding from a massive fall in the preceding month (-1.8%). Moreover, a good sectoral indicator of general activity, transport and mail services, fell by 0.6 MoM.

Industrial production also declined by 0.2% in May compared to April, despite the rebound in extractive industries (9.2%). It accumulates a loss of 0.7% in the first five months of 2019 (IBGE´s PIM).

Foreign trade kept on suffering the effects of the global and regional slowdown and reinforced the domestic contraction. On the one hand, exports of goods and services amounted to US$ 110.9 billion in the first semester, falling 3.5% YoY. On the other, imports manifested the domestic conditions markedly: they stagnated in the semester (YoY) after skyrocketing 17.2% in 2018.

The growth in formalized job contracts reflected these global and domestic trends, according to the Ministry of Economy (CAGED). Though 32.1 thousand jobs were created in May, the performance was the worst for this month since 2016. Due to seasonal factors, agribusiness was responsible for the positive result, adding 37.3 thousand jobs (mostly in coffee and orange harvests).

In tandem, the unemployment rate remained stable in the quarter concluded in May, compared to the quarter concluded in February (QoQ), according to IBGE (PNAD survey). However, the underutilized population reached record level (25%), due to stable unemployment, increasing underemployed (+2.7% QoQ) and high discouraged population, both at record levels. Though the absolute number of employed people grew by 1.2% QoQ, the rise in the self-employed population (1.4%) and the number of employees without a formal contract (2.8%) explain most of the increase.

This scenario denotes a labor market with increasing informality, unprecedented levels of discouragement and underutilization, confirming the perception of worsening working conditions due to macroeconomic circumstances, and institutional changes brought by the 2017 Labor Reform. All this explains why real monthly average earnings fell by 1.5% QoQ, probably holding household consumption at a low ebb for some time.

Hence we can reiterate our hypothesis: without an unlikely rebound of exports due to an unexpected turn in the global economy, we can expect more of same, especially if the government doubles down on its bet in "expansionary austerity" in macroeconomic policy and institutional reform.

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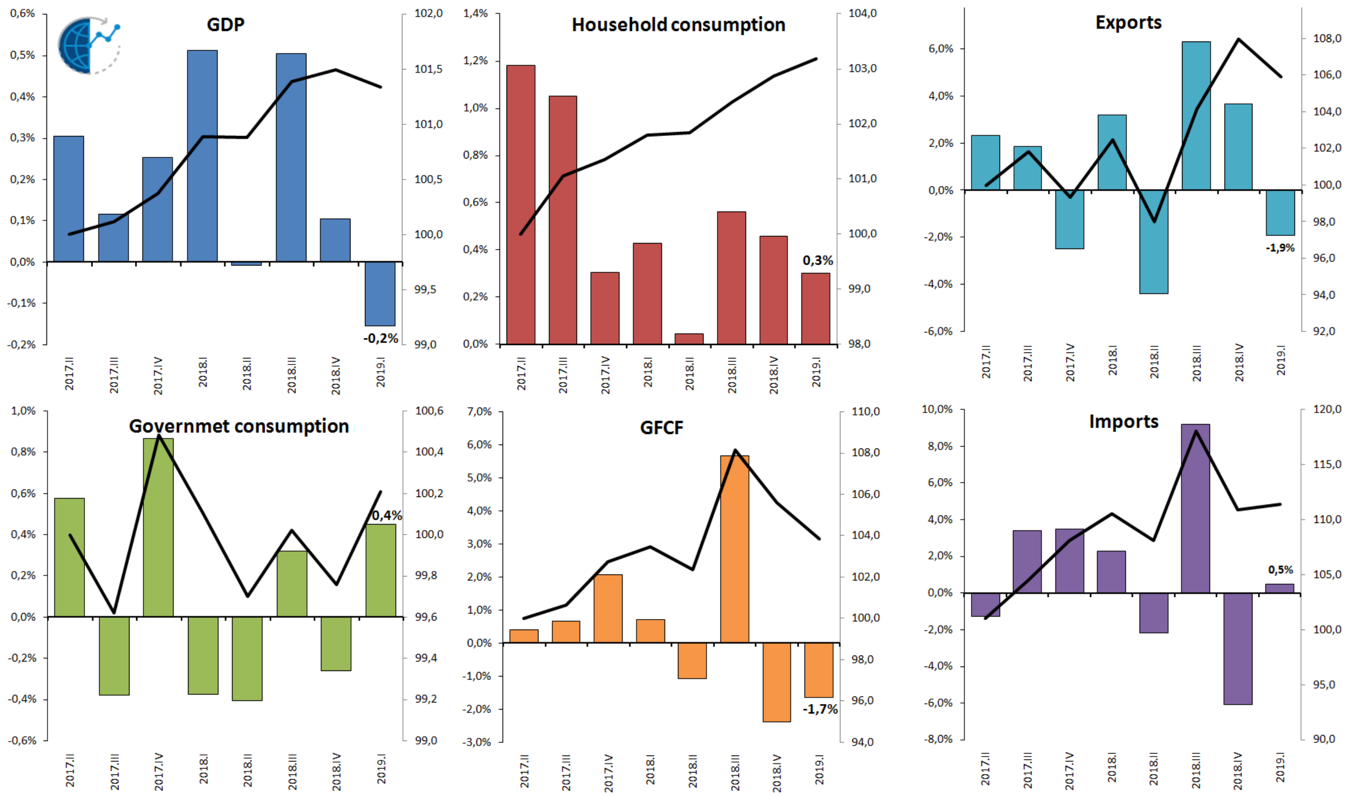
[1] IBGE is the Brazilian Institute for Geography and Statistics, the official institution responsible for measuring the GDP and many other social and economic indicators.

Panel 1- Demand factors, seasonally adjusted quarterly volume series.
Right axis: 1ºT2017 = 100 (lines); Left axis: quarterly growth against the previous quarter (bars)



Source: National Accounts, Cecon/UNICAMP.

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