Brazil: a macroeconomic analysis

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Main messages

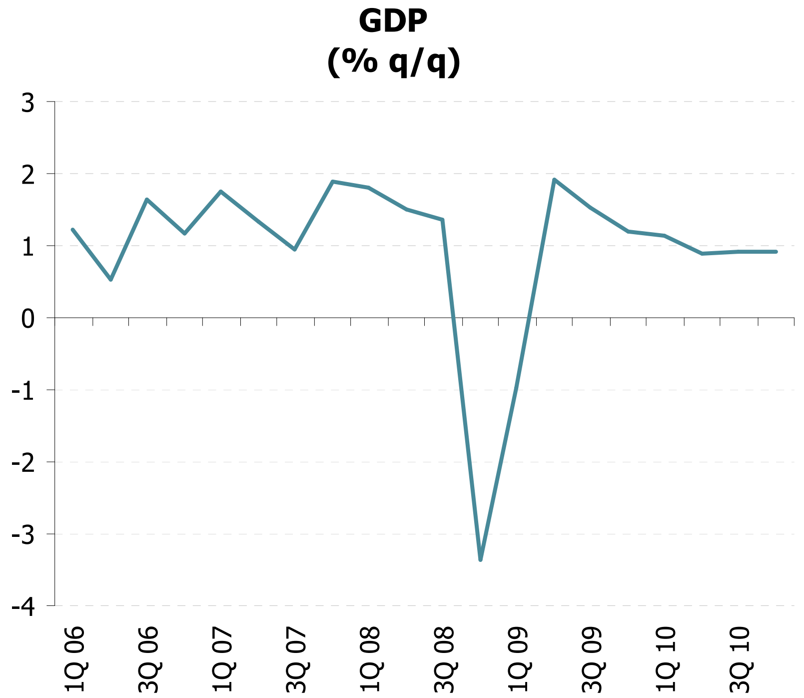
- Current macroeconomic environment: The crisis is over and the country is already growing at pre-crisis pace. The robustness of the domestic demand is starting to drive both inflation and current account deficit high. While the fiscal policy will remain expansive, the Central Bank will soon have to adjust interest rates upwards.

- Positive structural factors: Some factors support a positive view towards Brazil.
  - ✓ institutional stability
  - ✓ the size of the domestic market
  - ✓ the demographic bonus
  - ✓ the strategic position as a commodity producer
  - ✓ the diversification of external markets
  - ✓ soundness of the banking system

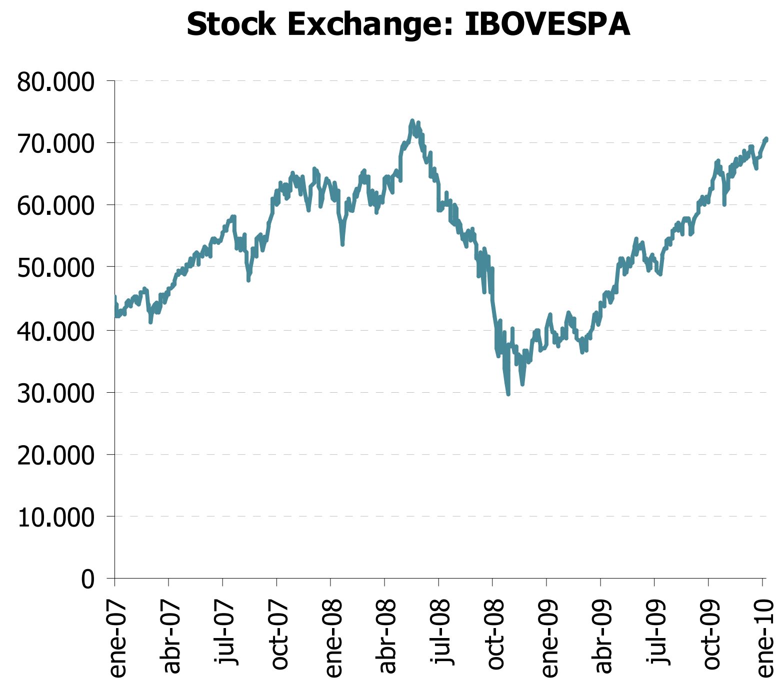
- Risks and challenges: But the current optimism seems to be drawing the attention away from the existent risks and challenges.
  - ✓ excessive public intervention
  - ✓ management of oil resources
  - ✓ low saving rates
  - ✓ slow progress of economic reforms
  - ✓ private sector imbalances

Index

The international crisis had a strong but temporary impact on the Brazilian economy.



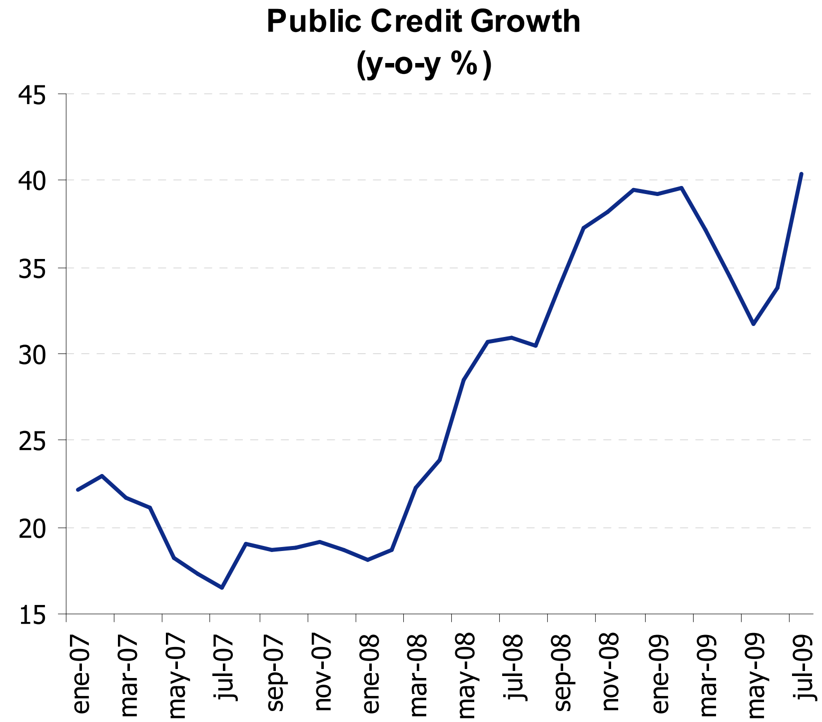
Source: Bloomberg, BBVA



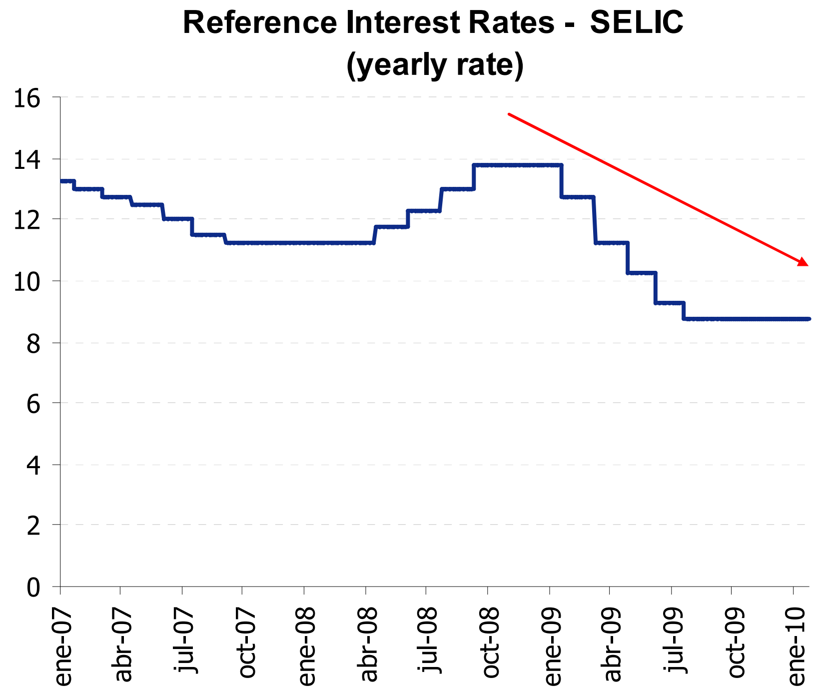
Source: Bloomberg

The GDP dropped two quarters in a row, in Q4 08 and Q1 09, due to a strong contraction of external demand (global trade), a reduction in commodity prices, the deterioration of the perspectives and liquidity problems. However, the economy has been recovering solidly in the last quarters.

Due to structural advances observed in the last years (improved public and external accounts), during this crisis the country was able to implement countercyclical measures for the first time.



Source: Central Bank of Brazil

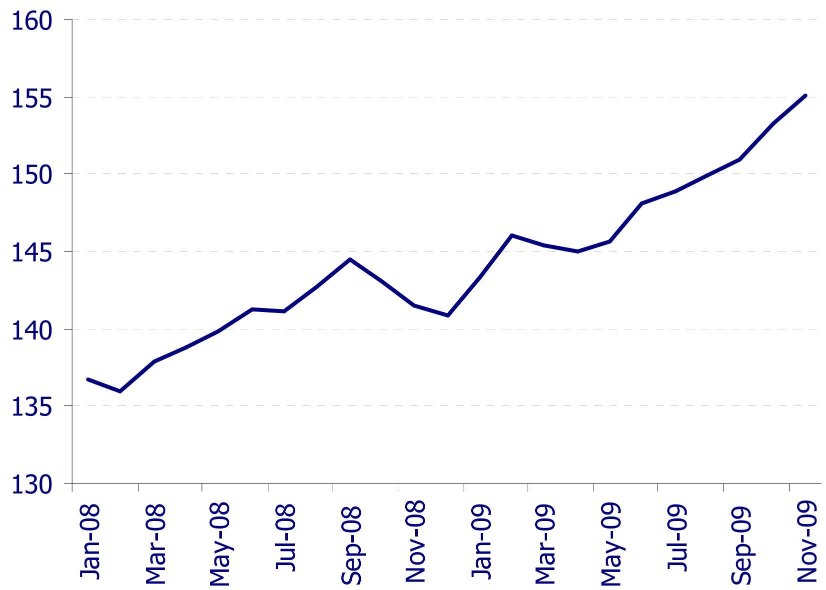


Source: Bloomberg

The government cut taxes and kept expenditures growing at a high pace. Loans from public banks accelerated to compensate for a drop in the loans from private banks. In the monetary front, the Central Bank cut rates to historical lows (8.75%).

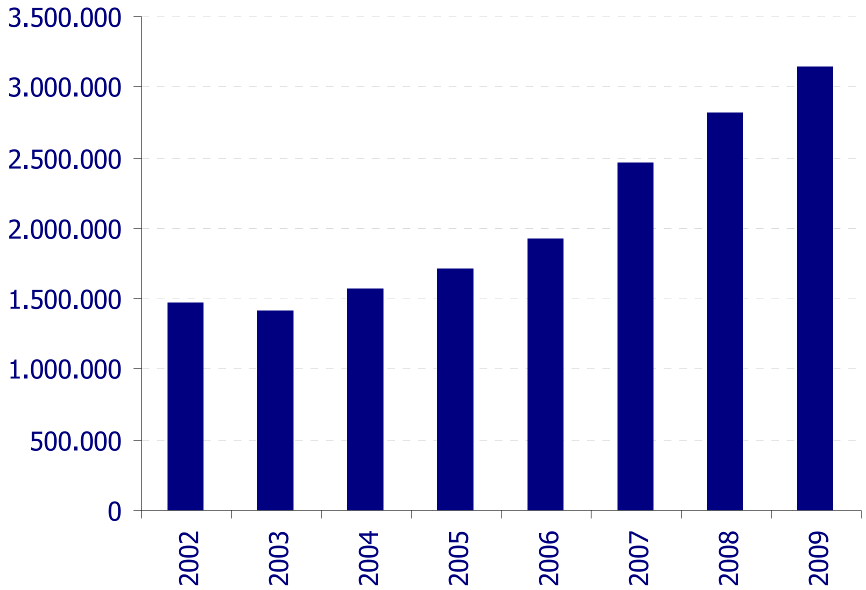
Another important support to face the crisis came from the strength of private consumption. Retail sales, for example, continued to grow strongly despite some initial deterioration. Car sales, for another example, reached the highest levels ever in 2009.

Retail Sales Index (seasonolly adjusted)



Source: IBGE

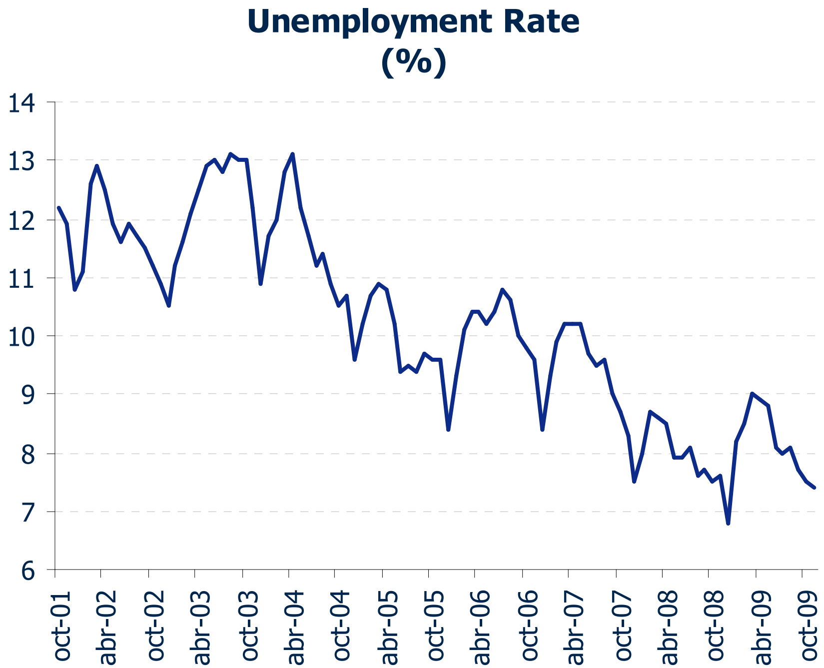
Car Sales (units)



Source: Bloomberg

Many factors contributed to the resilience and the strength of private consumption: availability of credit (currently at 46% of the GDP vs. 24% in 2002), countercyclical measures, improvements on the labor market front and structural advances such as poverty and inequality reductions.

The labor market provided significant support to private consumption. Both the unemployment rate and employment creation deteriorated less than expected and are already recovering very positively.

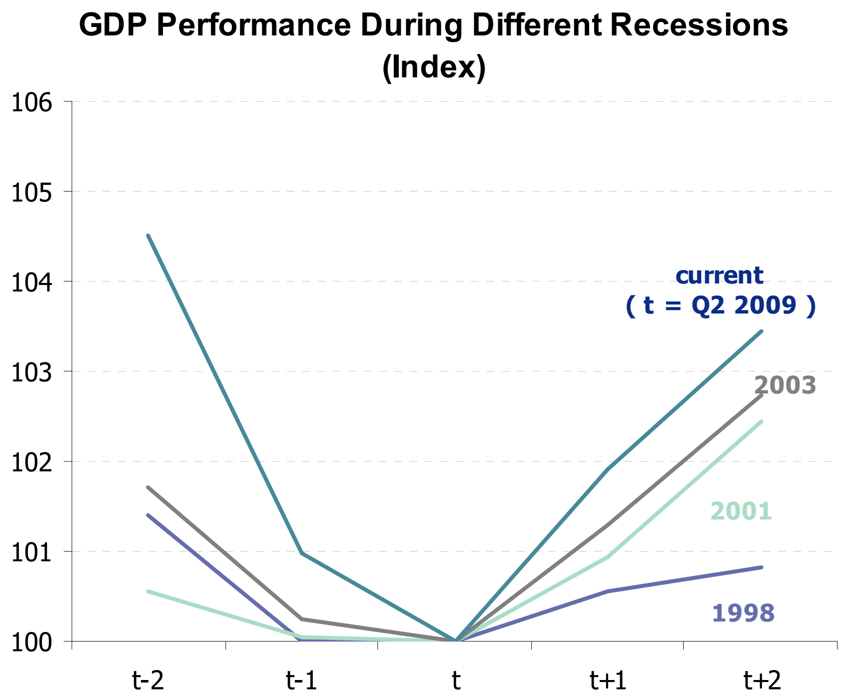


Source: BBVA

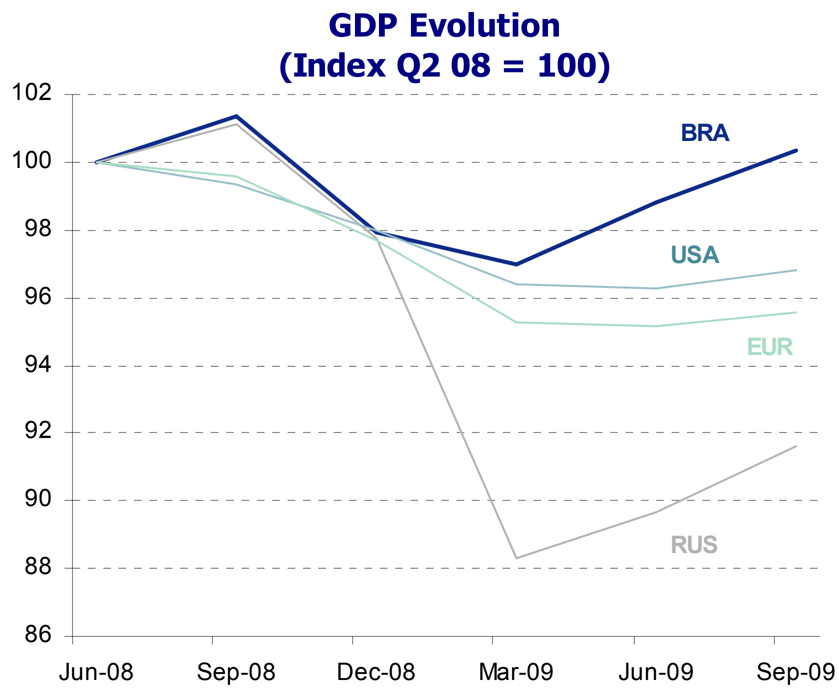
Source: Bloomberg

The unemployment rate is close to historical lows. This is in part due to the reduction in informality rates and in the structural reduction of the equilibrium unemployment rate (NAIRU).

All in all, the country was able to face the crisis better than in the past and also better than most countries.

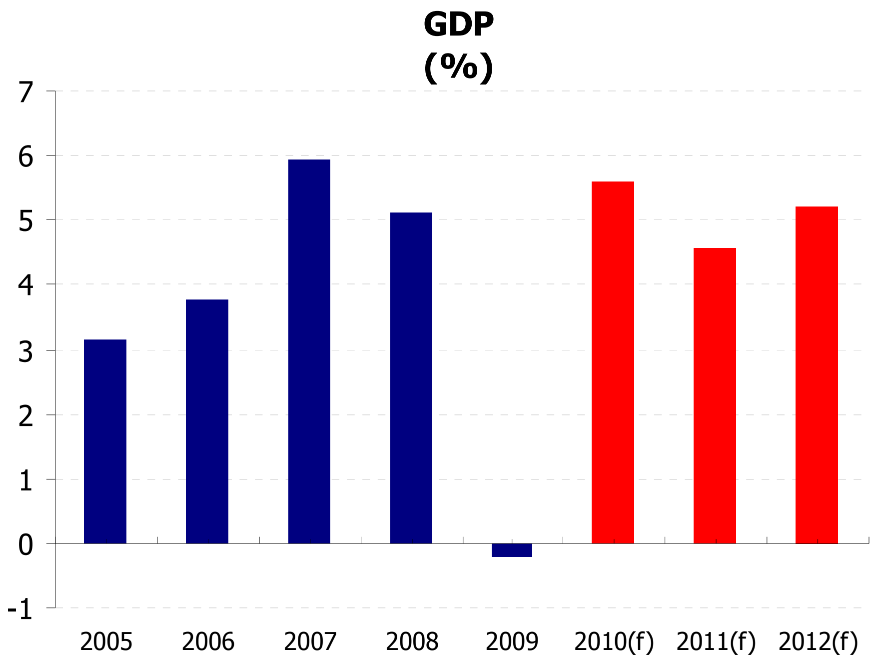


Source: IBGE, BBVA

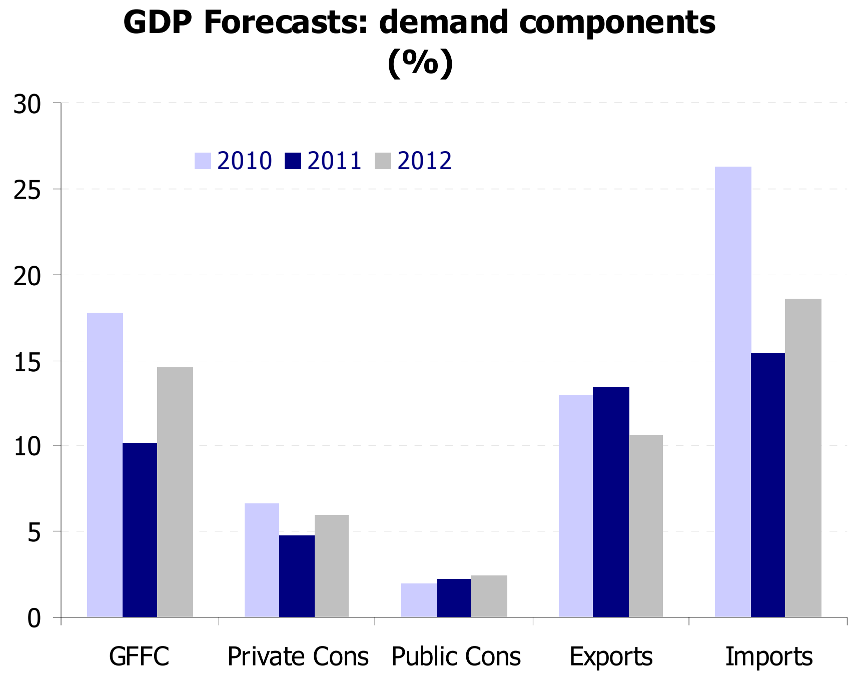


Source:BBVA

The crisis in Brazil is already over. Pre-crisis growth levels were already reached. The main drivers of this good performance are expansion of private consumption and investments.

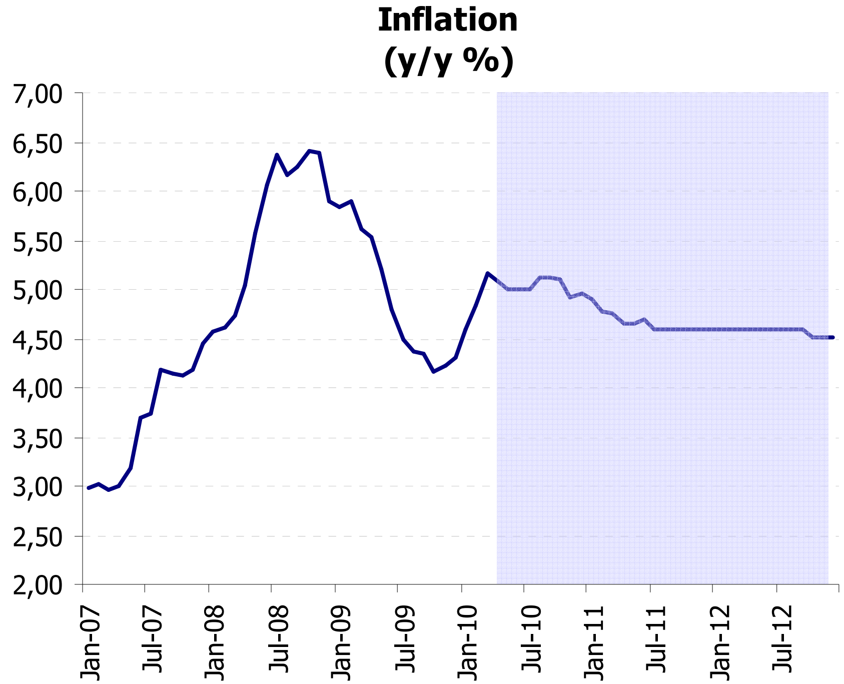


Source: IBGE, BBVA

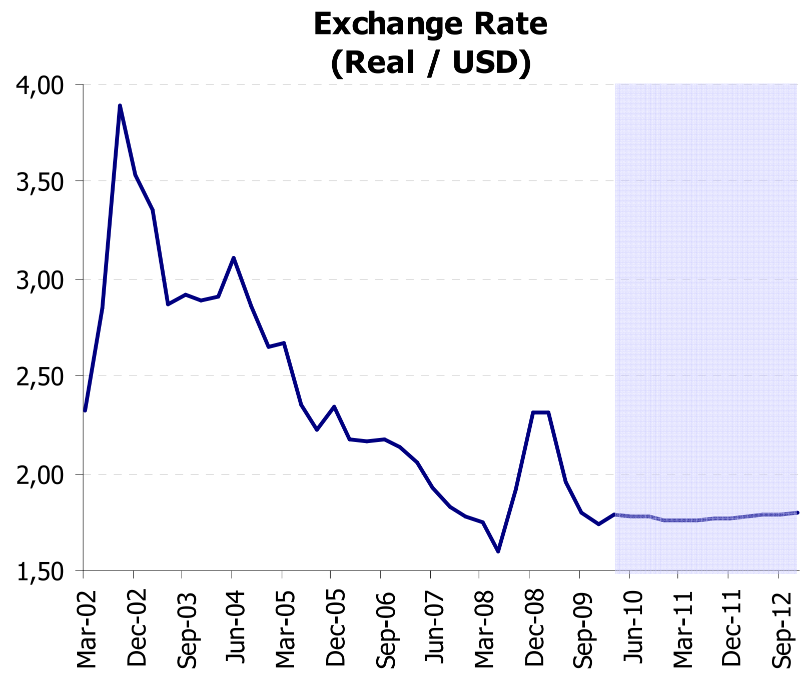


Despite the recent recovery, the GDP dropped 0.2% in 2009. For the next year a strong domestic demand should continue providing support and the GDP should grow slightly less than 6%.

The current dynamism of the economy, stimulated by expansive fiscal and monetary policies, has caused some inflationary pressures. The downward inflation trend observed throughout 2009 is already over. Market's expectations for the end of 2010 are already at 5.1%, above the 4.5% inflation target.



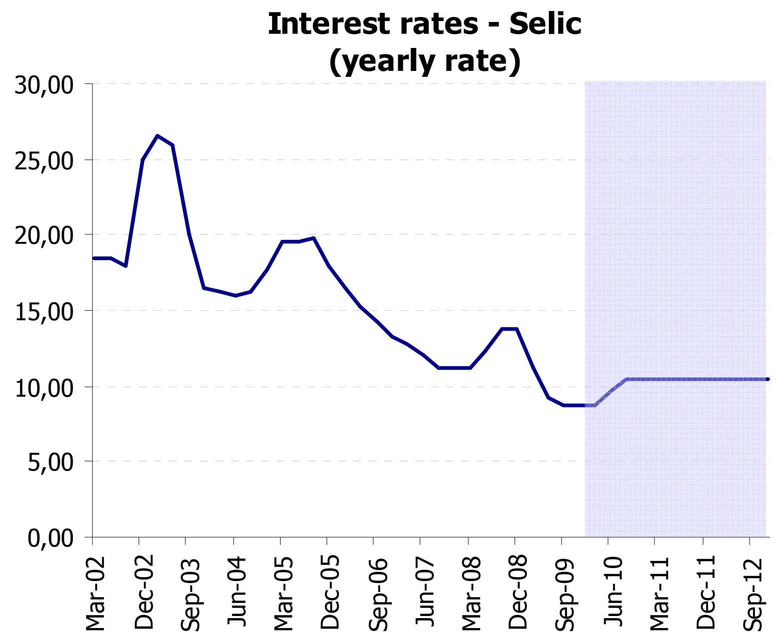
Source: IBGE; BBVA



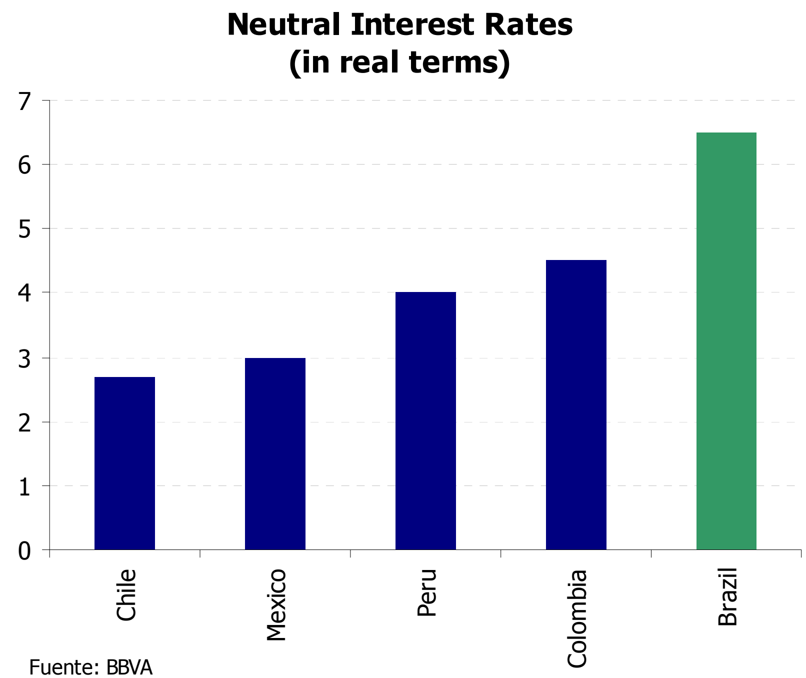
Source: Central Bank of Brazil; BBVA

Strong growth and higher interest rates should put pressure over the exchange rate, but the perspectives of intervention in FX markets by the government, electoral noise and increasing current account deficit should avoid a strong appreciation of the Real, at least this year.

We expect the CB to hike rates in response to higher inflation by 50bps in the April meeting. The adjustment would continue in the next two meetings and rates would reach 10.50% in Q3 10. The inflation is by far the main driver of interest rate decisions although political issues could have a (limited) impact on the decision.



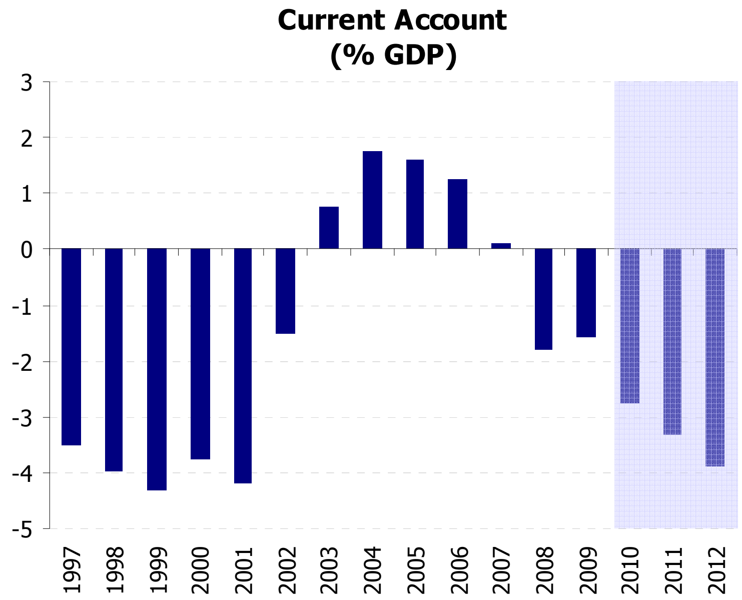
Source: Central Bank of Brazil; BBVA



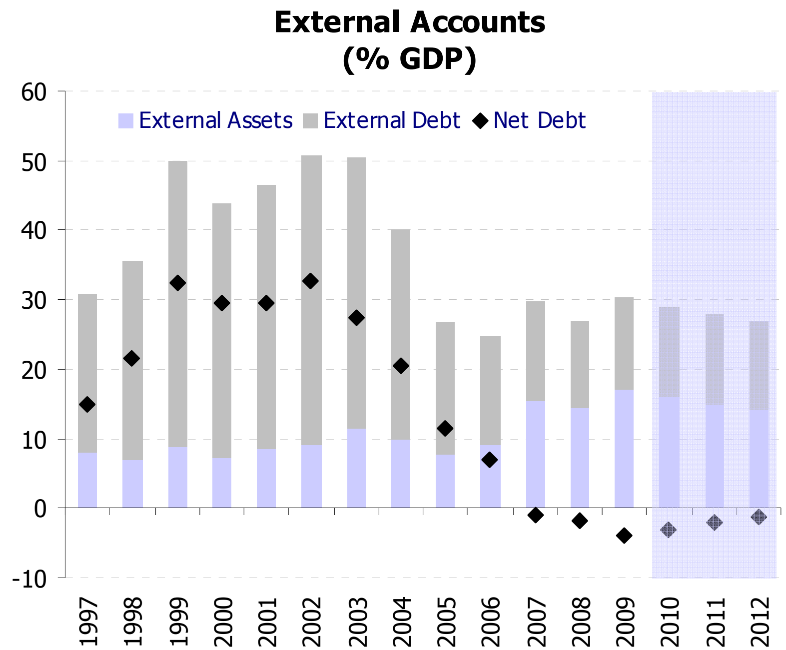
Fuente: BBVA

Although the Selic is currently at historical lows, interest rates continue at very high levels in comparison to other countries.

The dynamism of both public and private domestic demand in Brazil has been leading to a deterioration of external accounts. The current account deficit has started to rise and in 2010 it could easily reach 3% of the GDP after many years of surpluses or limited deficits.



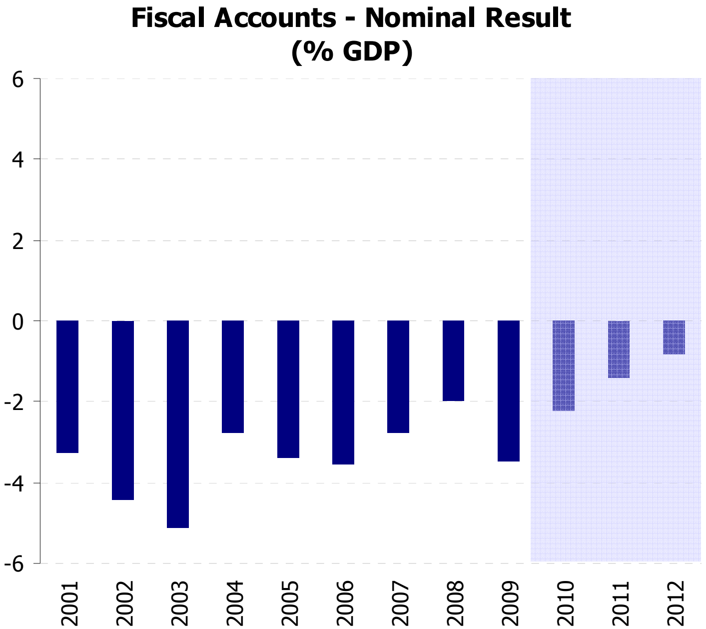
Source: Central Bank of Brazil; BBVA

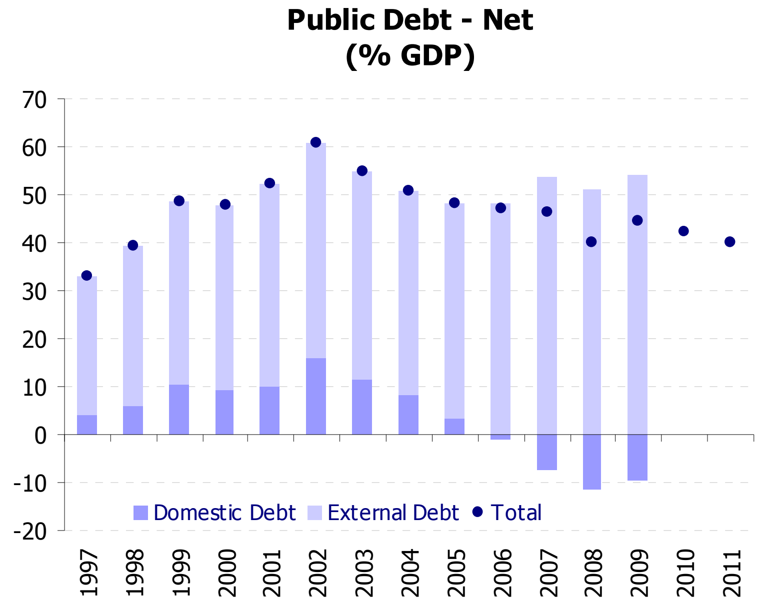


Source: Central Bank of Brazil; BBVA

External solvency is not a risk, as the country is currently a net creditor due to its large international reserves (15% of the GDP). Up to now foreign capitals have been very pleased to finance Brazil's external deficit, but if the mood changes, foreign inflows could slowdown and then the exchange rate would depreciate. External deficits should increase exchange rate volatility in the coming years.

The countercyclical fiscal policy implemented by the government last year worked as a buffer against the crisis but it caused a deterioration of the net public debt. In 2010, the government should be able, with some effort, to reach a primary surplus close to 3% this year. In addition, public debt should return to the pre-crisis downward trend.





Source: Central Bank of Brazil; BBVA

Solvency is not an issue again, but the mix of fast rising expenditures (especially non-investment expenditures) and high taxes creates an inefficient fiscal environment. Increase in current expenditures fuel current account and inflationary pressures and high taxes (40% of GDP) represent a heavy burden for the private sector.

We use a financial programming model to estimate the impact of three exogenous shocks – drop in commodity prices, rise in risk premium, and a currency depreciation – on three external and fiscal indicators.

Brazil - Summary Table Sensitivity Analysis
(percent points difference with respect to baseline)

Exogenous Shock	Fiscal Balance (% GDP)	Current Account (% GDP)	International Reserves / Current Account
10% fall in key commodity prices	-0,15	-0,18	-0,24
100 bp increase in risk premium	-0,40	0,01	-0,70
10% devaluation	-0,04	0,70	1,77

The results show that the deterioration of the fiscal result is more important in the case of an increase in risk premium than in the case of lower commodity prices and than in the case of an exogenous currency depreciation. And even in the case a 100 bps rise in risk hits the economy in the 2010-12 period, fiscal results would continue displaying a downward trend in the forthcoming years. The exercise reinforces our view about the strength of the fiscal accounts in Brazil. On the other hand, external indicators are much more sensitive to a currency depreciation. More precisely, in the event of 10% depreciation in the 2010-12 period, the current account deficit would shrink by 0.7 bps and the indicator "international reserves/current account" would increase 1.77 (i.e. reserves would rise from 4.3 times the size of the current account deficit to 6.0 times). A strong appreciation should, on the other hand, imply a big deterioration of current account but international reserves would still be large enough in comparison to financial needs.

We perform a second exercise to check the sensitivity of fiscal and external accounts to stress periods. This time we construct a risk macroeconomic scenario (growth around 3%, lower inflation and a more depreciated exchange rate which could be the result of a strong deterioration of the external environment) and then check how fiscal and external indicators would change in comparison to our base macroeconomic scenario.

Fiscal and External Indicators under Main and Risk Scenarios (% GDP)

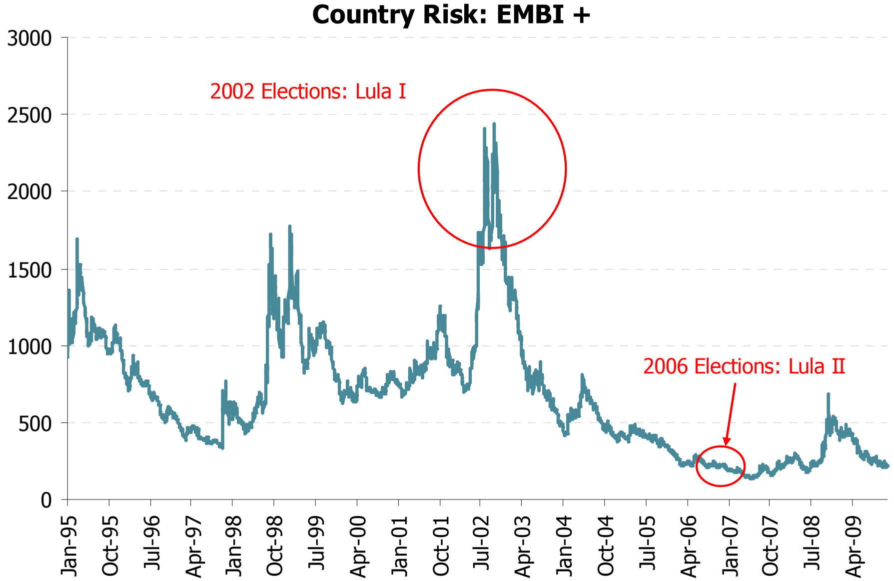
			Forecasts: Main Scenario			Forecasts: Risk Scenario		
	2008	2009	2010	2011	2012	2010	2011	2012
Fiscal Indicators								
Primary Result	3,68	2,14	3,13	3,18	3,37	2,85	2,47	2,21
Nominal Result	-1,98	-3,46	-2,22	-1,34	-0,73	-2,24	-1,69	-1,63
Total Net Debt	39,92	44,54	42,34	40,09	37,07	43,19	42,14	40,63
External Indicators								
Trade Balance	1,58	1,64	0,43	0,11	-0,07	0,62	0,48	0,29
Current Account	-1,79	-1,58	-2,75	-3,31	-3,89	-2,54	-2,75	-3,14
Capital and Financial Account	1,87	4,58	3,56	3,68	4,26	1,79	2,04	2,38
Net External Debt	-1,76	-3,97	-3,13	-2,15	-1,15	-1,80	-0,13	1,60

Source: BBVA

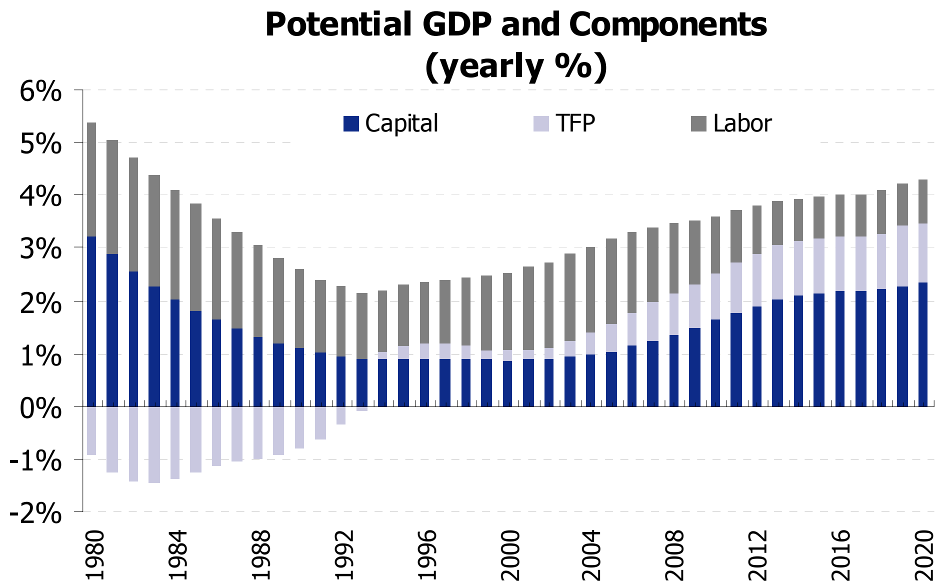
Under this more negative scenario public accounts deteriorate in comparison to the base scenario but both nominal result and total net debt continue to trend downwards. External indicators, on the other hand, improve following the moderation of activity and the depreciation of the currency. All in all, these exercises corroborates the view that neither external solvency nor fiscal solvency ar an issue in the short and medium term.

- Current macroeconomic environment
- Positive structural factors
- Risks and challenges
- Conclusion

1) <u>Institutional stability:</u> The election of Lula in 2002 was a very important test for the country. Since then political and economic stability have been important drivers of Brazil's development.



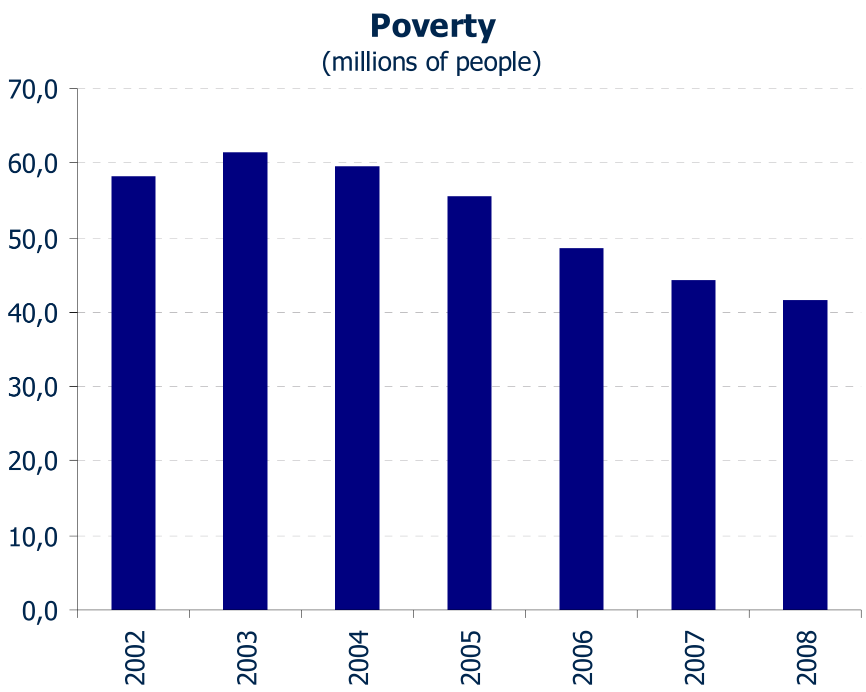
Source: Datastream



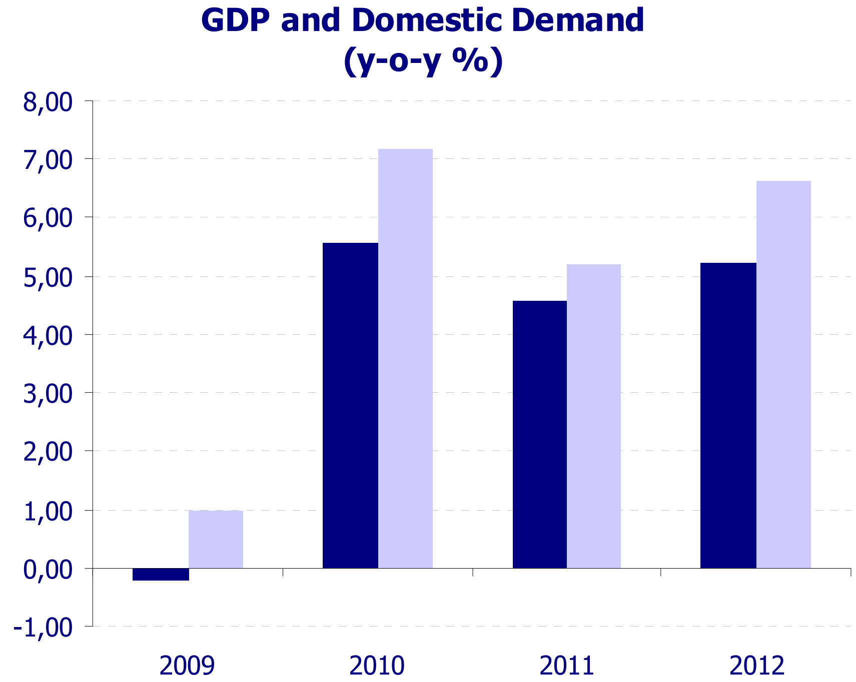
Source: BBVA

On the economic front, the positive performance of the Brazilian economy in the last years is a direct consequence of the option for implementing orthodox economic polices (basically inflation target, a flexible exchange rate and a fiscal discipline).

2) <u>The size of the domestic market:</u> domestic demand is, and will continue being, the main driver of the growth in Brazil.



Source: IPEADATA

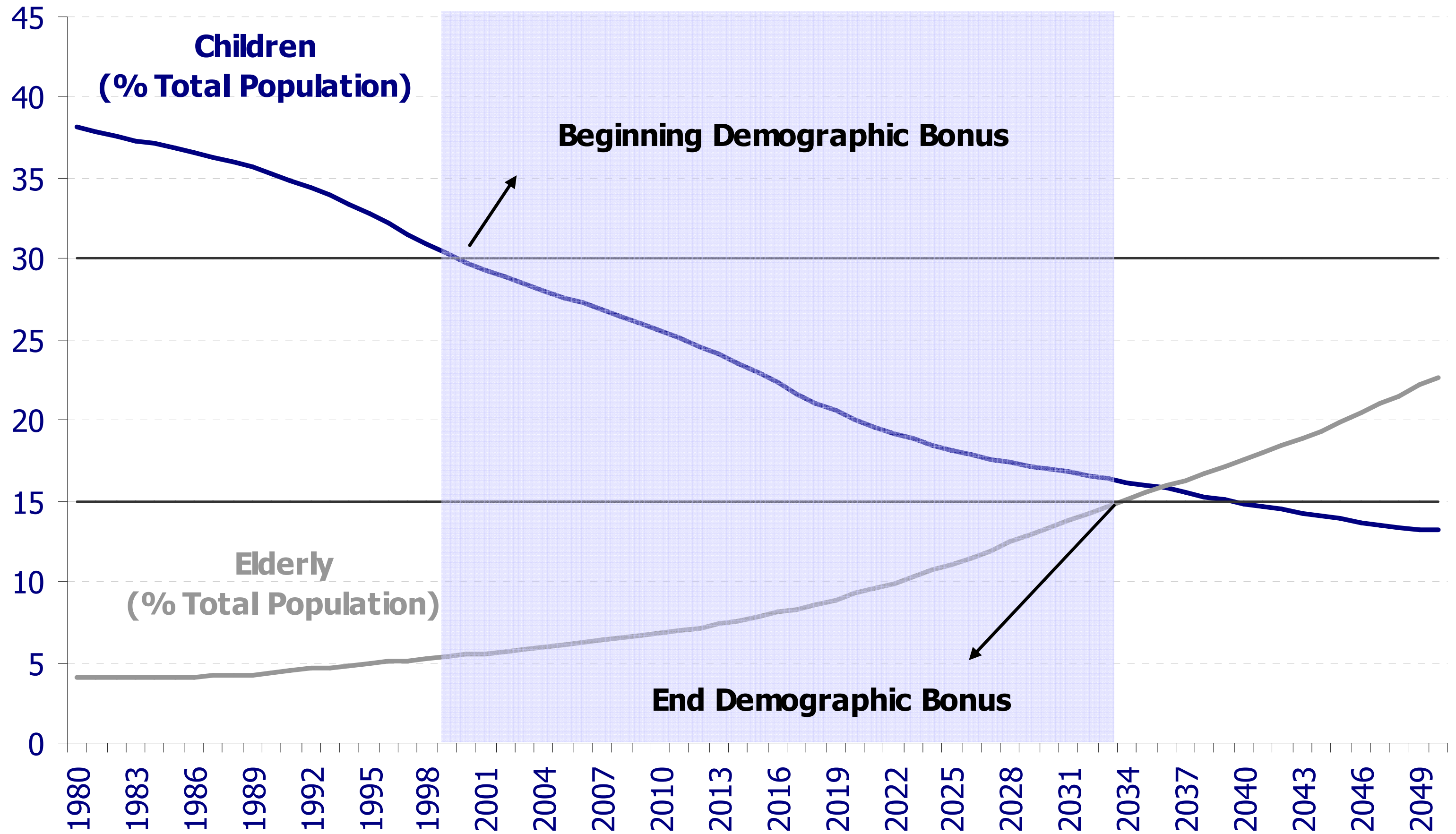


Source: BBVA

In the last 5 years, almost 20 million people left the poverty condition. There are still around 40 million people to be incorporated by consumption markets.

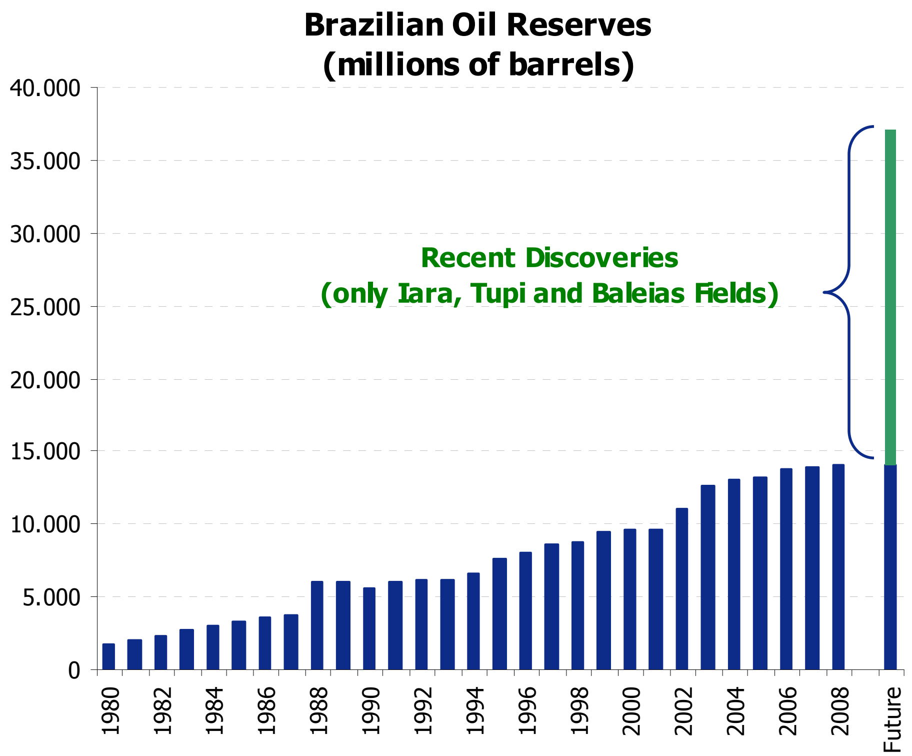
3) <u>The demographic bonus</u>: Brazil is in the beginning of a cycle in which the weigh of both children and elderly in total population is small. The bonus period is estimated to last around 25 years more.

Demographic Bonus



Source: IBGE

4) Strategic position as a commodity producer: as a commodity exporter, Brazil will continue benefiting from high commodity prices.

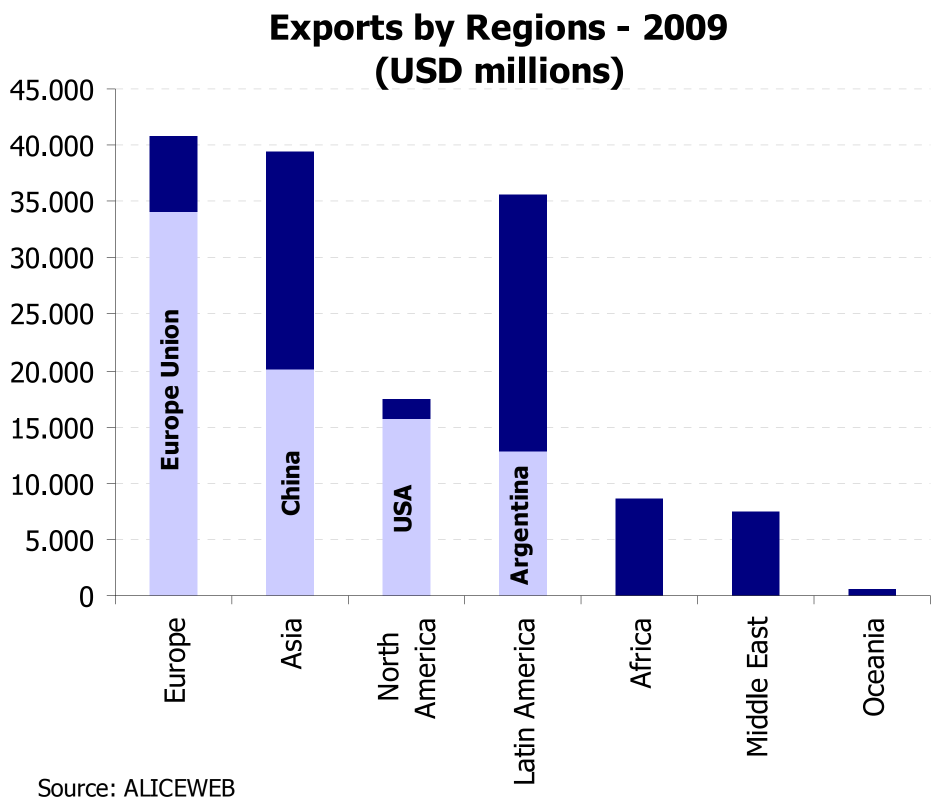


Source: Petrobras, Brazilian Government

Commodity abundance:

- recent oil findings
- comparative advantage in biofuels
- comparative advantage as well as in many agriculture and metal commodities
- abundance of arable land and water

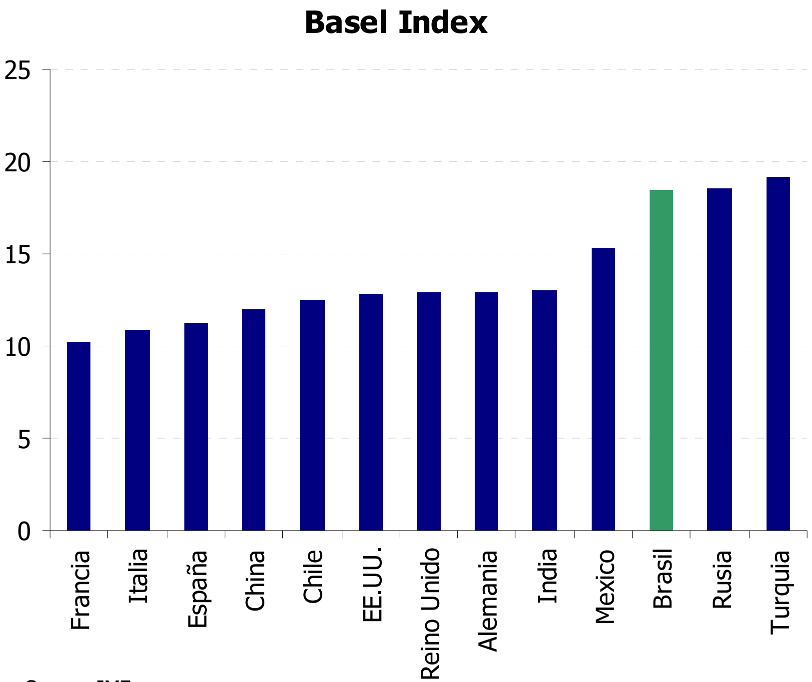
5) <u>Diversified external markets:</u> an alternative explication for the Brazilian resilience against the international crisis is that the country benefited from the dynamism of Chinese economy. Although partial, this explication illustrates the increasing dependence to China. More generally, Brazil's at some extent is being able to balance the dependence of USA, Europe and Asia.



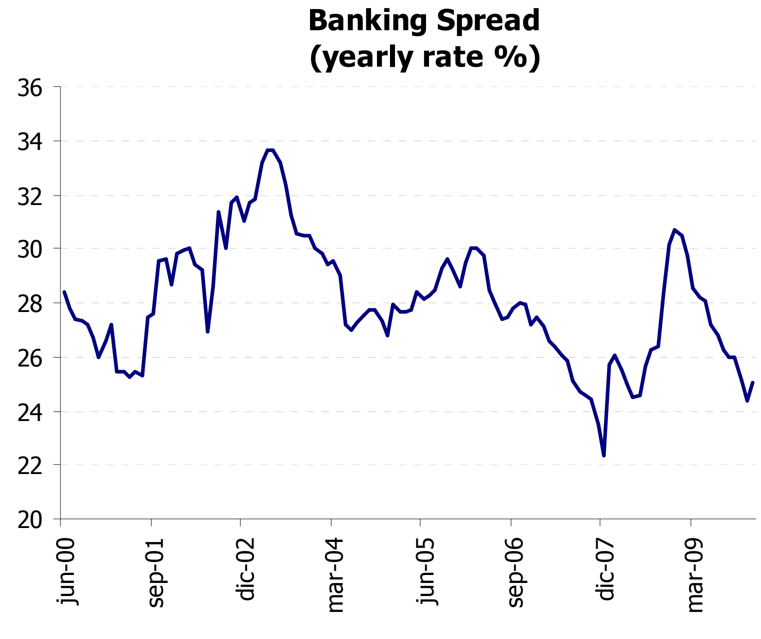
Source: ALICEWEB

Source: COMTRADE. Asia: India, China, Korea and Japan.

6) <u>Sound financial system:</u> Capitalization rates are higher than in the past and higher than in most countries. Leverage is very limited despite some recent expansion. Currency mismatch improved recently but during the crisis banks were threatened by client's exposition to FX derivatives. Current liquidity levels are adequate, but during crisis periods smaller banks are much more exposed than the big ones due to their relatively large dependence on non-deposit funding. In the next years, banks will face an increasing competition in the coming years as banking spreads should continue moving downwards.



Source:IMF



Source; Central Bank of Brazil

Index

- Current macroeconomic environment
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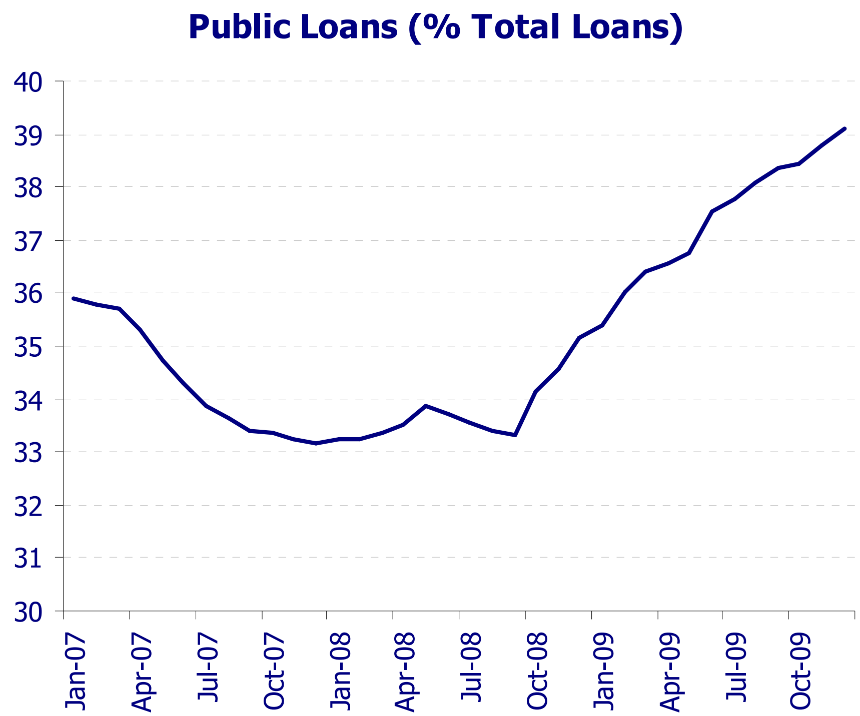
1) <u>Increasing public intervention:</u> As in many other countries, the intervention of the public sector in Brazil has been increasing since the beginning of the crisis.

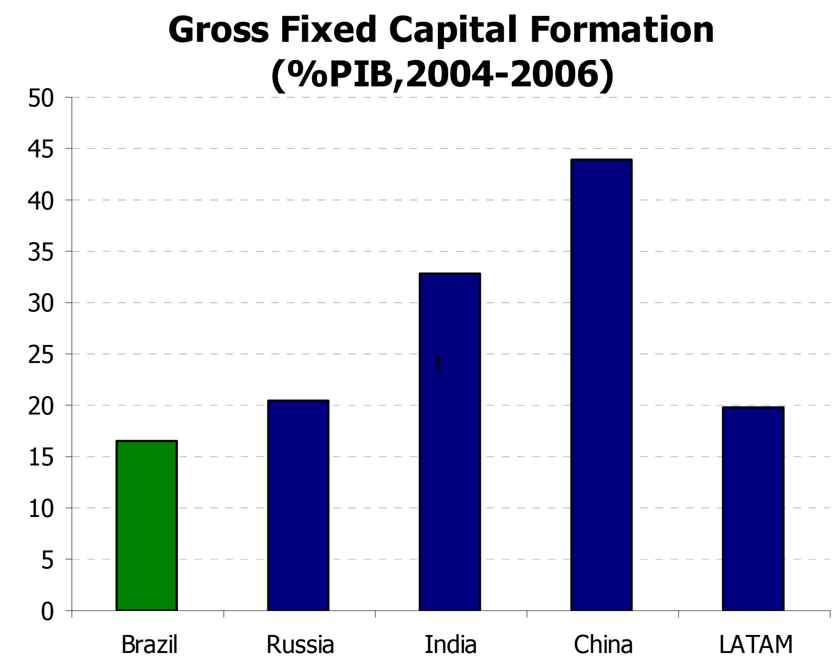


Source: Central Bank of Brazil

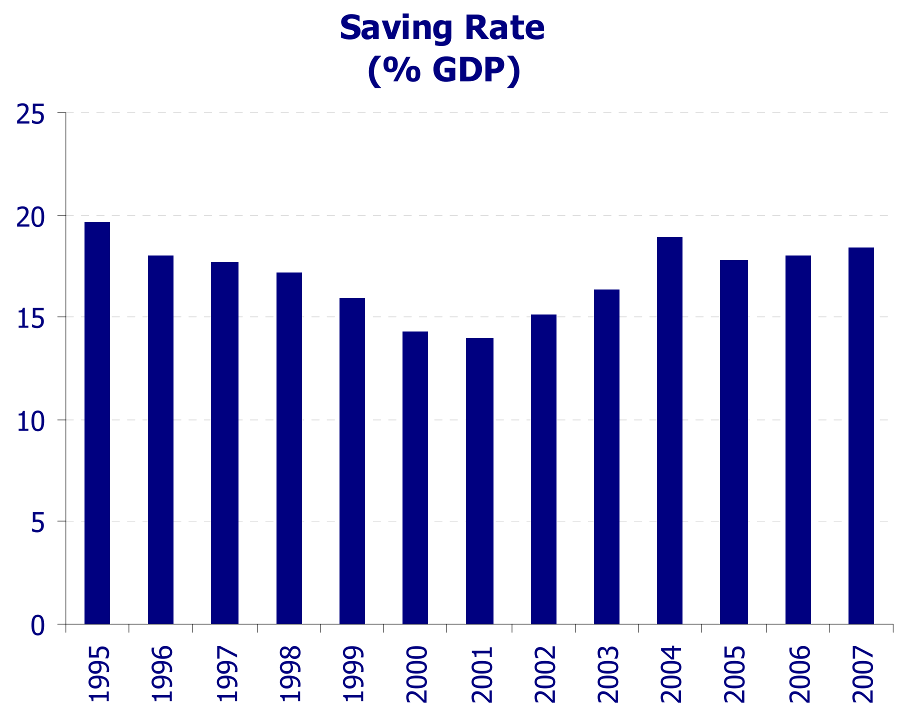
Signs of larger interventionism:

- **Public banks have now a higher share of total credit**
- **Tax on foreign flows**
- **Intervention on FX markets**
- **Public sector's higher role in oil sector production and regulation**
- **Emergence of an explicit industrial policy**
- **Main presidential candidates, especially Dilma Rousseuf, seem to favor a larger interventionism**

2) <u>Low saving rates</u>: public and private consumption rates are very high and therefore domestic saving rates are small and make more difficult a significant expansion of investment levels. External savings arises as an alternative, but it increases the dependence of external capital inflows…

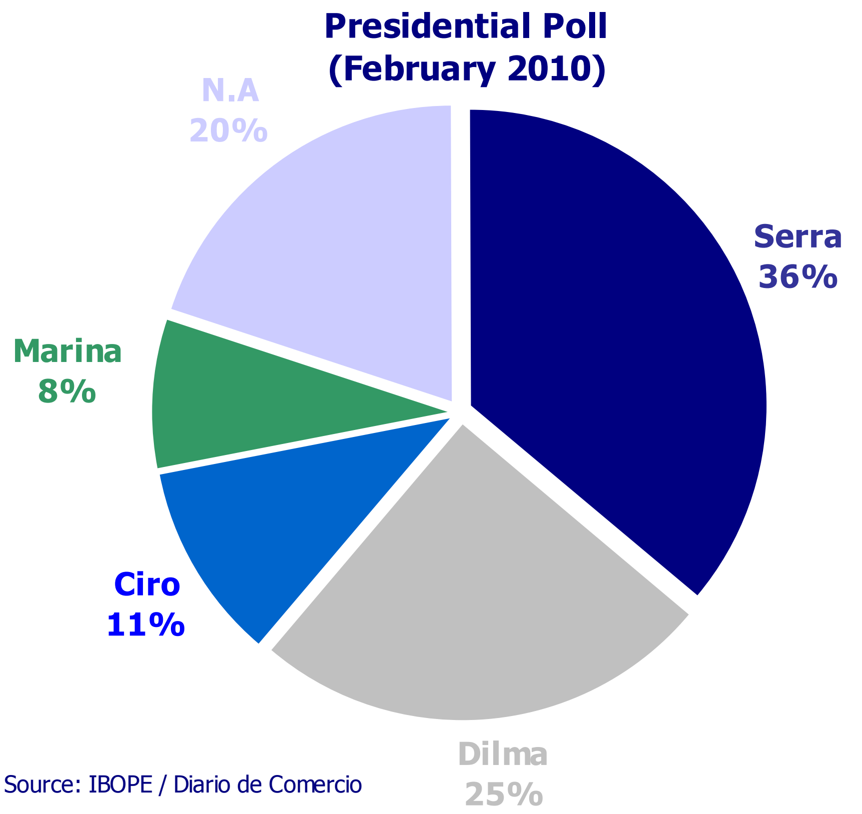


Source:World Bankl



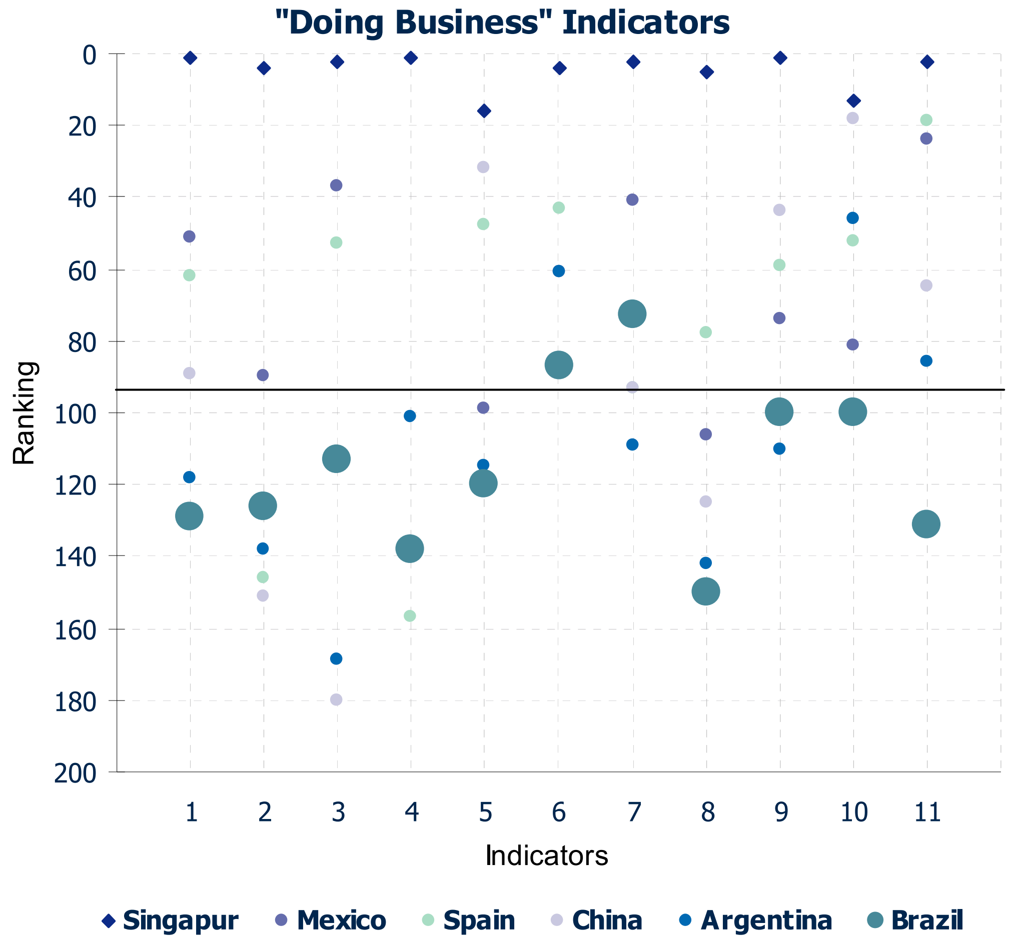
Source: IPEADATA

3) Elections: Presidential elections will be held in October of 2010 and they can potentially add some volatility to financial markets. The main candidates (Dilma Rousseff and Jose Serra) have recently criticized the current economic model and they could favor a more active intervention in foreign exchange markets, or restrictions on Central Bank's independency. The risks associated to presidential elections are not null, but they have diminished compared to the past thanks to a growing consensus about main economic policies. On the other hand it is not clear whether any candidates will be able to implement the economic reforms that are still needed.



Source: IBOPE / Diario de Comercio

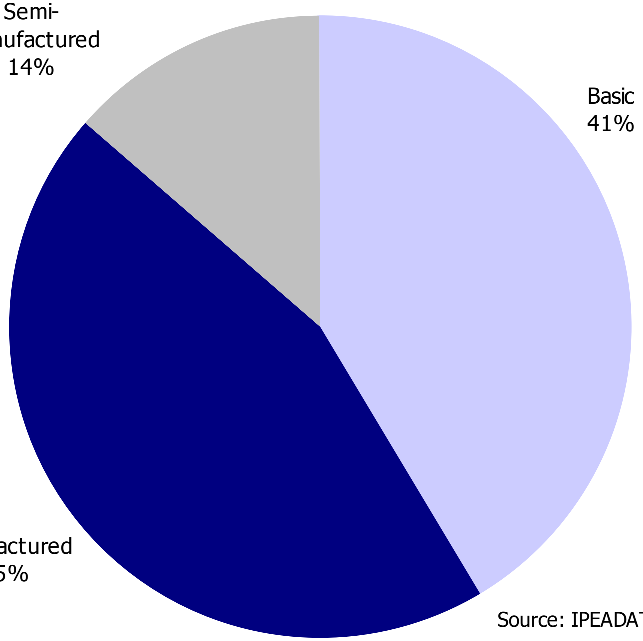
4) <u>Slow progress of economic reforms</u>: the optimism regarding the country seems to have take the attention away from the needed reforms (tax system, political system, pension system, judiciary system…) Some progress has been made, but at a slow rate…



	Indicator
1	Ease of Doing Business Rank
2	Starting a Business
3	Dealing w/ Construction Permits
4	Employing Workers
5	Registering Property
6	Getting Credit
7	Protecting Investors
8	Paying Taxes
9	Trading Across Borders
10	Enforcing Contracts
11	Closing a Business

5) <u>Commodities dependence and management of oil resources:</u> Although less than other Latin American countries, Brazilian exports are very concentrated in basic products. In the last years the share of basic products in total exports is increasing and this trend is likely to continue as the country will continue to feed the Chinese appetite. The perspectives of becoming an important oil exporter also contribute to the "commodity specialization" risk which make the country more sensitive to commodity price fluctuations. Management issues will be especially important as the country will benefit from increasing oil resources which will require an active attitude to prevent rent-seeker activities and to accommodate the interests of different players. It's not clear at this point whether the government will have the required maturity to manage these issues. Another risk associated to oil findings: Dutch-disease.

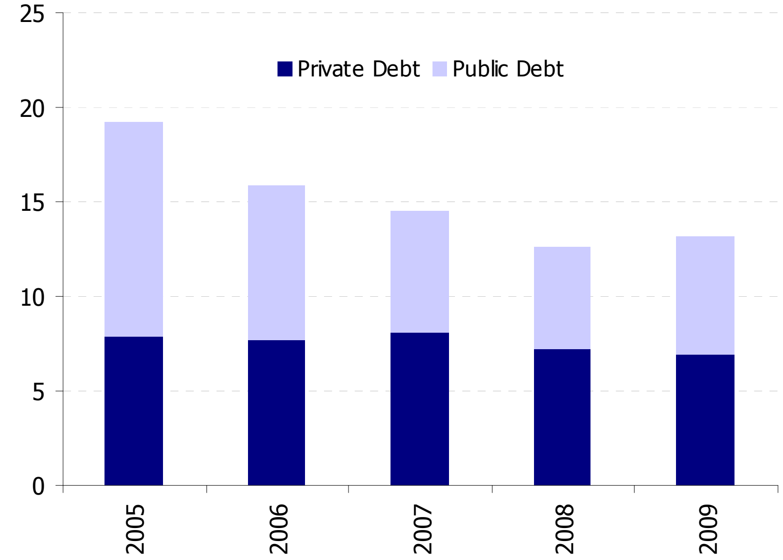
Exports by Products - 2009 (% total)



Source: IPEADATA

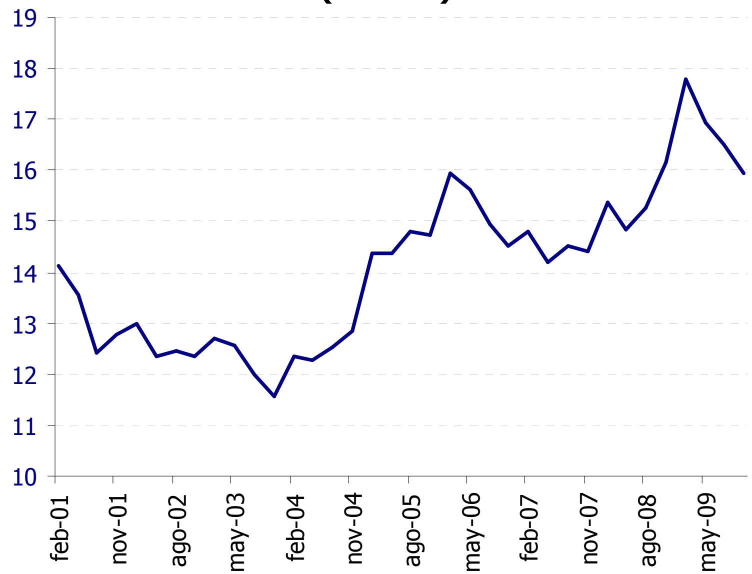
6) <u>Private sector vulnerability to financial shocks:</u> the private sector holds an increasing share of the Brazilian external debt. This and the still precarious management of FX risks (as shown by the recent problems related to exposition to FX derivatives) could be a future source of problems. On another front, despite increasing disposable income, families' debt burden is higher than in the recent past as lending rates continue at very high levels (more than 40% in yearly terms) and as credit continues expanding significantly.

Gross External Debt (% GDP)



Source: Central Bank of Brazil

Families' Debt Burden (% GDP)



Source: BBVA; Central Bank of Brazil

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Conclusion

Positive structural factors: Some factors support a positive view towards Brazil:

- ✓ institutional stability
- ✓ the size of the domestic market
- ✓ the demographic bonus
- ✓ the strategic position as a commodity producer
- ✓ the diversification of external markets
- ✓ soundness of the banking system

Risks : current optimism seems to be drawing the attention away from the risks and challenges.

- ✓ excessive public intervention
- ✓ management of oil resources
- ✓ low saving rates
- ✓ slow progress of economic reforms
- ✓ private sector imbalances

Overall the balance of risks is positive, but the optimism towards the country seems to have taken the attention away from existent risks.