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Brazil: positive perspectives amid some real risks

Enestor Dos Santos – Emerging Markets Unit, BBVA Research

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Main messages

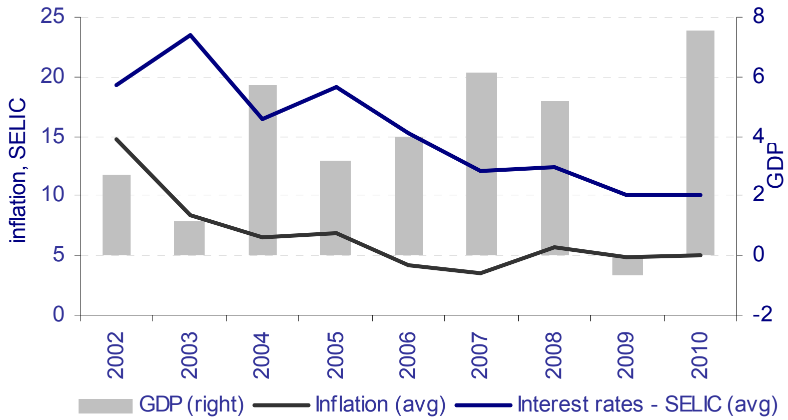
- Macroeconomic, political and institutional stability have set the basis for a significant improvement in economic performance over the past few years: GDP grew at an average 4.0% with stable and relatively low inflation, supported by structural improvements such as those related to fiscal and external accounts.
- The outlook for the country is positive: Brazil is expected to grow at an average 4.5% during the next decade and to be the third largest emerging country in terms of contribution to global growth.
- Brazil's robust performance has contributed to creating a sense of excessive optimism attracting large capital inflows. Those inflows have led to a very strong appreciation of the Real, which –together with very strong domestic demand –is putting pressure on the current account deficit. Fortunately, that deficit is still moderate thanks to the unusually good terms of trade and the very strong demand of commodities from Asia, especially China.
- If domestic demand kept growing over potential, a worsening current account would make the Brazilian economy vulnerable to a correction in commodity prices or to a reversal in capital inflows during the next couple of years. If markets force a sudden and large depreciation of the Real a host of negative feedbacks may follow.
- These macroeconomic short-term risks seem manageable and the most likely scenario is for an orderly correction of current misalignments.

Robust economic performance

Macroeconomic, political and institutional stability set the basis for a significant improvement in macro performance in the last years

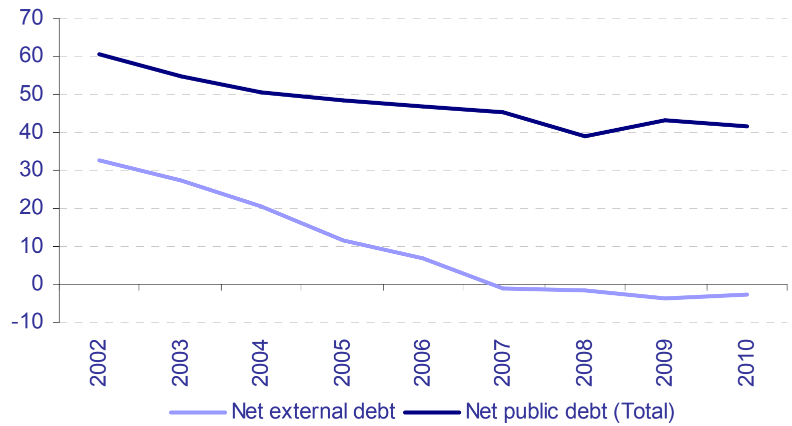
- The control of inflation and the continuity of orthodox economic policies based on fiscal consolidation processes and the reduction in public debt, the build up of a strong Central Bank committed to maintaining price stability, and the opening up of the economy under a flexible exchange rate system resulted in a significant improvement of Brazil's economic performance over the last decade.
- Economic stability and GDP growth were supported by a positive adjustment of fiscal and external accounts in the last decade.

GDP, inflation and interest rates



Source:Central Bank of Brazil

Fiscal and external debt (% GDP)



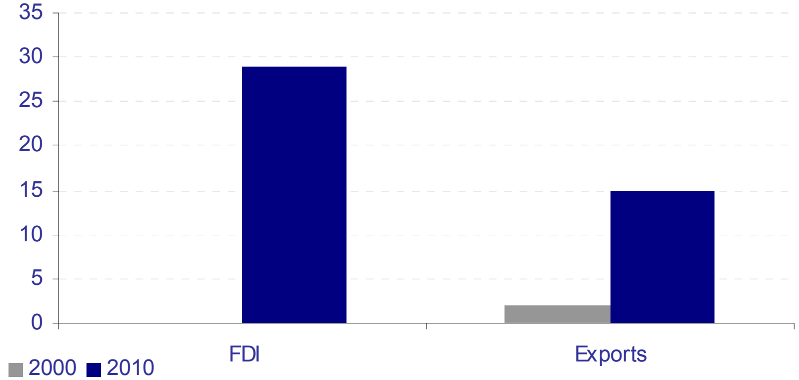
Source:Central Bank of Brazil

Robust economic performance

The country also benefited – and will continue to benefit – from emergence of China and its strategic position as commodity producer

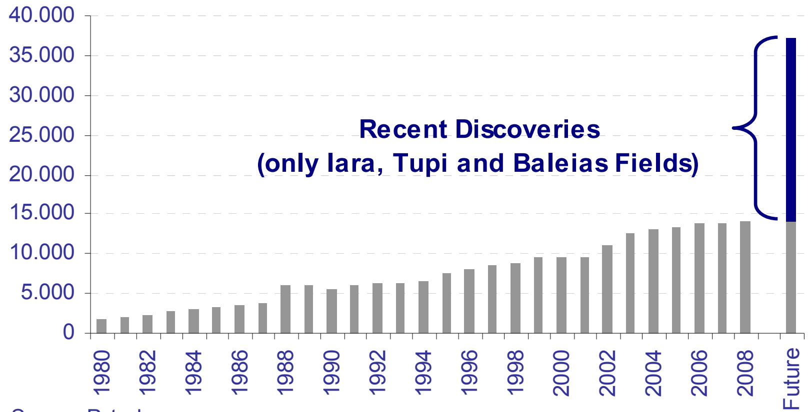
- China is one of the drivers of the recent macroeconomic performance.
- The country is a key player in commodity markets, and one of the few highly diversified commodity producers. It is already an important producer of biofuels, metals and agricultural products. Following recent oil findings, the country is set to have the 8th largest oil reserves in the world.

Share of China in FDI inflows and in total exports (%)



Source:ALICEWEB; Central bank of Brazil

Brazilian Oil Reserves (millions of barrels)



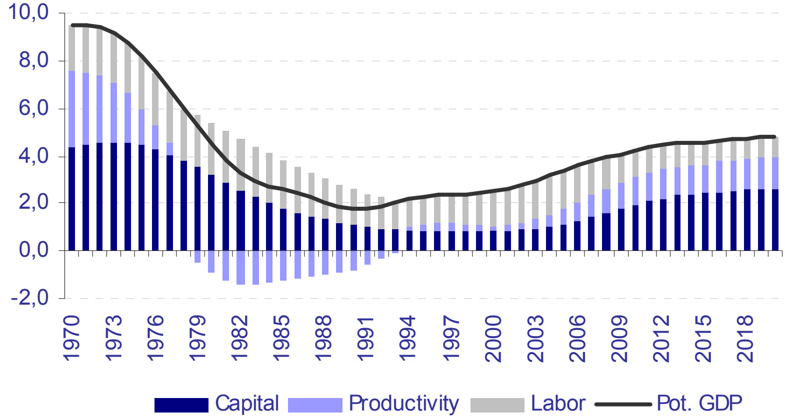
Source:Petrobras

Positive outlook

The outlook is positive as main domestic and external drivers will continue on place during the next decade

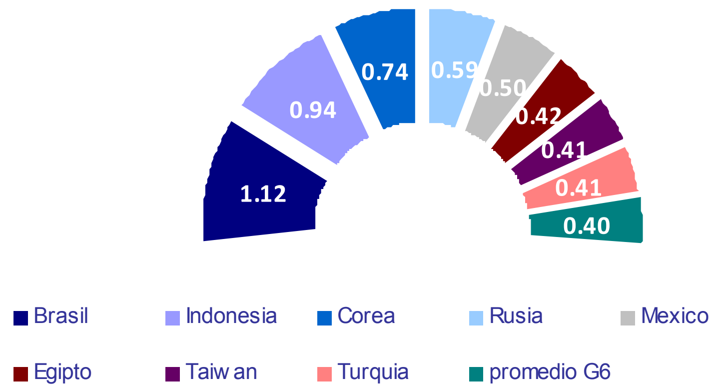
- Between 2010 and 2020, Brazil will grow around 4.5% per year and contribute with USD 1.1 trillion to world growth, making Brazil the third largest emerging country in terms of contribution to global growth.
- By 2020, the number of people whose income will be enough to demand durable goods and financial services (USD 800 per month) will move up to 36 million, from 22 million in 2010
- Other strengths: largest extensions of unused arable land in the world; an impressive potential for producing different types of energy; a diversified economic structure in which commodity sectors accounts for only 10% of GDP; demographic bonus.

Potential GDP (%)



Source:BBVA Research

Incremental GDP in trillions USD adjusted by PPP between 2010 and 2020



Source: BBVA Research

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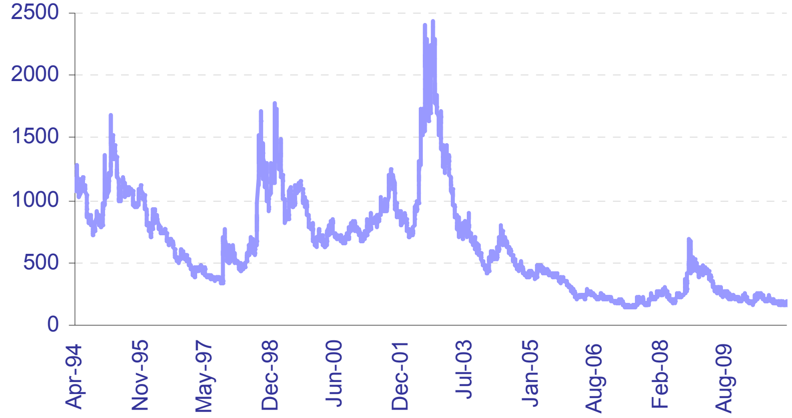
Some real risks

Recent economic performance triggered major reductions in risk premiums and capital inflows

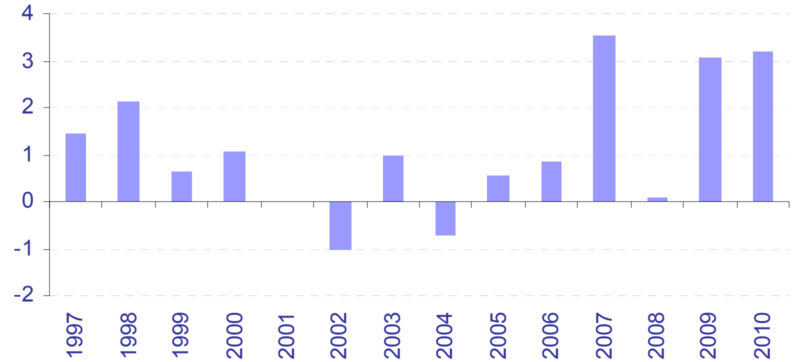
- Markets and credit rating agencies alike have rewarded the economic progress of Brazil in the last decade through major reductions in risk premiums and awarded “investment grade” to Brazil in the first half of 2008
- The overall process of macroeconomic progress and risk reduction since the beginning of 2003 induced a significant increase in foreign capital inflows to the country.

EMBI+



Source:Datastream

Net Portfolio Investments (% GDP)



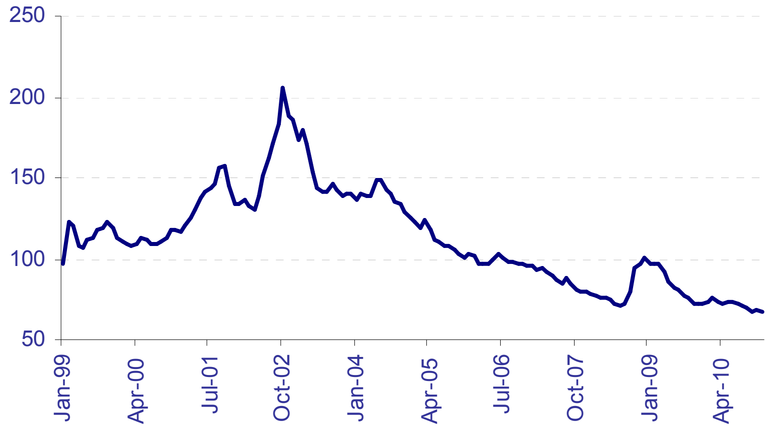
Source: Central Bank of Brazil

Some real risks

In this optimistic environment, the Real appreciated strongly in the last years

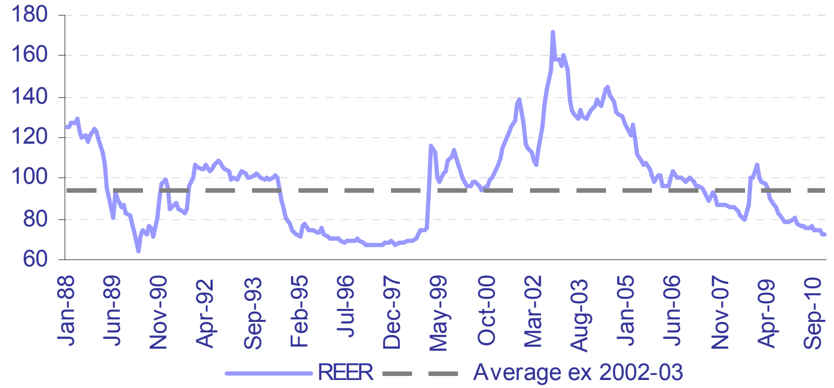
- At the end of last year the real was about 25% above the average value for the period 1988 – 2010, even when excluding the unusually depreciated period 2002-2003.

Real Exchange Rate - Index: BRL vs. USD



Source:Central Bank

Real Effective Exchange Rate (Index Jun 94 = 100)



Source: Central Bank of Brazil

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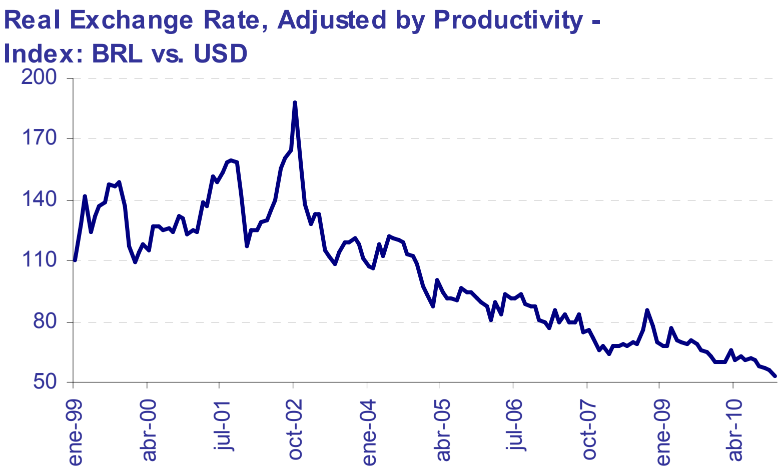
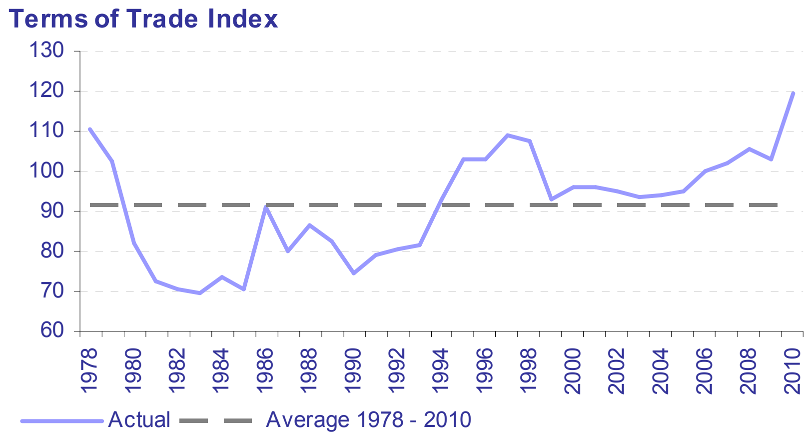
Some real risks

The current exchange rate reflects extraordinarily high terms of trade

- During the last years commodity prices had a major positive influence on terms of trade which at the end of 2010 stood 36% above the average for the period 1988-2010
- If exceptionally high terms of trade were to stand forever, the current real effective exchange rate could be consistent with the new equilibrium, but if terms of trade revert to the historical average, then the exchange rate should depreciate.



Source:Central Bank of Brazil



Source: IPEADATA

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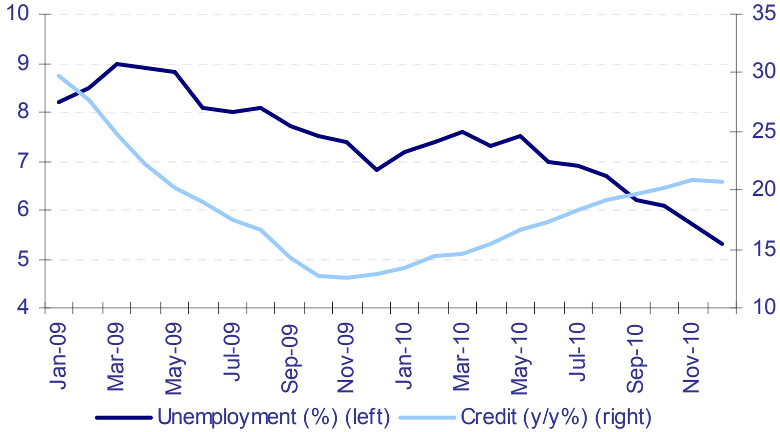
Some real risks

The country is facing a problem of overheating

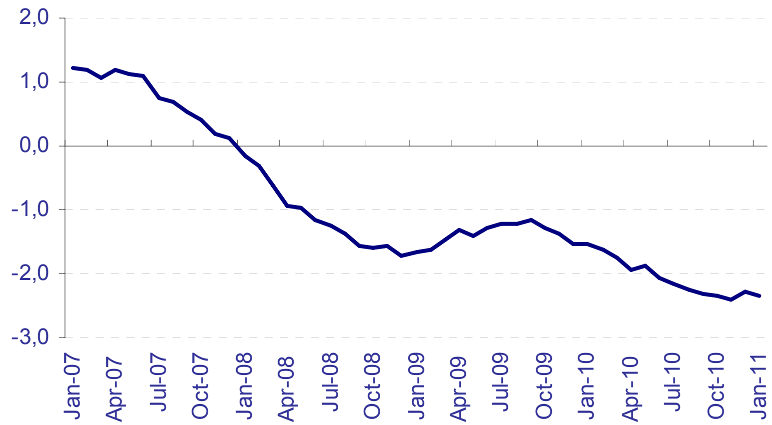
- The combination a large fiscal stimulus after the 2008 crisis, an expansionary monetary policy, together with aggressive lending by public banks in a context of favorable terms of trade and capital inflows have caused a major expansion of domestic demand (above 10% in 2010) and led inflation to rise above the official targets.
- The current account deficit has been rising (from very low levels) in a context of rising terms of trade.

Unemployment Rate and Credit Expansion



Source:Central Bank

Current account (yearly, % GDP)



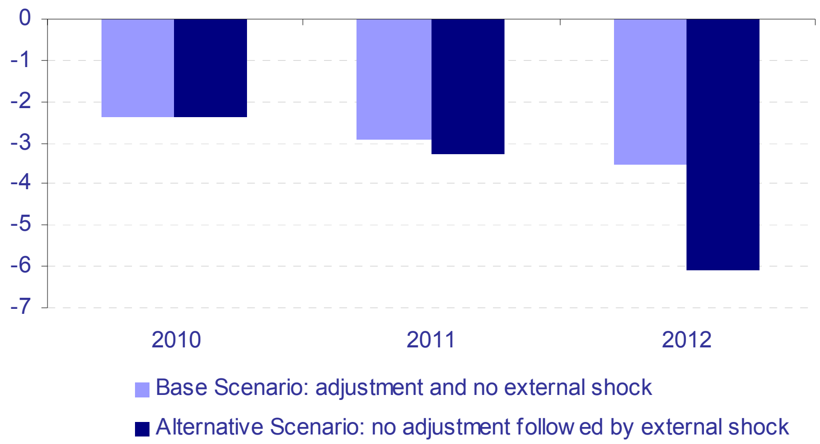
Source:Central Bank of Brazil

Some real risks

If domestic demand kept growing over potential, a worsening current account would make the Brazilian economy vulnerable

- If domestic demand refrains from moderating the country would be very vulnerable to a correction in commodity prices or other external shock
- Excessive intervention on exchange rate markets and measures to control capital inflows could also trigger a sudden correction of current misalignments
- If markets force a sudden and large depreciation of the Real a host of negative feedbacks may follow

Current Account (% GDP)



Source:BBVA

Risk scenario: commodity prices revert back to historical levels

- risk premiums would go up
- markets to force a major depreciation of the real
- sharp adjustment of domestic demand
- negative impact on credit and banking system

Orderly correction of misalignments

Risks seem manageable and the most likely scenario is for the currently very strong domestic demand to moderate

- Policy makers seem committed to slow domestic demand down and keep overheating risks under control

Fiscal policy

- Fiscal cuts mounting to 1.2% of GDP were announced
- Good sign after loose fiscal spending policy of the last few years
- They will complement counter-cyclical monetary policy's efforts, different from 2010
- More fiscal adjustments required to improve mix of macroeconomic policies

Monetary policy

- SELIC rates being adjusted up from 10.75% to probably 12.25%
- CB is relying more on macro-prudential measures to control credit growth
- Price stability seems not to be anymore the unique variable of attention. New Central Bank?
- Higher uncertainties

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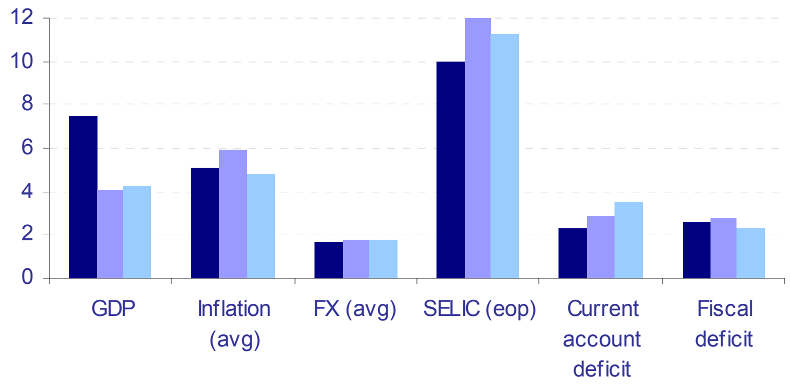
Orderly correction of misalignments

Economic activity moderation to take some steam off inflation, exchange rate and current account deficit

- Macro policies should bring GDP to around 4.5%, in line with Brazil's potential growth. Domestic demand will continue being the main driver of economic activity.
- Productivity to improve gradually following robust growth of investments and continuous – although very slow – implementation of economic reforms.
- In the medium-term the country will start to benefit from oil resources.
- Our base scenario assumes some reduction in commodity prices.

Current baseline forecast



Source:BBVA Research

Exchange rate perspectives

- Current misalignment to be gradually and orderly corrected in coming years due to:

  i) moderation of domestic demand

  ii) lower interest rates

  iii) lower commodity prices & global liquidity

  iv) productivity gains
- BBVA Forecasts (eop):

2011: 1.72; 2012: 1.78; 2013: 1.82; 2014: 1.85; 2015: 1.88

BBVA Research's forecasts

	2003-10	2010	2011(p)	2012(p)	2013(p)	2014(p)	2015(p)
GDP (%y/y)	4,0	7,5	4,1	4,2	4,4	4,5	4,5
Private consumtpion (%y/y)	4,5	7,0	4,4	4,6	4,9	4,9	4,9
Public consumption (%y/y)	3,2	3,3	3,1	3,2	2,9	2,8	2,8
Investments (%y/y)	7,1	21,8	8,9	7,1	8,7	8,7	8,7
Exports (%y/y)	6,0	11,5	7,3	7,1	8,2	8,2	8,2
Imports (%y/y)	12,3	36,2	12,1	9,3	11,2	10,4	10,4
Inflation (avg)	6,46	5,04	6,10	4,83	4,47	4,48	4,49
FX (avg)	2,34	1,75	1,70	1,76	1,80	1,84	1,87
SELIC (avg)	14,87	10,00	12,00	11,25	10,13	10,00	9,75
Trade balance (% GDP)	3,2	1,0	0,4	0,0	-0,2	0,0	0,2
Current account (% GDP)	-0,3	-2,4	-2,9	-3,5	-3,7	-3,7	-3,5
Net external debt (% GDP)	7,1	-2,6	-2,0	-1,0	-0,6	0,0	0,2
Fiscal surplus - primary (% GDP)	3,2	2,9	2,9	3,0	3,1	3,0	3,3
Payment of interests (% GDP)	6,5	5,5	5,6	5,3	4,9	4,8	4,6
Fiscal surplus - total (% GDP)	-3,3	-2,6	-2,8	-2,3	-1,8	-1,7	-1,4
Net public debt (% GDP)	46,9	41,5	40,4	39,3	37,9	36,4	34,7

Source: BBVA Research

Some other risks to watch

In addition to short-term overheating problems, there are other risks to be watched

• public sector:

✓ public expenditures

✓ negative externalities related to industrial policy

✓ tax burden...

• structural factors that will continue limiting Brazil's potential preventing from faster than 5% in a sustainable fashion:

✓ low levels of human capital

✓ poor infrastructure

✓ insufficient domestic savings

✓ vulnerable social security system

• mismanagement of oil resources and sports events

Main messages

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