

Economic Outlook

Brazil

Third Quarter 2011
Economic Analysis

- **Resilience of domestic demand and deterioration of inflation prospects in spite of a tighter monetary policy create a less positive outlook** for the Brazilian economy.
- **The economy will continue moderating**, but growth will stay strong and the actual GDP will remain above potential output. GDP to grow 4.0% this year and slightly more than that in 2012.
- **Inflation will soon peak and then will start to trend down by the end of the year.** Nonetheless, unlike what we expected, it will not converge to the target before the end of 2012.
- **Monetary policy will bear the main weight of driving both growth and inflation down.** There is limited room for fiscal policy to provide extra support to countercyclical efforts.
- **This macroeconomic environment will add to the pressures on the exchange rate, drive the current account deficit up, and increase competitiveness problems.** It could also generate excessive dynamism in credit markets.
- **We expect these domestic distortions to be under control.** The main risk is a deterioration of the situation in Europe.

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Closing date: August 2, 2011

1. Global environment: politics at the center of the economic outlook

The global economy will continue growing strongly, after a soft patch in the first semester

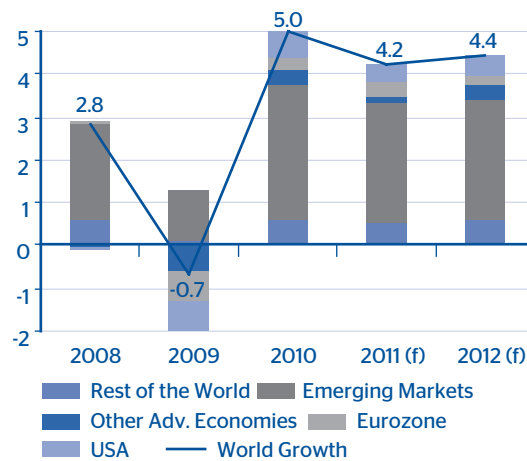
The global economy experienced a mild slowdown in the first half of the year, more pronounced in the US, but also in some emerging countries. Nevertheless, as the factors behind the slowdown are mostly temporary in nature (high oil prices, supply chain disruptions from Japan and bad weather), global growth is set to continue at a robust pace, at 4.2% in 2011 and 4.4% in 2012 (Chart 1).

However, risks to the outlook are now more tilted to the downside. Although the slowdown in activity in the US should be temporary as oil prices stop climbing and international supply chains are restored, the recovery is still weak and may be prone to relapses, as expected in the aftermath of a financial crisis with highly leveraged consumers. The recent soft patch in the US has reminded markets of that, and may dent consumer and producers sentiment going forward.

Both in Europe and the US, fiscal concerns pose big challenges for policymakers. As solvency concerns have not been fully addressed, the sovereign debt crisis in peripheral Europe intensified (Chart 2), with the risk of it becoming systemic as market pressure spreads beyond Greece, Portugal and Ireland to Spain, Italy and could eventually claim Belgium. Although its solvency is not being put in doubt, the US also faces the challenge of a large near-term fiscal adjustment, with the risk that political negotiations turn just to short-term fixes but not to a long-term consolidation plan. This would increase the chances of a sudden spike in long-term yields in the US.

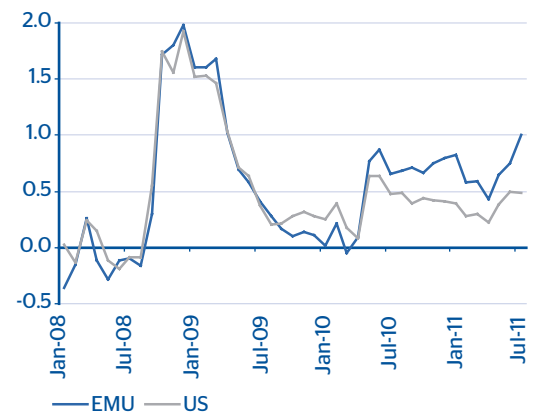
Finally, in emerging economies, overheating concerns have eased slightly as tightening measures continue to ease growth gradually in Asia and Latin America, although fiscal policies still remain mostly accommodative, thus overburdening monetary authorities, at a time when concerns over the appreciation of exchange rates in these economies remain.

Chart 1
Global GDP growth and contributions



Source: BBVA Research and IMF

Chart 2
BBVA Financial Stress Index



Source: BBVA Research

It is high time to address solvency concerns in Europe, and that requires continued bold actions from EU politicians

In recent weeks a new round of financial market stress in Europe has extended to Spain and Italy, and thus has increased the chances of the crisis becoming systemic in all Europe (with spillovers beyond the EU). This was the result of the delay in providing a second package to Greece and the insistence that private bondholders should bear part of the cost of further financial aid to that country, together with the lack of a comprehensive solution to underlying solvency concerns in Greece. This lack of resolve in Greece spilled over countries with no solvency problems such as Spain and Italy, and as a consequence to the European financial sector, which quickly saw their liquidity dry up.

In this context, with so much at stake, the Eurogroup agreed on July 21 to deal with liquidity and solvency concerns. For, the former, it decided to improve the EFSF by allowing it to lend preemptively to solvent countries in distress –much like the Flexible Credit Line from the IMF– and to buy sovereign bonds in secondary markets. Regarding solvency, it softened the conditions of official loans to Greece (also extended to other program countries) and reached an agreement with the private sector for a reduction of net present value of their holdings of Greek debt by 21%, through debt swaps and buy-backs.

These have surely been big –and, in some cases, unexpected– steps in the right direction towards solving the financial crisis in Europe. But Europe is not out of the woods, and that has been reflected in only a moderated reduction in risk premia in peripheral countries. Apart from filling in the technical details of the July 21 agreements, there are still four main lines of action. First, the EFSF should be expanded and pre-financed. Second, Europe needs to work towards a closer fiscal union, ending with the introduction of Eurobonds, together with fiscal rules and tight control of national budgets. Third, economic reforms should. Fourth, EU authorities should finally decide how they will bring Greece's debt to a sustainable level and end solvency concerns.

Until these four steps are not taken, Europe will be confronted with elevated sovereign spreads (not just for peripheral Europe) and a bigger debt restructuring down the road. In the meantime, Europe will continue to be subject to “accidents” due to reform fatigue or bailout fatigue leading to a disorderly debt restructuring, which could have a global impact.

Fiscal consolidation in the US also focuses the attention on politics

In the US, the political haggling between two opposite (and highly polarized) approaches to deficit reduction has added much noise, but so far has not increased market pressure on US rates. This reflected the belief that a solution to raising the debt ceiling would be found and default averted. But an accord to raise the debt ceiling without a plan for long term fiscal consolidation will not address long-term sustainability concerns. Here the risk also lies –as in Europe– in the temptation to kick the can down the road, postpone a solution after the 2012 elections and increase the chances of a spike in long-term interest rates.

Politics also holds the key to the outlook in many countries in Latin America

To a lesser extent, in Latin America, many countries also face uncertainty derived from the future course of politics. In some cases this is derived from perceived weakness by some governments as they are saddled by corruption charges or by massive protests. In other cases, it is the result of recent changes in governments or the uncertainty about the outcome of upcoming elections. Although it is true that the election cycle in the region has had less influence on the economic cycle in the last decade, it is crucial that this capital is not wasted by wide policy swings straying from continuing economic reforms.

Overheating concerns ease slightly in many emerging economies, but global risks and currency appreciation might turn policy tightening more cautious

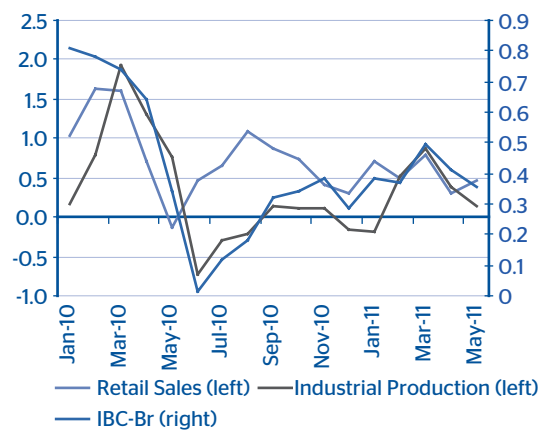
Emerging economies continue to show risks of overheating, although as a whole they have receded somewhat given ongoing tightening measures and headwinds (in Asia) from higher commodity prices and the earthquake in Japan. Importantly, risks of a hard landing in China were reduced as Q2 growth showed only a slight deceleration, still on track for a soft landing. However, inflation in emerging economies remains a concern, and there is the risk of policymakers falling behind the curve, in some cases as they remain cautious about the global environment and in other cases as they worry about excessive currency appreciation.

2. Economic activity is moderating, but GDP will remain above potential output

There is increasing evidence that economic activity is slowing down. High-frequency indicators such as retail sales, industrial production, and the Central Bank's Economic Activity Indicator (IBC-Br) are all growing at a lower pace than in 2010. Data available for the second quarter of the

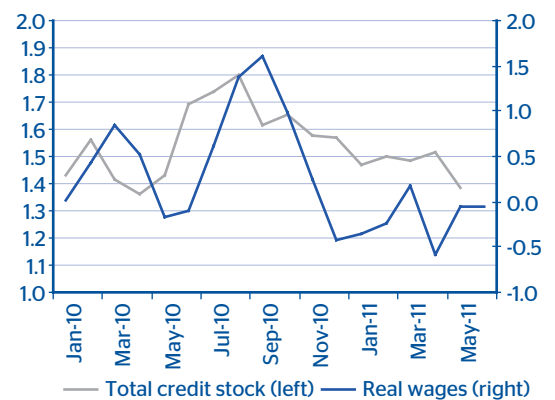
year show these indicators are also growing less than in the first quarter of the year (see chart 3 below). The recent performance of both the labor and credit markets also reinforces the view that the economy is moderating. Growth in real wages is now less marked than in the recent past and credit has been growing slower since the end of 2010 (see chart 4).

Chart 3
Retail sales, industrial production and economic activity index (3-month average; % m/m; SA)



Source: Central Bank of Brazil and IBGE

Chart 4
Real wages and credit stock (3-month average; % m/m; SA)

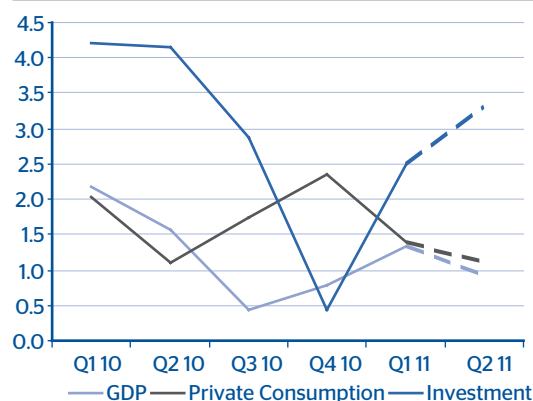


Source: Central Bank of Brazil, IBGE and BBVA Research

In line with this evidence, we expect GDP growth to be around 0.9% q/q in Q2, which is less than in the 1.3% q/q expansion observed in Q1 and also than the 1.25% q/q average growth of 2010 (see chart 5). We also expect growth to remain about 1.0% q/q in each of the quarters in the second half of the year so that 2011 GDP will end up at around 4.0%.

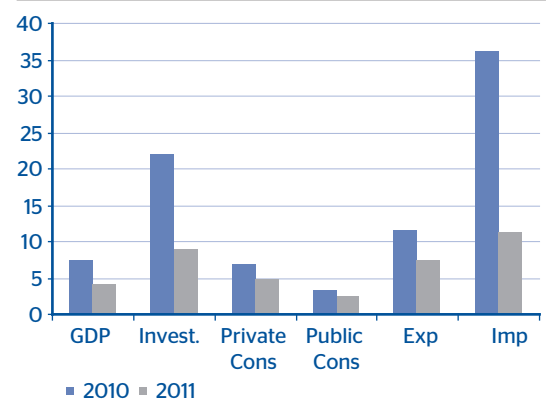
The convergence to a slower pace of growth will be driven by the weakening of domestic demand. After growing 1.75% q/q on average last year and 1.4% q/q in Q1, domestic demand should average 1.2% q/q for the rest of this year. We see more room for moderation in private consumption, which is the main focus of countercyclical policies, than in investment. More precisely, we expect private consumption to grow slightly under 0.8% q/q in the coming quarters compared with an average expansion of 1.8% q/q in 2010 (and 1.4% in Q1). Investment, on the other hand, should grow around 3.0% q/q over the next few quarters, which is not very different from the rate in 2010 (2.9% q/q). All in all, we expect private consumption and investment to grow 4.9% and 8.9%, respectively, this year. In addition, government consumption should grow 2.6% this year. Imports should expand 11.3% in 2011 due to dynamic domestic demand and the appreciation of the exchange rate, thus outpacing exports, which should grow around 7.3% this year, in spite of the support the latter are getting from high commodity prices (see chart 6).

Chart 5
GDP, private consumption and investment (% q/q)



Source: Central Bank of Brazil and IBGE

Chart 6
GDP growth by components (%)



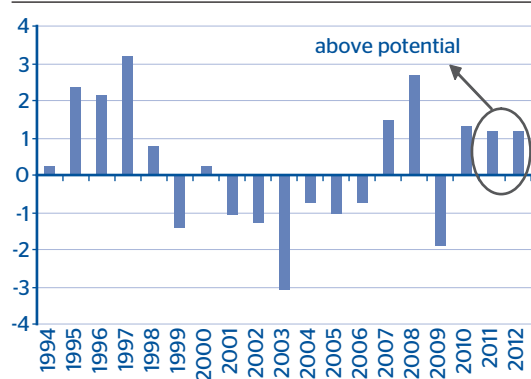
Source: Central Bank of Brazil, IBGE and BBVA Research

Even though there are clear signs that the economy is moderating, the slowdown will not be enough to guarantee the closure of the output gap soon, as we expected before.

According to our estimations, by the end of the year actual GDP will be about 1.1% above potential output. The closure of the output gap by the end of the year would require a yearly growth slightly lower than 3.0%, which is highly unlikely. Alternatively, a 3.0% growth next year would guarantee the closure of the output gap, but we also regard growth of such magnitude as unlikely, especially because the government will adjust the minimum wage by around 12% in nominal terms at the beginning of the next year, public investments will remain high due to infrastructure expenditures (including those related to the organization of sports events), and labor markets are likely to remain robust with the unemployment rate below the equilibrium rate (see chart 8).

Even though the output gap will be positive we expect it to remain limited (see chart 7).

Chart 7
Output Gap (%)



Source: BBVA Research

Chart 8
Unemployment rate (%)



Source: IBGE and BBVA Research

3. Inflation to trend down, but will not converge to the official target before 2013

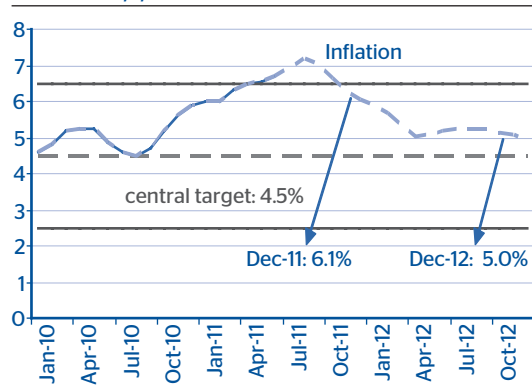
Inflation trended up and hit 6.7% y/y in July. This is higher than the upper limit of the target system (6.5% y/y). It is also the highest value since June of 2005. Even though the increase in commodity prices in global markets and some domestic supply shocks help to explain the upward trend observed since the end of 2010, strong domestic demand should take most of the blame for this high inflation. This is clear from the analysis of the prices of items most closely linked to domestic demand. Services inflation, for example, is currently at 8.7% y/y, the highest in more than 10 years. Core inflation measures also support this: the average of the main core measures used by the Central Bank reached 6.5% y/y in June.

Looking forward we see some room for inflation trending down. Behind this view is the fact that starting in September yearly inflation will benefit from a high base effect as in the last four months of 2010 inflation averaged 0.84% m/m, which is significantly more than we expect for the last four months of this year (0.45% m/m). In addition to this statistical effect, domestic prices will be impacted by the tightening of monetary policy and the implementation of macroprudential measures. The negative tone of economic activity in developed countries should prevent commodity prices from increasing very significantly, which will also create some room for inflation to trend down. Finally, inflation could benefit from the appreciation of the exchange rate, although we do not expect this effect to be very significant.

Inflation will moderate in the second half of the year, but it will be constrained by the continued excessive dynamism of the labor market. Accordingly, we expect inflation to approach 6.1% y/y by the end of 2011, which is slightly higher than we expected some months ago.

Chart 9

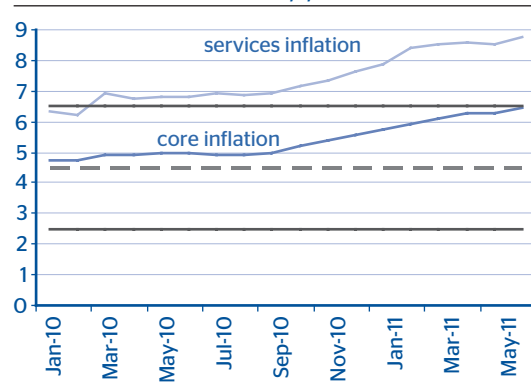
Inflation (% y/y)



Source: IBGE and BBVA Research

Chart 10

Core and services inflation (%y/y)



Source: Central Bank of Brazil

We expect the moderation of inflation to continue next year in spite of the negative impact of the increase in the minimum wage (both direct and indirect, as the minimum wage is an important benchmark for general wage negotiations). In any event, we do not expect inflation to converge to the 4.5% target in 2012. We have in fact revised up our inflation forecast for the end of 2012 to 5.0% y/y. Convergence to the official target should, therefore, not occur before 2013.

4. Monetary policy will bear the main weight of driving demand and inflation down

In the second half of 2010, when signs of overheating were already very clear and elections took center stage, the CB (Central Bank) refrained from adjusting the SELIC rate up and the government continued to implement a very lax fiscal policy. The only measure taken at the end of the Lula government, when inflation was already close to 6.0% and the main focus seemed to be on the exchange rate, was to increase bank's reserve and capital requirements.

The reaction to the excessive growth thus came too late. From the beginning of the year up to now the Central Bank hiked the SELIC up by 175 bps to 12.50%. The tightening of the monetary policy was accompanied by the implementation of some fiscal cuts, and by the announcement of numerous macroprudential measures, the most recent being the increase of the risk weighting factor of payroll-backed credit loans with maturity higher than 36 months to moderate consumer credit.

As domestic demand continues strong and inflation remains challenging, we expect more countercyclical measures to be taken. We see limited room for the implementation of more fiscal measures. Recent political turbulence made clear the problems the government faces in negotiating with the Congress as well as the very high political costs of public expenditures cuts. On top of that, the emphasis the government puts on the role of public expenditure to promote the development of the country also helps to explain some of the barriers for the adoption of a tighter fiscal policy.

In spite of the limited room for maneuver we expect the government to deliver the expected cuts announced at the beginning of the year. Together with the very good performance of public revenues, which are related to the dynamism of domestic demand, that should guarantee that the public sector meets the R\$ 119 billion (2.9% of GDP) primary surplus target for this year. Next year, however, the government will have more problems to reach the 3.1% primary surplus target due to the moderation of the domestic demand and, especially, the adjustment of the minimum wage¹. There is therefore limited room for fiscal policy to bring both domestic demand and inflation down. On top of that we regard a sharp moderation of public credit via BNDES as unlikely.

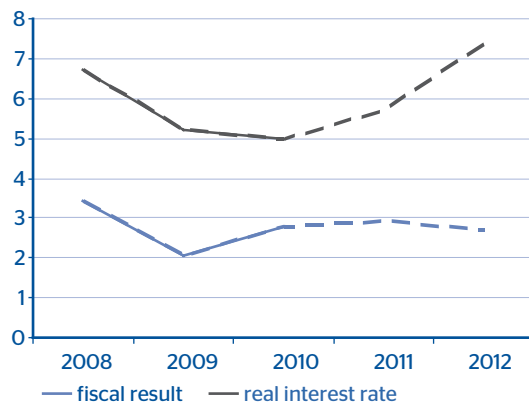
The main weight of driving the economy down will therefore fall to monetary policy (see chart 11). Even though the CB suggested recently that the current monetary tightening cycle is close to an end, and left the door open for keeping the SELIC unchanged at its next monetary policy meeting in the end of August, we expect the monetary authority to adjust the SELIC up by 25 bps to 12.75% and then to keep it constant at this level for an extended period. As chart 12 below illustrates, this means that the SELIC rate will be on average higher in 2012 than we expected and than in recent years. More

¹ The minimum wage adjustment should drive public expenditures up by around 0.5% of GDP in 2012.

precisely, we increased our average SELIC forecast for 2012 from 12.0% to 12.6%, which would make the 2012 average interest rates the highest since 2006. In addition to that, we see the announcement of additional macroprudential measures in the remainder of this year and also in 2012 as very likely.

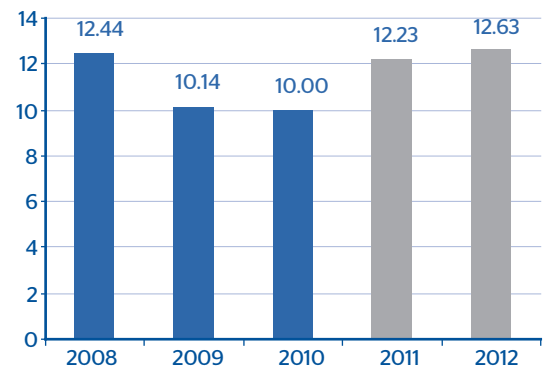
The recent communication by the monetary authority seems to confirm the dovishness of the current CB board in comparison to previous ones. However, we do not expect this CB to be excessively tolerant with inflation or to give priority to exchange rate concerns. In fact, we believe that any extra action related to a risk scenario where the economy does not moderate as expected will be centered on new hikes in the SELIC, which could actually undermine the view (included in our base scenario) that the SELIC will converge to international levels during this government.

Chart 11
Primary fiscal result and real interest rate (%)



Source: IBGE and BBVA Research

Chart 12
SELIC (average %)



Source: Central Bank of Brazil

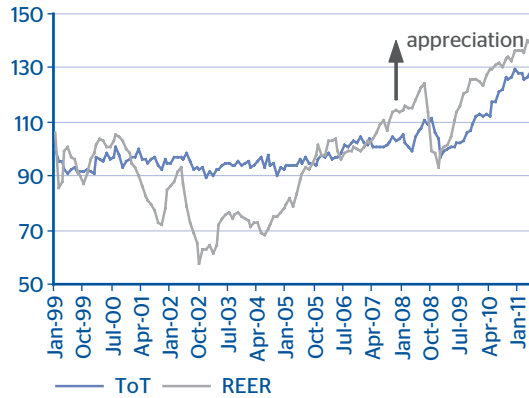
5. An accumulation of economic distortions

An economy running over its potential and a set of countercyclical measures focused on extraordinary high interest rates help to create a distortive environment, especially when developed economies are fragile. This environment, which is incorporated in our base scenario for Brazil, favors the over-appreciation of the exchange rate, the deterioration of external accounts, the loss of competitiveness, and some drawbacks for public accounts, especially in a country such Brazil where the public sector's interest outlays are very significant.

The impact of this environment on credit markets is not clear, as high interest rates and strong domestic demand have a contradictory impact on loans. The overall result will probably depend on the Central Bank's ability to take measures to moderate credit growth and prevent the creation of a bubble.

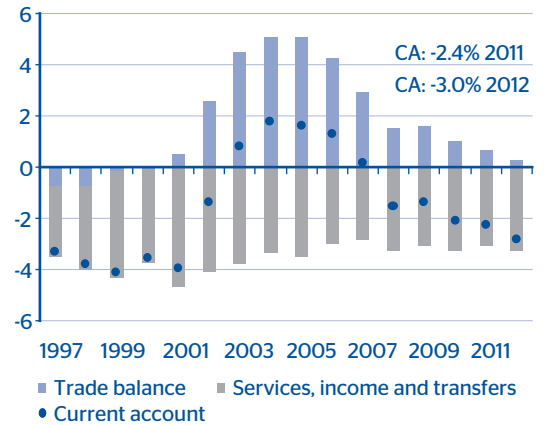
With regards to the exchange rate, appreciatory pressures from high interest rates and robust growth are actually being reinforced by record terms of trade, which are currently 41% over the historical average (see chart 13). We therefore expect the real to remain at very high levels in the short-term, specifically in the 1.50-1.60 range for the remainder of the year. The adoption of more measures to take some steam off the real, such as the introduction of an IOF tax on derivatives markets announced very recently, moderation in the economy, and some downward correction of the terms of trade should prevent a sharper appreciation in 2011 and should actually drive the real slightly down in nominal terms over 2012.

Chart 13
REER and Terms of trade (Index: 2005 average=100)



Source: IPEADATA and Central Bank of Brazil

Chart 14
Current account (% GDP)

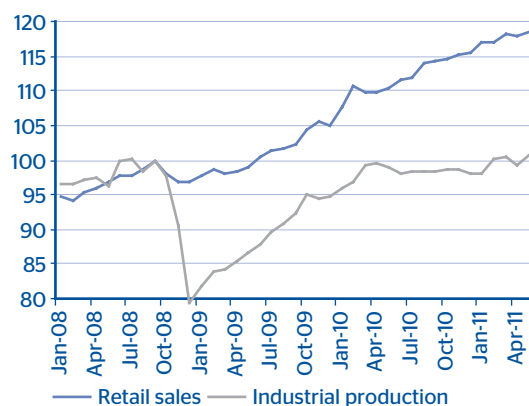


Source: Central Bank of Brazil and BBVA Research

The current scenario also favors the deterioration of the current account. In this case, however, the impact of exceptionally high terms of trade is positive. It has actually allowed the current account deficit to drop from 2.3% of GDP in the end of 2010 to 2.2%, instead of trending up towards 3.0% as expected at the beginning of the year. Over the coming periods, we expect a gradual and limited drop of Brazil's terms of trade to follow a slight decline in commodity prices. This supports our view that the current account deficit will start trending up again and will approach 3.0% next year.

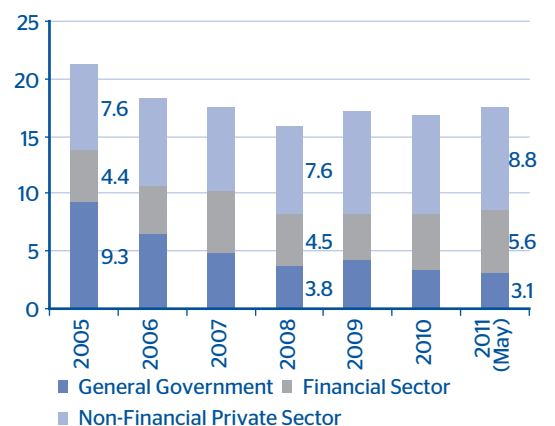
Among the significant distortions created by the current macroeconomic environment are the competitiveness problems faced by Brazilian companies, especially in the industrial sector. As chart 15 shows, the supply side of the economy is lagging behind the demand side. To provide support to the productive sector the government is likely to announce soon a set of industrial policy measures, which could, however, impose an extra fiscal burden for the economy.

Chart 15
Retail sales and industrial production (Index: Sep -2008=100)



Source: IBGE

Chart 16
Gross external debt (% GDP)



Source: Central Bank of Brazil

The fiscal accounts are not immune to the current macroeconomic environment: higher SELIC rates imply higher debt service. In 2011 and 2012 these expenditures will be around 5.5% of GDP and will drive up public sector's total fiscal result to 2.6% this year and 2.8% in 2012, in spite of the primary surplus effort.

Finally, the current environment creates incentives for agents to borrow abroad. Current external debt is not very high (see chart 16), but there are concerns related to the private sector as

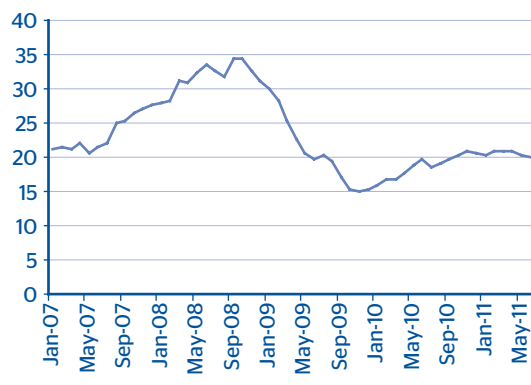
its foreign liabilities are growing significantly. On top of that, the private sector is not as well cushioned against a strong depreciation of the real as the public sector, which has international reserves that amount to 13% of GDP.

Increasing borrowing abroad is actually one of the elements that are generating a robust growth of credit markets in Brazil. However, the distortions related to foreign exchange exposure are limited because external liabilities represent on average a small share of banks liabilities (4.8% in May) and their maturity increased after the CB introduced a tax on short-term external bank funding (short-term external bank debt declined from 55% in September 2010 to 35% in May).

Although the effect of external funding is relatively limited, there are important concerns about the strong growth of credit markets (20% y/y in June). Total credit reached 47% of GDP in comparison to only 25% at the end of 2005². The credit-to-deposit ratio has climbed recently to 1.5, which is significantly higher than the 1.17 average observed in the 1997-2008 period (see chart 18).

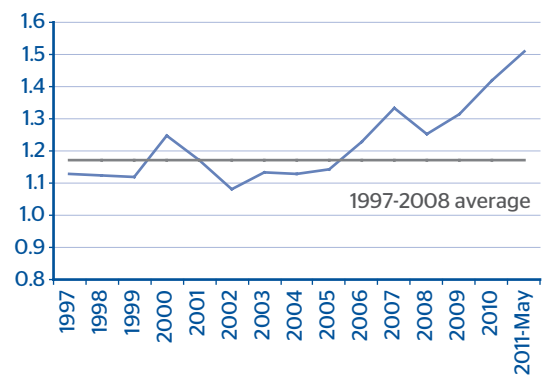
By segments, real estate credit is currently growing at 48% y/y, while consumption and corporate credit are growing 18% y/y and 19% y/y respectively. Even though the dynamism of the real estate segment is far greater than that of the other two segments, the main source of concern is the consumption segment, because it is the sector where both non-performing loans and loan-to-value ratios are highest. The increase in the household debt burden to 37% of net income from 23% at the end of 2005 reinforces concerns regarding this segment³.

Chart 17
Credit Stock (% y/y)



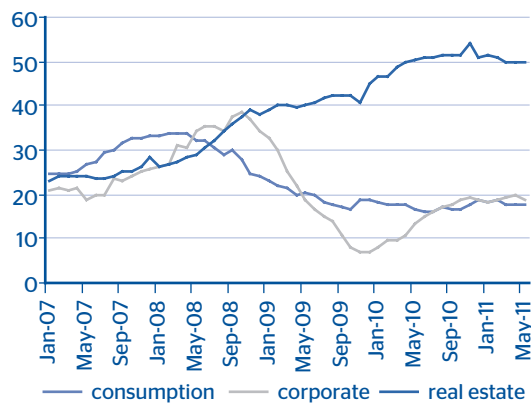
Source: Central Bank of Brazil

Chart 18
Credit / Deposit ratio



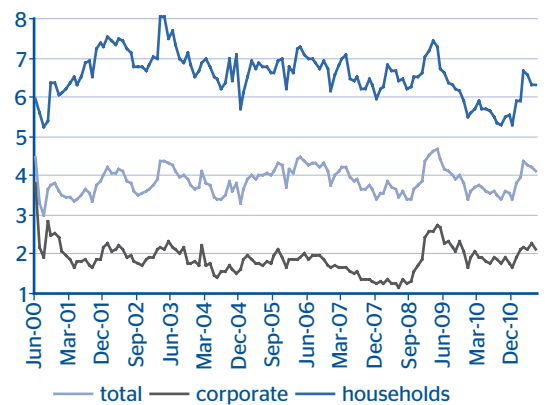
Source: Central Bank of Brazil and BBVA Research

Chart 19
Credit by segment (% y/y)



Source: Central Bank of Brazil

Chart 20
Default rates (between 15 and 90 days)



Source: Central Bank of Brazil

2: According to the World Bank, in 2009 credit-to-GDP amounted to 23% in Mexico, 37% in Turkey, 41% in Latin America, 45% in Russia, 47% in India, 127% in China, 133% in the Euro Zone, and 203% in the USA.

3: The debt burden is 88% in Italy, 99% in Germany, 104% in the USA, and 171% in the UK:

Since the end of 2010 the Central Bank has been taking measures to slow credit markets down, with a special focus on consumption credit. As a response to these measures, the credit dynamism eased somewhat recently. However, a more significant moderation is needed to keep distortions under control and it is likely that the Central Bank will need to take more macroprudential measures to do so. In any case, the high capitalization of Brazilian banks (17% in average) and NPL at relatively low levels (see chart 20) provide some relief to the concerns with the formation of a credit bubble.

6. The main risk for the Brazilian economy is not local, but the potential deterioration of the situation in Europe

Even though the current macroeconomic environment will create a number of distortions, we expect the problems generated by them to be under control. In other words, we regard as limited the risk that these distortions generate major turbulence and push the Brazilian economy off track.

The main risk that the Brazilian economy faces at this moment is not idiosyncratic, but rather a deterioration of the situation in Europe.

We therefore constructed a global risk scenario characterized by global risk aversion remaining at very high levels which, at the beginning of 2012, triggers a Greek debt default and consequently a generalized credit drop within the European Union that ends up pushing the region into a recession. As a result of lower growth and higher uncertainty, GDP in the USA and China declines around 100 bps in 2012 and somewhat less than that in 2013.

The Brazilian economy would, in this case, be directly affected by a reduction of global demand, the increase of global risk, by the decline of commodity prices with respect to our base scenario (15% in the case of oil and metals, and 10% in agricultural goods), and in particular by a reduction in both consumer and producer confidence.

As in the Lehman Brothers crisis, the impact of external turbulence would be smoothed by the implementation of fiscal and monetary countercyclical policies. In spite of that, GDP growth would drop in this risk scenario to 1.8% and 3.1% in 2012 and 2013 respectively, according to our estimates. Although the current account would initially be hit by a significant drop in the terms of exchange, a depreciation of the exchange rate and an adjustment of domestic demand driven largely by a confidence shock would pave the way for its reduction.

7. Forecast tables

Table 1
Macro Forecasts Yearly

	2010	2011	2012
GDP (% y/y)	7.5	4.0	4.1
Inflation (% y/y, eop)	5.0	6.1	5.0
Exchange Rate (vs. USD, eop)	1.75	1.61	1.76
Interest Rate (% eop)	10.00	12.75	11.75
Private Consumption (% y/y)	7.0	4.9	4.3
Government Consumption (% y/y)	3.3	2.6	3.1
Investment (% y/y)	22.0	8.9	10.2
Fiscal Balance (% GDP)	-2.5	-2.6	-2.8
Current Account (% GDP)	-2.3	-2.4	-3.0

Source: BBVA Research

Table 2
Macro Forecasts Quarterly

	GDP (% y/y)	Inflation (% y/y)	Exchange Rate (vs. USD)	Interest Rate (%)
Q1 10	9.3	4.9	1.80	8.75
Q2 10	9.2	5.1	1.80	9.75
Q3 10	6.8	4.6	1.74	10.75
Q4 10	5.0	5.6	1.69	10.75
Q1 11	4.2	6.1	1.66	11.42
Q2 11	3.5	6.6	1.58	12.08
Q3 11	3.9	7.1	1.57	12.67
Q4 11	4.3	6.3	1.60	12.75
Q1 12	3.9	5.6	1.64	12.75
Q2 12	4.0	5.1	1.69	12.75
Q3 12	4.3	5.2	1.73	12.75
Q4 12	4.3	5.1	1.75	12.25

Source: BBVA Research

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