

## Brazil

# Economic Outlook

November 2010

### Economic Analysis

- The new President Dilma Rousseff is widely expected to keep economic policies broadly unchanged. She has already committed to the three pillars of Brazil's economic stability: fiscal soundness, inflation control and exchange rate flexibility.
- The implementation of a tighter fiscal policy – recently hinted by the just elected President – would facilitate the control of both inflation and exchange rate appreciatory pressures. It would also ease the job of the monetary policy.
- The economy is currently moderating after having peaked in the first quarter. GDP is expected to grow by 7.5% in 2010, the highest in 25 years. Growth is likely to converge to around 4.5% in coming years.
- The slowdown in activity in Brazil and abroad, as well as a relatively appreciated exchange rate will help to keep inflation under control. Higher than expected commodity prices or wages pressures could, however, drive domestic prices up. In any case, we don't expect the Central Bank to increase interest rates next year. And yet, more measures to moderate the appreciation of the exchange rate are very likely.
- Fiscal accounts will benefit this year from unexpected revenues generated by the Petrobras' IPO. For the next year, some moderation in fiscal expenditures is expected and this will help public sector's debt to trend down.
- The current account deficit will continue widening and by the end of the next year it should be around 3% of the GDP. This is a variable to keep under watch, because an additional worsening could precipitate depreciations of the real and a tightening of economic policies.

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**Closing date: November 9, 2010**

## 1. Global outlook: slow north, fast south

Global growth continues to be strong, and is expected to reach 4.7% in 2010, and 4.1% in 2011 (Chart 1), mostly unchanged with respect to three months ago. This strong performance is mostly due to strong outturns in emerging economies, which have been less affected by the financial crisis and have thus recovered rapidly. In contrast, renewed cyclical concerns in the US have joined financial concerns still dominating Europe, where macroeconomic and financial adjustments are still pending. Thus, the outlook for the next two years continues to highlight the growth gaps between the advanced north and the emerging south (Chart 2) even if the latter also embarks on a controlled slowdown to ameliorate the risk of overheating.

But there are also significant policy differences inside each of these groups. In the US, monetary expansion is set to intensify in relative terms with respect to Europe (and most other countries), thus depreciating the dollar against the euro and complicating Europe's recovery. In emerging economies, a strong asymmetry in exchange rate policy between Asia and Latin America continues, forcing the latter to bear (together with the euro) a disproportionate part of the exchange rate appreciation derived from renewed monetary easing in the US.

Over the last quarter, relatively weak indicators of economic activity in the US have raised the specter of a possible relapse into a recession –a double dip in economic activity–. The weakness observed in some key sectors that had benefited directly from fiscal support through incentives for purchases (durable goods and housing) is a strong signal that private sector demand in the US still cannot recover at a fast pace. And this is clearly the result of an ongoing household deleveraging process and a weak labor market, which will continue to support higher saving rates than those observed since the second half of the 1990s. Even though this goes in the right direction for the rebalancing of the US growth model, it increases cyclical concerns since consumption (one of the pillars of recovery in past recessions) will remain muted and only partially compensated by stronger investment in equipment by firms.

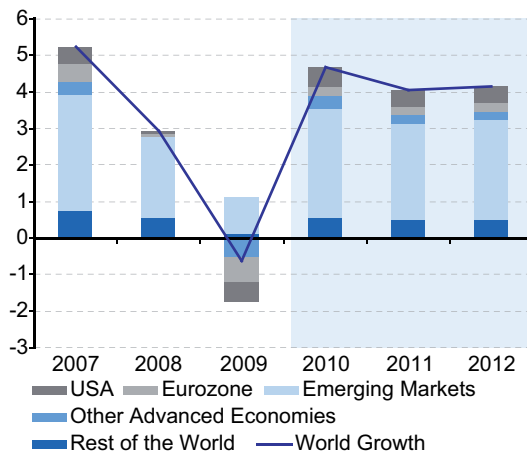
Recent concerns about the health of the housing sector are excessive and the possibility of a relapse into further real estate price drops is very small. There are certainly elements of concern, such as elevated house inventory levels and a possible further supply of housing from new foreclosures, either because of increased delinquencies or because owners walk away from increasingly negative housing equity. But there are also elements of support, such as the huge gains in housing affordability since the crisis started and the demographic trends that should help prop up demand going forward. Thus, the scenario of further price drops is highly unlikely –and in any case the banking system should be able to withstand a moderate drop–, and instead a period of relatively stable house prices seems more likely, while past excesses are finally reabsorbed.

All in all, the drags on consumption and the low probability of further fiscal stimulus –out of concerns about the size of current deficits and especially if there is a change in the balance of power after November's congressional elections– imply an exit from the crisis in the US at a pace much lower than in previous cycles (Chart 3), as we have been forecasting for a long time. But the possibility of a double dip in the US is highly unlikely. In any case, the lack of strength of domestic demand will induce the US more and more to press the rest of the world (especially countries with a current account surplus) to increase their demand and contribute to the necessary global rebalancing. The renewed monetary expansion in the US can be interpreted in this context as one way to force part of this adjustment onto the rest of the world.

After decisive advances in fiscal consolidation, measures to provide support to distressed governments and especially after the financial sector stress tests, there has been a qualitative change in the dynamics of the crisis in Europe. On the one hand, even if average sovereign spreads have remained relatively stable, markets have started to differentiate between sovereign assets, thus reducing the risk of a systemic event. In addition, financial markets have started to open –though selectively– and renewed debt issuance is a further sign of lower tensions.

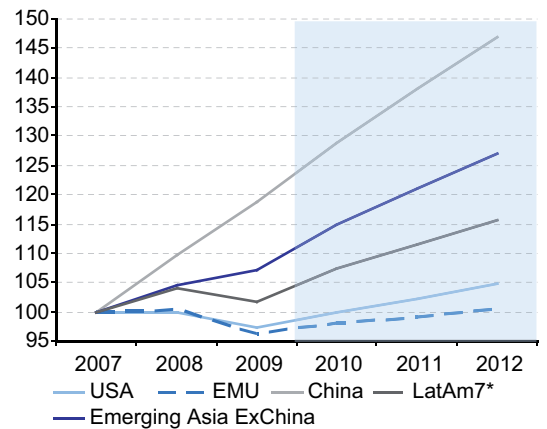
Notwithstanding this, financial market stress in Europe is still the main source of risk for the region (Chart 4) especially given the link between sovereign concerns and risks to the financial sector, and given their national and cross-border exposure. In addition, the recent strengthening of the euro means an added cyclical challenge given that the best performing economies had been supported by external demand. In the short run, this makes it more imperative to tackle the sources of macroeconomic vulnerability in the region, namely fiscal sustainability and external imbalances, as well as avoiding further delays in restructuring the weak part of banking systems. The key is to continue rebuilding confidence to reduce market tensions and rebuild the autonomous strength of private sector demand. In addition, to sustain growth in the long run, it will be crucial to undertake much needed structural and institutional reforms, the latter especially geared towards preventing and resolving future fiscal imbalances.

Chart 1  
**Global GDP growth and contributions**



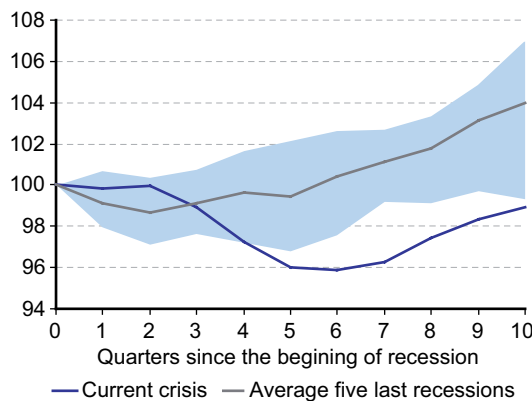
Source: BBVA Research

Chart 2  
**GDP level: 2007=100**



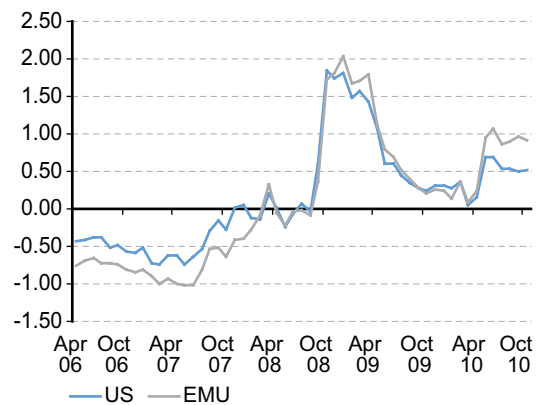
\* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela  
Source: BBVA Research and Datastream

Chart 3  
**US GDP: current cycle vs. previous recessions\***  
**Beginning of each recession=100**



\* Shaded area: range of GDP during last 5 recessions  
Source: BBVA Research and NBER

Chart 4  
**Financial Stress index**



Source: BBVA Research

Prospects of very low growth and subdued inflationary pressures in advanced economies will translate into low interest rates for a prolonged period in the three most important advanced areas (US, Europe and Japan). However, against the backdrop of renewed cyclical concerns and the much-reduced scope for further fiscal stimulus, markets were focused on the US embarking into a new bout of unconventional monetary easing (so-called Quantitative Easing 2, or QE2). The expectation of this further increase in liquidity lowered the exchange rate of the dollar across the board, including vis-à-vis the euro. Going forward, given that most of QE2 has been already priced in by markets, exchange rates should start to move more according to long-term fundamentals, meaning a strengthening of the dollar vis-à-vis the euro on account of better growth prospects and stronger investment inflows. At the same time, appreciating pressures on emerging economies will continue due to increased global liquidity, stronger macroeconomic fundamentals and positive return differentials favoring renewed capital inflows.

Emerging economies continue to grow strongly, with emerging Asia leading the world recovery. In both Asia and Latin America, private domestic demand is taking over policy-induced stimulus as the source of the recovery. Going forward, growth in Asia will slow down as countries try to reign in domestic credit growth, thus reducing the risk of overheating. But the region will continue to contribute the most to global growth.

Both Asia and Latin America confront increasing monetary and exchange-rate policy dilemmas, between cooling strong domestic demand, preventing strong capital inflows, and preserving competitiveness in foreign markets. Some countries have started introducing administrative measures to discourage strong capital inflows and others have slowed their rate of monetary tightening.

Given the inflexibility of exchange rates in Asia (and China in particular), Latin America is facing a disproportionate part of the adjustment, to the point that further exchange-rate appreciations will start to be a problem for growth. Thus, many countries in the region are weighing further exchange rate interventions, although experience shows that their effectiveness is mostly limited to slowing down the rise in exchange rates but not preventing them. The risk is that increased intervention in foreign exchange markets could translate into retaliatory trade measures. This highlights the importance of increased exchange rate flexibility in Asia as a way to provide more policy space to the rest of the world.

## 2. Economic policy under Dilma Rousseff

Lula's candidate Dilma Rousseff was unsurprisingly elected President of Brazil in the second round of elections held a few days ago. She was given 56% of valid votes while her opponent, Jose Serra, was given 44%.

Dilma will take office on January 1st for a four year term. From now until then, the focus of attention will be on the announcements of the members of the new government, as well as on comments about economic policies to be implemented at the beginning of next year.

Continuity in economic policies is widely expected. Dilma has already committed to each one of the three pillars of Brazil's economic stability: fiscal soundness, inflation control and exchange rate flexibility.

Dilma has recently hinted at tighter fiscal policy, addressing concerns that government's expenditures would remain expansive and that fiscal mismanagements could create risks in the medium term. We expect the new government to announce a rule-type policy to be followed during the next four years. This could be, for example, the definition of a goal for the net debt of the public sector (to cut it down from 41% to 30% in the end of 2014 as some have been rumoring) or the announcement of a yearly fiscal result goal more in line with the 3.3% primary surplus goal used recently. In any case, we expect some fiscal moderation to be implemented at the beginning of next year or even at the end of this one.

Fiscal moderation would help GDP to remain close its potential level, therefore keeping inflation under control. This could then take some pressure off of the real and require less intervention in exchange rate markets. In other words, the full commitment to the fiscal soundness pillar would ease the commitment to the other two pillars.

In spite of its positive effects, we don't expect a major fiscal moderation to keep inflation low and exchange rates more depreciated so easily. This would also depend on monetary policy. A tight monetary policy should prevent inflation from increasing significantly but would put more appreciatory pressures on the real (and would then trigger intervention in foreign exchange markets). A lax monetary policy should, on the other hand, keep the real more depreciated and result in higher inflation. This trade-off will be more important if the fiscal adjustment is more limited than what we expect.

The new government's economic team should shed some light on how monetary policy will be used to accommodate both inflation and exchange rate goals. An important sign will be whether the balance of forces between the Central Bank and the Ministry of Economy will be preserved or not. A stronger name in the Ministry of Economy vis-à-vis the Central Bank would imply that risks tilt towards a more accommodative monetary policy.

Independent of the mix of macroeconomic policies, the next government is expected to continue to try to prevent the real from appreciating. If this cannot be done through monetary and fiscal policy, more interventions (such as those recently implemented) will be announced.

The next government is very likely to implement an active industrial policy in line with what we have observed in the last few years. In this sense, public sector activism will continue. On the other hand, the perspectives of some needed economic reforms (such as tax and social security reforms) have improved recently. Their implementation would ease the government's job of achieving fiscal soundness, inflation controls, and exchange rate flexibility objectives.



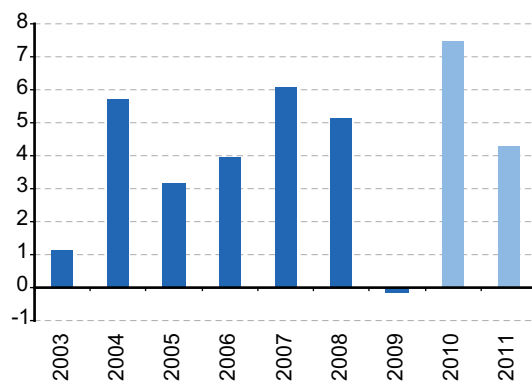
### 3. Strong domestic demand but not so strong domestic supply

The Brazilian economy peaked in the first quarter of the year, when GDP expanded 3.7%q/q, and then started to moderate following the slowdown of central economies and the reversal of the tone of macroeconomic policies. In the second quarter of 2010, GDP grew 1.2%q/q, and in the next two quarters we expect growth to average around 0.6%q/q. This would imply an overall expansion of 7.5% of GDP in 2010.

This year's growth is not expected to be repeated in coming years as Brazilian potential GDP remains constrained in the 4.0%-4.5% range. More specifically, we expect GDP to grow 4.3% in 2011 and 4.6% in 2012.

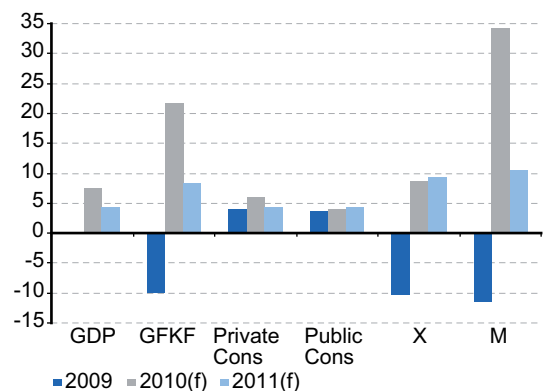
Domestic demand will continue being the main driver of Brazilian growth. Although we expect fiscal policy to be relatively less supportive in coming periods, labor and credit markets should continue to be robust.

Chart 5  
**Brazil: GDP Growth (%)**



Source: IBGE and BBVA Research

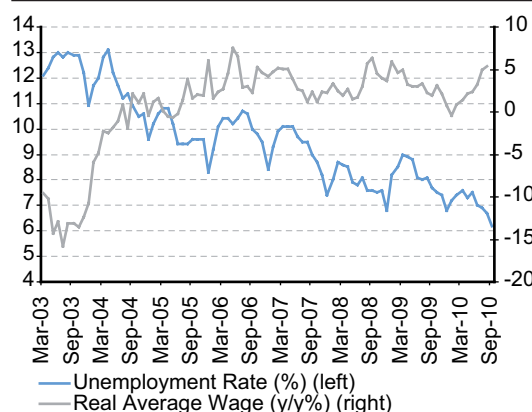
Chart 6  
**Brazil: GDP Growth. Demand Components (%)**



Source: IBGE and BBVA Research

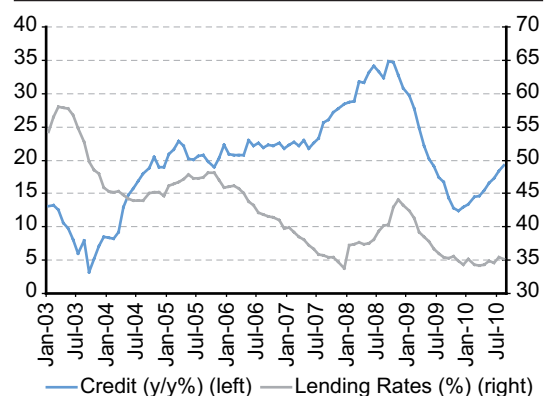
The unemployment rate has been falling continuously since the beginning of 2009 and is now at 6.2%, the lowest since the series started in 2002. Average real wages are currently increasing at around 5%/y/y. From January to September, 2.2 million jobs were created, a record for the period. The share of informal jobs is around 24%, the lowest in many years (it was 31% just six years ago). Credit markets also show a robust and supportive dynamism. Loans to the private sector will not grow as much as before the crisis (35%/y/y in September of 2008) but are already expanding at around 20%/y/y. Credit conditions continue to improve in spite of the recent increments in the SELIC. Lending rates are relatively stable at around 35% in yearly terms, close to historical lows. The average maturity of credit loans is trending upwards and reached 458 days in September. The stock of credit now represents 47% of GDP, another record.

Chart 7  
**Brazil: Unemployment Rate (%) and Average Real Wage (y/y %)**



Source: IPEA

Chart 8  
**Brazil: Credit to the Private Sector (y/y %) and Lending Rates (%)**

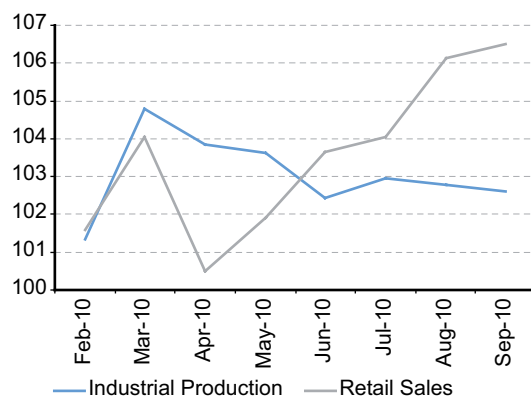


Source: Central Bank of Brazil

Although the dynamism of both labor and credit markets could moderate in coming months, they will continue to drive up domestic demand. More precisely, we expect total consumption to expand 5.4% and 4.3% in 2010 and 2011 respectively. Investments are forecasted to grow 21.6% this year and then moderate to 8.2% next year. The moderation that we expect to take place in the second half of this year and also in 2011 is explained by less expansionary fiscal policies, the lagged impact of monetary tightening implemented this year, and the moderation of global activity. The very low comparative base helps to explain why we expect investments to grow 21.6% this year (investments dropped 10% in 2009) and why we see such a sharp moderation in investment growth rates.

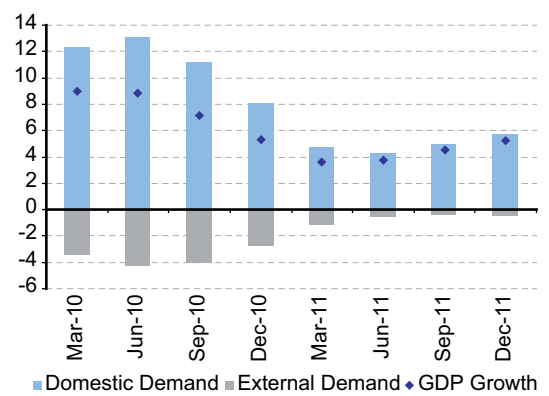
The dynamism of domestic demand is not being (and in coming periods will not be) identically followed by domestic supply. Recent high frequency indicators provide a good picture of the situation. In average, retail sales (a demand-side indicator) expanded 1.2%/m/m in the last three months (and 1.1%/m/m monthly, year-to-date) and industrial production (a supply-side indicator) declined 0.2%/m/m in the last three months (and increased 0.5%/m/m in the monthly average year-to-date). This demand-supply gap, natural for developing countries such as Brazil, is explained by a productive capacity that is constrained by multiple factors such as poor infrastructure, lower human capital levels, a distortionary and inefficient tax system, and by a strong fiscal demand. The appreciation of the exchange rate makes imports more competitive than domestic production in order to help fill the gap with imported goods. If appreciation is limited through FX interventions and capital controls, the adjustment will come through higher inflation.

Chart 9  
**Brazil: Industrial Production and Retail Sales (Index: Jan 10 = 100; SA)**



Source: IBGE

Chart 10  
**Brazil: Domestic Demand and External Demand Contribution to the GDP (y/y %)**



Source: IBGE

According to our forecasts, the contribution of the domestic demand to GDP growth will be 11.9% this year and 4.9% the next year. As we expect GDP to expand by 7.5% and 4.3% in 2010 and 2011 respectively, the contribution of the external sector to GDP growth will be -3.6% this year and -0.7% in 2011.

## 4. Switching the focus of monetary policy?

After few months of stability in the middle of the year, inflation moved significantly up again in the last two months due to some supply shocks and a still too strong domestic demand. Yearly inflation is currently at 5.2% and we expect it to be around 5.3% by the end of the year, higher than the 4.5% target but within the 2.5%-6.5% range used by the Central Bank. For 2011 we expect inflation to average 4.8% (4.9% in 2010) and to close the year also at 4.8%. The moderation of domestic activity triggered by a fiscal tightening and by the lagged effect of the SELIC adjustment implemented recently will help to keep inflation pressures under control next year. The slowdown of international economies and a relatively appreciated exchange rate will also be supportive. In addition, yearly inflation should remain limited, especially in the first half of 2011, due to a high comparison base.

In this inflation environment we expect the SELIC interest rate to be kept unchanged at the current level (10.75%) throughout the next year as we expect monetary authorities to remain mindful of impacts interest rate hikes on the currency. Although the Central Bank could be more tolerant with inflation, a new round of monetary tightening in 2011 should not be disregarded in case domestic prices rise faster than expected (due, for example, to a surge in commodity prices following the announcement

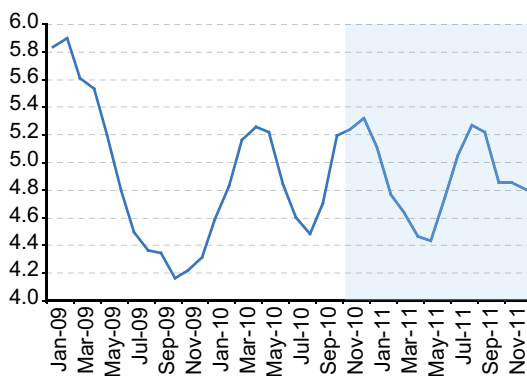
of quantitative easing measures in the US or to wage pressures in the case domestic labor markets refrain to moderate as expected).

Regarding the exchange rate, the recent measures announced by economic authorities (increase in the IOF tax on fixed income from 2% to 6%, increase in the IOF tax on local futures market margins from 0.38% to 6% and the authorization for the Treasury to expand dollar purchases for the payment of external debt) apparently helped moderate appreciatory pressures, even though they coincided with a brief period of USD recovery in global markets. More than the direct effect of the measures, the perception that the government is committed to keeping the real under the 1.70 mark is driving markets.

We do expect more measures to be adopted (Treasury purchases of dollars through the Sovereign Wealth Fund mechanisms, new IOF increased on fixed income, rises in the IOF on equity investments...), especially if the real consistently remains below the 1.70 level. In addition to these measures, the Central Bank should continue actively buying dollars on foreign exchange markets (USD 37 billions were purchased this year from January to October) and paying the price for doing so (see section below). Also, following the “currency war”, we should not disregard the country entering actively in a “trade war” by fostering exports and reducing the competitiveness of imports. On top of all this, some other factors should in our opinion stimulate a relative depreciation of the real in 2011: a limited but not insignificant recovery of the dollar in international markets, a moderation in the domestic economy, a more accommodative monetary policy, and increasing current account related pressures. All in all, we expect the real to be around 1.70 at the end of this year, to average 1.73 in 2011 and to close next year around 1.78. The risks are, however, tilted towards more appreciated levels, given the recently announced quantitative easing measures in the US.

Chart 11

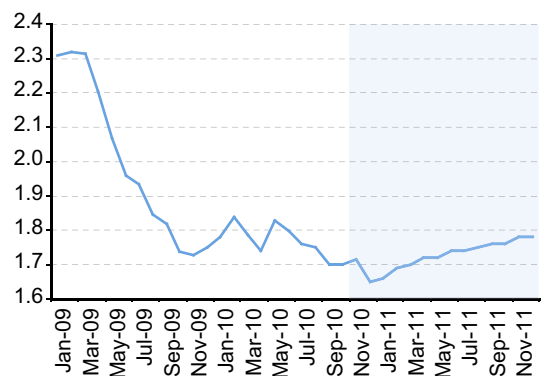
**Brazil: Inflation (y/y %)**



Source: IBGE and BBVA Research

Chart 12

**Brazil: Exchange Rate (BRL/USD)**



Source: BBVA Research and Central Bank of Brazil

## 5. Brazilian twin deficits

The fiscal policies implemented during the crisis and gradually withdrawn during 2010 and the recurrent strength of fiscal expenditures will contribute this year to the expansion of both fiscal and current account deficits.

Although the trade balance will remain positive and at a much higher level than expected some months ago, the strength of the domestic demand in a scenario of weak global demand coming from the advanced countries in Europe, North America and Asia as well as an appreciated exchange rate will drive services and income balance significantly up. More precisely, we expect the trade balance to reach USD 17 billions (33% less than in 2009) by the end of the year and the incomes and balance services to display a deficit around USD 69 billions (30% more than in 2009). International transfers should be around USD 3.5 billions at the end of 2010 and the current account deficit would then reach USD 48.5 billions (2.4% of GDP) doubling the 2009 level (USD 24.3 billions).

For 2011, the current account deficit should continue deteriorating and reach USD 62.5 billions (2.9% of the GDP) as a consequence of a narrowing surplus in trade balance (USD 9 billions) and a widening of the income and services balance.

Although international capital seems at this moment very willing to fund the Brazilian external deficit (we forecast the capital and financial account to reach USD 88 billions and USD 78 billions respectively



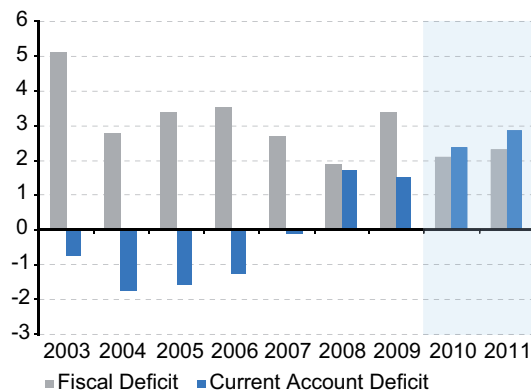
this year and next one) and although international reserves will remain at very high levels (around 14% of GDP), the current account deterioration will increase the risks that a sudden change in the humour of international markets have a very significant impact on the exchange rate with no negligible effects on the real side of the economy (see section below for more on these risks).

On the fiscal side, the capitalization of Petrobras ended up generating an unexpected windfall of resources (R\$31.9 billions; around 1% of GDP) for the public sector in September as the government got R\$ 74.8 billions from the sale of 5 billion barrels of oil to Petrobras and paid R\$ 42.9 billions to increase its share in the oil company's capital. Excluding this exceptional event, in September primary surplus accumulated 2% of GDP in the last 12 months and total fiscal result (including the payment of interests) reached -3.3%. These figures compare poorly with pre-crisis fiscal results: in 2008 primary surplus reached 3.5% and total result, -1.9%.

If we consider Petrobras-related revenues (as official fiscal statistics do), the primary surplus and total result improve considerably to 3% and to -2.4% respectively. The government seems, in this way, able to meet the 3.3% primary surplus target by the end of the year, with no need of any particularly important fiscal control (total expenditures are growing at around 9%/y in real terms. The total fiscal deficit by the end of the year should be around 2.1% of the GDP (instead of 2.6%, as we estimated before without taking in account Petrobras' revenues). For 2011, we expect the primary surplus to be around 3% and total fiscal deficit to reach -2.3% of GDP. These figures will represent, in practice, a higher fiscal effort than in 2010 although they will be worse than this year's results due to the resources generated by the capitalization of Petrobras (an operation with a state-owned company that in practice represents an anticipation of future – and therefore uncertain - oil resources and that raises concerns with the government's fiscal accountability).

Chart 13

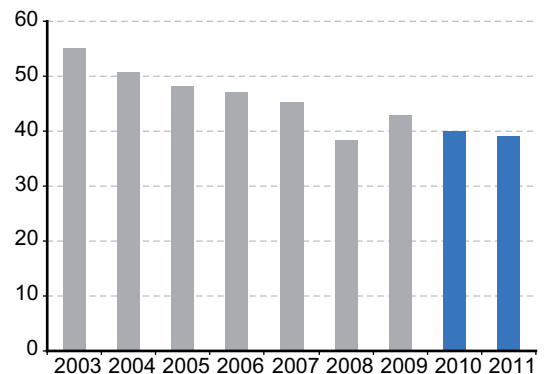
**Brazil:**  
**Fiscal and Current Account Deficit (% GDP)**



Source: BBVA Research and Central Bank of Brazil

Chart 14

**Brazil: Net and Gross Debt (% GDP)**



Source: BBVA Research and Central Bank of Brazil

The strong GDP growth, accumulation of primary surpluses (although less than in the past), and a moderation in the total spent on payment of interest rates should guarantee the total net debt to drop to from 42.8% of GDP last year to around 40% in the end of this year and to 39% in 2011 (close to the 38.4% level observed before the crisis, in 2008).

Net debt's positive trend hides some increasing (and sometimes only implicit) costs related to reserve accumulation, estimated to amount to around 1.5% of GDP. This is due to the fact that reserves are USD-denominated and earn very low interest and are sterilized by bond issuances denominated in reais whose returns are linked to the SELIC. Also BNDES subsidised loans, whose interest rates are much lower than the SELIC paid on the bonds issued to capitalize the development bank, add to the losses. In addition, the total net debt of the public sector, which is the standard debt figure in Brazil, hides other important public sector costs and risks. It excludes transactions between different parts of the public sector as, for example, the capitalization of the BNDES (a state-owned company) by the Treasury that amounts now to 6.8% of GDP in comparison to 1.2% in 2008. The total gross debt of the general government (which excludes the Central Bank and State-owned companies and therefore accounts for some quasi-fiscal costs as the BNDES capitalization) is currently at 59.6% of the GDP, much higher than the net debt. Therefore, although public sector's net debt will trend positively in coming periods, fiscal costs/risks should be watched carefully.

## 6. What if the world economy double-dips?

As the Lehman Brothers crisis showed, the Brazilian economy is nowadays much better prepared to face turbulence than in the past, but the same crisis also demonstrated that the country is not immune to shocks (in spite of all its strengths, Brazilian GDP dropped 0.2% in 2010). Although the main risks for the Brazilian economy seem to be related to a double-dip of central economies, there are also idiosyncratic risks to be watched.

A strong deterioration of the external environment generated by increasing concerns with sovereign problems and financial stress in Europe and also by a significant slowdown of the growth in United States would imply an upward adjustment of global risk-aversion and a weakening of the already weak global demand. The effects of this scenario could then be exacerbated in Brazil by increasing concerns regarding the funding of the country's current account deficit and would force the economy to adjust sharply to the deteriorated situation. This would be done through a forced adjustment in fiscal accounts and by a sharp depreciation of the real (more than through an automatic adjustment of the private demand as in the end of 2008). The monetary policy would not have the same degree of freedom to ameliorate the effects of the shock as in the Lehman Brothers crisis, as inflation could trend upwards (because domestic demand could be relatively stronger than in the last crisis and the exchange rate would depreciate sharply) and the external financial needs would be a constraint.

In this risk-scenario, we estimate that GDP growth could drop almost 4p.p. in comparison to our base scenario for 2011 and then recover gradually until the global environment stabilizes and current account concerns ease.

## 7. Tables

Table 1

### Macroeconomic Forecasts Quarterly

	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11
GDP (% y/y)	-2.1	-1.6	-1.2	4.3	9.0	8.8	7.1	5.3	3.6	3.7	4.5	5.2
Inflation (% y/y)	5.8	5.2	4.4	4.2	4.9	5.1	4.6	5.3	4.8	4.6	5.1	4.8
Exchange Rate (vs. USD)	2.32	2.08	1.87	1.74	1.80	1.79	1.74	1.69	1.68	1.73	1.75	1.77
Interest Rate (%)	12.62	10.33	8.86	8.75	8.75	9.75	10.75	10.75	10.75	10.75	10.75	10.75

Source: BBVA Research

Table 2

### Macroeconomic Forecasts Annual

	2009	2010	2011
GDP (% y/y)	-0.2	7.5	4.3
Inflation (% y/y, average)	4.9	5.0	4.9
Exchange Rate (vs. USD, average)	2.00	1.75	1.73
Interest Rate (% , average)	10.10	10.00	10.75
Private Consumption (% y/y)	4.0	5.9	4.2
Government Consumption (% y/y)	3.7	4.0	4.2
Investment (% y/y)	-9.9	21.6	8.2
Fiscal Balance (% GDP)	-3.5	-2.1	-2.3
Current Account (% GDP)	-1.6	-2.4	-2.9

Source: BBVA Research

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