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Economic Outlook

Brazil

Second Quarter 2012
Economic Analysis

- **Government and Central Bank act to permanently bring interest rates down.** We expect the SELIC to soon reach 8.25%, an all-time low. Real interest rates will be below neutral levels for a long time.

- **Growth and inflation have been surprising to the downside, but we expect both to pick-up following the adoption of a lax monetary policy.** GDP is forecasted to grow 3.3% in 2012, still below the potential, and inflation is expected to reach 5.4% by the end of the year, above target. In 2013 GDP should grow 4.3% and inflation should be around 6.0%.

- **A more depreciated real will impact growth and external accounts positively and inflation negatively.** The real depreciated more than 15% since the end of February following increasing intervention in exchange rate markets, the reduction of interest rates and, especially, a deterioration of the global optimism towards the country.

- **The transition to a new macroeconomic equilibrium based on lower interest rates and a more depreciated exchange rate brings challenges.** Main risks continue to come from the external environment, even though idiosyncratic risks are now higher.

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External environment: global recovery, but risks reign

After a gradual deceleration during 2011, especially in the last quarter, the global economy is starting to show signs of increased dynamism. Global growth in 2012Q1 is expected to have been higher than in Q4, given stronger growth in Asia ex China (including Japan) and Latin America and sustained –but modest– dynamism in the US. We estimate that global growth will continue increasing and surpass 1% quarter-on-quarter at the end of 2012 (0.6% in 2011Q4). This recovery will also be quite heterogeneous, increasing the divergence in growth rates between the main economic areas. The increase in growth in 2012 will be more evident in Asia, given the rebound from natural disasters in Thailand and Japan (affecting regional supply chains) and the partial turnaround of policy tightening measures implemented until mid-2011. Also, growth in Latin America is likely to pick up, as Brazilian growth rates increase on the back of easier monetary policy and Mexico maintains growth over 3.5% helped by US demand, improved competitiveness and supportive funding conditions. On the other hand, the US will continue sustaining quarterly growth rates of around 0.6% in 2012 and 2013, significantly lower than in previous recoveries. Still, this will be better than a basically stagnant activity in the euro-area in 2012, dragged in peripheral countries by aggressive fiscal consolidation and persistently high financial stress, after tensions eased temporarily in the first quarter.

Therefore, emerging economies will recover their growth differential vis-à-vis developed economies, of around 4 percentage points, for the whole of 2012 and 2013. In turn, Europe and the US also will continue to increase their growth gaps in the next two years, even as we expect European authorities to continue taking decisive actions which will slowly lower financial tensions.

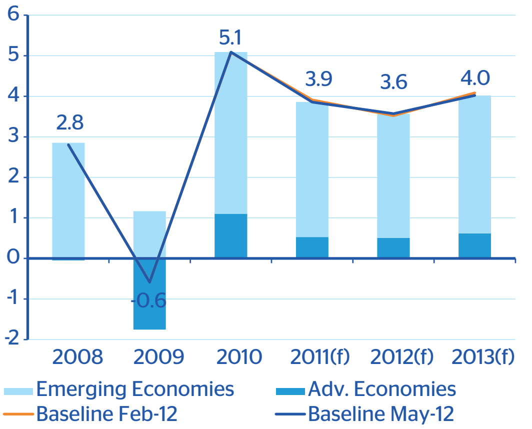
All in all, our growth projections are not very different from those of our previous Global Economic Outlook (published in February). We expect global growth of 3.6% in 2012 and 4% in 2013, with emerging economies contributing around 80% of that increase in global activity (Chart 1). But, as mentioned before, this scenario is conditioned on the evolution of the crisis in Europe, and thus risks to these projections are still strongly tilted to the downside.

In this context, monetary policies in advanced economies will continue to be very accommodative for an extended period, fulfilling the role of bridging the slump in activity towards the medium and long-run. However, the effectiveness of further intervention (conventional or not) is decreasing, while at the same time the costs increase –including the risk of reduced central bank independence and the collateral damage from unconventional measures–. Thus, it is time for other policymakers and institutions in the US and Europe to decisively take up part of the burden of reviving growth from central banks, implementing economic and institutional reforms and managing fiscal risks. While these measures take effect, central banks should continue supporting an adequate functioning of the monetary transmission mechanism.

Easy monetary policies in advanced economies will mean favourable financing conditions in emerging countries. Here central banks will have to weigh the pressure from capital inflows and an uncertain external demand against inflationary risks (in part from oil prices) and strong domestic demand. The difference in inflation projections in Asia and Latin America –declining in the former but stable in the latter- will condition a different outlook for monetary policies. We expect the easing cycle to have ended in much of emerging Asia (except, notably, in China and India), and a cautious tightening bias in most of Latin America, except in Brazil.

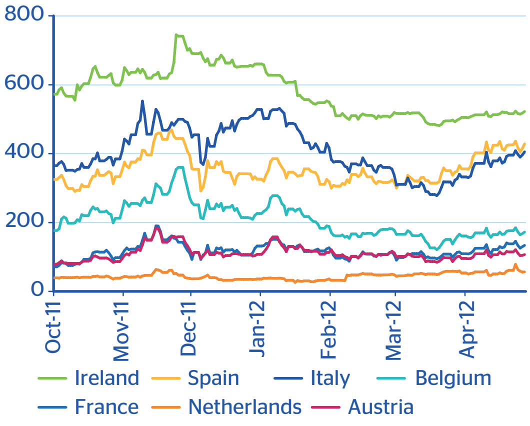
In the last months, there have been some advances towards the solution to the European crisis, but there are still many important pending issues. First, Greek sovereign debt held by the private sector was restructured, although substantial doubts about its long-run sustainability persist, including reform fatigue and a possible deeper recession than projected. Second, the European Stabilization mechanism (ESM) was provided with a fresh lending capacity of 500bn EUR (on top of 200bn already committed by the EFSF). However, that has not been enough to quell market anxiety, given its falling short of Spain and Italy's financing needs for the next 3 years and the presumption that ESM loans would be senior to existing private bondholders, thus seriously impairing its catalytic effect on further financing from the private sector. Further, it was not clear to what extent the increase in IMF resources by 430bn USD (approximately 330 bn EUR) could be targeted to European countries. Also, the fiscal compact was sanctioned (pending national approval), committing governments to structural deficits not bigger than 0.5% of GDP. This is a significant change towards controlling member's budgets, but the allowance for deviations to the rule under "exceptional circumstances" may depict it as not strong enough to justify a more forceful action by hardliners at the ECB of core countries in Europe. In addition, there have been no advances towards a fiscal union or Eurobonds. All in all, a clear roadmap to where Europe is heading continues to be missing.

Chart 1
Global GDP growth (%qoq)



Source: BBVA Research

Chart 2
European sovereign risk premia (10yr bond spreads to Germany, bps)



Source: Datastream abd BBVA Research

Undoubtedly, one of the most important actions in the last four months was the provision of long-term liquidity by the ECB. This allowed, at least until March, a significant reduction in liquidity risk in European banks, a timid opening of wholesale funding markets and a compression of sovereign spreads in peripheral countries (Chart 2). But these positive effects proved temporary, as markets (i) detected some complacency on the part of policymakers as risk premia decreased in the first quarter of 2012, and (ii) they both doubted the ability of many peripheral countries to reach their fiscal targets and feared the fallout on growth of actually achieving them. Thus, since March, risk premia increased rapidly in Italy and Spain, in the latter to levels similar to the high tensions reached back in November (Chart 2).

The short-lived effect of the long-term liquidity injections and the conundrum between fiscal consolidation and restoring growth highlight two conclusions. First, ECB actions can only bridge the short-run while the underlying economic and institutional problems are tackled. This means that talk of exit strategies for the ECB should not come too soon, but it also implies that economic reforms should be pushed forward, at the same time as demand is rebalanced within the Euro zone, with core countries stimulating it. Second, it is imperative to reconsider fiscal consolidation paths in a coordinated way (or risk being singled out by markets), targeting structural deficits –consistent with the spirit of the fiscal compact– in a more gradual trajectory. In exchange for more gradualism, member states must produce explicit, comprehensive, detailed and multi-annual consolidation plans. This way, sound public finances could be achieved without big damage to short-term growth. At the same time, this will allow to reap the benefits of long-term structural reforms that are being implemented in peripheral countries.

In this context, we still see a new flare-up of the European crisis as the main risk, with potentially very negative consequences for global growth. Increased tensions can come about from reform fatigue in peripheral countries coupled with bailout fatigue in core countries, in the context of electoral processes –and a referendum– in many European countries: France, Greece, Germany –two states–, Ireland and the Netherlands are holding them in the first half of this year.

A second threat to the global economy is a further increase in oil prices. The recent spike at the beginning of 2012 can be traced back in part to tightening fundamentals (demand and supply) but also to an increase in the geopolitical risk premium to around 10-15 USD per barrel, given tensions around Iran and very reduced market buffers (oil inventories and producer's spare capacity). In our baseline scenario, we consider prices around 120 USD per barrel of Brent oil for much of 2012, around 15% higher than in our February forecasts. In our view, this will only have a moderate negative impact on global growth, as central banks in advanced countries will view this as a temporary shock and their weak cyclical positions will prevent them from tightening monetary policy, one of the traditional channels of transmission to lower growth. Nevertheless, should the conflict in the Gulf escalates, there could be a very large spike in oil prices, and even if central banks still do not react, growth could be damaged through the associated increase in global risk aversion. We consider that the probability of an escalation in the Gulf is relatively reduced, but it is a scenario that would have a significant impact on global growth should it materialize.

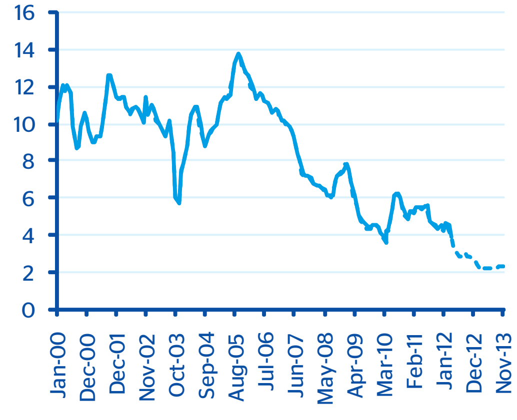
Government and Central Bank act to permanently bring interest rates down

Interest rates are now at the heart of the macroeconomic debate in Brazil. Both Federal Government and Central Bank have been making efforts to permanently bring down domestic interest rates. This is a legitimate objective as domestic rates have been, for many years, among the highest in the world. Nonetheless, permanently cutting down interest rates involves many risks, especially if it follows a political determination rather than a technical decision.

Since mid-2011 the Central Bank has been cutting the SELIC and surprising markets to the downside: the policy interest rate is currently at 9.0%, 350bps less than in July 2011 and significantly less than most analysts expected some months ago. The reduction of the SELIC observed since the middle of the last year follows a sharp deterioration of the external environment and also of domestic conditions. In our view, however, the adoption of a more lax monetary policy is also related to the monetary authority intention to bring the SELIC permanently closer to international standards, which might imply more tolerance with inflation.

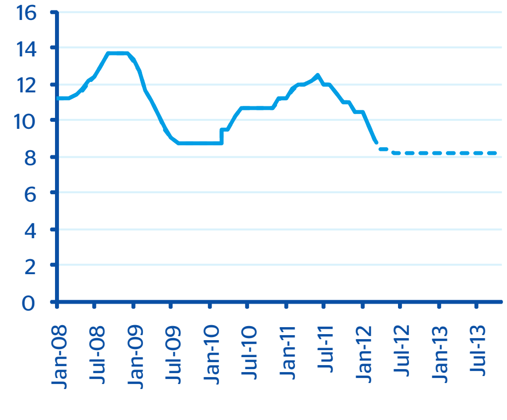
The monetary authority has recently introduced in its official communication references to the fact that the real interest rate has been declining over the last years. As the Chart 3 below shows, the real interest rate has, effectively, trended downwards in the last years. According to the Central Bank, this is a consequence of a series of structural improvements such as lower risk premium (due to "meeting inflation targets for the eighth year in a row, macroeconomic stability and institutional advances"), a change in the structure of financial and capital markets, deeper credit markets, reduction of the public debt, and increasing (and cheaper) supply of external savings. After accounting for all these improvements, we – and most Brazil analysts - estimate neutral interest rates to be around 4.0%, which is similar to the current level of real interest rates.

Chart 3
Real Interest Rates (%)



Source: BBVA Research and Bloomberg

Chart 4
SELIC (%)



Source: BBVA Research and Bloomberg

Reducing interest rates is, explicitly, one of the priorities of President Dilma's government. Accordingly, some measures have been adopted to support the Central Bank action. Fiscal policy has been made less expansionary to make room for a more lax monetary policy, as we have been highlighting since the beginning of 2011 (see, for example our Q2 – 2011 Brazil Economic Outlook as well as the section below about fiscal policy).

In addition to that, the Government has recently announced a change in the remuneration of a popular form of savings accounts (the "contas de poupança") to help the SELIC to continue declining. Previously, these savings accounts would get 0.5% per month plus a small monetary correction (in the last years around half of official inflation), tax-free. This scheme created a floor for the SELIC rate as resources would massively migrate to saving accounts from SELIC-investment funds if interest rates were to fall below this floor (somewhere between 8.0% and 9.0%). This scheme was then replaced by a new one in which savers will get 70% of the SELIC plus the same small monetary correction in the case the SELIC is below 8.5% (the previous remuneration scheme will remain in the case the SELIC is equal to or above 8.50%).

Even though this is a very positive measure from a structural point of view, it could create additional pressures for the (legally non-independent) Central Bank and also extra risks in terms of inflation (see the section below for more information on inflation).

In this environment, we expect the Central Bank to continue to adjust the SELIC downwards in the next few months, when annual inflation will refrain from trending upwards (due to a large extent to positive base effects). More precisely, we expect a 50bps cut to be delivered at the very end of May and a final 25bps cut to be announced in July. The SELIC would then remain stable at 8.25% -50bps less than the former all-time low- for a long period of time (see Chart 4).

In the short-term (the next few months) we see downside risks to this call meaning that a SELIC below 8.25% and even below 8.0% should not be seen with surprise, especially if domestic activity refrains from moderating or the global environment refrains from stabilizing. In the medium-term (end of this year and beginning of 2013), however, the risks are to the upside as we should not rule out a temporary and limited upward correction of the SELIC to keep inflation expectations under control. In any case, in spite of eventual hikes, we expect the SELIC to continue trending downwards in the long-term and real rates to be below the neutral one, which implies a risk in terms of inflation.

A lax monetary policy will be a key element of what apparently will be Brazil's macroeconomic equilibrium in the next years: the stimulus from lower interest rates (and also from a weaker real) will, to some extent, offset the impact of a less positive global environment, and a bigger fiscal effort and slower credit growth will be required to keep inflation under control. The growth potential of this new "model" will also depend on the Government's ability to address structural problems which are currently reducing the degree of competitiveness of the economy.

Growth and inflation have been surprising to the downside, but we expect both to pick-up following the adoption of a lax monetary policy

After having practically stagnated in the second half of the year following the impact of countercyclical policies taken in the first semester and the deterioration of the external scenario, available data shows that the economy recovered in the first quarter of the year. This recovery, however, was at a slower-than-expected pace and we see, actually, downside risks to our 0.6%q/q Q1 GDP forecast.

Supply – demand dichotomy continues to be evident: retail sales and labor market indicators available for the first months of the year show that domestic demand remained relatively strong, at least in comparison to supply, which remained weak as industrial production indicators show (See Chart 5).

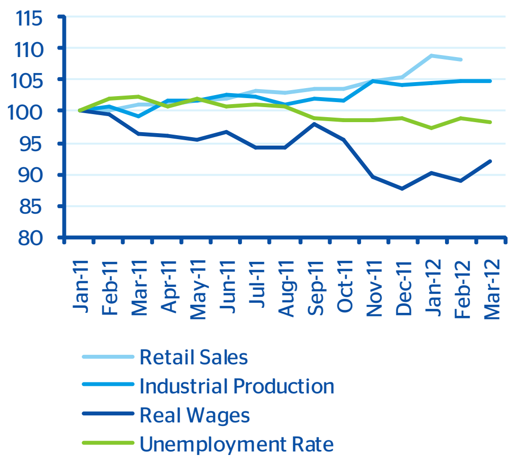
The strength of domestic demand is explained by short-term factors, such as the 14% increase in the minimum wage and the recent decline of both interest rates and inflation, and by more structural factors, such as the investment opportunities generated by high commodity prices and by the expansion of middle classes observed in the last years. The weakness of the supply side, on the other hand, is due to problems such as the appreciation of the exchange rate, the tightness of the labor market, poor infrastructure, and high tax burden.

Looking forward, we expect domestic demand to be supported by historically low interest rates in the remainder of the year. We actually expect this support to increase and, therefore, GDP to accelerate over the year, in line with the lagged impact of monetary policy on domestic activity.

After growing 0.6%q/q –or slightly less- in the first quarter of the year, GDP should grow around 1.5%q/q in the three remaining quarters. In addition to the support from monetary policy, labor and credit markets will continue to play a positive role, exports will remain relatively dynamic (especially because commodity prices will remain high and in spite of global turbulences) and the industrial sector will contribute less negatively given the reduction of inventory levels.

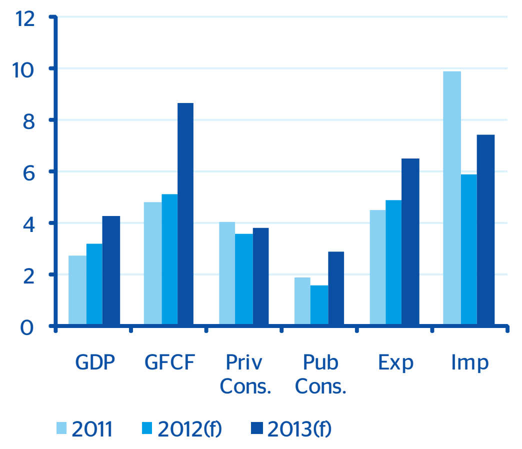
In yearly terms, GDP is forecasted to grow 3.3% in 2012, slightly more than in 2011, when growth was of 2.7%. In 2012 domestic demand should expand around 3.5%, driven by the expansion of fixed investments (5.1%), private consumption (3.7%) and public consumption (1.7%). In 2013 we expect economic activity to continue to recover so that the economy grows 4.3% and the output gap -which will remain in negative terrain until then- closes (see Chart 6).

Chart 5
Activity Indicators (Index Jan 2011 = 100)



Source: Bloomberg and IPEADATA

Chart 6
GDP and demand components (% growth)

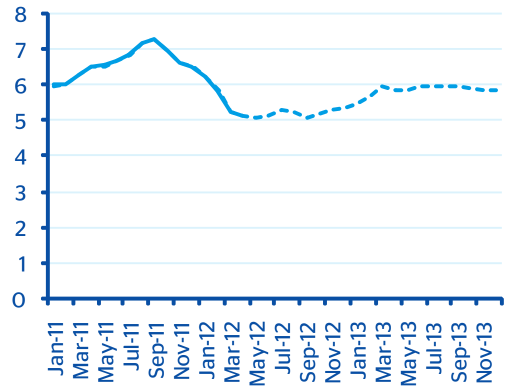


Source: BBVA Research and Bloomberg

In line with the expected GDP acceleration, we expect inflation to be under more pressure in the second half of the year than in the first. Positive base effects, which allowed inflation to fall from more than 7.0% at the end of 2011 to 5.1% in April, will wane after May. We, therefore, see very limited room for inflation to move under the 5.0% mark and regard as very unlikely the convergence with the 4.5% target. More precisely, inflation should bottom in the end of the first semester, when it will reach around 5.0%, to average 5.2% in the second semester, and then to close the year at 5.4%. Inflation will continue under pressure next year: we forecast it to be at 5.9% by the end of 2013, closer to the upper-limit of the inflation target (6.5%) than to the central target (4.5%) (see Chart 7).

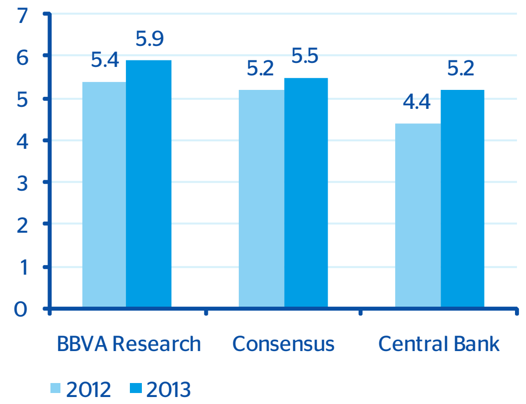
Even though available evidence suggests that the pass-through from the exchange rate to domestic inflation is relatively low in Brazil, the fact that the real will be at a more depreciated level than in the past and also than we expected previously (see section below for more information on this issue) will help to keep inflation under pressure. High commodity prices and inertia will also leave less room for inflation to trend down.

Chart 7
Inflation (% y/y)



Source: Research and Central Bank of Brazil

Chart 8
Inflation forecasts (%; end-of-period)



Source: BBVA Research and Central Bank of Brazil

Fiscal policy: committed to achieving the primary surplus target, not necessarily to driving public demand down

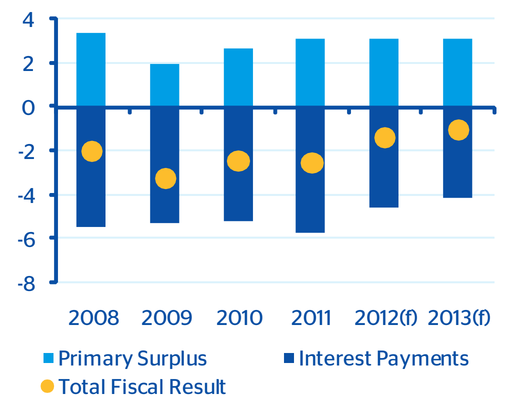
Uncertainties about the fulfillment of the fiscal target for 2012 (primary surplus of R$139.1bn, which represents around 3.1% of GDP) waned after the government announced, some months ago, a restriction of R$ 55bn (1.25% of GDP) of expenditures budgeted for the year. For achieving such objective, however, more important than this move will be the apparent intention to use fiscal policy to make room for the Central Bank to permanently bring down the SELIC and the capacity to generate one-time, non-recurring revenue (for example, by granting airport service concessions to the private sector).

Recent fiscal data also lead us to believe that the public sector will deliver the 3.1% primary surplus result by the end of the year (as happened in 2011, but not in the two last years of Lula's government): net central government revenues expanded by 14.6% in the first quarter compared to the same period last year, outlays increased by "only" 12.0%, and, as a consequence, the primary surplus of the Central Government grew by 31.3% in the period. This helped the public sector (which is made-up of the Central Government, Regional Governments, and state-owned companies) to present a R$46bn primary surplus in the quarter, which represents one third of the target for the year.

We, therefore, expect the government to deliver the R$129.1bn primary surplus by the end of the year, which is a positive step, especially if we take into account that this is an electoral year (regional elections will be held in October). Nonetheless, meeting the target by generating one-time revenues instead of adopting a more strict control of expenditures does not imply that fiscal policy will be restrictive (we actually expect the Federal Government's primary expenditures to grow 6.5% in real terms this year). This issue suggests that the adoption of structural fiscal targets (adjusting fiscal balances for economic conditions and one-time revenues or expenditures) could be more appropriate than the use of nominal targets.

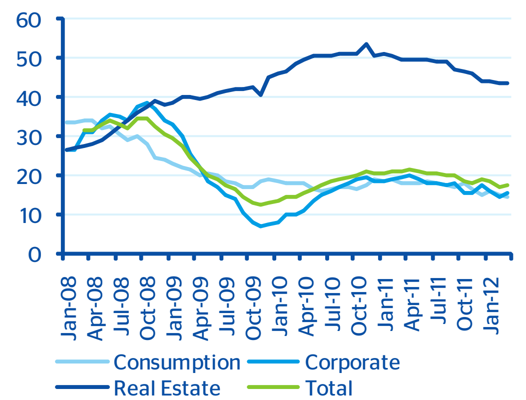
Anyway, the generation of a significant primary surplus will add to the positive impact that lower interest rates will have on public accounts and will help the public sector to reduce its total deficit. More precisely, we expect interest payments to fall from 5.7% of GDP in 2011 to 4.5% this year and, therefore, total public sector deficit to drop from 2.6% of GDP in 2011 to 1.4% in 2012 (see Chart 9).

Chart 9
Fiscal Results (% GDP)



Source: BBVA Research and Central Bank of Brazil

Chart 10
Credit (% y/y)



Source: Central Bank of Brazil

Macro-prudential policies: flexibility to manage macroeconomic conditions

As we have pointed out in our recent reports (see, for example, our Q1 2012 - Brazil Economic Outlook), macro-prudential measures are expected to play a more important role in the future macroeconomic management in Brazil. This is a consequence of the relative rigidity of other main macroeconomic policies, at least in our base scenario in which global turbulences remain under control: on the one hand the SELIC rate seems set to trend downwards and fiscal policy has limited room for action given the commitment to the primary surplus target. The perception that macro-prudential measures adopted in recent years had a significant impact on macroeconomic variables adds to the view that this type of measures will be used more often in the future.

Therefore, it would not be surprising if in the next few months (or even in the next few days), macro-prudential measures, such as the reduction of reserve requirements determined by the Central Bank or of capital requirements on consumption credit, are announced to increase the dynamism of credit markets and to make more room for banks to reduce their spreads. With respect to the former, real estate, consumption and corporate credit have all slowed down recently and total credit growth is around 17.0%, the slowest pace since the first half of 2010 (see Chart 10). This moderation is related to the weakening of economic activity observed since mid-2011 and to the increase in the share of non-performing loans (NPL), which is currently at 3.7% compared to 3.2% one year ago. Regarding banking spreads, the Government has recently launched a crusade to force banks to drive them down (Brazilian spreads are significantly high: 28% in annual terms according to the most recent available data), in line with President Dilma's goal of reducing domestic interest rates.

Even though the pressure to drive banking spreads down could have a negative impact on credit supply, credit markets should rebound mildly in the second half of the year in line with the acceleration of domestic activity which should help drive NPL down, and the eventual announcement of macro-prudential measures.

Reducing banking spreads is a legitimate objective (not to say a necessity), but could negatively impact the banking system and, therefore, the economy if it is not accompanied by measures such as the reduction of the share of earmarked credit and of reserve requirements. The risks related to cutting banking spreads are especially important for public banks, given their recent expansion and their particular exposure to political pressures (see Box below for more information on this issue).

If in the short term macro-prudential measures will likely help support credit expansion and domestic demand up, by the end of this year and over 2013 macro-prudential policies should then be used to take some pressure off inflation. Macro-prudential policies, therefore, have an expansionary bias in the short-term and an accommodative bias in the longer-term.

Current account: still under pressure in spite of the resilience of commodity prices and the weakness of the real

We have recently revised our commodity price forecasts up as they have been showing higher-than-expected resilience against global stress. As a direct consequence, we now expect Brazil's terms of trade (the ratio between export and import prices) to drop 4% instead of 7% as we forecasted earlier (see Chart 11).

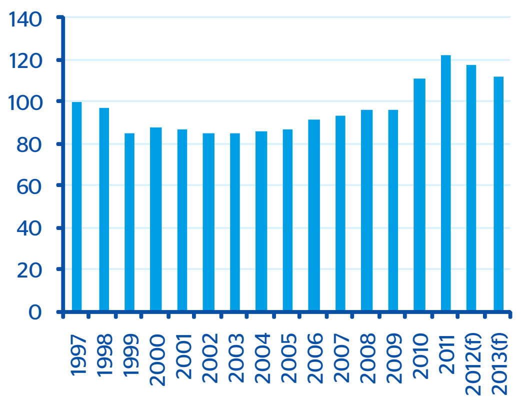
The real, on the other hand, lost 7.5% with respect to the dollar since the beginning of the year and 17.6% since the end of February. Although the global environment remains unstable, this depreciation is due, to a large extent, to domestic factors.

First, the intervention in exchange markets has increased recently: on the one hand the Government announced in March new measures to weaken the real (it extended some thresholds from which external issuance would be exempt from paying the IOF tax) and the Central Bank, to some extent relieved by positive surprises on inflation, accelerated its purchases of dollar even with the real at much more depreciated levels (see Chart 12). These interventions supported the view that both the Government and the Central Bank welcome an exchange rate in the 1.90 – 2.0 range.

Second, the aggressive reduction of the SELIC rate also weighed on markets and helped weaken the real.

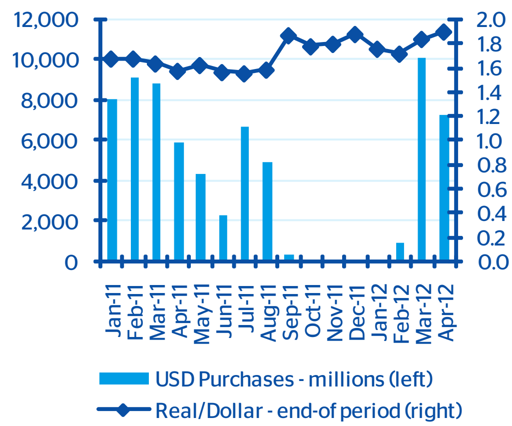
Finally, and perhaps most importantly, there is currently a much less positive sentiment towards the country due to a number of factors such as the increasing intervention in exchange markets, the apparent higher tolerance with respect to inflation, the mounting signs of lack of competitiveness of the industrial sector, the adoption of less orthodox trade measures, and the poor activity performance in the last quarters. In line with this deteriorated view of the country (and also with the external scenario), the BOVESPA index is 15% below the levels observed at the end of February, and the country-risk measured by the EMBI+ is 15bps higher now.

Chart 11
Terms of Trade (Index: 1997 = 100)



Source: BBVA Research and IPEADATA

Chart 12
Central Bank's Dollar Purchases (USD million) and Exchange Rate (end-of-period)

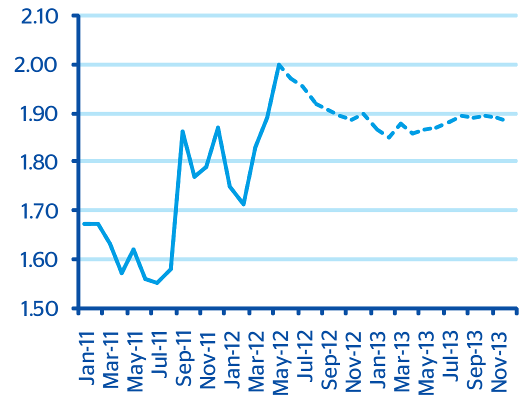


Source: Central Bank of Brazil and Bloomberg

Looking ahead, we expect the recovery of domestic activity and the relative strength of commodity prices to support a moderate appreciation of the real. More precisely, we expect it to be in the 1.90-2.0 range in the remainder of the year (see Chart 13)[1] .

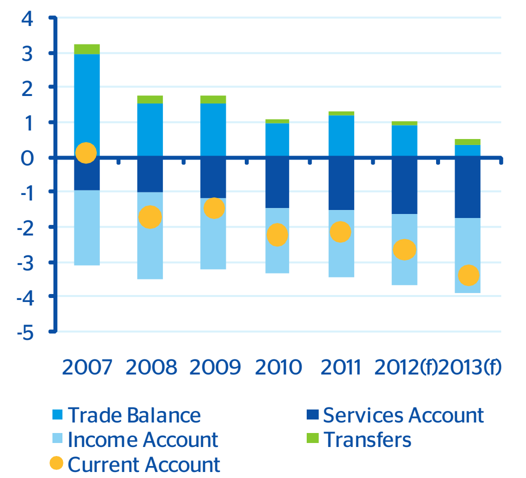
1: The new forecasts for the real were not included in our most recent Latin America Economic Outlook because its edition was closed on May 11, before we released the new exchange rate forecasts.

Chart 13
Exchange Rate (Real per Dollar)



Source: BBVA Research and Bloomberg

Chart 14
Current Account (% GDP)



Source: Central Bank of Brazil and Bloomberg

The impact of both a more depreciated currency and higher terms of trade on external accounts will be positive, but we continue to expect the current account deficit to deteriorate (especially in the second half of the year) due to the existing gap between domestic demand and domestic supply (see Chart 14).

Main risk continue to come from the external environment, but idiosyncratic risks are now higher

Our base scenario for the Brazilian economy described above is subject to some risks. The most important one is the external risk. There are still many uncertainties hovering around Europe and the chances of a disruption are clearly not negligible.

If this disruption materializes we might witness a credit crisis and a recession in Europe, a hard-landing in the US, and a deceleration in China.

In this environment, the Brazilian economy would be significantly hit. GDP growth would be around 1.0% as result of i) the negative impact of a spike in global risk aversion on domestic demand, ii) a sharp drop in commodity prices, iii) a reduction of external demand, and iv) the spreading of the global financial stress to domestic financial markets.

A recession would be avoided by the adoption of a more expansive fiscal policy and by an additional reduction of the SELIC rate. The adjustment to the new global environment would require not only an accommodation of domestic activity, but also a more depreciated exchange rate.

Although the main risk to Brazil's base scenario comes from abroad, local risks are now more significant than in the past as the transition to a new macroeconomic equilibrium based on lower interest rates and a more depreciated exchange rate bring challenges for economic policies, especially in terms of inflation management.

Another local risk – also more relevant now than in the past – is related to the lack of competitiveness of the industrial sector which could, on one hand, undermine growth perspectives and, on the other hand, trigger the adoption of measures, such as the excessive expansion of public credit (see Box below for more information on this issue), that add to the concerns about public sector intervention in the economy and deteriorate the view about Brazil's institutional environment.

Box: "The increasing power of public sector banks in Brazil: back to the past?"

Credit from public banks accounted for around 70% of total credit in Brazil at the end of the 80s. This was a consequence of both a chaotic macroeconomic environment, characterized among other things by hyper-inflation and fiscal crises, and a set of inadequate incentives which, for example, allowed the political use of public banks and inhibited the expansion of private banks.

From the end of the 80s on, the share of public credit declined significantly, especially after inflation and fiscal problems were reigned in, a series of more appropriate incentives were set, and some public banks were privatized.

The share of public credit reached 34% in 2001 and remained practically stable until the end of 2008, when the Lehman Brothers crisis hit the country. At that time, private credit decelerated due to an increase in risk aversion, liquidity problems, and a significant deterioration of growth perspectives. In sharp contrast, public credit accelerated from the end of 2008 on.

As public loans continued to expand at a more robust pace than private loans after the economy started to recover from the external shock and even after overheating signs emerged in 2010, public banks' market share increased significantly and reached 44% of total credit at the end of 2011, practically 10 p.p. more than their share in mid-2008 (See Chart 15).

The expansion of public banks was widespread. It was not only related to the expansion of the BNDES, the National Development Bank, but also to the dynamism of public commercial banks.

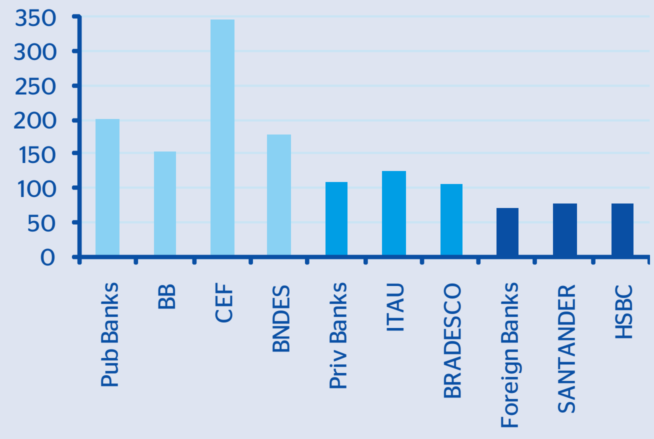
In the four years between December of 2007 and December of 2011, the credit extended by public commercial banks grew 199% while BNDES credit grew 178%. This compares to a growth of 109% and 69%, respectively, in total credit extended by domestic and foreign private banks.

Within public commercial banks, credit from Banco do Brasil (BB) and Caixa Economica Federal (CEF), which together account for 96% of public banks' total assets, grew 152% and 347%, respectively.

Chart 15
Public Credit (% of Total Credit)

Source: Central Bank of Brazil

Chart 16
Credit growth between 2007 and 2011 (%)



Source: Central Bank of Brazil

The over-expansion of public banks is also evident when other measures are considered, such as total assets and capital. In the last four years, public commercial banks' total assets increased 116% and BNDES' total assets, 204%. Domestic and foreign private banks expansion was not as big: 96% and 51%, respectively. While, on the one hand, public commercial banks had their capital increased by 96% between 2007 and 2011 and the BNDES by 144%, on the other hand, domestic and foreign private banks had their capital adjusted 69% and 112% up in the period.

Although the expansion of public banks' capital and assets was also very robust in the last years, it was not as significant as the expansion of public credit, which suggests that the balance of public banks deteriorated in comparison to the balance of private banks. The "not-so-significant" growth of public banks' deposits -at least compared to domestic private banks- suggests the same.

The Basel Index for BB, CEF, and BNDES was 14.5, 13.3, and 21.5 in December of 2011, significantly higher than the minimum level required by the domestic regulator (11.0%) and also than levels usually required internationally. These levels, however, are lower than four years ago and also lower than the levels shown by foreign and domestic private banks.

The analysis of other basic ratios, such as credit/assets, credit/capital and credit/deposits, reinforce the claim that the situation of public banks is, in general, not as strong as in 2007 and not as strong as the situation of private banks (see Charts 17, 18, 19 and 20). This is direct consequence of the very significant growth of public credit in the last years. In other words, the expansion of public credit granted public banks a higher market share, but also more risks due to lower capitalization and higher leverage.

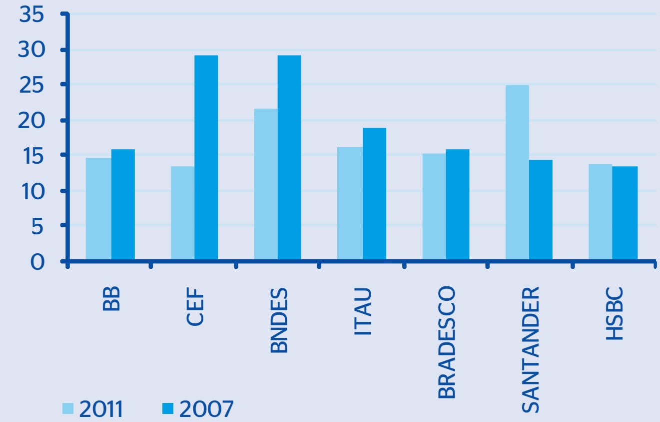
These facts do not imply that the financial situation of public banks is weak. Rather the opposite. The balance sheets of public banks remain sound, and certainly much sounder than decades ago. In some aspects their financial situation is better than the situation of private banks: the share of non-performing loans (NPL), for example, was 2.1 compared to 5.0% in domestic private banks, and 5.4% in foreign private banks at the end of 2011.

The deterioration pictured above, however, suggests that problems could arise in the medium/long term if public banks continue to grow at the pace seen in the last years, especially if public banks are (politically) used to address macroeconomic distortions.

The decision to drive public credit up after the country was negatively affected by global turbulences in 2008 was one of the main counter-cyclical measures that allowed the country to reduce the impact of the external crisis and to start a robust economic recovery already in 2009. In spite of the positive support public credit provided to the economy at the time, the political use of public banks to revive the economy generated concerns about the long term performance of the public banking system and, therefore, of the banking system as whole.

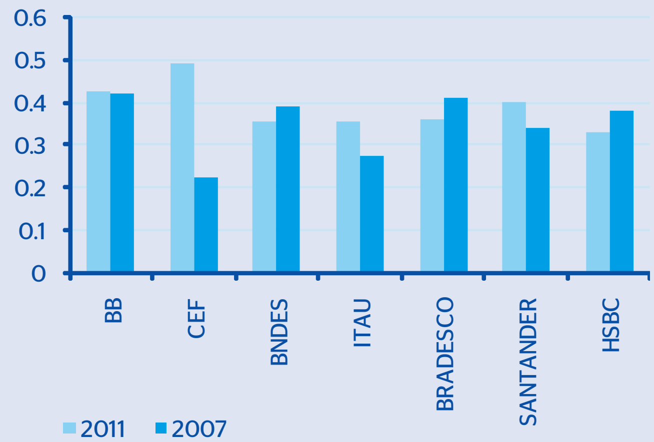
These concerns were reinforced by i) the fact that public credit remained very dynamic even after overheating signs emerged in 2010; ii) the continuous use of Treasury (subsidized) resources to capitalize the BNDES (R$235bn -6.5% of GDP- between 2009 and 2011 and R$45bn -1.0% of GDP- in 2012); and, especially, iii), the very recent announcement that the two main public commercial banks (Banco do Brasil and Caixa Economica Federal) will cut their interest rates to force a reduction of banking spreads in Brazil.

Chart 17
Basel Index



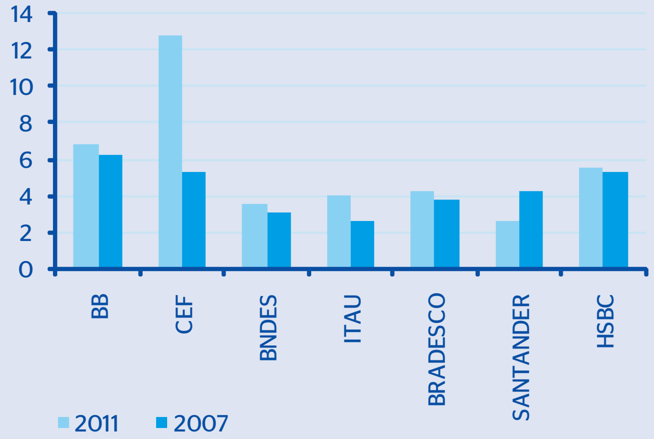
Source: Central Bank of Brazil

Chart 18
Credit / Asset ratio



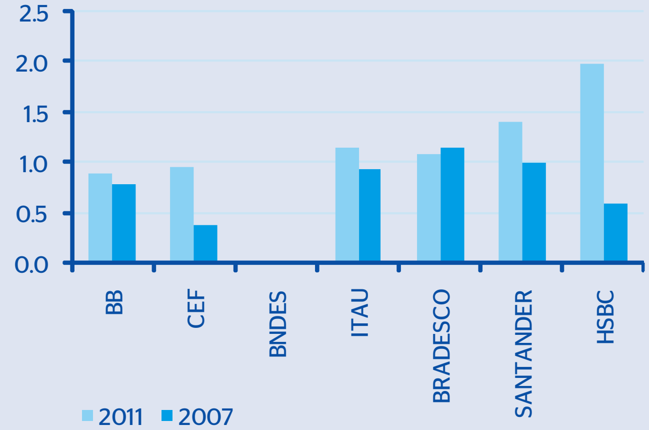
Source: Central Bank of Brazil

Chart 19
Credit / Capital ratio



Source: Central Bank of Brazil

Chart 20
Credit / Deposits ratio (*)



(*)BNDES wasnot included in the analysis as it does not get demand/time/term deposits. Source: Central Bank of Brazil
Source: Central Bank of Brazil

The use of public credit to support the economy and the decision to reduce the lending rates charged by public banks (which should not be followed – at least not with the same intensity - by private banks, in spite of increasing political pressures) suggest the likelihood that public financial institutions will continue to expand at a more dynamic pace than private institutions. It is, therefore, not unlikely that in the near future public banks will account for more than half of the credit market in Brazil, a situation that resembles that of decades ago.

As outlined above, we see a risk in the excessive expansion of public banks, especially if it is politically driven. In addition to causing a deterioration of public bank balance sheets and exposing them (and, therefore, the whole system) to an eventual economic downturn, continued growth of public banks could add to the concerns about the creation of a credit bubble in Brazil. It could also reduce the room for the Central Bank to bring the SELIC rate down to international levels, which is – paradoxically – one of the main objectives of this government.

Tables

Table 1
Macro Forecasts Yearly

	2010	2011	2012	2013
GDP (% y/y)	7.6	2.7	3.3	4.3
Inflation (% y/y, eop)	6.0	6.5	5.4	5.9
Exchange Rate (vs. USD, eop)	1.66	1.87	1.90	1.88
Interest Rate (%, eop)	10.75	11.0	8.25	8.25
Private Consumption (% y/y)	7.0	4.1	3.7	3.9
Government Consumption (% y/y)	4.2	2.0	1.7	2.9
Investment (% y/y)	21.5	4.8	5.2	8.7
Fiscal Balance (% GDP)	-2.5	-2.6	-1.4	-0.9
Current Account (% GDP)	-2.3	-2.2	-2.6	-3.4

Source: BBVA Research

Table 2
Macro Forecasts Quarterly

	GDP (% y/y)	Inflation (% y/y)	Exchange Rate (vs. USD)	Interest Rate (%)
Q1 11	4.1	6.3	1.63	11.75
Q2 11	3.3	6.7	1.56	12.25
Q3 11	2.2	7.3	1.86	12.00
Q4 11	1.4	6.5	1.87	11.00
Q1 12	1.3	5.3	1.83	9.75
Q2 12	2.1	5.1	1.95	8.50
Q3 12	4.0	5.1	1.89	8.25
Q4 12	5.5	5.4	1.90	8.25
Q1 13	5.8	6.0	1.88	8.25
Q2 13	5.0	6.0	1.87	8.25
Q3 13	3.8	6.0	1.89	8.25
Q4 13	2.6	5.9	1.88	8.25

Source: BBVA Research

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