BBVA | RESEARCH

Economic Outlook

Brazil

First Quarter 2012
Economic Analysis

- **Activity will accelerate over 2012 after having stagnated in the end of 2011.** The worst in terms of growth is already over. Output will rebound in the first half of 2012 and will speed up in the second one. GDP to grow 3.2% in the year and 4.3% in 2013.

- **Inflation will remain above target.** The IPCA will slowdown in H1 12, but will have limited room to continue doing so in H2 2012. We expect the IPCA to close the year at 5.4% and inflationary pressures to remain strong over 2013.

- **Monetary policy will continue to be lax.** The CB has already indicated the SELIC will reach a single-digit soon. We expect it to be at 9.50% by the end of this year, but an even lower rate should not be seen with surprise. In addition to that, we see relevant the chances of the SELIC not being adjusted upwards in 2013.

- **Meeting the fiscal target this year will be challenging, but not unlikely.** Lower revenues and pressures from higher wages and investment needs will give the government less room of maneuver on fiscal policy. However, the commitment to fiscal solvency and the support a more strict fiscal policy would provide to monetary policy create incentives for the fulfillment of the primary surplus for the year.

Index

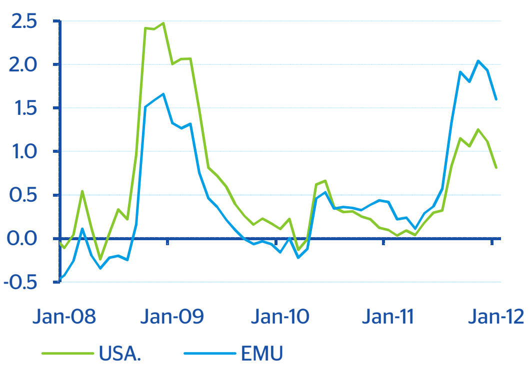
Closing date: February 10, 2012

1. External environment: global slowdown and a recession in Europe

The global economy decelerated markedly in the last quarters of 2011. This was the result of weaker growth in Europe (with negative growth already in Q4) and the deceleration in emerging economies, to around 1% quarter-on-quarter at the end of 2011, their lowest growth rate since the 2008 crisis. However, the drivers of this deceleration could not be more different in both areas. Europe is starting to feel the effects of persistently high financial tensions since September (see Chart 1), given the lack of major advances to solve the sovereign and financial crisis. On the other hand, the slowdown in emerging economies, apart from headwinds coming from developed economies, is partly the result of deliberate policy tightening until the first half of 2011, designed to avoid overheating.

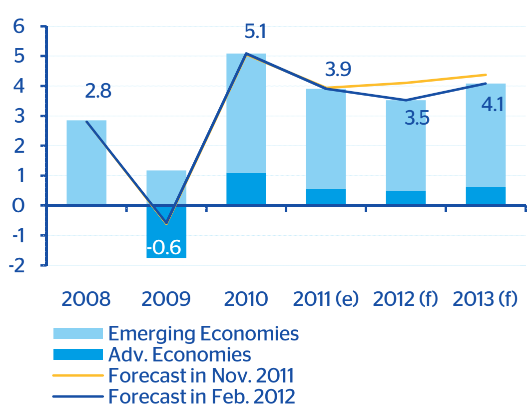
Going forward, we expect decisive action by European authorities that will slowly lower financial tensions in Europe and also global risk aversion, conditioning a global rebound in the second half of 2012. The biggest contribution to that rebound will nonetheless come from emerging economies, as their growth rates recover their historical differential of around 4 percentage points relative to those of developed countries and their policies turn more and more into growth-supportive mode. At the same time, even though the US will grow less than in previous recoveries, it will decouple from the recession in Europe in the first half of the year. Thus, relative to our previous Global Economic Outlook published in November, we are revising down our forecasts for global growth by 0.6pp in 2012 and 0.3pp in 2013, to 3.5% and 4.1%, respectively (Chart 2).

Chart 1
BBVA Financial Stress Index



Source: BBVA Research

Chart 2
Global GDP growth (%yoy)



Source: BBVA Research and IMF

Even with the downward revision of growth rates in Europe and emerging countries, we still see risks to the global growth outlook tilted markedly to the downside. These risks continue to hinge on the evolution of the sovereign-financial crisis in Europe, which continues unabated and can potentially deepen the recession there and spill to other regions through trade links, financial exposures and an increase in risk aversion.

Although there have been some advances since October –mainly the provision of long-term liquidity by the ECB and some agreement towards more fiscal discipline– there needs to be more decisive action on the three main lines of action to solve the crisis in Europe. First, on the sovereign debt front, concerns about the solvency of Greece need to be cleared by finishing the deal with private sector bondholders. At the same time, sizable and credible sovereign firewalls must be erected to avoid contagion to illiquid countries. Second, macroeconomic reforms should continue to be pushed forward to increase growth, including those aimed at repairing financial institutions' balance sheets but taking care to avoid a sudden deleverage and a reduction in credit to the private sector. Finally, further advances in euro area governance are necessary to reinforce the monetary union, making it easier to implement sovereign firewalls establishing a clear roadmap to a fiscal union.

In line to these three points, European prospects would be greatly helped if the agreed fiscal compact is finally approved at the national level and rapidly implemented after the March EU summit, together with economic reforms proposed for peripheral countries to reduce their vulnerabilities and increase long-term growth. Rapid implementation of that side of the implicit "grand bargain" between core and peripheral Europe will allow the discussion to pivot to two urgent measures to reduce sovereign stress in Europe. First, rapidly increase the resources available to erect a sovereign firewall around Greece, perhaps with a more decisive action by the ECB; second, take into account the negative effect of a weaker cycle on the ability to meet the agreed deficit targets in most European countries.

Financial tensions in Europe continue at levels higher than after the fall of Lehman Brothers in 2008 (Chart 1). This, together with the effect of fiscal adjustment in peripheral countries, imply a downward revision of our growth projections for Europe, and we are now expecting negative growth at least in the first half of 2012, and -0.5% for the year as a whole, with a slow rebound in 2013. Nonetheless, it is important to note that these projections depend on a fast resolution of the crisis and a notable reduction of financial stress, to avoid a sharper effect on growth. The different performance between the core and the periphery in Europe will continue to be large, partly because of the large fiscal adjustment in the latter.

Contrary to Europe, the US will show resilience in 2012, as in the second half of 2011. Our forecast remains unchanged from 3 months ago, at 2.3% in 2012 and 2.2% in 2013. However, this recovery is weaker than post-recession cycles, and is surrounded by the risks emanating from Europe and the domestic risk of high policy uncertainty, including a possible massive fiscal tightening in 2013 (as tax cuts expire and automatic spending cuts related to the debt ceiling limit agreement are implemented automatically). In addition, weak housing conditions, tight credit markets and ongoing deleverage will limit the pace of consumption growth. All in all, we see more risks to the downside than to the upside in the US.

One important aspect of the current crisis is that confidence has remained resilient in emerging economies, as opposed to the aftermath of the fall of Lehman Brothers in 2008. One possible determinant of this resilience is the surprising nature of the Lehman fall (mostly absent in the European crisis) and the different speed at which each one develop (the European crisis advancing in "slow motion"). This has allowed domestic demand in emerging economies to hold up well, even as some of the effects of increased global risk aversion are felt in financial markets in the region, through lower capital inflows, some impact on trade finance, reduced asset prices and lower exchange rates.

The slowdown in emerging economies during 2011 meant that their growth gap relative to advanced economies was close to 3 percentage points at the end of 2011, below the historical 4 percentage points seen since the beginning of the 2000's. We expect global risk aversion to remain high, but ease slowly in the second half of 2012, in line with the expected gradual reduction of tensions in Europe. In addition, economic policies will take advantage of existing buffers (including lower inflationary pressures and some fiscal space) and turn more and more into growth-supporting mode, in contrast with the tightening experienced in the first part of 2011. This will allow domestic demand to continue supporting growth in the region, in the face of external headwinds coming from developed countries. In this context, emerging economies are expected to recover growth rates close to 2% quarter-on-quarter at the end of 2012 (from 1% at end-2011), and grow 6.2% for the year as a whole. The main exception to this good performance will be concentrated on emerging countries in Europe, as they will be more affected by closer trade and financial links to the euro area.

Economic activity cooled down in the second half of 2011 due to both the negative impact of a turbulent global environment and the lagged impact of the more restrictive policies implemented in the first half of the year. GDP surprised analysts to the downside and remained stable (0.0%q/q) in the third quarter and is expected to have recovered mildly (0.3%q/q) in the last quarter of the year. The GDP performance in the second half of the year was, therefore, significantly weaker than in the first half of 2011 when quarterly growth was around 1.0%q/q. The deceleration in the end of 2011 justifies a downward revision of our GDP forecast for the year as whole. More precisely, we expect now GDP to have expanded 2.8% in 2011. This is less than our previous forecasts (3.2%) and, more importantly, significantly below the growth rate observed in 2010 (7.5%).

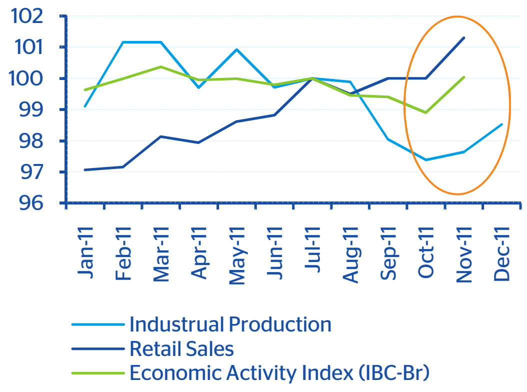
2. Activity will accelerate over 2012 after having stagnated in the end of 2011

Economic activity cooled down in the second half of 2011 due to both the negative impact of a turbulent global environment and the lagged impact of the more restrictive policies implemented in the first half of the year. GDP surprised analysts to the downside and remained stable (0.0%q/q) in the third quarter and is expected to have recovered mildly (0.3%q/q) in the last quarter of the year. The GDP performance in the second half of the year was, therefore, significantly weaker than in the first half of 2011 when quarterly growth was around 1.0%q/q. The deceleration in the end of 2011 justifies a downward revision of our GDP forecast for the year as whole. More precisely, we expect now GDP to have expanded 2.8% in 2011. This is less than our previous forecasts (3.2%) and, more importantly, significantly below the growth rate observed in 2010 (7.5%).

Even though the general picture for the second semester of 2011 was certainly not positive, high-frequency data show that the economy showed signs of revival in November and December and that the worst in terms of economic activity is already behind us (see Chart 3). This revival was driven, on one hand, by a slight improvement of the global environment and, on the other hand, by the adoption of more supportive policies (reduction of the SELIC, announcement of macro-prudential measures to facilitate credit concession, and lower taxes on consumption goods, credit and long-term foreign capital). These factors will, actually, continue playing a role in 2012 and should help to sustain domestic activity dynamism over the year. Moreover, 2012 growth will be supported by the 15% minimum wage adjustment conceded in January, by a still very vibrant labor market, and by public and private investments ahead of the 2014 World Cup and 2016 Olympic Games.

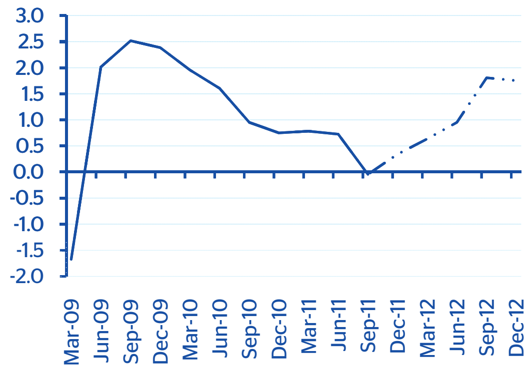
We see two different moments in the year ahead. In the first half of the year, quarterly growth should be no significantly higher than 1.0%q/q, while in the second semester GDP should grow well above this mark (see Chart 4). This acceleration over the year will be a consequence, especially, of the lagged impact of the monetary easing being implemented since August of 2011. In other words, the positive support provided by lower interest rates will be felt mostly in the second half of the year as the maximum impact of a SELIC adjustment is usually reached after 2-3 quarters.

Chart 3
Activity Indicators (seasonally adjusted)



Source: IBGE, Central Bank of Brazil

Chart 4
GDP (q/q %; seasonally adjusted)



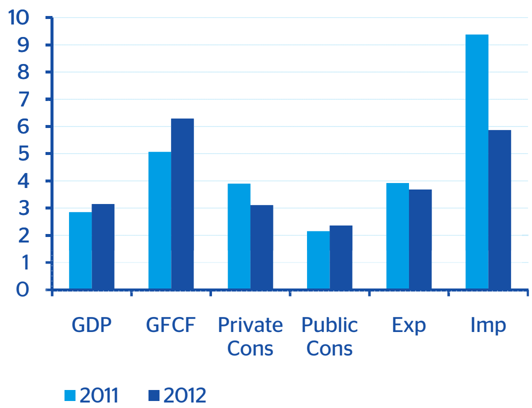
Source: IBGE

As in the last years, domestic demand will be Brazil's engine of growth in 2012. We expect private consumption -which accounts to around 60% of GDP- to expand 3.1% in 2012 in comparison to 3.9% in 2012. This moderation is in line with the "soft landing" of labor markets we are expecting for this year and also with a slight deterioration of consumer confidence due to a more turbulent global environment. However, the other two domestic demand components, public consumption and investment in fixed capital, which account respectively to around 21% and 18% of GDP, should rebound -mildly though- this year. The former is expected to grow 2.4%, slight more than in the previous year when expansion is estimated to have been equal to 2.1%. The latter should benefit from government efforts to accelerate investments in infrastructure and from the needs related to the organization of the 2014 World Cup and the 2016 Olympic Games. Investments in fixed capital should grow 6.3% this year in comparison to 5.1% in 2011.

With respect to the external demand, we expect exports to grow 3.7% this year, which is less than the 3.9% expansion estimated for 2011 and also less than the growth forecasted for imports, 5.9%. The stronger performance of imports is in line with the growth gap between domestic and external economies (i.e. the relative strength of Brazilian economy in comparison to the weakness exhibited by developed economies).

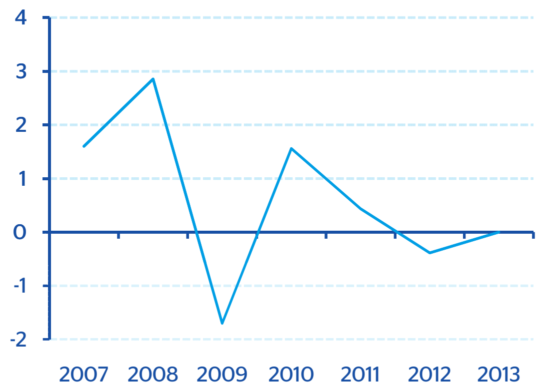
It is important to highlight that in 2012 GDP growth will benefit much less from statistical effects (i.e. carry-over from previous year, which is precisely the growth the country would display if the GDP were to stay constant at the same level observed in previous year's last quarter). More precisely, this effect will add 0.4% to this year's growth in comparison to 1.4% in 2011.

Chart 5
GDP growth forecasts by demand components (%)



Source: BBVA Research

Chart 6
Output gap (%)



Source: BBVA Research

All in all, we expect GDP to grow 3.2% in 2012, which is not enough to bring the output gap in positive territory again (see Chart 6), but on the other hand is a relatively strong performance given global economy's gloominess. In 2013 we expect growth to continue accelerating, GDP to grow 4.3% and activity to close the output gap.

In our view, therefore, Brazil will be able to continue growing –at least at a moderate pace- in spite of the slowdown in developed economies. The resilience of the Brazilian economy is at some extent determined by the resilience of China and commodity prices. However, it is also explained by the magnitude of Brazil's domestic markets, by the room existent to implement countercyclical policies, by the soundness of the financial system (and of the private sector in general), and by the relative strength of public and external accounts. In comparison to the 2008-2009 crisis episode, the country will benefit from a positive reputational effect: while in the Lehman Brothers crisis episode the resilience of the Brazilian economy surprised most, this time markets are already expecting Brazil (and other emerging markets) to respond (relatively) well to an external crisis. This should help us to understand why the Brazilian economy is now in a better position than other economies (and also in a better position than in 2008-2009) to face an external crisis. This does not mean, however, that the country will be able to "decouple". If the external scenario deteriorates sharply (due to an "extreme event" in Europe, for example), the Brazilian economy will be significantly hit. We analyze this risk scenario for the country in the last section of this report. The other sections of this Brazil Economic Outlook deal with other aspects of our base scenario for the country.

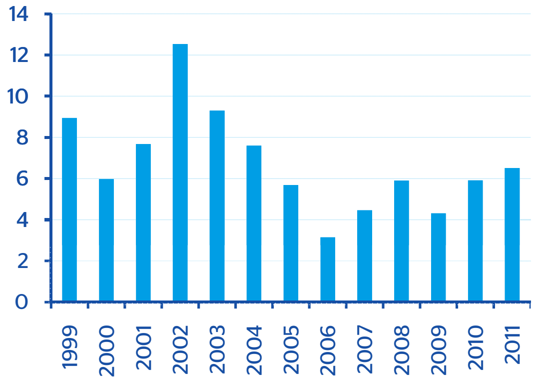
3. Inflation: moderating, not converging, and still an important source of risks

According to our estimations, the output gap was negative by the end of 2011, meaning that the economy closed the year running below its potential (see Chart 6). Even though, inflation reached 6.5% in 2011, in the upper-bound of the range target (2.5%-6.5%) and the highest figure since 2004 (see Chart 7). Inflation vigor was determined by a supply shock that drove food prices up at the beginning of the last year, by the impact of a buoyant labor market (which remained very robust throughout the year in spite of the activity slowdown observed in the second semester), and by the well-know price stickiness of the economy.

Yearly inflation should decline from 6.5% to 5.2% in April. This downward trend is more related to a high base effect than to significantly lower demand pressures: in the first four months of 2011 monthly inflation averaged 0.8%m/m and this year we expect it to average around 0.5%m/m. Once these base effects vanish, we expect inflation to have very limited room to continue moving downwards (see Chart 9) as non-tradable inflation should remain robust (it is currently around 8.6%). More precisely, we expect inflation to be in the 5.2%-5.6% range from April on and to close 2012 at 5.4%. We, therefore, do not share Central Bank's view that inflation will converge to the target by the end of the year. In our opinion, it would require a much worse global scenario than the one we (and even the Central Bank) incorporated in our (their) base scenario to see inflation reaching the 4.5% target in 2012.

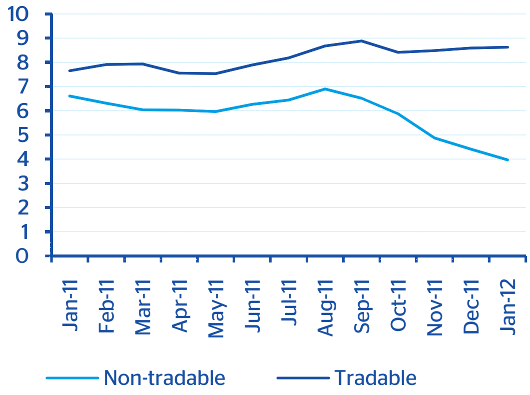
And looking forward, the inflation scenario for 2013 is not benign either: we expect inflation to be average 5.5% and to close that year at 5.6% as domestic demand growth nears 5% and the output gap closes.

Chart 7
IPCA (%)



Source: IBGE

Chart 8
Tradable and non-tradable inflation (y/y %)

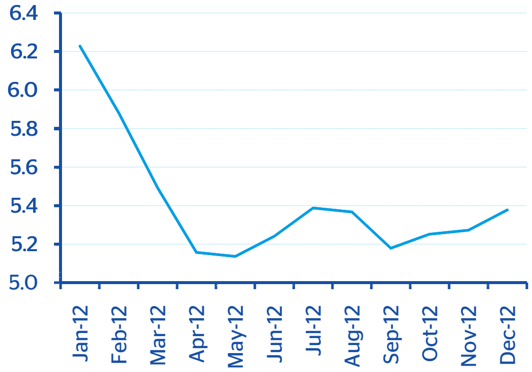


Source: Central Bank of Brazil

As the Chart 10 shows, periods of inflation below 4.5% in Brazil are the exception and not the rule. The 4.5% mark, actually, looks more like a floor than like a target. Since the beginning of the inflation target system in 1999, inflation was below the 4.5% mark only 20% of the months and only in three periods: i) in the first half of 1999; ii) from May of 2006 to December of 2007; iii) from August to December of 2009. In the first and third cases, the country was dealing with serious recession risks[1], while in 2006-2007 the economy was not in recession, but real interest rates were very high, around 10%.

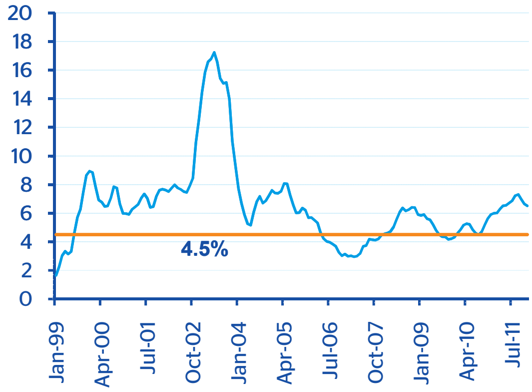
In our view, the country would benefit from a renewed discussion about the adoption of measures to take inflation lower, such as the revision of some indexation mechanisms or the fixation of a lower inflation target. Although we do not see it as something especially likely, we would not be surprised if this issue emerges sooner than expected, within the discussions to take domestic interest rates permanently down, which is one of this government's main goals.

Chart 9
Inflation forecast (y/y %)



Source: IBGE

Chart 10
IPCA (y/y %)



Source: Central Bank of Brazil

1: In 1999, the world economy was still recovering from the worst of the Asian crisis and in Brazil prices still reflected the overvaluation of the real which had been practically fixed for many years then. Ten years later the country was dealing with the effects of the Lehman Brothers crisis.

4. Towards a single-digit SELIC

Following four consecutive 50bps interest rate cuts which took the SELIC down to 10.5%, the Monetary Policy Committee (COPOM) of the Central Bank, in the minutes of the last monetary policy meeting released in the end of January, attached a high probability to a single-digit SELIC scenario. This generalized the perception that the monetary easing will continue in the next few months. At BBVA Research, we expect two additional 50bps cuts, the first in March and the second in April. Afterwards, we think that the most likely is to see the SELIC constant at 9.50% during the remainder of the year, but the recent dovishness of this Central Bank make us not discard additional cuts.

A 9.50% SELIC rate will imply a real interest rate around 4.0%, which is a historically low value for the country. As the Chart 11 below suggests, real interest rates in Brazil have declined gradually over the last years. This decline is in part related to the cooling down of the global economy in the last few years and also to a series of domestic factors such as those pointed out by the COPOM in its last minutes: lower risk premium (due to "meeting inflation targets by the eight year in a row, macroeconomic stability and institutional advances"), a change in the structure of financial and capital markets, deeper credit markets, reduction of the public debt, and increasing (and cheaper) supply of external savings. In spite of this downward trend, our assessment is that the neutral interest rates are currently between 5.0% and 6.0%, therefore higher than the real interest rate expected to be seen throughout 2012.

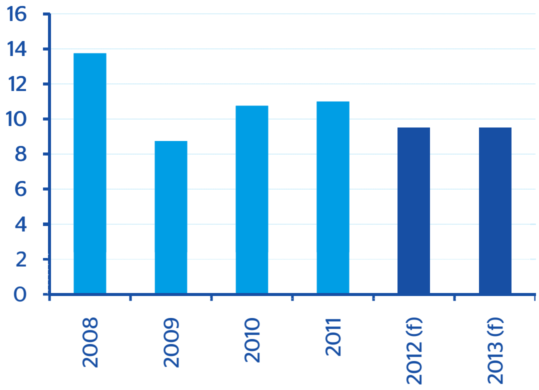
Holding real interest rates under neutral rates will fuel inflation pressures, at least if global risk aversion refrains from deteriorating. However, differently from what most analysts are currently expecting, we do not foresee this misalignment to be corrected in 2013. More precisely, we see more likely that the SELIC rate is left unchanged at 9.5% and that the real interest rate remains close to 4.0% next year. This contrasts with markets' predominant view that the SELIC will be adjusted upward to 10.75% - and the real interest rate to around 5.75%- by the end of 2013.

We see support to the view that interest rates will not be adjusted significantly up next year in series of factors: i) the clear dovishness of this Central Bank; ii) the willingness of the Central Bank to accommodate inflation within the broad range (2.5%-6.5%) instead of sticking to the central target (4.5%); iii) the government's intention to take interest rates permanently down; iv) our expectation that the public sector will fulfill 2012 and 2013's fiscal targets (see more on this issue in the section about fiscal policy below); v) a relatively supportive external sector (i.e. low growth and low interest rates in developed economies) ; vi) the possibility of using other tools – macro-prudential measures- to calm down domestic demand pressures; vii) more debt upgrades by agency rates; and vii) the possibility of implementing some supportive structural reforms (such as the social security reform for public employees and the change in the rules governing the remuneration of some banking deposits – the "contas de poupança" – which currently prevent the SELIC from falling more significantly).

Chart 11
Real interest rate (%)

Source: BBVA Research

Chart 12
SELIC (%; end- of- period)



Source: Central Bank of Brazil and BBVA Research

5. Meeting the fiscal target this year: challenging but not unlikely

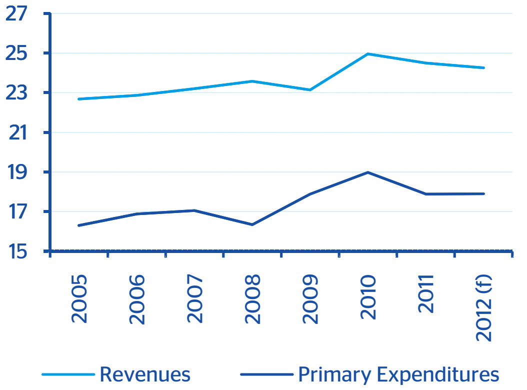
One year ago, at the beginning of 2010, the government was preparing some expenditure cuts to allow the fulfillment of the fiscal target for the year. The cuts were announced in February, but at that time few believed that the target would be achieved. At the end of the year the government then delivered a 3.1% primary surplus and met the target. The environment for meeting the target this year is more challenging, but we think that the 2011's story will repeat itself and that the government will find room to deliver it one more year. This would reinforce this government's commitment to fiscal solvency and would ease the Central Bank job.

Meeting the fiscal target this year will be more challenging than in 2011 because revenues are not expected to repeat previous year's dynamism and expenditures will be pressured by the 15% minimum wage increase and by public investments on infra-structure.

Public revenues in 2011 benefited from the extraordinary performance of domestic demand in 2010 (+10.9%), due to a one-year lag in the payment of some taxes (such as income tax). As domestic demand expanded less than 4.0% in 2011, this effect will not be as positive as in 2011. The revenues gains related to more efficient tax collection and to the increasing degree of formalization of the economy will hardly be repeated this year. The same could be said about extraordinary revenues, even though the revenues related to the concession of some public services (such as airport management) to the private sector could surprise to the upside this year. All in all, we expect federal government revenues to grow around 2.0%-3.0% this year in real terms in comparison to 11.0% in 2011.

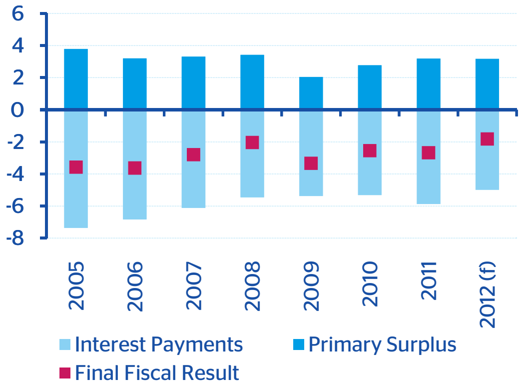
Amidst pressures from the minimum wage adjustment and public investments, the federal government will have to impose a very tight control of expenditures to meet the fiscal target. More precisely, it will have to prevent primary expenditures (which exclude interest payments) from growing more than 4.0% in real terms this year. That is doable, but has a big political cost, especially in an electoral year (city majors and councilors will be elected in October).

Chart 13
Federal Govement's Revenues and Primary Expenditures (% GDP)



Source: BBVA Research

Chart 14
Fiscal Accounts - Consolidated Public Sector (% GDP)



Source: Central Bank of Brazil and BBVA Research

As the Chart 14 above shows, interest payments are expected to decline to 4.9% in 2012 from 5.9% in 2011 in line with a significant reduction of the SELIC (which averaged 11.7% last year and is expected to average 9.7% this year). Given that we expect the primary surplus to be around 3.1%, the total fiscal deficit should be equal to 1.8% this year.

Public credit and macro-prudential measures to have an increasing role in macroeconomic management

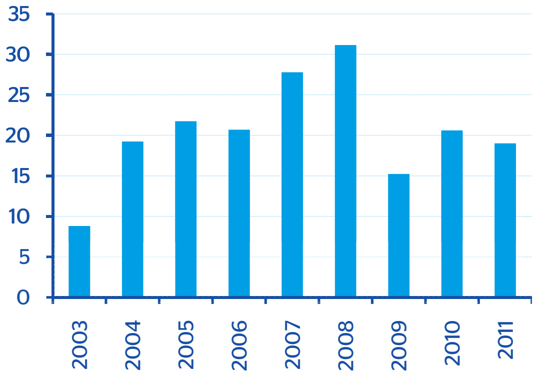
As fiscal policy will be restricted by the commitment to the primary surplus target and with the monetary policy constrained by economic authorities' goal to bring the SELIC down, we expect the government to rely more on credit from public banks and on macro-prudential measures to manage macroeconomic conditions.

Therefore, over this year the government could – especially if activity refrains from rebounding more sharply in the first half of this year- announce more macro-prudential measures such as those announced during the second semester of 2011 when activity surprised to the downside and the economy stagnated (for example, a reduction of the IOF tax and of capital requirements on consumption credit). In addition, public banks could be oriented to accelerate credit concessions to support domestic demand as in 2008-2009 and, more recently, in the end of 2011.

This could, therefore, prevent credit growth from moderating over 2012. We see more likely that credit growth remains around 20% (the expansion in 2010 and 2011 was equal to 21% and 19%, respectively) instead of moderating significantly (the Central Bank forecasts a growth of 15%). In addition to that, the share of public credit, which increased from 34% at the beginning of 2008 to 44% in the end of 2011, should continue increasing this year. The significant expansion of credit from public banks should, actually, be carefully watched as it could be a source of problems in the longer term.

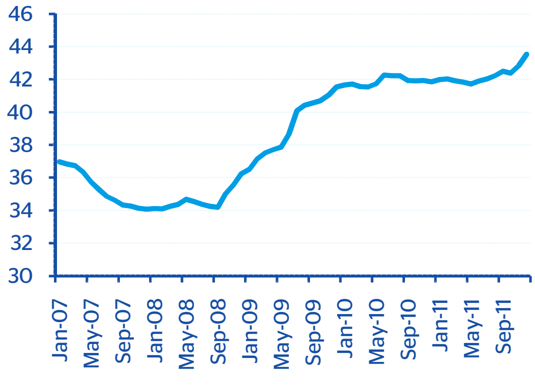
When the output gap closes and inflation pressures intensify in 2013, macro-prudential measures should then be adjusted to slowdown domestic demand and prices. We actually expect measures such as the increase in capital and reserves requirements to give some room for the Central Bank to keep the SELIC stable (or at least to limit eventual hikes) in 2013.

Chart 15
Credit Growth (%)



Source: Central Bank of Brazil

Chart 16
Public Credit (% of Total Credit)



Source: Central Bank of Brazil and BBVA Research

6. Lower terms of trade will imply a deterioration of external accounts

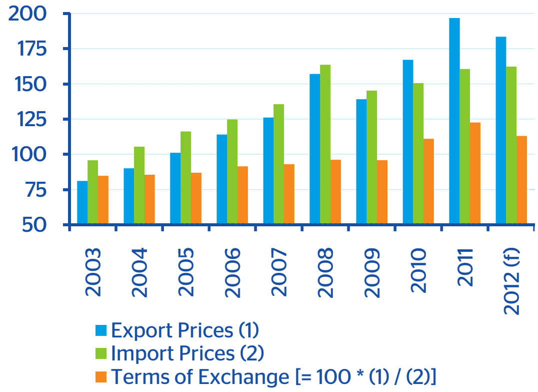
In line with the moderation of global growth, we expect commodity prices to slow down and to drive Brazilian terms of trade (which are given by the quotient between the price of exports and the price of imports). As the Chart 17 below illustrates, we estimate that the price of Brazilian exports will drop around 7% and the price of Brazilian imports will remain practically constant. As a consequence, terms of trade will drop 8% (they will, however, remain 23% higher than the 1997-2010 average). According to our estimations, this adjustment will help to drive trade surplus down from USD 29.8bn (1.2% of GDP) in 2011 to USD 10.0bn (0.4% of GDP) in 2012. The relative strength of Brazil's domestic demand will be another driver of this reduction.

The erosion of the trade surplus will pressure downwards the current account deficit, which has been stable around 2.0% of GDP since the middle of 2010. Additionally, the other two main components of the current account -services and income accounts- will continue displaying a significant deficit. We, therefore, forecast that the current account deficit will move away from the 2.0% - 2.3% range it has been since 2010 and will be higher than 3.0% this year.

This will leave the country more exposed to fluctuations in the global mood, but should not necessarily be a big problem, at least while the foreign capital continues willing to flow into the country, as they certainly did in 2011. Foreign direct investments (FDI), which are the most stable source of funding, reached 2.8% of GDP in 2011, the highest value in almost ten years. FDI will remain strong in 2012, although not as strong as in 2011. We expect FDI flows to reach 2.2%. Portfolio inflows are expected to be at least as significant as in 2011 when net inflows were equal to 1.0% of GDP (significantly less than the 3.0% observed in both 2009 and 2010). In any case, the country counts with large international reserves, around 15% of GDP, which provide an insurance against a deterioration of the external environment and capital outflows.

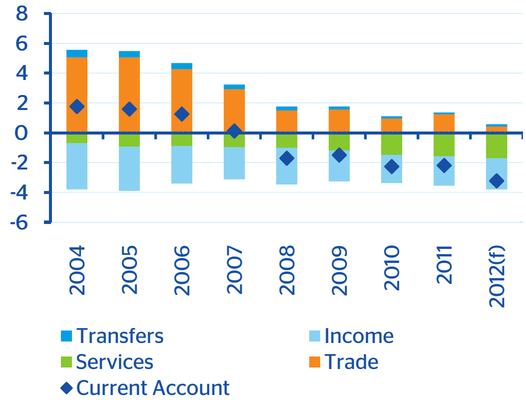
Taking into account the decline in terms of trade, the still bumpy external scenario and the perspectives of capital inflows we expect the real to stay within the 1.7 – 1.8 in the remainder of this year. Appreciatory pressures, which could eventually take the exchange rate below the 1.70 mark, would be at some extent offset by economic authorities' renewed intervention in exchange rate markets.

Chart 17
Export and Import Prices;
terms of trade (Index: 1997=100)



Source: IPEADATA and BBVA Research

Chart 18
Current Account (% GDP)



Source: Central Bank of Brazil and BBVA Research

7. The impact of a more stressful environment in Europe on Brazil is potentially high

The main risk to our base scenario for the Brazilian economy described above comes from the external environment, more precisely from the deterioration of the situation in Europe.

We therefore simulate the impact a disruption in Europe would have in Brazil. More precisely, we create a global risk scenario where the financial market shutdown in peripheral Europe generates a credit crunch in the periphery and severe credit restrictions in core Europe, and GDP falls 3.5% in 2012 and 1.5% in 2013 (in comparison to a GDP drop of 0.5% in 2012 and a 1.0% expansion incorporated in our base scenario). In the US the increase of risk aversion is around 30% of the increase in the Lehman Brothers event and activity drops 1.6% and 0.3% in 2012 and 2013, respectively (while in the base scenario growth is equal to 2.3% in 2012 and 2.2% in 2013). In this risk scenario, reduced demand from Europe and the US and increased global risk aversion have relatively modest net effects on growth in China where the existent room for policy stimulus should be enough to ensure a floor of 7% on growth rates in China.

Given this global risk environment, the Brazilian economy would be impacted especially by a deterioration of domestic confidence and by a negative impact on trade. On one hand, lower confidence would drive domestic demand growth down while, on the other hand, lower terms of trade and lower global demand will imply a poorer performance of exports in comparison to the base scenario and also in comparison to the performance of imports in the risk scenario.

To palliate the impact of the external shock, the Central Bank would cut the SELIC rate to 8% and would also announce macro-prudential measures to stimulate credit. The contribution of fiscal policy would be positive but not very significant (as it could reduce the space for an expansive monetary policy). Although liquidity problems will not be as severe as in 2008-09, government will inject liquidity in foreign currency by selling dollars and in domestic currency by reducing reserve requirements.

These counter-cyclical policies would support domestic demand and prevent the country from entering into a recession. More precisely, we estimate GDP would grow 0.9% in 2012 and 2.6% in 2013 (versus 3.2% and 4.3% in the base scenario). Inflation would reach 4.9% in 2012 and 4.7% in 2013, still above target as the relative strength of domestic demand and a weaker real will offset part of the effects of lower commodity prices. The current account would deteriorate further and reach 3.4% in 2012 and 4.0% in 2013. Meeting the fiscal target would not be a priority. Primary surplus would be around 2.5% in 2012-13.

8. Forecast tables

Table 1
Macro Forecasts Yearly

	2010	2011	2012	2013
GDP (% y/y)	7.5	2.8	3.2	4.3
Inflation (% y/y, eop)	5.0	6.5	5.4	5.6
Exchange Rate (vs. USD, eop)	1.75	1.67	1.77	1.88
Interest Rate (%, eop)	10.00	11.0	9.50	9.50
Private Consumption (% y/y)	7.0	3.9	3.1	4.4
Government Consumption (% y/y)	3.3	2.2	2.4	2.8
Investment (% y/y)	22.0	5.1	6.3	8.0
Fiscal Balance (% GDP)	-2.5	-2.6	-1.8	-1.3
Current Account (% GDP)	-2.3	-2.2	-3.2	-3.6

Source: BBVA Research

Table 2
Macro Forecasts Quarterly

	GDP (% y/y)	Inflation (% y/y)	Exchange Rate (vs. USD)	Interest Rate (%)
Q1 10	9.3	4.9	1.80	8.75
Q2 10	8.8	5.1	1.80	9.75
Q3 10	7.1	4.6	1.74	10.75
Q4 10	5.4	5.6	1.69	10.75
Q1 11	4.1	6.1	1.66	11.42
Q2 11	3.2	6.6	1.58	12.08
Q3 11	2.2	7.1	1.66	12.17
Q4 11	1.8	6.7	1.81	11.17
Q1 12	1.7	5.9	1.80	10.33
Q2 12	1.9	5.2	1.78	9.50
Q3 12	3.8	5.3	1.76	9.50
Q4 12	5.2	5.3	1.76	9.50

Source: BBVA Research

DISCLAIMER

This document and the information, opinions, estimates and recommendations expressed herein, have been prepared by Banco Bilbao Vizcaya Argentaria, S.A. (hereinafter called "BBVA") to provide its customers with general information regarding the date of issue of the report and are subject to changes without prior notice. BBVA is not liable for giving notice of such changes or for updating the contents hereof.

This document and its contents do not constitute an offer, invitation or solicitation to purchase or subscribe to any securities or other instruments, or to undertake or divest investments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

Investors who have access to this document should be aware that the securities, instruments or investments to which it refers may not be appropriate for them due to their specific investment goals, financial positions or risk profiles, as these have not been taken into account to prepare this report. Therefore, investors should make their own investment decisions considering the said circumstances and obtaining such specialized advice as may be necessary. The contents of this document is based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. BBVA accepts no liability of any type for any direct or indirect losses arising from the use of the document or its contents. Investors should note that the past performance of securities or instruments or the historical results of investments do not guarantee future performance.

The market prices of securities or instruments or the results of investments could fluctuate against the interests of investors. Investors should be aware that they could even face a loss of their investment. Transactions in futures, options and securities or high-yield securities can involve high risks and are not appropriate for every investor. Indeed, in the case of some investments, the potential losses may exceed the amount of initial investment and, in such circumstances, investors may be required to pay more money to support those losses. Thus, before undertaking any transaction with these instruments, investors should be aware of their operation, as well as the rights, liabilities and risks implied by the same and the underlying stocks. Investors should also be aware that secondary markets for the said instruments may be limited or even not exist.

BBVA or any of its affiliates, as well as their respective executives and employees, may have a position in any of the securities or instruments referred to, directly or indirectly, in this document, or in any other related thereto; they may trade for their own account or for third-party account in those securities, provide consulting or other services to the issuer of the aforementioned securities or instruments or to companies related thereto or to their shareholders, executives or employees, or may have interests or perform transactions in those securities or instruments or related investments before or after the publication of this report, to the extent permitted by the applicable law.

BBVA or any of its affiliates´ salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, BBVA or any of its affiliates' proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. No part of this document may be (i) copied, photocopied or duplicated by any other form or means (ii) redistributed or (iii) quoted, without the prior written consent of BBVA. No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

In the United Kingdom, this document is directed only at persons who (i) have professional experience in matters relating to investments falling within article 19(5) of the financial services and markets act 2000 (financial promotion) order 2005 (as amended, the "financial promotion order"), (ii) are persons falling within article 49(2) (a) to (d) ("high net worth companies, unincorporated associations, etc.") Of the financial promotion order, or (iii) are persons to whom an invitation or inducement to engage in investment activity (within the meaning of section 21 of the financial services and markets act 2000) may otherwise lawfully be communicated (all such persons together being referred to as "relevant persons"). This document is directed only at relevant persons and must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this document relates is available only to relevant persons and will be engaged in only with relevant persons.The remuneration system concerning the analyst/s author/s of this report is based on multiple criteria, including the revenues obtained by BBVA and, indirectly, the results of BBVA Group in the fiscal year, which, in turn, include the results generated by the investment banking business; nevertheless, they do not receive any remuneration based on revenues from any specific transaction in investment banking.

BBVA is not a member of the FINRA and is not subject to the rules of disclosure affecting such members.

"BBVA is subject to the BBVA Group Code of Conduct for Security Market Operations which, among other regulations, includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. The BBVA Group Code of Conduct for Security Market Operations is available for reference at the following web site: www.bbva.com / Corporate Governance".

BBVA is a bank supervised by the Bank of Spain and by Spain's Stock Exchange Commission (CNMV), registered with the Bank of Spain with number 0182.

This report has been produced by the Emerging Economies Unit:

Enestor Dos Santos
enestor.dossantos@bbva.com

BBVA Research

Contact details:

BBVA Research
Paseo Castellana, 81 – 7th floor
28046 Madrid (Spain)
Tel.: +34 91 374 60 00 and 91 537 70 00
Fax: +34 91 374 30 25
bbvaresearch@bbva.com
www.bbvaresearch.com