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Economic Outlook

Brazil

Fourth Quarter 2012

Economic Analysis

- **World economic growth will pick up steadily to 3.5% in 2013,** supported by lower risk aversion in response to the measures taken by central banks, in particular the ECB.
- **The Brazilian economy is rebounding in the second half of the year, after one year stagnated.** The country will grow 1.6% in 2012 and 4.2% in 2013.
- **Government's new focus on supply-side policies to improve competitiveness is positive,** but we revise down our lower long-term growth forecasts.
- **Inflationary pressures will build up next year,** but will be partially offset by the impact of tax cuts.
- **The SELIC rate is expected to remain stable for an unprecedentedly long period,** after a historical downward adjustment.
- **The main challenges for Brazil are concentrated in the external environment,** but there are increasing idiosyncratic risks.

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Closing date: November 19, 2012

1. Summary

Decisive intervention by central banks in developed countries has limited the possibility of a systemic risk scenario arising. The ECB has dissipated fears regarding the irreversibility of the common currency and forged a path for continued progress toward a new institutional framework. The Federal Reserve's injection of liquidity has anticipated the potential impact of a major fiscal adjustment in the U.S. at the start of next year. To sum up, global uncertainty has receded. In this context, we expect the world economy to continue to recover steadily, with rates of growth of between 3% and 3.5% in 2012 and 2013.

Brazil will grow 1.6% in 2012 and 4.2% in 2013. The Brazilian economy rebounded in the third quarter of the year, after remaining practically stagnated for one year. Even though there is still uncertainty about the strength of growth in the quarters ahead, we expect that the expansive tone of monetary policy, the reduction of industrial inventories, the expansion of public expenditure and, especially, tax incentives provided to boost the automobile sector will keep domestic demand at relatively strong levels will continue over the quarters ahead.

Government's new focus on supply-side policies to improve competitiveness is positive, but we revise down our long-term growth forecasts. The government reacted to criticism on the Brazilian growth model and the sharp deceleration of activity by announcing a series of measures to improve competitiveness. Even though the adoption of a competitiveness agenda is good news, we revised slightly downwards our potential GDP forecasts for the 2014-2016 period from 4.2% to 3.8% as there are still doubts about the implementation of recently announced measures and as investment had been trending downwards until recently.

Inflationary pressures will build up next year, but will be partially offset by the impact of tax cuts. Inflation reached 5.5% in October, pressured by higher food prices. The negative impact of this group on inflation, however, is matched by the impact of some other non-demand shocks. One-off factors, such as the reduction in electricity tariffs, will continue to have an important impact on inflation. In our view, policy-makers will be able to keep inflation far from the 6.5% mark by managing one-off factors and by adopting some restrictive measures. We expect inflation to close 2013 at 5.3%, but see an increasing upward bias in this forecast.

The SELIC rate is expected to remain stable for an unprecedentedly long period, after a historical downward adjustment. In line with our expectations, the Central Bank cut the SELIC by 25bps to 7.25% and called for an end to the monetary easing cycle in October. We expect the SELIC to remain constant at 7.25% at least until the end of 2013. This would be the longest stability period since the inflation target system was adopted in 1999.

Recent fiscal figures show a deterioration of the public sector's primary surplus, which is a consequence of relatively strong expenditures and less robust revenues. We expect primary surpluses to drop from around 3.2% in the last decade to something around 2.6% in 2012 and 2013, as interest payments will be significantly lower than in the past (due to the reduction in the SELIC) and, therefore, will generate some room for the adoption of a less restrictive fiscal policy.

After remaining stable for many months, we expect the exchange rate to appreciate slightly and the current account to deteriorate in 2013. The real moved from around 1.8 per dollar to around 2.03 at the end of May. Perhaps more surprisingly than the new jump of the real was its stability around the new level. We expect the recovery of the Brazilian economy, some moderation of global turbulences and increasing concerns about inflation to trigger a slight depreciation of the real over 2013. Even though the exchange rate will continue to be on average 15% weaker than in the period 2009-2010 and commodity prices will remain at relatively strong levels, we expect the current account to deteriorate over 2013.

The main challenges for Brazil, are concentrated in the external environment. They arise from how a possible crisis in Europe or the fiscal adjustment measures in the U.S. are handled, and also from the increasing use of macroprudential measures to control global liquidity. However, there are some non-negligible domestic risks such as inflation, the exhaustion of the current growth model, the excessive expansion of public banks and government's interventionism.

2. External environment marked by the decisive measures taken by the ECB and the Fed

Bold actions by central banks have clarified the global economic outlook but challenges remain for policy-makers to avoid setbacks

The world economy is expected to continue its soft recovery with a GDP growth rate of 3.5% in 2013 (3.2% in 2012, 4.1% on average in 2010-12). It is supported by lower risk aversion, following the influential decisions taken by central banks, especially the ECB. However, three factors stand out among those that could make this outlook deteriorate significantly: first and most worrying, troubles in Europe, if euro break-up fears that loomed during the first half of the year resurface; second, in the US, the still-hanging threat of the so-called fiscal cliff, i.e., a spending-cut and tax-hike package worth 4% of GDP due to come into effect at the beginning of 2013 that would push the US economy back into recession; third, a severe slowdown in the emerging economies, in particular in China and some commodity-oriented economies, if Chinese appetite for raw materials decreased.

Central bankers to the rescue; other policy makers should follow suit

Against a backdrop of high uncertainty and threats to the world economy recovery, over the past months authorities across the world – in particular central bankers in the eurozone and the US – have taken significant steps forward. Those bold measures have spared the world economy from a systemic event that would have been comparable with the financial developments of late 2008. Both central banks have built a bridge to a new institutional environment in the case of Europe, and to a new fiscal pact in the US; these actions have paved the way for other policy makers to use their room for manoeuvre. However, the FED's actions are more open-ended than the ECB's due to different conditionality: strict fiscal fulfillment is compulsory in Europe, whereas labour market improvement is the objective in the US.

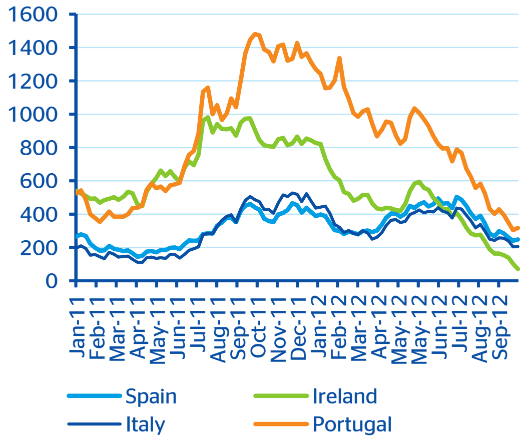
"… whatever it takes…"

In our view, when the European Central Bank (ECB) President Mario Draghi announced the implementation of a new bond-purchase program (Outright Monetary Transactions, or OMT) in late July, the institution took a decisive step to put an end to the debt crisis in Europe. Under certain conditions, the ECB could intervene in the secondary sovereign-debt markets. The ECB's move came after a eurozone summit in June where leaders reached some agreements to reinforce the currency union: a broad roadmap towards a single banking supervision, far-reaching plans covering fiscal issues and growth-supporting measures. The rationale behind the Draghi announcement is clear. Yields on some peripheral bonds are elevated because markets are partly pricing in eurozone break-up fears, compromising the ECB's mandate amid a severe financial fragmentation.

The ECB move was more decisive than anticipated. We consider that break-up fears are not justified now as long as this process continues. Tensions in financial markets have eased significantly since June (see Chart 1) and, in our view, the maintenance of this situation in spite of recent adverse market events is proof of its capacity to dispel doubts.

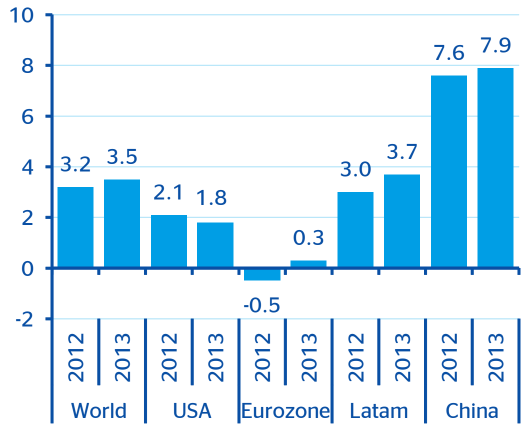
At the end of the process, we think the eurozone may eventually come up with a full package that will reinforce its governance. As we have long argued, it should comprise a banking union, a fiscal union and a lender of last resort to prevent fragmentation. Progress has been made on all of these fronts. Probably that progress has not been ambitious enough to revert the current dynamic quickly. Yet, policy makers seem committed enough to the process and we think the worst of the crisis may, at last, be over. In the short term, the ECB's program and the ESM support under fiscal conditionality creates a benchmark to deal with difficult funding situations that countries such as Italy and Spain could face. At the same time, the proper implementation of the banking-union plans and further definition of the fiscal-union design will be a key factor to the long-term sustainability of the eurozone.

Chart 1
Financial Stress Index for eurozone countries



Source: BBVA Research

Chart 2
GDP growth rate (%)



Source: Bloomberg and BBVA Research

"… as long as needed…"

The US economy is still growing, but at historically low rates and the unemployment rate remaining persistently high. This is the result of a still high indebtment that should keep on reducing, but also of the uncertain external environment regarding the final resolution of the euro crisis and, from a domestic perspective, of the lack of agreements about how to reduce the high public debt while avoiding the automatic income and expense adjustment that is coming closer by the day (fiscal cliff).

Against this backdrop, the Fed additionally eased the monetary policy in its September meeting. It announced that it intends to keep rates at its current low levels at least until mid-2015, a year over what was previously declared. But to support the improvement of the job market's expectation, it also announced a new round of quantitative easing (QE) through the purchase of mortgage backed securities (MBS) in an attempt to improve financial conditions for households. With this, the Fed is buying insurance against the "fiscal cliff," that in our baseline scenario we expect not to fully happen.

The potential effects of QE3 are not restricted to the US economy. As previous programmes showed, they prompt inflows to emerging economies, decreasing risk premia, and lowering funding costs in those countries, boosting the availability of credit, their growth rates and also their inflation.

Central bankers' responses are not enough to bring the global economy back to a firm expansion

The world economy may have avoided decelerating to the slowest growth in the last 30 years (apart from the 2009 great recession) but the low growth environment continues. The advanced economies have been losing momentum since 2011 as one should expect given the current deleveraging environment. More recently the emerging economies have been hit too, though in some important cases, as Brazil and China, recent data shows that activity is stabilizing.

However, the actions that have been taken by central banks in the US and in the eurozone are partly dispelling some doubts and improving the outlook. Under our baseline scenario, growth in the eurozone is likely to gain momentum entering 2013. Although the eurozone's GDP will decrease in 2012 (-0.5%), it will rebound slightly in 2013 (+0.3%). In the US, we have maintained our forecasts: growth will remain at around 2% in 2012 and 2013. The main downward revision in our October scenario corresponds to China (by -0.2 pp in 2012 and -0.4 pp in 2013), although its growth rate will remain close to 8% both years due to expected policy stimulus to compensate partially the slowdown it is experiencing (see Chart 2).

All in all, the world economy is expected to continue undergoing a soft recovery with a GDP growth between 3% and 3.5%. Yet this scenario relies on several key assumptions, in particular on whether European policy makers will deliver on their commitments. First, this scenario assumes that the recent wrangling over financial supervision does not substantially affect June's agreements, so the vicious link between sovereign and bank risk is broken and the monetary policy transmission, which in the eurozone is conducted mainly by banks, works again. Second, we assume that the mechanism in place to eliminate the "convertibility risks" is activated in full if needed. This will keep yields in peripheral economies contained, but substantial reductions will happen at the same time as Europe progresses in its new institutional arrangement and the commitments are fulfilled Finally, in this scenario, Greece will continue being part of the euro, which will, in turn, require further support from Europe by additional funding and/or a longer period to fulfill fiscal conditionality. Based on past experience, too many things could still go wrong, but policy makers tend to find solutions to Europe's problems when crunch time approaches.

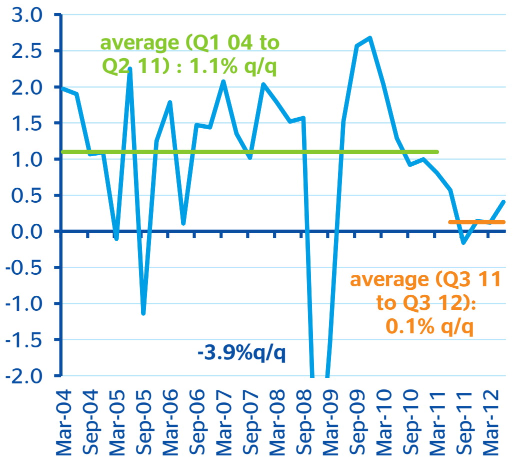
3. Brazil: struggling to grow

The Brazilian economy is rebounding in the second half of the year, after one year stagnated

After years of robust growth, the Brazilian economy remained practically stagnated since the middle of 2011 until very recently. The average GDP growth in the last four quarters, from the third quarter of 2011 to the second quarter of 2012 (data for the third quarter of 2012 has not yet been released) is 0.1%q/q, significantly less than the 1.1%q/q average observed since 2004 (see Chart 3).

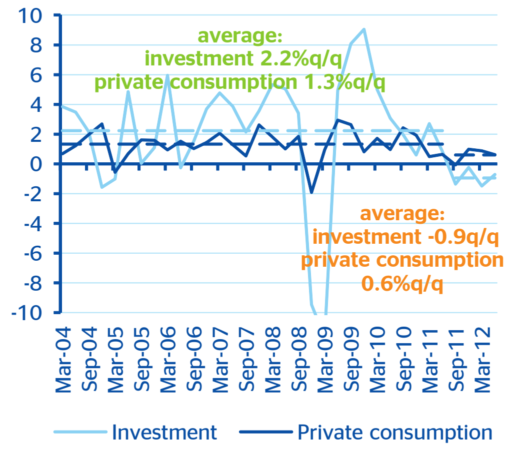
As we commented in our previous Brazil Economic Outlook, there are external, and especially, domestic factors behind this economic slowdown. In short, global uncertainty has had a non-negligible impact on the Brazilian economy while concerns about the industrial sector's increasing lack of competitiveness, credit markets' moderation and government's interventionism prevented domestic demand, especially the investment segment (see Chart 4), from displaying a more positive tone.

Chart 3
GDP growth (q/q%)



Source: IPEADATA

Chart 4
Private consumption and investment growth (q/q%)



Source: IPEADATA

Data for the third quarter of the year suggests, however, that GDP growth is back to robust levels. Evidence provided by high-frequency data, such as industrial production, retail sales, car sales, labor market indicators, confidence surveys, among others, all suggest the economy rebounded in the third quarter of the year. In line with this evidence, we expect the economy to have grown 1.4%q/q in the period, which would have been the most dynamic pace since the beginning of 2010.

The long-awaited revival of economic activity in Brazil follows the expansive tone of monetary policy, the reduction of industrial inventories, the expansion of public expenditure and, especially, tax incentives provided to boost the automobile sector and others.

Even though the main drivers of the activity rebound observed in the third quarter are, basically, domestic, the reduction in global risk aversion, triggered by the announcement of a new bond-purchase program (Outright Monetary Transactions, or OMT) by the European Central Bank and a new round of monetary stimulus (Quantitative Easing, or simply QE3) by the Fed, was also supportive.

Activity recovery in the second half of the year will not prevent 2012 GDP from growing less than 2.0% this year

In spite of a positive GDP outturn in the third quarter (which will be officially announced on November 30th), growth in the quarters ahead is all but guaranteed. At this moment, growth remains very dependent on the performance of the auto sector (and, therefore, on policy measures to support the sector). In addition, while the performance of private consumption has been not completely disappointing, investment expenditure has not yet taken off and it is not clear whether the improvement in the global mood and, especially, the government's new focus on supply-side issues to boost competitiveness will pave the way for a new wave of investment in fixed capital. Moreover, credit markets have not yet shown solid signs of recovery and default rates have not yet declined as expected, which poses doubts about its contribution to economic activity in the quarters ahead. Finally, the external environment clearly continues to be a potential source of turbulences (for a more detailed review of domestic and foreign risks, see the section at the end of this report).

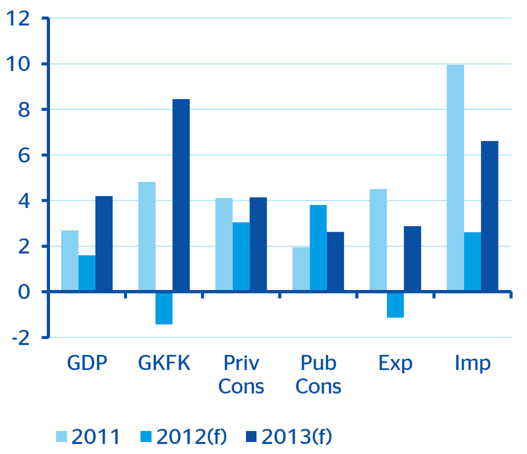
Nonetheless, in spite of these risks, we believe that it is more likely that the set of drivers that allowed an activity rebound in the third quarter will continue to play a role in the quarters ahead and sustain GDP growth around 1.0%q/q. In other words, we foresee an easing of monetary and fiscal conditions, the need to adjust inventories upwards and the absence of an "extreme event" in developed countries.

With respect to activity in the fourth quarter of the year, we expect GDP growth to be slightly lower than in the third one, but still significantly stronger than in the first half of the year.

In spite of the dynamism seen in the second half of the year, we expect GDP to grow only 1.6% in 2012. For the second year in a row, then, growth would be below the potential (which we estimate to be around 3.8%) and below the average observed in the 2003-2010 period (4.1%).

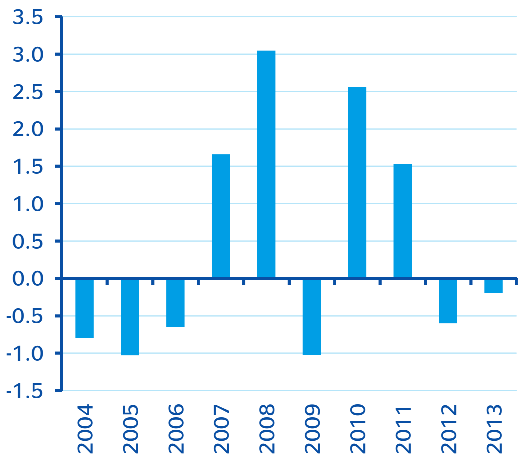
Our current forecast for 2012 GDP is also below our previous forecast (2.2%). This downward adjustment is a consequence of lower than expected growth in the second half of the year and also of perspectives of a slightly softer recovery.

Chart 5
GDP growth (%)



Source: BBVA Research and IPEADATA

Chart 6
Output gap (*) (%)



(*) Output Gap = (Observed GDP - Potential GDP) / Potential GDP
Source: BBVA Research

We expect GDP to grow 4.2% in 2013, after two years of poor performance

The recovery of the economy in the second half of 2012 should pave the way for a better 2013. From a statistical perspective, it will generate a carry-over effect of around 1.8bps, i.e. if the economy were to stay constant throughout 2013 at the same level it closes 2012, 2013 GDP would then grow 1.8%. From an economic perspective, the dynamism in the second half would help the economy to start 2013 in a much better situation than it started this year, as lower industrial inventories and higher confidence would help boost domestic demand more than in 2012.

Looking at GDP's demand components, we expect investments to increase around 8.0% next year, compared to a decline of more than 1.0% in 2012, thanks to higher public expenditures, infrastructure concessions to the private sector, and a more dynamic macroeconomic environment. Therefore, as opposed to 2012, next year domestic demand should also be supported by the investment segment and not only by consumption (see Chart 5). Regarding the latter, we expect labor market tightness to keep it at relatively robust levels (3.7%, compared to the 3.2% growth we expect for 2012).

Regarding the external components of GDP, we expect exports to recover mildly in 2013 after having declined around 1.0% this year. This recovery would be determined by factors such as better crop harvests, a recovery of the Argentinean economy (which is an important buyer of Brazilian manufactured goods), a slightly stronger growth in China (7.9% in 2013 compared to 7.6% this year), and a more depreciated exchange rate. The exports expansion we expect in 2013, around 3.0%, will fall short of the 2003-2010 average, 5.5%, as the dynamism of the global economy –and especially of developed economies- in 2013 will not be as intense as in that period. With respect to imports, we expect them to pick up in 2013, in line with the rebound in domestic demand. More precisely, we estimate imports will grow more than 6.0% in 2013 after expanding less than 3.0% this year.

Overall, the activity rebound we expect in 2013 will be determined by an acceleration of domestic demand, whose contribution to GDP will reach 5.1%, compared to only 2.2% in 2012. The more robust expansion of imports with respect to exports will imply that external demand's contribution to GDP will be more negative than in 2012, more precisely -0.9%, compared to -0.6% this year.

The recovery of the economy would practically close the output gap at the end of 2013, after a long period in negative territory (see Chart 6).

Government's new focus on supply-side policies to improve competitiveness is positive. Nonetheless, we revise down our long-term growth forecasts

In the last few months, the government reacted to criticism on the Brazilian growth model (for more details about this criticism, see our previous Brazil Economic Outlook) and the sharp deceleration of activity by announcing a series of measures to improve competitiveness. Among these measures are the reduction of the tax burden for some sectors, the cut in electricity tariffs (around 20% due to a tax reduction and the renewal of the concessions to the private sector) and the concession of infrastructure investments to the private sector. In addition, the government is studying more measures to reduce the tax burden as well as some of the distortions of the tax system. This is a very sensitive reform as there is a multitude of agents involved in it, but any advance will have a positive impact.

The establishment of a new agenda of reforms to foster competitiveness will not replace those aimed at driving credit and consumption further up as the government considers there is still significant room for credit/consumption growth in the years ahead.

Measures to enhance competitiveness will therefore be a complement rather than a substitute to measures to boost demand taken in recent years. This is understandable in an environment of weak domestic activity, but could be a source of problems when the economy recovers. In other words, the insistence on demand policies (together with supply policies) is positive in terms of short-term growth (especially because the output gap is negative), but in the medium/long run it could also generate problems such as excessive credit growth (the next credit/consumption hang-over could generate more serious headaches than those observed recently).

Even though the adoption of a competitiveness agenda is good news, there is still uncertainty surrounding the government's ability to implement these measures. Moreover, the government's micro-managerial / interventionist style poses doubts on the new, adjusted model.

The doubts on the implementation of the new competitiveness agenda and the concerns about the excessive intervention of the government in the economy added to the recent decline of investments and triggered a downward revision of our long-term forecasts for the country. More precisely, we revised slightly downwards our potential GDP forecasts for the 2014-2016 period from 4.2% to 3.8% (see the Box below for more details about the issue). The effective adoption of the competitiveness agenda, i.e. the significant reduction of the tax burden, the simplification of the tax structure and the increase in both public and private investment, could lead to an upward revision of these forecasts.

Box. Lower capital and TFP contributions drive Brazil's potential output down

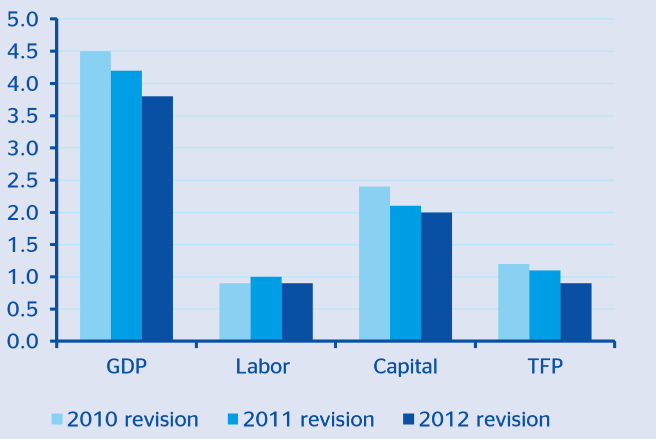
We have recently revised our potential output model, which follows the production function approach. For the second year in a row, our model shows a reduction in the country's growth perspectives. More precisely, the model tells us that Brazil's potential output for the period 2014-2016 is now around 3.8%, lower than estimated in the two previous years (4.2% in 2011 and 4.5% in 2010).

As Chart 7 illustrates, the downward revision of potential GDP in the last two years is explained by worse perspectives about the evolution of both the capital factor and total factors productivity (TFP, which is, broadly speaking, a measure of the productivity in the use of both labor and capital). The Capital factor contribution to potential growth in 2014-2016 declined, according to our estimates, from around 2.4% in 2010 to 2.1% in 2011 and to 2.0% now. Similarly, the TFP contribution declined from 1.2% in 2010 to 1.1% in 2011 and 0.9% in 2012. The Labor factor contribution to GDP growth remained practically constant, around 0.9%.

The deterioration in the perspectives of contribution from both Capital and TFP are, in our view, related to the inability to drive investments up and a paralysis of the reform agenda in recent years. Regarding the latter, investment expanded 4.8% in 2011 and is expected to drop more than 1.0% this year. These figures compare poorly to the 9.3% average expansion recorded in the 2004-2010 period. Although the external environment was certainly not supportive, the governments' inability to drive public investment up and the negative impact of institutional and regulatory uncertainties on private investments are also a key factor behind investment's weak performance. Regarding the reform agenda, in the last years of the Lula administration and in the first years of Dilma's very little progress was made to improve domestic competitiveness.

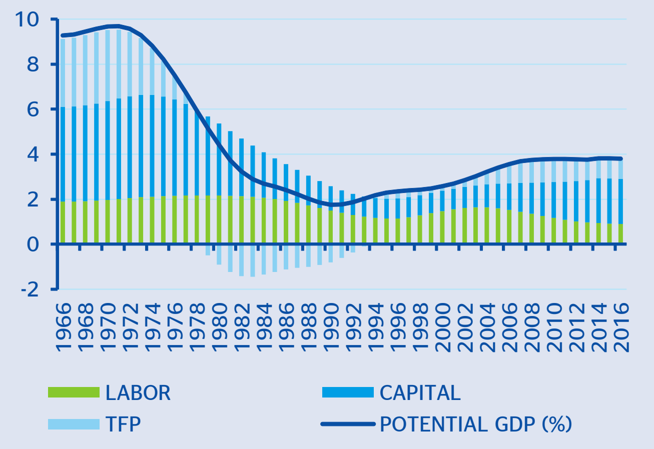
As we commented in the body of the report, there is now a chance that the adoption of some positive structural measures will help improve the outlook for the contribution of both TFP and Capital in the years ahead. As Chart 8 shows, the most updated version of our potential GDP model predicts that the contribution of TFP will remain broadly constant and the contribution of the Capital factor will increase in the coming years. More than that is needed, however, for the economy to grow sustainably at a pace around 4.0% or more in the future, especially because demographics and current labor market conditions (very low unemployment) will keep the contribution of the Labor factor constrained.

Chart 7
Potential growth and contribution by factors (%), 2014-2016 average



Source: BBVA Research

Chart 8
Potential growth and contribution by factors (%)



Source: BBVA Research

Inflationary pressures will build up next year, but will be partially offset by the impact of tax cuts

In the last few months, inflation has been pressured up by food prices, which have been trending up sharply in line with supply shocks. In October, headline inflation reached 5.5%y/y, the largest figure since February. In the same period, food inflation reached 10.5%y/y (see Chart 9).

If food inflation had remained close to the average observed in the first half of the year (which is not far from the average recorded since 2004) instead of spiking sharply, then overall inflation would now, and also at the end of the year, stand at 4.8% . This is significantly less than current inflation, but is still above the 4.5% inflation target.

However, if we were to exclude the impact of one-off, non-demand factors on inflation (as policy-makers are asking analysts to do), we would also have to see how inflation would have performed if the inflation methodology had not been changed and tax cuts on vehicles and other goods had not been adopted. Our calculation suggests that inflation in 2012 would have been around 80bps higher if these factors were excluded. Therefore, inflation would now (and also at the end of the year) be around 5.6% if not only negative food shocks, but also positive one-off factors were removed from the inflation calculation.

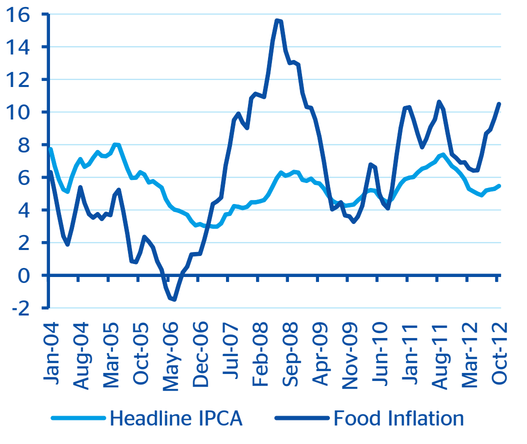
One-off factors will continue to have a major impact on inflation in 2013. In line with recent announcements, electricity tariffs are expected to decline around 20% at the beginning of next year, with will take around 50bps off inflation in 2013. Moreover, we believe that the adoption of other tax cuts with a non-insignificant positive impact on inflation is very likely next year. On the other hand, an eventual adjustment in fuel prices (which were kept practically constant in 2012 to avoid a negative impact on inflation) and the end of temporary tax breaks are a source of upside risks to inflation.

In our view, a moderation in food prices will allow inflation to remain practically stable throughout the rest of the year. We expect the IPCA to close the year at 5.4%. In 2013 we expect inflation pressures to resume as the economy recovers and closes the output gap. The tone of fiscal and monetary policies, the unwillingness to accept a sharper appreciation of the currency and the adoption of higher import tariffs should contribute to create a less favorable environment for inflation.

Nonetheless, we believe that policy-makers will be able to keep inflation far from the 6.5% mark -the inflation target's upper bound- by managing the one-off factors listed above (fuel prices, electricity tariffs, tax cuts…) and by adopting some restrictive measures (see section below).

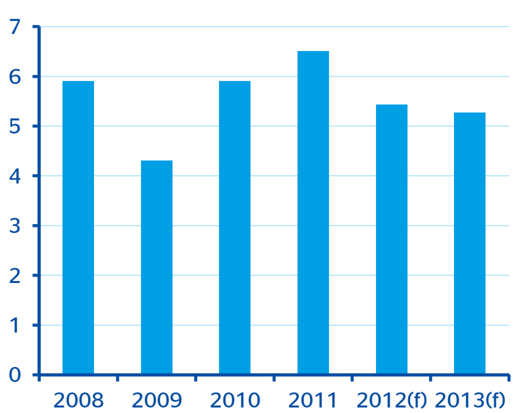
We expect inflation to close 2013 at 5.3% (see Chart 10), but see an increasing upward bias in this forecast (for more on this issue, see the section below about idiosyncratic and external risks faced by the Brazilian economy).

Chart 9
Inflation: headline and food group (%y/y)



Source: IBGE

Chart 10
Inflation: end of period (%)



Source: BBVA Research and IBGE

The SELIC rate is expected to remain stable for an unprecedentedly long period, after a historical downward adjustment

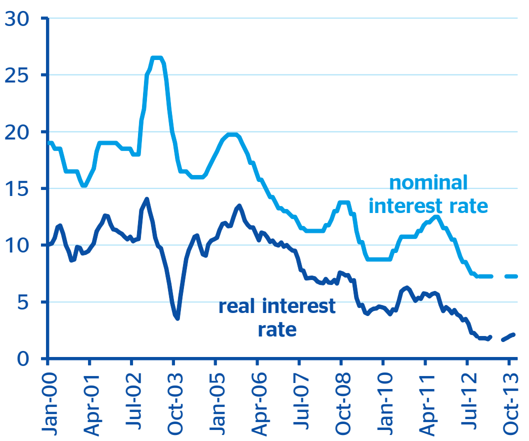
In line with our expectations, the Central Bank cut the SELIC by 25bps to 7.25% and called for an end to one of the most aggressive monetary easing cycles in the country. From August 2011 to October 2011, the reference interest rate was reduced by 525bps (see Chart 11). In the period, some of the barriers preventing the reduction of the SELIC rate to historically low levels, such as the remuneration of saving accounts (the "contas de poupança"), were overthrown.

In addition to cutting the SELIC, the monetary authority kept the focus on the ("disinflationary") external environment (in spite of "short-term" food pressures) and suggested, more explicitly than expected, that rates will now remain stable for a "sufficiently prolonged period".

We expect the SELIC to be remain constant at 7.25% at least until the end of 2013. This would be the longest stability period since the inflation target system was adopted in 1999.

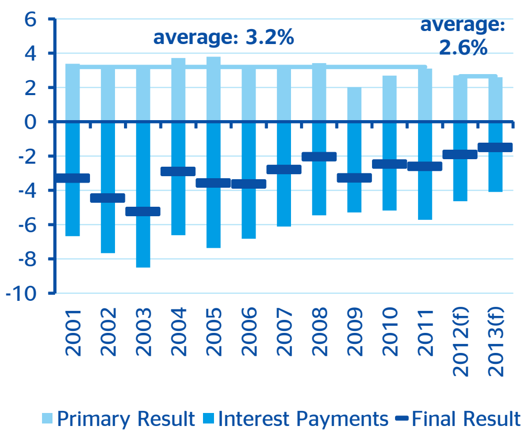
In our view, higher inflationary pressures over 2013 will not trigger interest rate adjustments. As we commented before, we expect these pressures to be controlled through a managed reduction of some taxes. In addition, we expect some tightening of fiscal policy to be enacted, some appreciation of the real to be accepted and some restrictive macroprudential measures to be adopted (as we show below, on Chart 15, Brazil has been using this type of measures more actively than any other country in the region). In other words, the economic authorities would use tools other than the SELIC to prevent inflation from running out of control.

Chart 11
SELIC interest rate (%)



Source: BBVA Research and Central Bank of Brazil

Chart 12
Public accounts (% GDP)



Source: BBVA Research and Central Bank of Brazil

More public investment and lower tax burden in exchange for lower primary surpluses?

Recent fiscal figures show a deterioration of the public sector's primary surplus: in annual terms, it declined to 2.3% of GDP in September from 3.2% one year ago. The drop in the primary surplus account, which excludes interest payments, is a consequence of relatively strong expenditures and less robust revenues (due to the moderation of the economy and tax reductions.).

The reduction of the primary surplus is neither unreasonable nor surprising, especially because i) the economy is running below its potential; ii) interest payments are declining steadily due to the sharp reduction of the SELIC rate (interest payments reached "only" 5.1% of GDP in September, compared to 5.7% one year ago and 6.2%, on average, in the period 2004-2011); and iii) public debt dynamics remain very positive (35.3% in September, compared to 36.3% in September of 2012 and 44.5% in the period 2004-2011).

Although the primary surplus reduction has a cyclical component, it also has, in our view, a structural one. More precisely, we expect the government to generate lower primary surpluses from now on, even after the economy recovers. As we expect most of the recent interest rate reduction to be permanent, even primary surpluses around 1.0% of GDP –much lower than the current 3.1% target- would guarantee that the public debt / GDP ratio does not increase.

In our view the government will be successful in the adoption of a new fiscal regime if it is able to meet two conditions. First, to use the fiscal space left to reduce the tax burden and/or increase public investment (which would help increase the private sector's competitiveness and avoid bigger pressures on inflation). Second, to replace the current primary surplus target by another fiscal anchor to guarantee that public debt continues to trend down and manage expectations.

Although at this point it is not clear how the government would transition from the current system to a new one (in fact, it is not even clear that there will be one), we expect a reduction in the tax burden and an increase in public investment from this year onwards. Accordingly, we expect primary surpluses to drop from around 3.2% in the last decade to around 2.6% in 2012 and 2013, and even less in the years ahead.

As Chart 12 shows, the reduction in the primary surpluses would be accompanied by a drop in interest payments that would guarantee a reduction of the total fiscal result to somewhat below the -2.0% level. Finally, we expect public debt to remain close to 35% in 2012 and 2013 and near 30.0% in the year ahead.

Even though the relaxation of the current fiscal targets (or simply the reduction of the public sector's primary surpluses) is not a source of concern from a debt perspective, it could be in terms of the impact on inflation. In other words, a more expansive fiscal policy could add to inflationary pressures next year, so we think it will be fine-tuned (meaning it could become less expansive) when the economy recovers and the output gap closes. If not, there is a risk of inflation trending up and the SELIC being adjusted upwards (which is not our base-case scenario but rather a risk scenario for the country as described below).

After remaining stable for many months, we expect the exchange rate to appreciate slightly and the current account to deteriorate in 2013

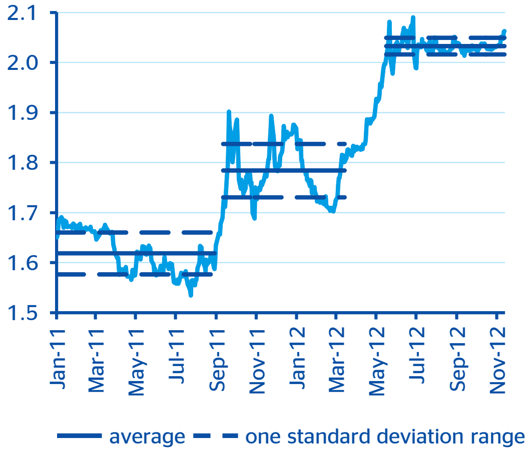
As Chart 13 shows, the real moved from around 1.8 per dollar to around 2.03 at the end of May, following a new burst of pessimism about the eurozone. Even though the external mood has improved somewhat since then, the real failed to move back to a more appreciated level, as the government and the Central Bank continued to intervene -and promised to intervene even more if needed- in exchange rate markets (see Chart 15 for a an evaluation of the degree of intervention in exchange rate markets in Brazil and also other countries in the region) and the SELIC continued to be reduced.

Perhaps more surprising than the new jump of the real was its stability around the new level. More precisely, the exchange rate volatility declined sharply in the last months: the exchange rate standard deviation around the mean (2.03) since May is 0.02, less than half the standard deviation observed in previous periods (see Chart 13). This striking stability has led some analysts to say that the current exchange rate system is not a free regime but rather a crawling peg one.

We expect global tensions and domestic intervention to keep the real broadly within the current range throughout the rest of the year. We expect the recovery of the Brazilian economy, some moderation of global turbulences and increasing concerns surrounding inflation to trigger a slight depreciation of the real over 2013. Our forecast is that the real will remain around 1.95 during most of 2013 and close the year at 1.96.

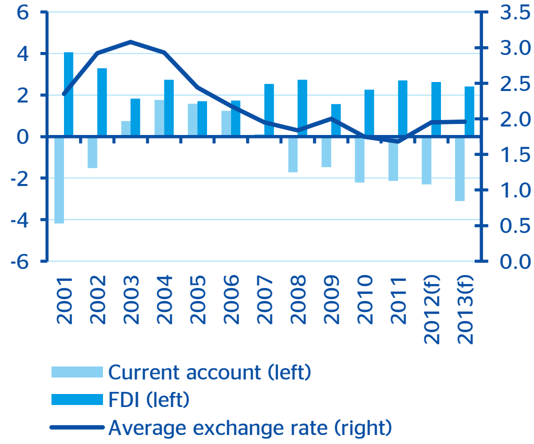
Even though the exchange rate will continue to be, on average, 15% weaker than in the period 2009-2010 and commodity prices will remain at relatively strong levels (especially food commodities), we expect the current account to deteriorate over 2013 and to stand at more than 3.0% by the end of the year (see Chart 14). This deterioration would follow a long period of stability around 2.0%-2.3% and is in line with the expectation that domestic demand will rebound in the quarters ahead. Nevertheless, we expect that foreign direct investment (FDI) will continue to fund most of the current account deficit and international reserves will continue to provide a significant cushion against sudden reversals in capital flows.

Chart 13
Exchange rate: BRL per USD



Source: BBVA Research and Central Bank of Brazil

Chart 14
Current account, foreign direct investment (% GDP) and exchange rate (BRL per USD)



Source: BBVA Research and IBGE

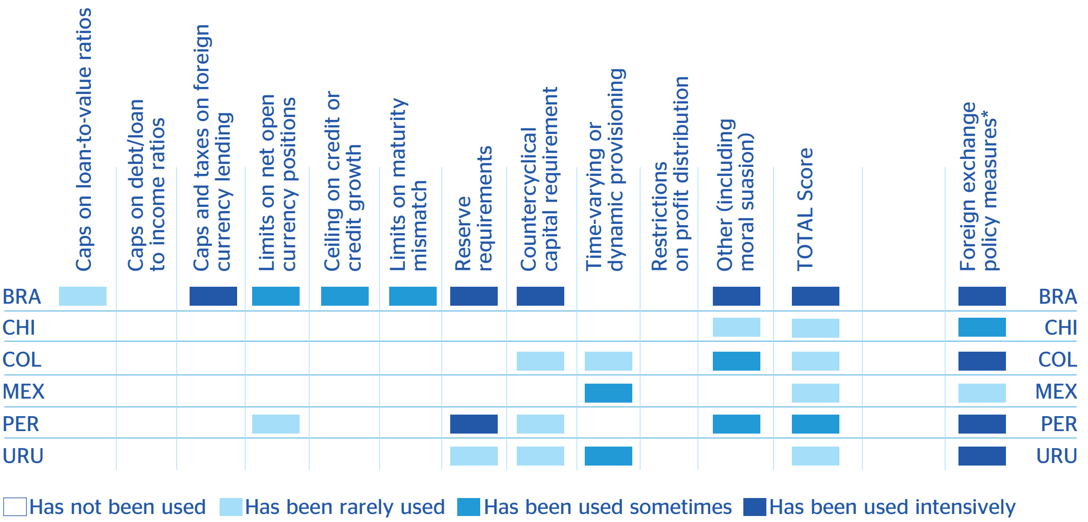
Risks do not only come from the external environment, but also from idiosyncratic factors

The main challenges facing Latin American countries, including Brazil, are concentrated in the external environment. They arise from how a possible crisis in Europe or the fiscal adjustment measures in the U.S. are handled, and also from the increasing use of macroprudential measures to control global liquidity.

Regarding the latter, the risk of an "accident" either in Europe or in the United States is lower than three months ago, but clearly non-negligible. Nonetheless, we believe that Brazil has tools to manage the consequences of a new global crisis, even though this impact on the country would be significant (see our previous Brazil Economic Outlook for more details on our evaluation of the impact of a global accident on Brazil).

Regarding the increasing use of macroprudential measures, the authorities should be aware of existing costs/risks, especially in Brazil, which has been using these measures more intensely than any other country in the region (see Chart 15). First, if the macroprudential policies shift capital flows to other emerging countries, boosted by the expansive monetary policies in developed economies, there is an overall risk of an excess use of these macroprudential measures. Second, the economic authorities do not yet have sufficient experience (their own or others') in the use of most of the macroprudential measures. Finally, we should bear in mind that macroprudential measures end up being a drag on progress in the financial penetration needed in the region, given that most of the countries still have, for example, credit/GDP ratios that are far below those expected of economies of their characteristics (see our Latin America Economic Outlook for more details on this issue).

Chart 15
Use of macroprudential policies in Latin America between January 2010 and October 2012



* Includes, for example, FX intervention, limits to foreign investment by pension funds, limits to foreign currency purchase by pension funds, etc.
Source: BBVA Research

Regarding idiosyncratic issues, we see increasing inflationary risks in Brazil. We see a likely scenario where inflation is kept under control by a series of tax cuts and some restrictive measures adopted next year. Nonetheless, we should not rule out the possibility that inflation will end up being higher than expected, especially if authorities are slow to react to increasing demand pressures next year or if fiscal policy turns out to be more expansive than we are foreseeing (by using the room left by lower interest payments to expand public consumption instead of boosting investment or reducing taxes).

Inflation is not the only potential source of domestic risks. We continue to see risks of an exhaustion of the current model, excessively based on the expansion of credit and consumption, even though these risks are now lower than three months ago due to the announcement of measures to boost competitiveness. Moreover, there is a risk of excessive expansion of public credit, which could bring problems to public banks if the economy fails to recover as expected or in the event of a new global crisis. Finally, recent episodes, such as the negotiation of concessions and tariff cuts regarding the electric sector, alert against the risk of excessive public intervention as well as regulatory risks, which could end up reducing the profitability of some sectors and hampering private investments.

4. Tables

Table 1

Macro Forecasts Yearly

	2010	2011	2012	2013
GDP (% y/y)	7.6	2.7	1.6	4.2
Inflation (% y/y, eop)	6.0	6.5	5.4	5.3
Exchange Rate (vs. USD, eop)	1.66	1.87	2.02	1.96
Interest Rate (%, eop)	10.75	11.0	7.25	7.25
Private Consumption (% y/y)	7.0	4.1	3.0	4.1
Government Consumption (% y/y)	4.2	2.0	3.8	2.6
Investment (% y/y)	21.6	4.8	-1.4	8.5
Fiscal Balance (% GDP)	-2.5	-2.6	-1.9	-1.5
Current Account (% GDP)	-2.2	-2.1	-2.3	-3.1

Source: BBVA Research

Table 2

Macro Forecasts Quarterly

	GDP (% y/y)	Inflation (% y/y)	Exchange Rate (vs. USD)	Interest Rate (%)
Q1 11	4.2	6.3	1.63	11.75
Q2 11	3.3	6.7	1.56	12.25
Q3 11	2.1	7.3	1.86	12.00
Q4 11	1.4	6.5	1.87	11.00
Q1 12	0.8	5.3	1.83	9.75
Q2 12	0.5	4.9	1.83	8.50
Q3 12	2.1	5.3	2.03	7.50
Q4 12	3.1	5.4	2.02	7.25
Q1 13	4.1	5.5	1.98	7.25
Q2 13	4.7	5.7	1.96	7.25
Q3 13	4.2	5.2	1.94	7.25
Q4 13	3.8	5.3	1.96	7.25

Source: BBVA Research

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