What will drive Brazil’s wider current-account deficit in the coming years?

- Brazil’s current-account deficit narrowed to about 0.5% of GDP in 2017 from 4.3% of GDP in 2014, due to a weaker currency and slower economic activity.

- This paper explores the main drivers that we consider in our external-account forecasts for the next years. We show that the rebound in activity will contribute to an increase in the current-account deficit, but not to the point of compromising the country’s external sustainability. The current-account deficit should hover around 2.0% of GDP, a comfortable level even in a scenario of reduced global liquidity.

External accounts: A simplified model

We start from a simplified model in which the aggregate current-account deficit (as a share of GDP) is a function of the real exchange rate, the terms of trade and economic activity\(^1\).

The weaker the exchange rate, the wider the current-account balance will be. The same goes for the terms of trade: the higher the ratio between export and import prices, the wider the current-account balance. On the other hand, the stronger is the economy, the greater the demand for imported goods and services will be and, thus, the narrower the current-account balance.

The chart below compares the path of the actual and forecasted current-account balance, showing that the estimated model seems to explain the dynamics of external accounts in the past well, and corroborates our expectation of a widening deficit in the next years\(^2\).

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1 We used capacity utilization (NUCI, as published by FGV) as a proxy for economic activity in Brazil.
2 Our official forecasts are based on more complex models (bottom-up and top-down analyses), but we show here that a simple model can explain the current-account dynamics well and reinforces our expectation of a widening deficit in the next few years.
Interestingly, even with a rebound in economic activity, the current-account deficit is unlikely to return to the 4% of GDP level seen in the early 2000s and in 2013/2014, thus reducing risks related to eventual liquidity shock. In other words, an eventual reduction in foreign capital flows would have less impact on the exchange rate and, consequently, on the economy, because the need for external financing (set by the size of the current-account deficit) is moderate.

Another way to see that a rebound in activity would not pressure external accounts too much is by estimating today’s current-account deficit if Brazil had not experienced a recession that reduced GDP by more than 8% in recent years. To that end, we used the simplified model described above, but considered capacity utilization at a neutral level, instead of the actual level. Ceteris paribus (i.e., considering the actual path for the exchange rate and the terms of trade), the current-account deficit would now be at 2.9% of GDP – 2.4 pp of GDP above the current 0.5% of GDP – if it were not for the recession, but below the 4% level seen in 2013/14. In other words, even if the economy were running at full employment, the current-account deficit would not be larger than 3.0% of GDP.

External accounts in detail: What to expect in the coming years

We explain below the main drivers for a wider current-account deficit in the coming years. But first, it is important to recall the current account’s composition as well as its evolution in recent years.

The current account encompasses transactions of goods and services between residents and non-residents. In Brazil, the trade balance (exports - imports) usually runs a surplus, but services and income balance are usually negative. Hence, Brazil usually posts a current-account deficit.

Between 2014 and 2017, this deficit narrowed from USD 104 billion (3.3% of GDP) to approximately USD 10 billion (0.5% of GDP). The trade balance provided the main positive contribution, turning from a USD 7 billion deficit to an all-time-high surplus of USD 67 billion (according to the Ministry of Trade – MDIC), followed by shrinking service and income deficits.

However, in the next few years, the current-account deficit will not remain as low as its most recent readings. Despite a still-depreciated exchange rate, the rebound in economic activity tends to boost imports of goods and services, as well as profit and dividend remittances.

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<td>-10</td>
<td>-31</td>
<td>-45</td>
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<tr>
<td>% GDP</td>
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<td>-2.9%</td>
<td>-3.0%</td>
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<td>-3.3%</td>
<td>-1.3%</td>
<td>-0.9%</td>
<td>-1.5%</td>
<td>-2.1%</td>
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Trade balance

The trade balance provided the largest positive contribution in recent years. The sharp decline in investments (of about 30% between 2014 and 2017) caused a substantial retreat in imports, as input for production of other goods and capital goods represent 75% of total Brazilian imports. Meanwhile, exports also receded, in line with the drop in international prices for commodities, which represent about 40% of total Brazilian exports.

Recently, shipments to overseas markets regained strength thanks to higher prices (commodities rebounded after hitting a low in late 2015/early 2016) and higher quantities (supported by the larger crops). Going forward, commodity prices should remain stable at current levels, so exports will not expand much in the next few years.

Imports remain at historically low levels, but should pick up in line with the economic recovery, particularly in investments. We forecast investments will climb 5% in 2018 and 8% in 2019, leading to increases in imports of about 7% and 11%, respectively.

These moves will result in a still-positive trade balance in the coming years, but smaller than in 2017.

Service deficit

Contracting economic activity and currency depreciation also affected the services deficit, which narrowed to about USD 35 billion from USD 50 billion. The decline was widespread across the main items: international travel, transportation and equipment rentals.

Starting in 2014, higher unemployment and currency depreciation caused a decline in the nominal wage bill measured in U.S. dollars. Hence, expenditures by Brazilian residents when travelling abroad (particularly tourism) also fell, to about USD 20 billion in 2017 from USD 26 billion in 2014. Going forward, falling unemployment tends to boost expenditures by Brazilian residents overseas.

The transportation deficit, which measures expenditures and revenues related to passengers and freight services, also narrowed. These expenses have substantial correlation with the trade flow (measured by the sum of imports and exports). Naturally, the bigger international trade transactions are, the larger the freight expenditures. In recent years, declines in imports and exports helped to reduce the transportation deficit. Going forward, the increase in trade flows should result in larger transportation expenditures.

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3 Intermediary goods (62%) and capital goods (13%)
Income deficit

Unlike the service deficit, the decline in the income deficit was not widespread across items: it was driven by the profit and dividends account. Between 2014 and 2017, the deficit in this item narrowed to USD 21 billion from USD 31 billion, while the interest account (another important component of the income account) remained virtually stable.

To assess the behavior of profits and dividends, one must analyze the evolution of net external liabilities that pay profits and dividends (i.e., the net stock of foreign investments that generate profit and dividend payments). Hence, the larger direct investments (in the form of equity capital transactions) and investments in the stock market are over time, the greater the net stock of foreign investments that pay profits and dividends will be and the greater the deficit in this account.

Importantly, a substantial part of these liabilities is denominated in Brazilian reais, so that exchange rate depreciation reduces their value in U.S. dollars and, consequently, reduces profit and dividend expenses. This is precisely what happened after 2014: sharp currency depreciation, combined with the recession, reduced net external liabilities (in dollars) that pay profits and dividends and, consequently, drove the decline in the income deficit.

In the next few years, the rebound in economic activity should trigger a rebound in direct investments and stock investments in Brazil, boosting profit and dividend payments.
**Conclusion**

Different indicators suggest that the current-account deficit will widen again in the coming years, but, even with an economic recovery, it will remain at still-moderate level. Brazil is now in a more comfortable situation than in the past to absorb eventual external and internal shocks.

**Julia Gottlieb**

**Appendix 1**

**Elasticities based on the simplified model:**

- 10% real exchange rate depreciation → 1.0 p.p. of GDP increase in the current-account balance
- 10% increase in terms of trade → 0.2 p.p. of GDP increase in the current-account balance
- 1p.p. increase in the capacity utilization index → 0.6 p.p. of GDP decrease in the current-account balance
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