

Brazil

# Economic Outlook

August, 2010

## Economic Analysis

- After growing at the most intense pace in fifteen years in the first quarter of the year, the economy is expected to slowdown from now on following the new tone of macroeconomic policies.
- Inflation is also expected to moderate although it will only get near the 4.5% target next year.
- The withdrawal of fiscal and monetary incentives already started as clear signs of economic overheating popped out. However, the burden of the cyclical adjustment will be borne mostly by monetary policy as primary expenditures are still rising too fast.
- Credit to the private sector recovered in the last months and is expected to continue growing robustly although the monetary tightening cycle and the moderation of economic activity should constrain future expansions (as well as additional non-performing loans declines).
- The strengths of the Brazilian economy kept the country relatively isolated from turbulences coming from Europe. But if external turbulences get worse then the country would be hit.
- If turbulences in Europe moderate as expected, the Real will remain relatively appreciated, although government's interventions should avoid the currency to trade below the 1.70 mark.
- The risks of political noise are higher in the second half of the year as Presidential elections near. Although political-generated turbulences will remain much milder than in the pasts, risks are higher than the markets are currently discounting.



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**Closing date: July 22, 2010**

# 1. Reassessing the outlook for the global economy

The effect from the fiscal adjustment on growth in Europe will be lower than commonly assumed. The positive impact on credibility will almost compensate the negative effect from reduced public demand. Conversely, medium-term risks from unsustainable fiscal positions in other developed regions are probably underestimated.

One of the most important channels through which the fiscal crisis has affected the European economy has been the loss of confidence, and a prerequisite to restore confidence is fiscal prudence. Consolidation plans in Europe are being implemented according to schedules presented to the European Commission at the beginning of 2010. Fiscal consolidation in Europe needs to focus on the structural side, but a positive factor is that adjustment is fast and tilted towards reducing expenditure, which will boost confidence and almost compensate the negative effect on growth from reduced public demand. Thus, as long as the determination on fiscal consolidation is maintained, the impact on European economic activity will be limited and transitory. On the other hand, other advanced economies, where fiscal impulses have been substantial and debt levels have increased at similar pace as in Europe, are relatively slow in coming to grips with reducing deficits and—at least—stabilizing debt levels. This is a medium-term risk that is being underestimated, as experience shows that the effect of lax fiscal policy on interest rates in highly non-linear, and there is a risk of sudden increase in long-term rates and a displacement of private demand; exactly the opposite effect as intended by the fiscal stimulus packages.

The main risk to the global outlook is still coming from financial markets. Stress tests have had positive—though asymmetric—impacts throughout Europe. Although risks have been reduced, the potential fallout from renewed tensions is still sizable.

Financial risks, which stemmed from sovereign debt concerns, formed a feedback loop that ended up increasing market risk and drying up liquidity, especially in Europe. Nonetheless the sharp increase in financial tensions in Europe in the second quarter is starting to abate (see Chart 1). The release of European stress test results has had positive effects on lowering tensions, although there has been a clear differentiation across countries. In particular, it may act as a powerful driver for removing uncertainty surrounding the Spanish financial system, as the implementation of the exercise looks rigorous and the outcome seems credible and is very informative. Undoubtedly the risk to Europe and the global economy coming from financial markets is still the main source of concern.

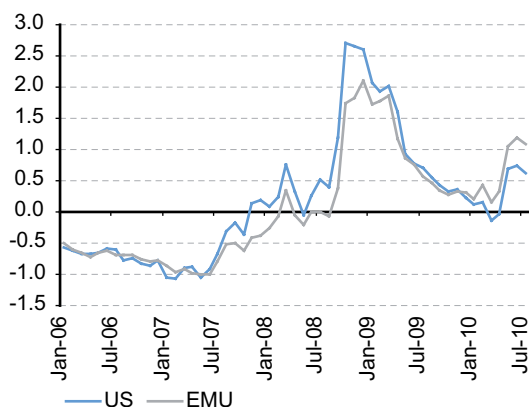
Increasing divergence in monetary policy strategies is expected. Heightened uncertainty will prompt the Fed and ECB to postpone the exit from accommodative policies. On the contrary, tightening has resumed across much of Asia and Latin America.

Financial strains in Europe and uncertainty about the pace of recovery in the US will prompt central banks in both regions to postpone their first rate rises and keep very low policy rates for an extended period. Inflationary pressures in both areas will remain subdued, allowing them to keep lax monetary policies. Nonetheless, a faster recovery in the US will mean that the monetary exit will be earlier there than in Europe, and both factors will weigh down on the euro. Although both central banks will postpone monetary tightening, communication and the assessment of risks continue to differentiate both institutions, limiting the ECB's relative capacity to react, in particular to deflationary risks. On the other hand, in emerging economies monetary tightening is resuming, after a pause (especially in Asia) as the European debt crisis unfolded. This will help reduce inflationary pressures in Asia—where they were starting to build—and prevent potential pressures from developing later in the year in South America. An important exception is Banco de México, likely to hold rates beyond the second quarter of 2011, even when inflation edges up in the last months of this year.

The global economy is on track for a mild and differentiated slowdown. It will be a healthy development for China and the rest of emerging Asia, with growth converging towards more sustainable rates. However, in the US private demand will remain weak without policy support, whereas in Europe confidence will be negatively affected by the fallout from the financial crisis.

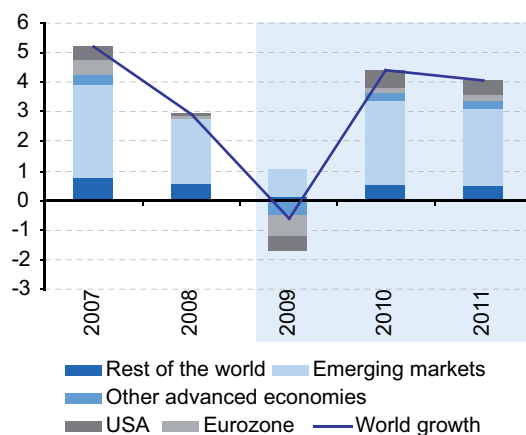
Spillovers from the European financial crisis to other geographical zones have been relatively limited. Nonetheless, the global economy will slow down going forward (see Chart 2). The severity of financial tensions in Europe will affect confidence and reduce growth in the second half of 2010 and the beginning of 2011. Moreover, external demand will not be as strong as it was in the first half of the year, although it will provide some support for economic activity. In the US, the recovery is likely to lose momentum on account of softening labor and housing markets. This shows the limits of private demand taking over as an autonomous driver of growth. In China, slowing GDP growth in the second quarter and moderating activity indicators are evidence that the authorities' tightening measures are being effective to steer the economy to more sustainable growth rates. Latin America will also slow down in 2011, but keep robust growth rates going forward. Therefore divergences will continue to widen both between advanced and emerging economies and within each of those groups.

Chart 1

**Financial Stress Index\***

\* Composite indicator of financial tensions in 3 credit markets (sovereign, corporate and financial), liquidity strains and volatility in interest rate, foreign exchange and equity markets  
Source: BBVA Research

Chart 2

**Contributions to Global GDP growth**

Source: BBVA Research based on national accounts

Although there were some steps in the right direction, going forward the necessary global rebalancing of demand and the narrowing of global imbalances is still pending.

The rebalancing of the Chinese economy towards more internal demand (particularly consumption) continues, and the recent renewal of currency flexibility should help. However, further reforms are needed to bring the weight of consumption more in line with international standards. Other advanced surplus countries also need to implement reforms to increase domestic demand, most notably in the service sector. On the other hand, the US and other countries with substantial external financing needs need to switch from a consumption-led model to investment, especially in tradable sectors. The recent financial crisis has shown the limits to foreign financing of growth. Economies with high external financing needs are highly vulnerable to an upsurge of international financial tensions, and the resulting sudden movements in exchange rates risk undermining global financial stability.

## 2. Growth in Brazil: moderation after the surge

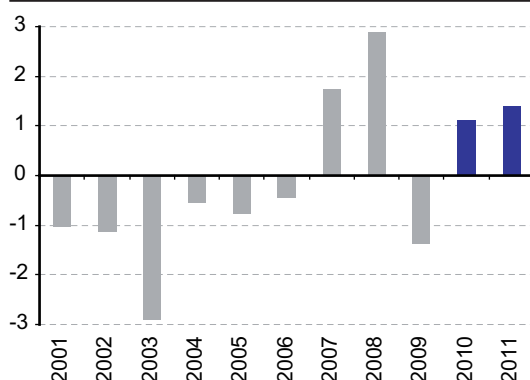
The Brazilian economy expanded 9.0% y/y in the first quarter of the year, the most intense pace in fifteen years. This result is due to last years' low comparison base but also to the intense dynamism of the domestic demand (investments and private consumption grew 26.0%/y/y and 9.3%/y/y respectively). A large set of macro and microeconomic indicators show, however, that this pace is unsustainable. On the macroeconomic side, both inflation and the current account deficit shot up in the first months of the year. Inflation moved up from 4.3% at the end of 2009 to around 5% currently (non-tradable inflation, which better captures the impact of domestic activity on prices, is currently higher than 7%). Markets' expectations for the end of the year are at 5.5%, significantly higher than the 4.5% inflation target. The external deficit reached about 2% of GDP due to the explosive performance of the imports of goods (44%/y/y in the first five months of the year) and of income and services expenditures (28%/y/y in the same period). The unsustainability of the current growth pace is also evidenced on the microeconomic front. There is, for example, anecdotic evidence of skilled and unskilled labour shortages in many sectors. There is also indication of production bottlenecks in Brazilian ports, overcrowding in the airports, concerns regarding electric power shortages, to name a few. All these examples are in accordance with our estimations that the economy is growing above its potential. For 2010 as a whole we expect GDP to be 1.1% higher than potential GDP (see Chart 3).

Despite some public demonstration of enthusiasm with respect to growth figures, the government also recognizes the unsustainability of the current growth. Fiscal and monetary incentives implemented during the crisis are being withdrawn as they are clearly not necessary anymore. In addition to less expansive macroeconomic policies, other factors are also expected to contribute to a slowdown in the economic activity after a frenetic first quarter. Inventories are already at pre-crisis levels and should contribute less to GDP expansion from now on. The recent increase in the debt burden should reduce the margin for further consumption expansion. Finally, uncertainties with respect to sovereign debt problems in Europe and a moderation of growth in USA and China in the second half of the year should also contribute towards a moderation of economic growth in Brazil.

After growing 2.7%q/q in the first quarter, we expect quarterly growth to average 0.5% over the remaining of the year. For 2010 as a whole we now forecast GDP to grow by 6.9%, 100bps more than we forecasted previously. This upward revision is mainly due to positive surprises in the first quarter of the year – as domestic demand, especially investments, proved to be more resilient than forecasted to the beginning of the withdrawing of temporary incentives. Commodity prices also helped, since they have remained higher than expected.

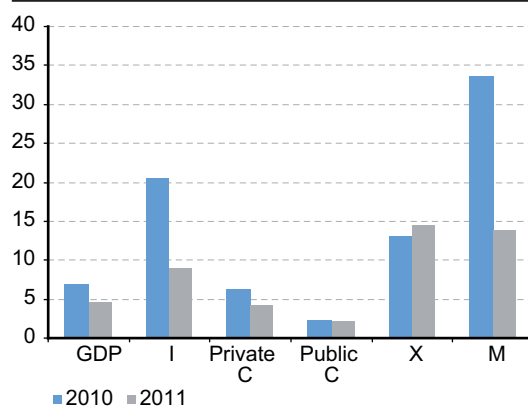
This annual forecast encompasses a 21% investment growth and a 5.2% expansion of overall consumption (6.4% growth of private consumption). As for external components of the GDP, we envisage exports growing by 13% and imports by 33% (see Chart 4). Although growth will moderate from the second quarter on – as it is already being revealed by high frequency indicators as industrial production and retail sales– the private components of the GDP will continue benefiting from very supportive labour market conditions and from the continuity of some long-term movements as the reduction in the poverty and in the inequality.

Chart 3

**Output Gap (%)**

Source: BBVA Research

Chart 4

**GDP Forecasts (%)**

Source: BBVA Research

External accounts and especially inflation will benefit from this moderation of the economic activity. Recent data actually already shows this. After increasing by six months in a row – and in the absence of significant supply shocks – yearly inflation dropped in the last two readings and should continue relatively moderate in the remainder of the year. We expect domestic prices to grow by 5.4% in 2010.

The current account deficit also declined for the first time after many months of expansion. In the first five months of the year the accumulated current account deficit amounts already to USD 19 billions. By the end of the year we expect it to reach USD 51 billions (2.7% of GDP). The trade balance surplus is currently 43% lower than the observed during the same period last year. Recently, however, the trade balance surprised to the upside, driven by very dynamic exports of some commodities (as oil and iron ore) and automobiles. We therefore revised upwards our forecasts for the trade balance from USD 8 billions to USD 12 billions in 2010.

In addition to an economic slowdown, the depreciation of the real – which averaged 1.79 in the second quarter, 2% more than we had forecasted – helps us to understand recent external accounts movements.

In the first half of the year the Central Bank intervened constantly in exchange rate markets to buy dollars with the goal to accumulate reserves to moderate exchange rate volatility. Total purchases amounted to USD 14 billions in the period and international reserves reached USD 253 billions (around 5 times the current account deficit forecasted for the end of the year). Although international reserves work as a self-insurance for periods of turbulences, the purchases of dollars by the Central Bank are followed by sterilization operations that increase public debt. Some specificities of the sterilization process in Brazil make intervention costs particularly high. More precisely, the debt placed to sterilize dollar purchase is very concentrated in the short term and, in addition, its cost is very high as it is usually indexed to the SELIC (which is much higher than the remuneration the monetary authority gets on its external assets). These costs rise with international reserves. By the end of 2010 we forecast international reserves to get near USD 280 billions.

Regarding exchange rate, from now on some factors could push the real downwards, namely financial turbulences in the developed world and the consolidation of the view that exchange rate intervention



will be triggered by a marked appreciation of the real. In addition, some volatility can be added in the coming months by the presidential race, although in any case the impact on markets of the political developments will certainly be more limited than in the past. On the other hand, the capitalization of both Banco do Brasil and Petrobras can create some appreciatory movements, depending on the degree of participation of foreign agents – that should be high – and on the degree that Central Bank will absorb foreign inflows – that should also be high. All in all, we expect the exchange rate to be in the 1.70 – 1.80 range for the remainder of the year, probably closer to the lower bound in the third quarter and to the upper bound in the fourth.

With respect to our post-2010 scenario, we see more risks than the markets are currently discounting. The current interventionist trend is likely to be strengthened either by Dilma Rousseff - in line with what we have been witnessing since the beginning of the Lehman Brothers crisis - or by Jose Serra – in line with his recent references to a model in which the Executive would have a bigger say in monetary policies. At this point the presidential race is open.

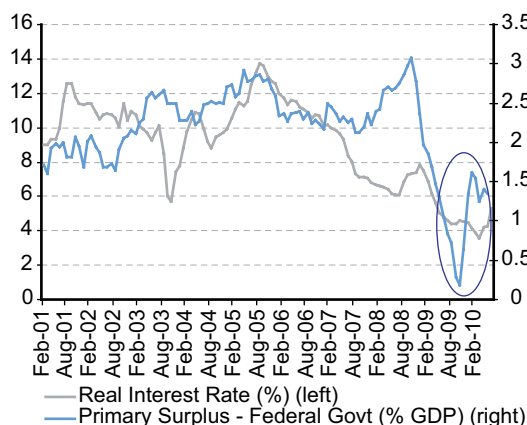
In spite of some mismanagements and twists in economic policy, we expect intense growth to continue in the coming years although not as much as in 2010 (4.7% in 2011 and around 5% afterwards). The driver of GDP growth will continue being domestic demand, and that should continue putting pressure on inflation and to the current account. We forecast inflation to reach 4.8% in 2011, slightly over the 4.5% target, and to converge to target in 2012. The current account deficit, however, is expected to continue widening and to reach 3.3% of GDP in 2011 and almost 4% in 2012. The robustness of the Brazilian economy in the coming years should keep the real at appreciated levels. More precisely, we expect the Brazilian currency to fluctuate around the 1.78 mark, in real terms.

### 3. Monetary and fiscal policies: complementary?

One feature of the counter-cyclical policies implemented during the crisis was the complementarity between monetary and fiscal policies. The government was able to cut taxes while keeping expenditures relatively expansive. The Central Bank, on the other hand, had room to bring interest rates down to historical lows. Thus the counter-cyclical role of the fiscal policy was reinforced by the monetary policy, and vice-versa. In the end of 2009 and in the first months of 2010, therefore, both fiscal and monetary policies were exceptionally expansive (see Chart 5). This is central to understand the strong dynamism of the activity in the first quarter of 2010.

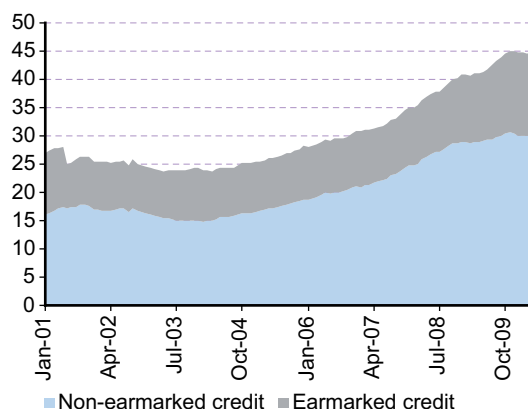
Recently, however, fiscal and monetary incentives implemented during the crisis started to be withdrawn as clear signs of economic overheating popped out. The Central Bank initially elevated banking reserve requirements on March and then, some days ago, announced new adjustments that will set requirements at pre-crisis levels gradually by 2014. These measures frustrated expectations that the cuts announced during the crisis would be permanent getting Brazilian reserve requirement rates closer to international levels. In addition the Central Bank started in April to adjust interest rates up. The SELIC was first adjusted from 8.75% to 9.50% and then to 10.25% in June. More recently, in July, the reference rate was adjusted 50bps up, to 10.75%. We expect the pace of monetary adjustments to continue slowing down in coming months and the SELIC to close the year around 11.50%. The risks are tilted to the downside, i.e. to less aggressive adjustments, as recent decisions exposed the dovishness of the members of the Monetary Policy Committee. Anyway, it should be taken into account that the effectiveness of the monetary policy now is probably higher than in the past as both total credit and non-earmarked credit represent now more than ever a larger share of the GDP (see Chart 6).

Chart 5

**Fiscal and Monetary Policies**

Source: BBVA Research and BCB

Chart 6

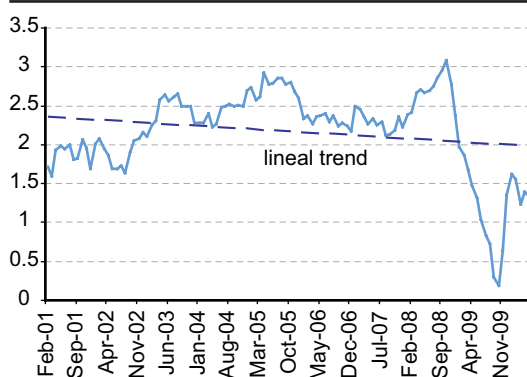
**Credit (% GDP)**

Source: BBVA Research and BCB

With respect to the fiscal policy, most incentives implemented last year were recently withdrawn. The primary surplus of the federal government, nonetheless, recovered very modestly from historical low levels and is still much lower than pre-crisis levels (see Chart 7). As shown in Chart 8, federal revenues are climbing up but primary expenditures remain too strong to allow for any improvement in the primary surplus of the federal government. Some populist decisions, such as the 7.7% increase in pension payments, as well as the rising interventionism of the public sector also keep the primary surplus low.

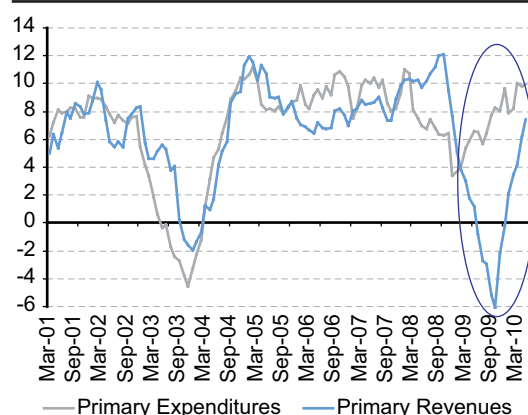
Primary expenditures could moderate slightly in the second half of the year, but will continue growing and imposing a bigger burden for monetary policy. We are currently forecasting primary surplus to reach 2.9% of GDP in 2010. This is higher than in 2009, but less than both pre-crisis levels and the 3.3% fiscal goal for the year (which should, however, be officially met as an increasing amount of investment expenditures can now be deducted from the target). The improvement with respect to 2009 will be mostly due to an increase in revenues than to a moderation in expenditures. In nominal terms, i.e. including interest payments, we forecast a 2.8% deficit. The public debt would, according to our estimations, drop from 44.5% of the GDP last year to something slightly over 42% this year.

Chart 7

**Primary Surplus - Federal Government (% GDP)**

Source: BBVA Research and BCB

Chart 8

**Federal Government Accounts - Accumulated in 12 months (y/y %)**

Source: BBVA Research and BCB

## 4. Credit expansion continues

After slowing down at the end of 2008 and during most of 2009, credit to the private sector recovered in the last months and is currently growing at 17%/y/y as illustrated by Chart 9. By sectors, real estate credit is currently the most dynamic. It is growing around 51% in yearly terms, while credit for consumption and credit to firms are growing 17% and 18% respectively. Part of the dynamism of real estate credit in Brazil is, however, explained by the very low starting levels.

Looking at more disaggregated data, we see a larger role of credit from BNDES – the National Development Bank – and to the rural and real estate sectors, among others. More precisely, earmarked resources now take up 33% of total credit in comparison to 28% two years ago. Another important credit trend is the expansion of payroll credit which now represents 60% of total personal credit.

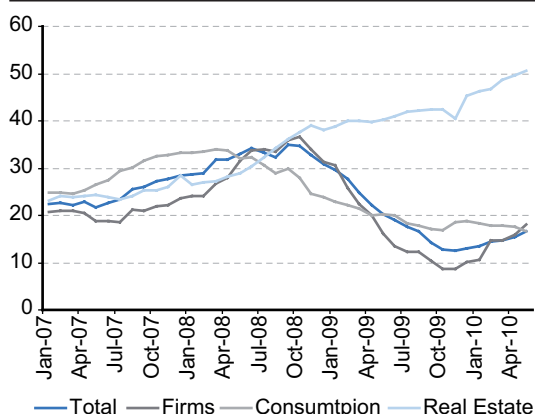
In the remainder of the year, credit is expected to continue growing robustly although the monetary tightening cycle and the moderation of economic activity should constrain future expansions (as well as additional NPLs declines). By the end of the year, we expect credit to be growing around 20%/y/y.

Although the recent capitalization of some public banks - as BNDES and Banco do Brasil - will renew their capacity to lend, private banks should recover at least part of the market share lost during the crisis.

Regarding the financial system, there were concerns about excess of liquidity, but the current tone of the monetary policy as well as recent reserve requirements adjustments should help to reduce current liquidity levels (in the first four month of the year short-term assets represented 21% of total assets, the highest proportion in many years). Capital ratios remain high while banking profitability continues reflecting both the good economic momentum and limited NPL losses. All in all, conditions seem set to allow Brazilian financial markets to continue performing well (see Chart 10 for the information on the recent development of the financial system in Brazil).

Chart 9

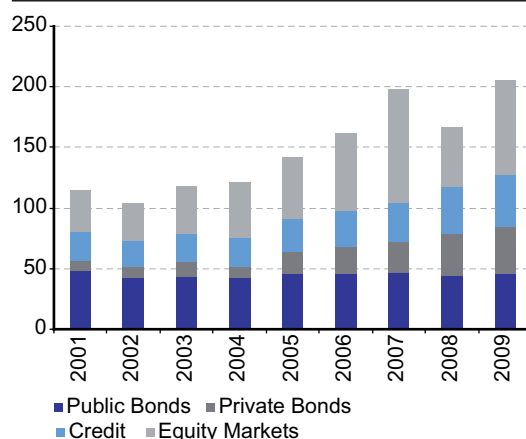
### Credit to the Private Sector (y/y %)



Source: BBVA Research and BCB

Chart 10

### Financial Markets (% GDP)



Source: BBVA Research, Bloomberg and BCB

## 5. Risk scenarios for the Brazilian economy

The strengths of the Brazilian economy – as the robustness of its domestic demand, the geographically well-diversified exports structure, the soundness of its financial system and the relatively new capacity to implement counter-cyclical policies – kept the country relatively isolated from turbulences observed in Europe. The volatility of domestic markets at the end of May shows, however, that if external turbulences get worse then the country would be hit. The main risk hovering around the robust growth scenario we are currently envisaging for the Brazilian economy is therefore that global risk aversion trends upwards due to the deterioration of the problems in Europe and that the recovery in developed economies peters out. In this case, a correction in commodity prices and especially financial turbulences in global markets will have a recessive impact on economic activity in Brazil. Domestic demand would still provide support but not enough to keep growth rates unchanged.

As for 2010, carryover effects and the performance in the first half of the year should guarantee solid growth, probably between 5.5% and 6.0%, but as for 2011 and 2012, GDP growth should be around 200bps inferior to what we are forecasting in our main scenario. In this case however, current account



and especially inflation tensions would moderate. According to our forecasts the latter would trend downwards and converge to levels around 4% in 2011 and 2012. The former, on the other hand, would stabilize around 3% of GDP in the next two years due to both a moderation of the domestic demand and to a depreciation of the real, which in this case would near the 1.9 mark in the remainder of this year, slightly more than that in 2011 and 2012. The funding of the external accounts should, in this case, be made more difficult and could add volatility to exchange rate markets. In any case the Central Bank would have more than enough international reserves to face a scarcity of dollars. Regarding fiscal policy, revenues would be hit by lower growth rates and primary surpluses would fall to levels around 2.7% - instead of 3% in the base scenario. There would be, nevertheless, limited risks related to external and fiscal accounts, although an environment of lower tolerance with mismanagements in the fiscal side could hurt the country.

A less likely but still existent risk is that growth refrains to moderate as expected. In this case, 2010 GDP could easily reach 8% or even more (in quarterly terms, this would mean a 1.3%q/q average growth from the second quarter on, in comparison to the 2.7%q/q observed in the first quarter and to the 0.5% average we have incorporated in our base scenario).

In this "overheating scenario", inflation would trend upwards and a stronger adjustment in macroeconomic policies will be needed. This adjustment would likely be implemented through a more aggressive monetary policy, as well as a more restrictive fiscal policy. The policy mix will probably be influenced by who is elected President. We expect Dilma to be more reluctant to apply an early fiscal adjustment than Serra, placing a heavier burden on monetary policy in 2011.

In any case, the impacts of a sudden stop in activity growth are non-negligible, especially regarding the negative effects on public accounts (recently public revenues have been particularly sensitive to variations in economic activity levels). Other of the main distortions in this scenario would be a stronger than expected deterioration of the current account deficit which could imply a more depreciated exchange rate and also more volatility in exchange rate markets.

## 6. Tables

Table 1

### Macroeconomic Forecasts Quarterly

	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11
GDP (% y/y)	-2.1	-1.6	-1.2	4.3	8.9	8.2	6.3	4.3	2.9	3.9	5.2	6.5
Inflation (% y/y)	5.8	5.2	4.4	4.2	4.9	5.1	5.0	5.3	4.9	4.5	4.7	4.8
Exchange Rate (vs. USD)	2.32	2.08	1.87	1.74	1.80	1.79	1.76	1.78	1.82	1.82	1.83	1.85
Interest Rate (%)	12.6	10.3	8.9	8.8	8.8	9.8	11.3	11.5	11.5	11.5	11.5	11.5

Source: BBVA Research

Table 2

### Macroeconomic Forecasts Annual

	2009	2010	2011
GDP (% y/y)	-0.2	6.9	4.7
Inflation (% y/y, average)	4.9	5.1	4.7
Exchange Rate (vs. USD, average)	2.00	1.78	1.83
Interest Rate (% , average)	10.1	10.3	11.5
Private Consumption (% y/y)	4.0	6.4	4.2
Government Consumption (% y/y)	3.7	2.2	2.1
Investment (% y/y)	-9.9	20.5	9.0
Fiscal Balance (% GDP)	-3.5	-2.8	-2.4
Current Account (% GDP)	-1.6	-2.7	-3.3

Source: BBVA Research

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