Economic Outlook

Brazil

Third Quarter 2012
Economic Analysis

- **Global economic growth should recover gradually in 2013** as European and US authorities clear up uncertainties.
- **Brazil will grow less than in 2011 and certainly not much more than 2.0% in 2012,** as external and domestic factors weigh on the economy.
- **The monetary easing cycle has still some way to go,** even though the downward trend in inflation has come to an end.
- **The credit slowdown and the manufacturing sector's loss of competitiveness** pose a challenge to policy-makers and send warning signals about the exhaustion of Brazil's macroeconomic model.
- **Brazil has tools to cushion the economy against a new global crisis,** which could, however, arrive when the country is in a much weaker cyclical position than in the previous crisis in 2008.

Index

Closing date: August 13, 2012

1. Summary

We have trimmed our global GDP growth forecasts slightly, to 3.4% in 2012 and 3.7% in 2013. The downgrade derives from financial stress in Europe and the slowdown –slightly greater than expected three months ago- above all in the main emerging economies, e.g. China, India and Brazil. Our global scenario is predicated on the assumption that authorities will adopt the necessary policies to progress in the institutional development of the European Monetary Union (EMU) and to prevent the fiscal cliff in the US.

Brazil should grow 2.2% in 2012, less than the 2.7% observed in 2011 and the 3.3% we expected some months ago. Global turbulence and domestic factors such as the credit slowdown and the weakness of industry have been preventing the economy from recovering. We expect activity to speed up going forward in line with the increasing support provided by monetary policy.

The short-term inflation outlook has improved in line with the negative tone of economic activity. We expect, however, the recent downward trend to be reversed and inflation to stay above the 4.5% target over the year as domestic demand recovers, positive base effects wane, and food prices increase.

The central bank will continue easing monetary policy in the months ahead as it keeps focused on external risks. We expect the SELIC to reach 7.0% in October and then to be left unchanged for a long period.

Tax revenues will not be as strong as in 2011, but the government should still have room to increase its primary expenditures without abandoning the fiscal target. Fiscal policy will be effective in driving public debt down, but not necessarily in taking some pressure off inflation.

The Brazilian Real has reached a new, weaker range (2.0-2.1), where we expect it to continue in the short-term. The depreciation of the currency follows the deterioration of the external environment, concerns about the sustainability of the Brazilian growth model, the decline in terms of trade, the reduction of the SELIC and government's intervention in exchange markets.

Either an external shock triggered by a deterioration of the situation in Europe or by the fiscal cliff in the US would have a considerable impact on the Brazilian economy. The country has significant room to implement measures to cushion the economy from a major external shock. A severe recession could, likely, be avoided, but GDP growth would hardly be positive. One of the country's main vulnerabilities is that, in comparison with 2008, this time the external shock could come at a time when the country is in a much weaker cyclical position than in 2008.

The current account deficit has remained relatively stable over the last months, but we expect some deterioration ahead. The impact of a weaker real has offset the negative effect of lower terms of trade. The current account deficit, therefore, has remained close to 2.2% of GDP. We expect the current account to close the year around 2.5%.

The economy's stagnation over the last year has created many doubts about the sustainability of the Brazilian growth model, based on credit expansion and private consumption. The continued emphasis on the demand side has generated significant problems, such as the increased households' debt, the appreciation of the currency and the rise in labor costs (not matched by productivity). Because of these problems, credit markets slowedand the competitiveness of the manufacturing sector was eroded. Looking ahead, we expect a reduction in interest rates, supportive commodity prices and some (very limited) rebalancing of the growth model towards the supply side will keep the country on track, although growth will not be higher than 4% in the medium/long-term. This scenario has a clear downside bias as it depends on the (uncertain)- moderation of credit markets and fiscal policy in the long-term.

Within Latin America, doubts surrounding the sustainability of Brazil's growth model stand in contrast to the relatively more upbeat stemming from competitive gains in Mexico. This is feeding through to a reversal of market expectations regarding the two countries.

2. External environment: a slowdown that may deepen unless decisive economic policy action is taken

Global growth will improve only if economic policy measures are fully implemented in time

After the deterioration in global economic conditions in the first part of 2012, our current scenario that still envisages a slight economic rebound in 2013 is very dependent on economic-policy issues. Our global GDP growth forecast stands at around 3.5% in 2012-13 (Chart 1), but relies on the assumption that necessary policy measures are implemented in time to avoid a financial mess in Europe, an automatic fiscal adjustment in the US in 2013, and help reach higher growth rates in emerging economies. However, if economic policies fail to achieve their goals, the slowdown now in place since 2011 is likely to intensify in 2012 and 2013. That could leave 2013 global GDP growth at its slowest pace in 30 years (except for the 2009 recession).

At a summit in June, the eurozone leaders reached agreements in the right direction to reinforce the currency union: single bank supervision in the euro area, far-reaching plans covering banking and fiscal issues, and growth-supporting measures. However, financial-aid mechanisms that have been approved to ensure financial stability in the eurozone (i.e., EFSF&ESM) must be used in their full capabilities as soon as possible to avoid a financial "accident." This is the only way to make sure that those economies currently struggling to access financial markets have the chance to implement fiscal-consolidation plans and structural reforms. This should include the involvement of the ECB.

In the US, there must be an agreement to prevent that automatic spending-cut measures and the expiration of tax cuts come into force at the beginning of 2013. This "fiscal cliff" would not solve long-term sustainability of the country's public finances and, if all measures materialized, they would push the US economy back into recession in 2013. As the presidential campaign makes any kind of agreement difficult until the election, the surrounding uncertainty over the outcome of this process is likely to play a key role in shaping the economic and financial outlook as we move towards the end of the year.

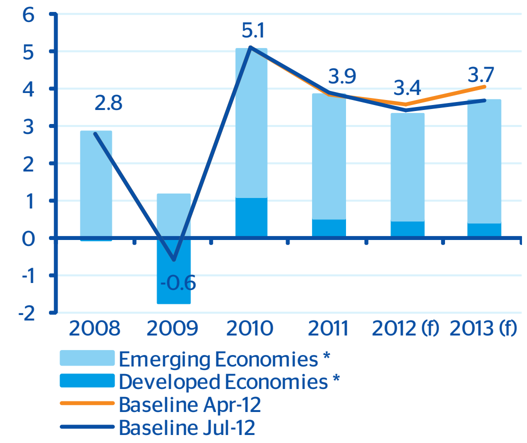
Meanwhile, in emerging economies with room for policy stimulus, measures are needed to prop up domestic demand so that the effects of the external slowdown are mitigated. Additionally, volatility of capital inflows could increase due to the ebbs and flows of the eurozone crisis and, on the other hand, flows related to a new round of quantitative easing the US Fed is likely to embark on.

Failure to dovetail sovereignty transfer with debt mutualisation at the rhythm that markets demand drags the euro crisis out

The main uncertainty over the current economic scenario is whether the efforts that the eurozone countries will have to make to reinforce its governance will be preceded by a further deterioration in its financial situation. If this were the case, we think that it will produce massive interventions from EU mechanisms to eventually assure the financial stability of the eurozone. The decisions already taken, if implemented forcefully could suffice, but that requires that the measures approved at the end of June are implemented quickly, and also the effective use of the European stabilization mechanisms (first the EFSF and later the ESM) for intervening the markets.

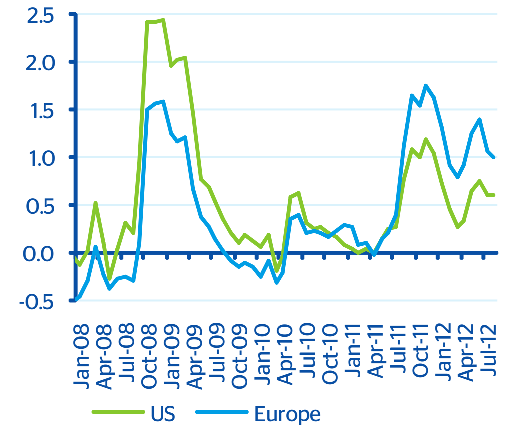
All in all we have revised downwards our forecast for the eurozone due to continued financial stress (Chart 2) and ongoing deterioration in global economic confidence. This scenario implies a period of stagnation in the eurozone in 2012- 13. Despite this revision, in our view, the balance of risks continues to be tilted to the downside, given the likelihood that approved measures are introduced too slowly due to domestic-policy considerations in some countries. If that were to happen, then the risk of a recession in Europe in 2013 would be relevant, especially in countries such as Spain and Italy.

Chart 1
Global GDP growth (%yoy)



* Growth contributions
Source: BBVA Research, Haver and Bloomberg

Chart 2
BBVA Financial Stress Index



Source: BBVA Research

Eurozone countries have to solve the liquidity squeeze on some markets. Those constraints are a consequence of market participants assigning some chance that a euro break-up may occur. Euro countries are unable to dovetail the transfer of fiscal and banking sovereignty with effective mechanisms of reduction of imbalances at the rhythm that markets demand. As long as this situation continues, the risk of a euro break-up is fuelling the fragmentation of financial flows across the eurozone and impeding funding access for those economies with a net debt position with the rest of the zone. A fast implementation of financial-aid mechanisms and their reinforcement in terms of size and access to ECB's funding are key factors to eliminate the risk of a eurozone break up. However, in our opinion this extreme outcome is a tail risk; sooner or later, the measures needed to set up common institutions for banking supervision, deposit guarantee and banking resolution will be approved. Although there is political will to reinforce European currency-union institutions and governance, the implementation of appropriate measures are lagging behind. In the end, those measures will imply a transfer of national sovereignty to the European institutions and, at the end of the process, some form of liability sharing (debt mutualisation). That will also happen as for the fiscal policy, for example in the form of national consolidation plans having to be submitted to European institutions. If the challenges ahead are met satisfactorily, global growth could gradually increase during 2H12.

In the case of the US, the downward revision to our outlook for 2012 and beyond has been driven by a combination of disappointing growth figures in 1H12 and the impact of a high financial stress coming from the euro area.

As for Asia, growth in the first half of the year slowed in China more than expected. In line with the weaker global outlook, we have accordingly revised our projections for 2012-13 down. Nevertheless, monetary and fiscal measures to support growth should lead to a pickup, with growth in 2013 rising to 8.3%, a half percentage point higher than in 2012. Elsewhere in the Asia region there is also room for policy stimulus to support growth. But there are downside risks, including a more severe worsening of external demand and a continued slowdown in China, exacerbated by ongoing domestic financial fragilities.

3. Brazil: lower growth, higher risks

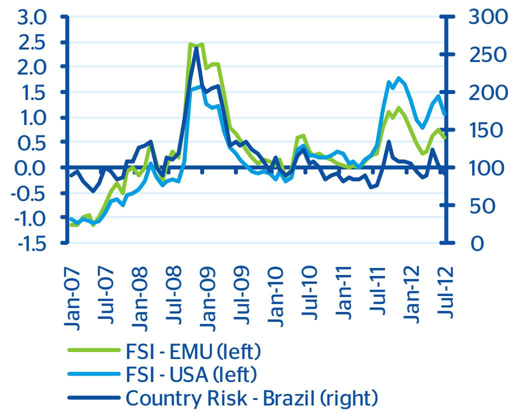
Domestic and external factors prevent a sound recovery, up to now

The Brazilian economy has practically stagnated since the middle of 2011. More precisely, economic activity accumulates a minuscule 0.2% expansion in the 12 months to May, according to the Central Bank's Monthly Activity Indicator, which is a good proxy for Brazil's GDP. GDP itself shows a very shy recovery (0.20%q/q in Q1 2012 and Q4 2011) after a small contraction of 0.15%q/q in Q3 2011. GDP data for the second quarter of the year has not yet been released, but high-frequency indicators (as the CB's Activity Indicator) suggest that a significantly stronger recovery for such period should not be expected.

There are many factors behind this growth moderation. Global turbulences are, certainly, among them. Financial stress in developed countries remains at unusually high levels, which, unsurprisingly, heightens domestic stress, drives capital inflows down, weakens the Brazilian Real (BRL) and imposes losses on the BOVESPA (see Charts 3, 4 and 5).

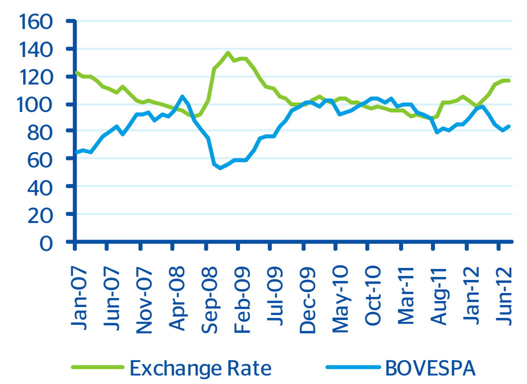
The impact of external turbulences thorough the financial channel has been particularly large, at least in comparison to other Latin American countries (see BBVA Research's most recent Latam Economic Outlook for more details on the issue). This is related to Brazilian financial markets' size and global integration, but the over optimism towards the country exhibited up to some months ago also make the current correction to be sharper than it otherwise would have been.

Chart 3
Financial Stress Indicator (FSI) and EMBI Brazil (Index 2010=100)



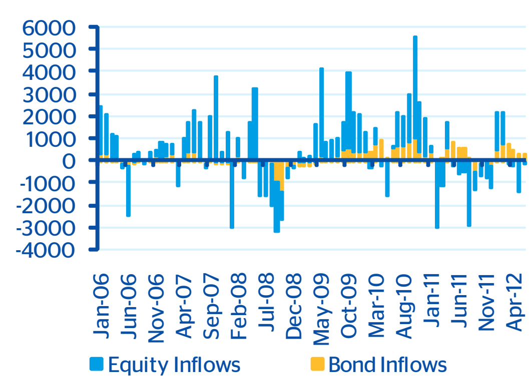
Source: BBVA Research and Haver Analytics

Chart 4
EMBI Brazil, Exchange Rate and BOVESPA (Index 2010=100)



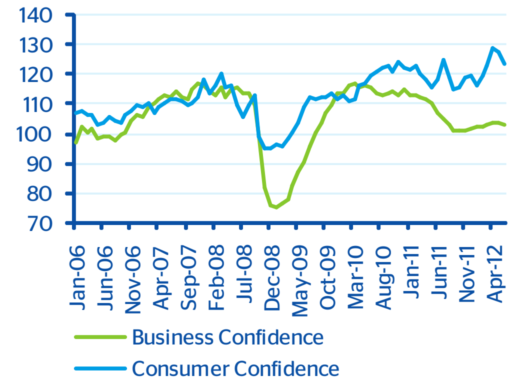
Source: Haver Analytics

Chart 5
Capital flows into Brazil(USD millions)



Source: Haver Analytics

Chart 6
Confidence (Index)



Source: FGV

The external mood also is weighing on the country through the confidence channel: business confidence and, more recently, consumer confidence have been trending downwards as it is shown at Chart 6.

The impact of a more negative global environment on both export prices and external demand has been also non-negligible. Export prices were 3% lower in year up to May in comparison to the 2011 average while the volume of exports declined 5% (the volume of manufactured exports declined 7% in the same period).

In addition to the non-supportive external environment, some internal factors are also imposing a heavy cost on the economy and preventing activity from reviving.

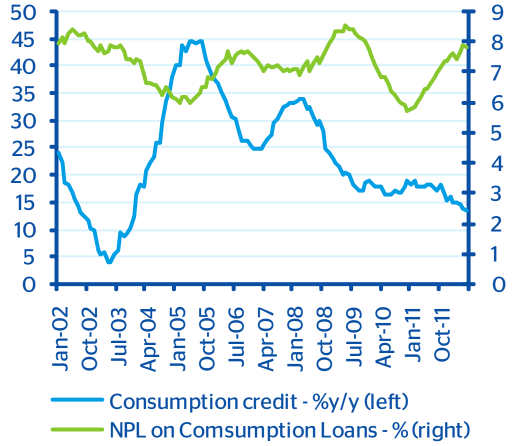
Consumption credit has been showing clear signs of fatigue. In June, consumption credit expanded by 13.4%y/y, the slowest pace since 2003. Non-performing loans on consumption loans are currently around 7.8%, in comparison to 5.5%-6.5% in the first half of 2011 (see Chart 7). The fatigue in consumption credit markets is, at some extent, a natural response to the excessive expansion observed in the recent past and to some other concerns regarding Brazilian credit markets (see the Box 1 “Slowdown in credit markets: concern or relief?” for more on this issue).

Another domestic factor that helps to explain the poor performance in the last months is the weakness of the industrial sector. Industrial production has been surprising to the downside in the last months and current levels remain lower than those observed before the 2008-09 crisis. In addition, inventories remain at high levels (see Chart 8). As we discuss in Box 2, the weakness of the industrial sector reflects its increasing lack of competitiveness in an environment of rising labor costs and still strong exchange rate (in spite of the recent depreciation of the Brazilian Real).

The impact of the historical downward adjustment of domestic interest rates – from 12.50% in the middle of 2011 to 8.0% in July - on activity has been small up to now. According to previous experience for Brazil, interest rates changes affect activity with a lag of around three quarters. This implies that the full impact of the monetary easing implemented recently (and to be implemented in the next few months) has yet to be seen. In addition, the external environment and the fatigue observed in domestic credit markets are working against the monetary stimulus provided by the Central Bank.

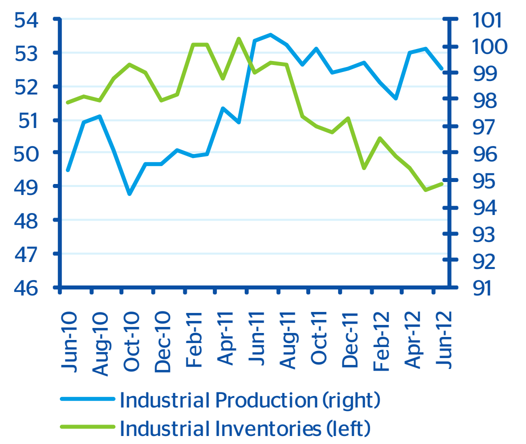
There is a large set of other measures being taken by economic authorities in the last months. Nonetheless, they are not being effective to drive activity up. They are, in our view, excessively focused on supporting credit markets and private consumption instead of on supporting fixed capital formation or on addressing Brazil’s structural problems. Some of them can end up being more a source of distortions, inefficiencies and imbalances than of support to the economy (e.g.: the increase of the IPI tax – Tax on Industrialized Products – on cars with a high proportion of foreign parts or the acceleration of credit from public banks). Some other were in the right direction but were too timid to have a real impact (e.g.: payroll tax cuts to some specific industry segments). In all cases, the measures taken in the last months seem to be more a desperate reaction to the situation than part of a long-term agenda to address pending issues and increase potential output. Finally, the measures announced in the last months up to some few weeks ago also reinforced the perception of excessive intervention of the government in the economy, which is a factor that does not support the recovery.

Chart 7
Consumption credit markets: growth and NPL



Source: Central Bank of Brazil

Chart 8
Industrial Production Index (Sep/2008=100; seasonally-adjusted) and Inventory Indicator*



* Inventory Indicators: higher than 50 when inventories are higher than planned; lower than 50 when they are lower than planned
Source: IBGE and CNI

On the positive side, private consumption remains relatively strong as labor markets remain tight

Even though credit markets have become less supportive, private consumption continues giving signs of strength. After a small decline in Q3 2011 (-0.075q/q), private consumption expanded by 1.0%q/q in Q4 2011 and in Q1 2012. This contrasts with the performance of fixed investment, which dropped 0.6%q/q in the last two quarters of 2011 and then contracted 1.8%q/q in the first quarter of 2012.

Private consumption's positive performance, actually, prevented the economy from entering into a recession in Q4 2011 and Q1 2012.

The resilience of the consumption segment in Brazil is also revealed by retail sales figures, which show an average expansion of 0.6%m/m (9.0%y/y) in the first five months of the year (in comparison to 0.5%m/m -7.4%y/y - in the same period last year).

The main reason behind the dynamism of private consumption is that labor markets remain robust in spite of the current macroeconomic environment. The unemployment rate has been very close to 6.0%, a historically low level, since the middle of 2011 (see Chart 9). Moreover, wages continue growing at a strong pace (4.8%y/y in real terms in the first five months of the year). The robustness of the labor market is benefiting from the dynamism of sectors such as agriculture, construction and services, from the recent decline in inflation and interest rates, and from some public policies (such as the 14% upward adjustment in the minimum wage at the beginning of the year).

The economy will gain momentum from now on, if the global environment assists

We expect domestic activity to recover more robustly from the second half of the year on. This is, however, conditional on European and North-American leaders taking the needed political decisions to avoid an "extreme event" and allowing the world economy to grow more strongly in 2013.

Within a relatively more benign external environment, which includes higher growth in China from the second semester of this year on, domestic recovery would be mainly driven by an increasingly supportive monetary policy, but also by an eventual revival in industrial production and some improvement on credit markets.

The revival in industrial production would be, in our view, determined by the end of an inventory adjustment process. In any case, this revival would be limited as the main barriers to competitiveness will continue in place.

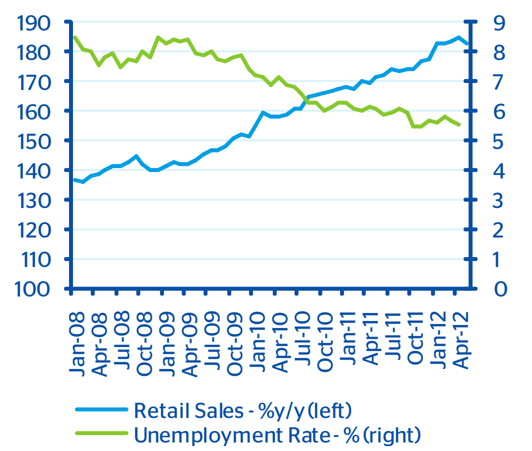
Regarding credit markets, we expect some improvement to be generated by a gradual decline in non-performing loans (NPL) due to a combination of a supportive labor market and lower interest rates.

In addition to these factors, based on some recent local news, we see some room for the adoption of measures that would support domestic activity more effectively than those announced in the last months. More precisely, these measures would be focused on driving fixed investment up and on addressing some of the country's main problems. Among those allegedly being studied by the government are the reduction of electricity taxes —allowing a non-negligible reduction in production costs—, the extension of payroll tax cuts, and a new wave of concessions that would allow the private sector to manage more airports, seaports and roads.

In line with all these factors, in especial the monetary stimulus, we expect GDP to accelerate in the second half of the year and grow 2.2% this year. In our base scenario for the Brazilian economy – which is in line with our outlook for the world economy commented above – the economy would then continue to pick up next year and GDP would grow 4.2% in 2013. It is important to highlight that next year, GDP growth will benefit from a significant carry-over effect (2.3%) which contrasts with the magnitude of this effect in 2012 (0.2%). By demand components, the recovery will be driven, in our view, by private consumption, which we project to expand by 3.6% and 4.7% respectively in 2012 and 2013, and by fixed investment, especially in 2013 when we expect it to grow 8.9% (for 2012 we expect a mere 0.6% growth).

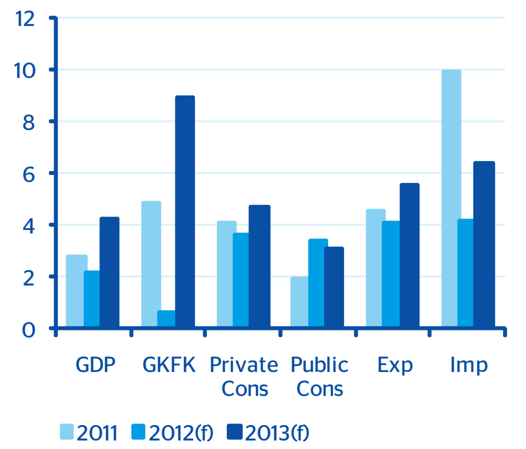
Even though our growth forecasts for Brazil are significantly lower than our previous ones back in May (3.3% and 4.3% in 2012 and 2013), risks are clearly tilted to the downside. The negative bias is in line with external risks and with concerns about the exhaustion of the current Brazilian growth model (we discuss these risks and concerns in more detail below).

Chart 9
Retail sales (%y/y) and unemployment rate (%) – Seasonally adjusted series



Source: IBGE

Chart 10
GDP growth (%)



Source: BBVA Research and IBGE

Short-term outlook for inflation improves, but inflation will not converge to the 4.5% target in 2012 or 2013

Inflation declined more sharply than we expected in the first half of the year. More precisely, some months ago we expected inflation to drop from 6.5%y/y in the end of 2011 to 5.2%y/y in June. It, however, ended up reaching 4.9% by the end of the first semester.

Inflation's downward trend, at a large extent due to positive base effects, was reinforced by a weaker-than-expected domestic demand (the output gap is in negative territory). In addition to that, commodity prices eased more than we had anticipated, offsetting the negative impact of the recent depreciation of the Brazilian Real (BRL): commodity prices measures in domestic currency stayed, on average, constant in comparison to the levels observed in the second half of 2011 and were 4.8% lower than in the first half of that period. Finally, inflation benefited from a series of non-negligible one-off factors such as the updating of the weights for the IPCA (the official CPI,), the reduction of taxes on fuels that prevented a rise in gasoline and diesel prices and tax breaks on products such as cars, home appliances and furniture.

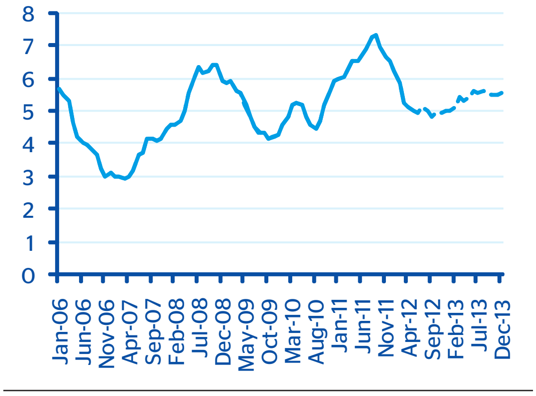
In spite of the support from all these factors, inflation remained above the 4.5% target during the first half of the year. Inflation, actually, moved up to 5.2%y/y in July, the first increase in almost one year. As we highlighted in a previous Brazil Economic Outlook, inflation only falls below 4.5% in exceptional circumstances (such as severe recession or abnormally high interest rates). This inelasticity is related to factors such as the still high degree of price indexation, the low weight of tradable goods on inflation (around 36%), and some inflation tolerance.

As commented before, we expect economic activity to be more dynamic in the second half of the year than in the first. This dynamism should reduce the room for inflation to trend downwards. In the same line, positive base effects will wane. Moreover, food prices, which represent 23% of the IPCA index, will be under more pressure given the recent increase in the price of some grains (such as soybean, corn and wheat) in international markets due to the drought in the US. Finally, local news suggest that gasoline and diesel prices could be adjusted upwards over the next few months in order to reduce the gap between domestic, subsidized prices and those observed in international markets..

Therefore, we expect inflation dynamics to be less positive in the remainder of the year than in the first semester. More precisely, inflation should stay within the 4.8%-5.2% range in the second semester and close the year at 5.0%y/y.In 2013, both global and local recoveries should keep prices under more pressure and, therefore, we expect domestic inflation to average 5.4% next year (in comparison to 5.2% in 2012) and to close that period at 5.5%.

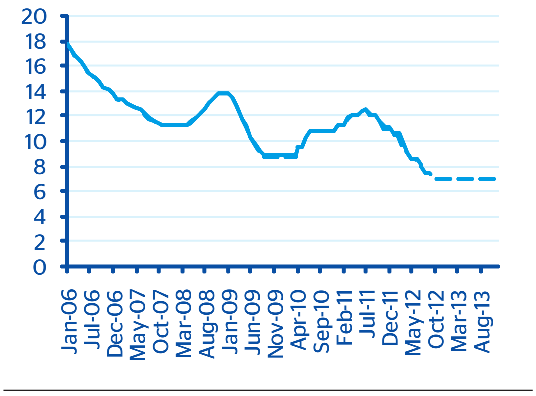
Even though we expect inflation to remain above the 4.5% target in both 2012 and 2013, the recent deterioration in the external environment as well as in the domestic scenario has improved the short-term outlook for inflation. This is reflected on the reduction of our forecasts for 2012 and 2013 from 5.4% and 5.9% three months ago to 5.0% and 5.5%.

Chart 11
Inflation (%y/y)



Source: BBVA Research and IBGE

Chart 12
SELIC rate (%)



Source: BBVA Research and IBGE

Monetary easing has still some way to go

The Central Bank of Brazil (BCB) has slashed the SELIC rate by 450bps to 8.0% in July, an all-time low. This historical adjustment followed the deterioration of both domestic and external economic activity. It was also the result of the decision by policy-makers to bring interest rates down to levels that are closer to international standards. Even though this adjustment has been surrounded by criticism as it can damage BCB's credibility and introduce important risks to inflation ahead, we expect this adjustment to be permanent. In other words, we do not expect SELIC to reach levels as high as those observed some few years ago.

Taking into account the current macroeconomic juncture and the preferences of the BCB's Board we expect the SELIC rate to be cut by 50bps in each one of the next two monetary meetings (in August and October) and then to be left unchanged for a long period. We expect policy makers to try to avoid an interest rate increase in 2013 when inflation pressures will resume more strongly, although that option should not be ruled out. This expectation is driven by, at least, five factors: i) BCB's willingness to accommodate high inflation within the 2.5%-6.5% range; ii) GDP will be under its potential for a long period (at least until the end of 2013); iii) policy makers' willingness to use other tools (fiscal policy and macro-prudential measures) to keep inflation under control; iv) the adoption of some positive structural changes such as the additional reduction of public sector's debt, the improvement of the debt profile by reducing the share of SELIC-linked bonds, the reform of social security and measures to reduce price indexation; and v) the negative impact of an increase in interest rates -at least from the government's point of view- on the exchange rate and on public accounts (see the section below for more details).

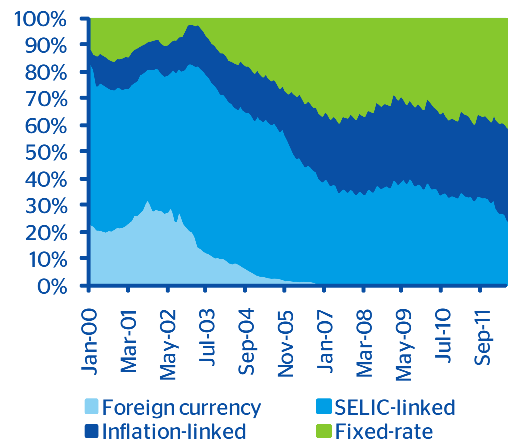
Fiscal policy: effective in driving public debt down, but not necessarily in taking some pressure off inflation

The significant reduction of interest rates will reduce public sector's interest payments. According to our estimations, interest payments will decline to 4.5% of GDP in 2012 and slightly less than 4.0% in 2013 from 5.7% in 2011 and 6.6% in average between 2001 and 2010. This will add to the generation of primary surpluses and the weakening of the BRL and will allow for a positive debt dynamics in the year ahead. Note that a weaker BRL has a positive impact on the net debt as the public sector is a net foreign creditor (due to the size of international reserves). According to our estimations, public sector's net debt will be around 35% of GDP in 2012 and 2013 and then will move towards the 30% mark in the years ahead which compare very well with the public sector' net debt in 2011 (36.4%) and especially in the 2001-2010 period, when it averaged 47.8%.

If on one hand lower interest rates impact fiscal accounts positively, on the other hand a lower debt and a better debt profile should take some pressure off interest rates.

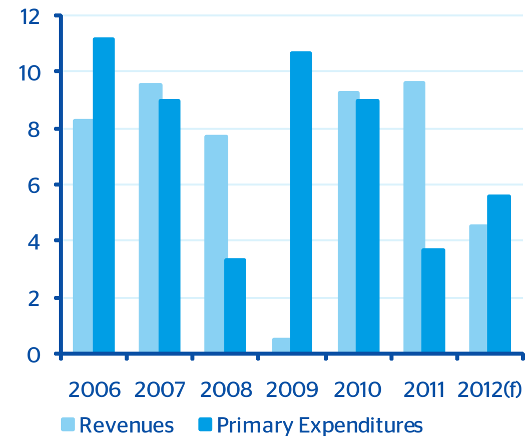
Regarding the public sector's debt profile, it has improved significantly in the last years. The share of total public bonds denominated in foreign currencies was reduced to practically zero from 24% in 2000. Moreover, the share of bonds linked to the SELIC was cut to 23.8% in June of 2012 from 60% at the beginning of 2000 (see Chart 13). We expect this share to continue declining in the years ahead.

Chart 13
Debt profile (share of total bonds%)



Source: Central Bank of Brazil

Chart 14
Federal government's revenues and primary expenditures (%y/y in real terms)



* Data for 2010 excludes revenues and expenditures related to Petrobras' IPO.
Source: BBVA Research and IBGE

The fact that public sector's net debt should fall in the years ahead and primary surpluses should not fall very short of the targets established for 2012 and 2013 does not imply that fiscal policy will not be expansive. This view is supported by recent evidence:, last year, for example, the debt declined to 36.4% of GDP from 39.1% in 2010, the 3.1% primary surplus target was met and primary expenditures increased 3.6% in real terms providing a clear support to economic activity. Meeting the fiscal target, reducing the net debt and, at the same time, adopting an expansive fiscal policy was only possible in 2011 because revenues were very robust (due to the dynamism of domestic demand and the government's capacity to generate one-off revenues).

In 2012, tax revenues will be less supportive than in 2011, but the government should still have room to increase its primary expenditures without abandoning the fiscal target. More precisely, we expect primary expenditures to grow around 5.0% in real terms this year and a primary surplus to be only slightly lower than the 3.1% of GDP needed to meet the target.

A criticism to the adoption of an expansive fiscal policy is that it could reduce the room that the CB has to cut interest rates by supporting excessively domestic demand and, therefore, driving inflation up. This could be particularly worrisome after the economy recovers from the recent slowdown in 2013. Another criticism is that public expenditures remain focused on consumption expenses instead of on investments, which adds to the Brazilian growth model's imbalances (see the section below for more details).

The exchange rate depreciates in line with the deterioration of the macroeconomic environment

Over the last three months, the Brazilian Real (BRL) remained broadly stable around the 2.04 mark and within the 2.0-2.10 range. This represents a depreciation around 15% with respect to the first quarter of the year.

The weakening of the BRL should not be a surprise given that domestic growth perspectives deteriorated sharply in the period, there are increasing concerns about the sustainability of the current Brazilian growth model, terms of trade declined, interest rates dropped sharply, and global stress remained at very high levels. In addition to all that, the government (including the Central Bank) seems more comfortable with current levels than with a more appreciated exchange rate.

The expected recovery of economic activity could drive the exchange rate slightly down in the months ahead especially in 2013. However, the space for appreciation is, in our view, small as interest rates should continue at record lows (helping to keep interest rate differentials with respect to international rates at lower levels than in the past), terms of trade should continue adjusting downwards, and the government will certainly be ready to intervene in case of a stronger appreciation. Overall, we expect the BRL to average 2.02 in the second half of the year and to close 2012 at 1.99 (see Tables at the end of the report for forecasts for 2013).

The impact of a weaker BRL on the current account has been positive, especially because it is helping to reduce profit remittances which reached USD 10bn in the first half of the year in comparison to USD 18.8bn in the same period last year. The effect of a weaker BRL on profit remittances offset the impact of lower terms of trade on the trade balance. As a result, the current account accumulated a deficit of USD 25bn in the first semester, very close to the deficit recorded in the first half of 2011 (USD 26bn). In yearly terms, the current account deficit reached 2.2% of GDP in June, slightly higher than in the end of 2011.

Looking ahead, we expect the current account deficit to reach USD 33bn in the second half of the year (it reached USD 27bn in the second half of 2011). The deficit in the end of the year would, therefore, stand at USD 58bn (2.5% of GDP). The deterioration ahead will be driven by some recovery of the domestic economy and the impact of lower terms of trade. As it has been happening since 2001, FDI inflows should be enough to fund the current account deficit in 2012. Moreover, international reserves should close the year at USD 381bn (16% of GDP), providing some insurance against an unexpected sudden-stop in capital flows into the country.

Higher risks: the Brazilian economy faces a more challenging global environment as well as increasing doubts about the exhaustion of its growth model

The Brazilian economy -and therefore our base-scenario for the country- remains subject to significant risks. These risks are, actually, higher than some months ago as the external situation has not stabilized and domestic problems continue to gain importance.

Our baseline scenario is predicated on the assumption that the necessary political agreements will be reached to gradually reduce tensions in Europe and to avoid a fiscal cliff in the US in the early part of next year. Nonetheless, the two factors, especially the situation in Europe, represent the main global risk. An external shock triggered by either of the two events would have a considerable impact on the Brazilian economy.

The country has significant room to implement measures to cushion the economy from a significant external shock. Even though domestic interest rates already are at record low levels, the BCB would certainly cut the SELIC aggressively to reduce the impact of the shock on the economy. In addition, mandatory bank reserves in the BCB currently amount to 9.2% of GDP (in comparison to 8.6% in Sept/2008 just before the Lehman Brothers crisis hit the country). These reserves represent an important source of liquidity that could be injected into the system, if necessary (as happened in 2008-2009). There would be less room to react on the fiscal front than in the monetary side, but the government could still react to an external shock by cutting taxes and adopting other measures, given the relatively low public debt (35% of GDP in Jun/2012, in comparison to 41% in Sept/2008). Finally, international reserves would also be a source of resiliency as they could be used to offset the impact of a sudden-stop in capital flows into Brazil (international reserves reached USD 376bn in Jul/2012 in comparison to USD 206bn in Sep/2008 and to a gross external debt of USD 301bn).

In dealing with a possible sharp deterioration of the external environment, policy makers would also benefit from the experience learned in the 2008-2009 crisis and, perhaps, from the positive reputation of having tackled successfully the previous crisis.

In spite of having room to adopt countercyclical policies the country would not be able to prevent an external shock from strongly impacting the economy, especially through the financial and confidence channels, but also due to a decline in commodity prices. A severe recession could probably be avoided, but GDP growth would hardly be positive.

One of the country's main vulnerabilities is that, in comparison to 2008, this time the external shock could arrive at a time when Brazil is in a much weaker cyclical position than in 2008.

On the domestic front, the stagnation of economy over the last year has led to many doubts about the sustainability of the Brazilian growth model, based on credit expansion and private consumption.

Credit expansion, especially in the consumption segment, has been one of the main pillars of the current Brazilian growth model. Together with domestic labor markets over the last years credit growth paved the way for an impressive performance of domestic demand and, therefore, of the whole economy.

The expansion of domestic demand has been, a source of support to the supply side, especially for those sectors that rely more on domestic markets. The boost from domestic demand was able to offset some of the problems of competitiveness faced by the supply side (tax burden, poor and costly infrastructure, high interest rates…) which traditionally also benefited from an abundant and low-cost labor force..

The continued emphasis on the demand side instead of supply has generated significant problems, such as the increase in households' debt, the appreciation of the currency and the rise in labor costs (not matched by productivity). The appreciation of the Brazilian Real and the increase in labor costs are particular concern for the manufacturing sector which is more dependent on domestic demand and also faces external competition (sector based on commodities rely more on the external demand and the services sectors are more isolated from external competition).

Because of these problems[1], credit markets slowed down, while the manufacturing sector has had its competitiveness eroded. Both effects clearly contributed to the recent stagnation of the economy.

Looking ahead, we expect the reduction of interest rates – combined with some improvement in the external front - to take some pressures off credit markets and the manufacturing sector. The economy should also continue to benefit from high commodity prices. Even though we regard the fall of domestic interest rates as historic, we do not count on any radical change of economic policies. Specifically, we expect the focus on the demand side to continue and the reform agenda to remain practically unchanged.

In our baseline-scenario for the Brazilian economy, we expect fiscal policy and the credit markets to contribute less to growth in domestic demand than in the past offsetting the greater from monetary policy.

Even under this relatively benign outlook, with a less hostile global environment and the government able to keep fiscal policy and credit growth under control, we do not expect the country to grow more than 4% in the medium/long-term. Growth could, actually, be closer to 3.0% than to 4.0%.

A more robust expansion would require a rebalancing of the Brazilian model, with more emphasis on the expansion of the supply side in general, especially of productivity, and less on the demand side. This is, however, something we consider to be highly improbable. .

In fact the risks of the country growing by much less than 3.0%-4.0% are not negligible (they are actually higher than some months ago). We can therefore say that our baseline-scenario for Brazil has a clear downside bias.

On the question of negative risks, in the short-term credit markets and industrial production could refrain from reacting as expected to the reduction in interest rates. That could end up weakening domestic labor markets and extend the stagnation for a longer period, which would then increase the chances of policy slippage (such as excessive SELIC cuts or exaggerated government intervention on exchange rate markets or aggressive trade/industrial policy). n the longer-term the government may not be able (or simply not be willing) to tighten credit markets and fiscal policy. As a result, their contribution to domestic demand would be added to that from a very lax monetary policy, thus creating a suitable scenario for overheating and bubbles to emerge in the economy.

Box 1 "Credit markets slowdown: concern or relief?" and Box 2 "Brazil and Mexico: changing perspectives and remaining challenges" add to the analysis presented in this section about the Brazilian growth model, its strengths and its weaknesses.

1: There are clearly other drivers behind these movements as the deterioration of the external environment, in the first case, and the high level of commodity prices, in the second.

Box 1. Slowdown in credit markets: concern or relief?

Since the end of 2004, and with the exception of a short space of time during the Lehman Brothers crisis, credit markets in Brazil have been growing at a rate of at least 20%y/y. This dynamism has driven the credit stock up to around 50% of GDP from 25% in the end of 2004.

During this boom in credit markets many (including us) have called for a moderation. Even though the starting levels were low, income was expanding, interest rates were falling and institutional changes had been introduced, credit growth was excessively fast.

In the middle of 2011, credit markets started to slow and at the end of that year and beginning of 2012 its growth slowed to 18%-17%. At the same time, non-performing loans (NPL) started to trend upwards. These movements were sharper in the consumption loans segment (see the Chart 15).

The credit moderation was triggered by the monetary tightening implemented in the first half of 2011 (the SELIC rate was raised by 175bps in this period) and the deterioration of the global environment in the middle of the last year (foreign funding to the banking system and external credit to the private non-financial sector, for example, slowed). There was also a more structural factor behind the slowdown: the concern about excessive household indebtedness.

According to BCB's data, household bank debt as a share of yearly income increased to 43.4% in May of 2012 (41% 12 months earlier) from 18% at the beginning of 2005. The increase in debt service over the same period was also significant (from 15% in 2005 to 22% in 2011-12), although not as much as the growth in debt because the average term of loans increased since 2005.

According to our own calculations, which differ in methodology from those of the BCB, the debt service in Brazil reached 17% of disposable income in 2011, significantly higher than the European average (11%) and other Latin American countries (in Chile, which has the highest rate in the region, it is around 12%) .

Therefore, the heavy household debt burden in an environment of higher uncertainty and a slowing economy triggered a correction in default rates (upwards) and credit supply (downwards).

In this context, a permanent reduction of domestic interest rate levels has certainly been welcomed by participants in credit markets, especially because interest payments represent around 36% of debt service in Brazil.

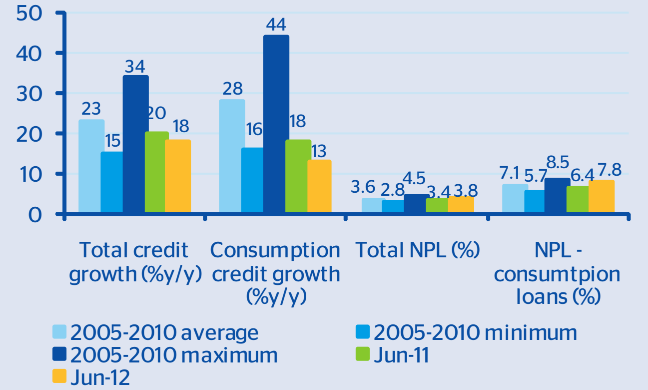
The reduction of interest rates as well as the adoption of other measures (such as the introduction of more incentives to allow the renegotiation of delinquent loans and the exchange of "older" (higher) interest rates by current (lower) rates) or the implementation of some policies supporting households income (which, in fact, remains at very robust levels) may make it easier to reducehousehold total debt and debt service. In the same line, the acceleration of the economy in the second half of the year would certainly be good news.

In any event, in our view a gradual, non-traumatic solution to the debt problem requires some degree of credit moderation. Not accepting a credit slowdown and insisting on credit-based policies to drive growth could add to the problem instead of helping to fix it.

Among the main countercyclical measures announced in recent months are the reduction of capital and reserve requirements for consumption loans, the reduction of the IPI tax on automobiles and other consumer goods and the growth in public credit (which already accounts to 45% of total credit).

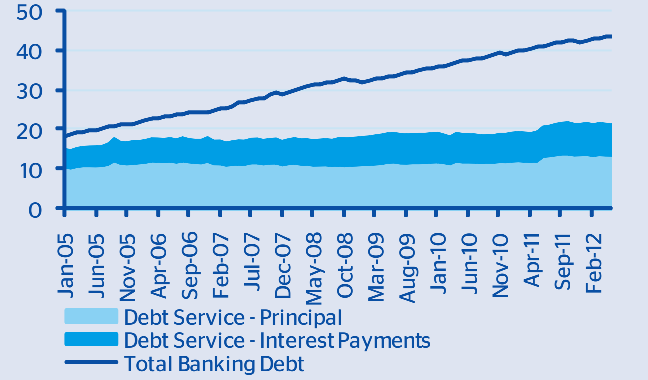
he fact that the recently announced measures focus on credit markets and private consumption is, in our view, something to worry about. For the aforementioned reasons, a credit moderation should be more a source of relief than of concern.

Chart 15
Credit growth and NPL



Source: Central Bank of Brazil

Chart 16
Total household banking debt and debt service (% GDP)



Source: Central Bank of Brazil

Box 2. Brazil and Mexico: changing perspectives and remaining challenges

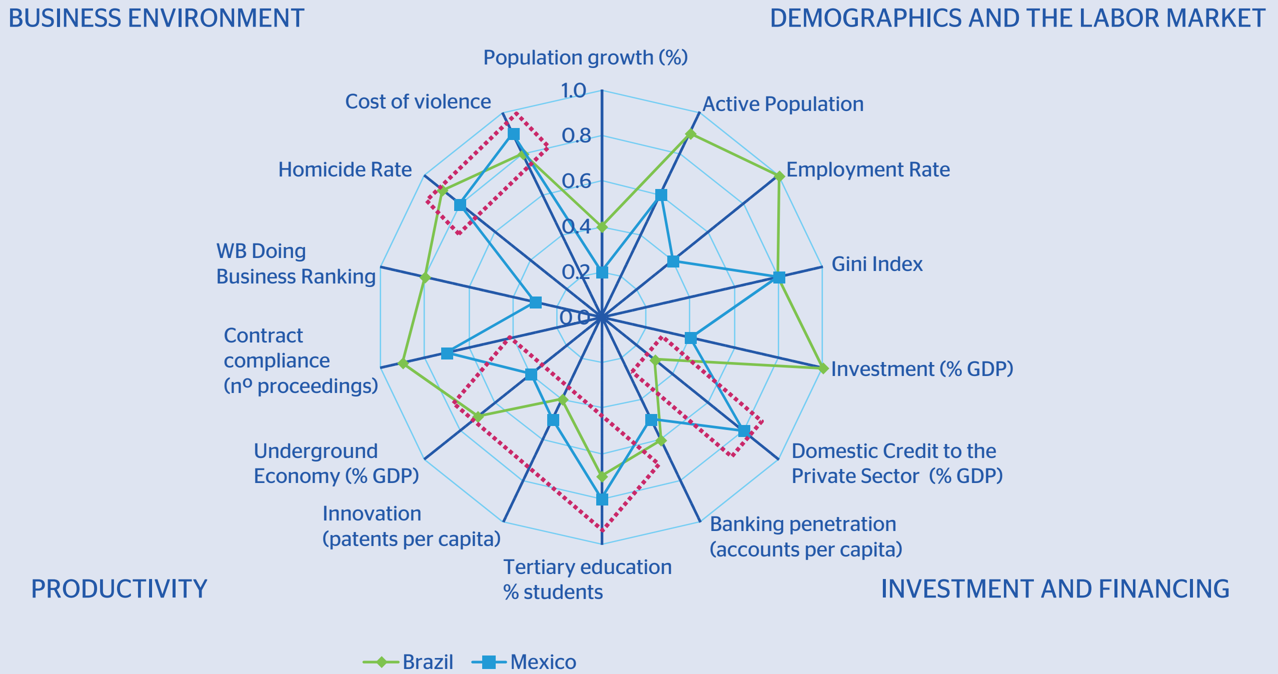
There has been an outlook change in recent quarters regarding the Brazilian and Mexican economies seen, for example, in consensus growth of 3.8% for Mexico in 2012, nearly two points above that for Brazil. If this turns out true, 2012 would be the second year in a run where Mexico grew more than Brazil, after four years where the average growth gap in Brazil's favor was 3.5pp.

Both Mexico and Brazil belong to the "EAGLES[1]" group, comprising countries which, in the next decade, will contribute more to global GDP than the average of developed economies. Mexico belongs to this group more for initial size than for growth which, in recent years, has been lower than other emerging economies and, specifically, than Brazil - the other Latin American "eagle". Brazil's GDP is almost 50% larger than Mexico's and has seen average growth of 3.8% in the last 10 years, around one and half points more than Mexico.

This performance coincided with a global shift in growth sources, with an increasing contribution from emerging Asian and Latin American economies and the standstill and decline of developed economies. This has had important effects on foreign demand from Brazil and Mexico, given their very different exposure to the aforementioned areas. In this sense, the main export destinations for Mexico are developed nations, with a total predominance by the US where around 83% of overseas sales of goods go. On the other hand, Brazil's exports to the US account for 12% of sales, while 68% go the high performance areas such as China, Asia and the rest of Latin America (in Mexico the figure is 12%). In this way, the GDP of destination economies for Brazilian exports grew 50% from 2003 while for the destinations for Mexican products, growth was only 20%.

In the medium term, the balance between both economies does not show a clear dominance for either, with advantages for each country in some of the more important factors. If we take an economy from a supply perspective, the capacity to expand by the appropriate interaction of production and efficiency factors, there are four major elements to consider: demography and the job market, investment and savings, productivity and, finally, the business environment (Chart 16).

Chart 17
Brazil and Mexico: vulnerability radar for emerging economies



Note: the lower the value, the better the relative position
Source: BBVA Research, with IMF, World Bank and UN data

1: Emerging and Growth-Leading Economies.

As for population and the job market, it would seem that the demographic boon is higher in Mexico than Brazil, with higher population growth and a higher share of the population in the job market. The low employment rate in Brazil stands out, measured as a percentage of those in work out of the working age population. According to available figures, this sits at 40%, around 20 points below the average for the group of countries looked at.

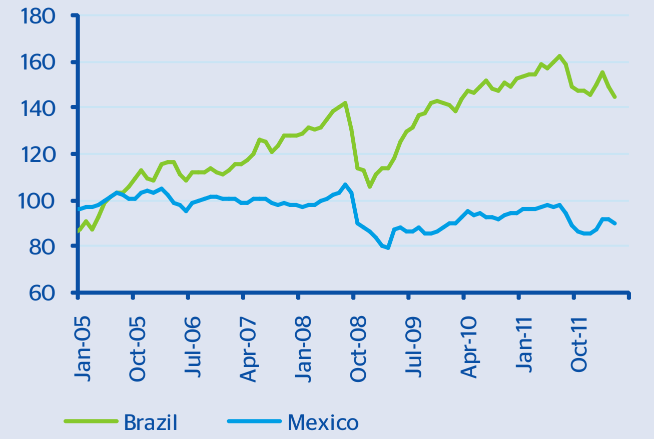
Both economies contrast in investment and bank financing with a better position for Mexico in the former and for Brazil in the latter. On average for the last decade, Mexico saw an investment ratio of GDP over five points higher than Brazil (24.6% vs. 18%), although without hitting levels in countries which, at times, are seen as reference points such as South Korea (29.4% over the same period). In short, the investment level in Mexico is rightly substantial for a country which does not have the domestic savings rate of an Asian emerging economy or that has not obtained savings from the overseas sector at an important level. The domestic savings rate in Mexico is 23.6% of GDP versus 17.3% in Brazil on average between 2001 and 2011. This is a clear limitation without help from overseas for increased investment. Both public and private consumption have a greater weight in Brazil, further boosted by greater access to bank credit.., Domestic banking sector credit is over 50% of GDP in Brazil, almost 30pp higher than in Mexico, with a higher gap in loans granted by public banking than in private banking.

Improving the business environment still requires work in both Brazil and Mexico. Although Mexico has a clear advantage over Brazil in terms of ease of doing business according to the World Bank's Doing Business. Increased violence, however, creates uncertainty for the Mexican economy.

The key to growth lies in efficiency using available productive factors. In the radar chart, as part of the selected variables as representative of productivity, figures do not favor Brazil. Quite the opposite, in fact: among other things, the weight of the black market as part of GDP is much higher in Brazil than in Mexico. Informality is a good sign of productivity since if the activity functions outside current regulations, mainly in fiscal matters, then economic agents cannot take advantage of economies of scale or adequately access the financial market to improve efficiency and increase its value in physical and human capital. In this sense, according to ILO data Mexico has a higher level of informality in the job market. In any event, it would seem that the challenge for both economies is to reduce the black market so that the main source of long-term economic growth (productivity) improves.

Chart 18

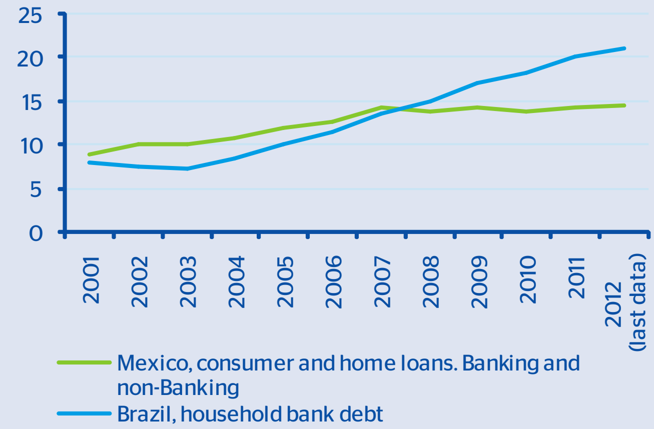
Price competitiveness, real effective exchange rate (2005=100)



Note: Increases in the index point to strengthening
Source: BBVA Research and Haver Analytics

Chart 19

Household debt (% of GDP)



Source: BBVA Research with CNBV data for Mexico and BCB data for Brazil

Brazil's strength of demand (not necessarily its supply capacity) and higher performance from its trading partners have created better perspectives in recent years. Nevertheless, the signs of exhaustion in the Brazilian model (too centered on higher demand) and the gains made in competitiveness in Mexico with regard to Brazil are contributing to a shifting relative vision of the two economies, in favor of the Mexican economy. In line with this analysis, it would appear that greater growth capacity in the medium term for Brazil cannot be justified by demography, labor participation or investment rates. In this way, the better GDP record must be linked from the supply side to efficiency or productivity where there seems to be no major differences in either economy in terms of the variables able to estimate it. On the demand side, the more favorable external environment and higher access to bank finance support higher growth in Brazil with regard to Mexico. However, both factors are not necessarily permanent: the performance of emerging Asian economies could slow and/or Brazil could lose competitive advantages in terms of prices. Borrowing ability could be less important for growth from a certain debt level for economic agents.

Indeed, there has been a recent change in market perceptions of both countries, in Mexico's favor, in line with the slowdown in China, fatigue on Brazilian credit markets and the negative impact that labor costs and the higher exchange rate had on Brazilian industry. The last two factors contrast with the recent dynamism on credit markets and signs of increased competitiveness in Mexico. In any event, they are two large economies with good growth potential over coming years. In addition, respective outlooks will continue to be determined by their different exposure to the global environment and by their ability to adopt reforms reducing their weaknesses.

4. Tables

Table 1

Macro Forecasts Yearly

	2010	2011	2012	2013
GDP (% y/y)	7.6	2.7	2.2	4.2
Inflation (% y/y, eop)	6.0	6.5	5.0	5.5
Exchange Rate (vs. USD, eop)	1.66	1.87	1.99	1.98
Interest Rate (%, eop)	10.75	11.0	7.00	7.00
Private Consumption (% y/y)	7.0	4.1	3.6	4.7
Government Consumption (% y/y)	4.2	2.0	3.4	3.1
Investment (% y/y)	21.5	4.8	0.6	8.9
Fiscal Balance (% GDP)	-2.5	-2.6	-1.5	-0.7
Current Account (% GDP)	-2.3	-2.2	-2.5	-3.2

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	0.7	5.3	1.83	9.75
Q2 12	0.9	4.9	1.83	8.50
Q3 12	2.7	4.9	2.02	7.50
Q4 12	4.3	5.0	2.03	7.50
Q1 13	4.9	5.5	1.99	7.50
Q2 13	5.0	5.6	1.97	7.50
Q3 13	4.0	5.4	1.99	7.50
Q4 13	3.0	5.5	1.96	7.50

Source: BBVA Research

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