

BBVA Research

A review of the Brazilian economy

May 31st, 2010

Section I

Economic Scenario

Section II

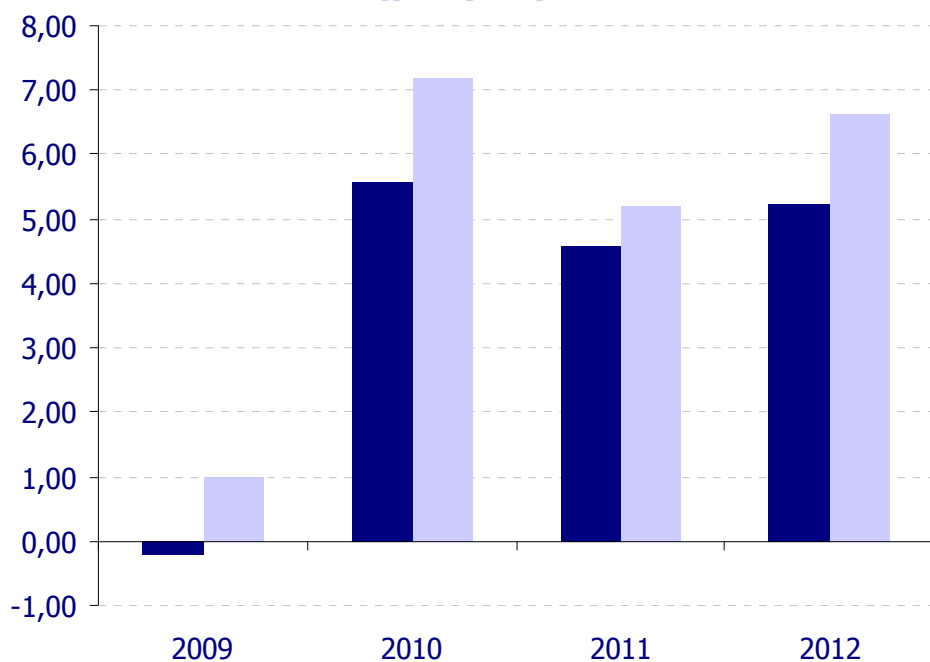
Structural Characterization

Section III

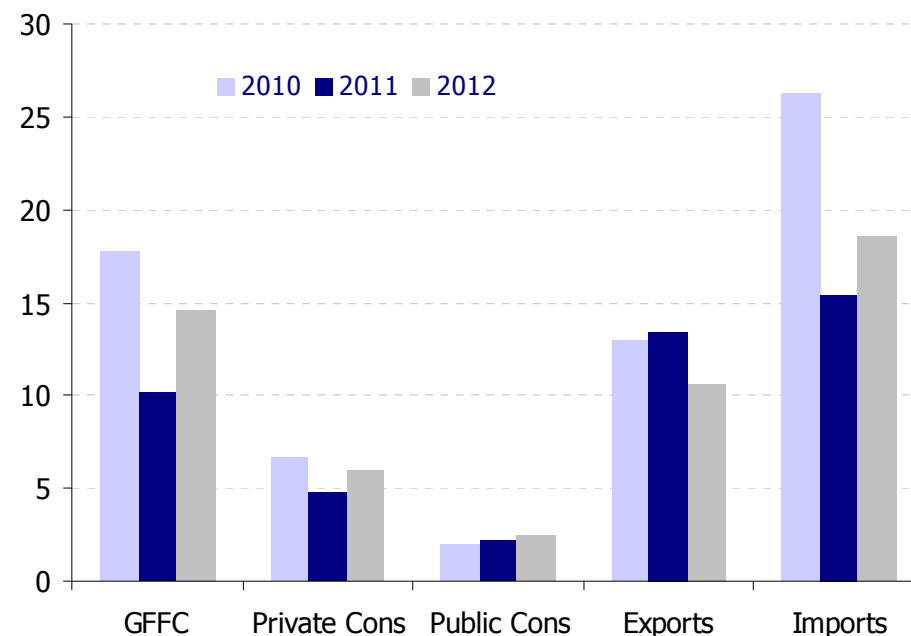
Strengths, Risks and Challenges

After dropping 0.2% in 2009, the economy will recover quickly and strongly in 2010. We forecast GDP to grow 5.9% in 2010 and to be around 5% in next years.

**GDP and Domestic Demand
(y-o-y %)**



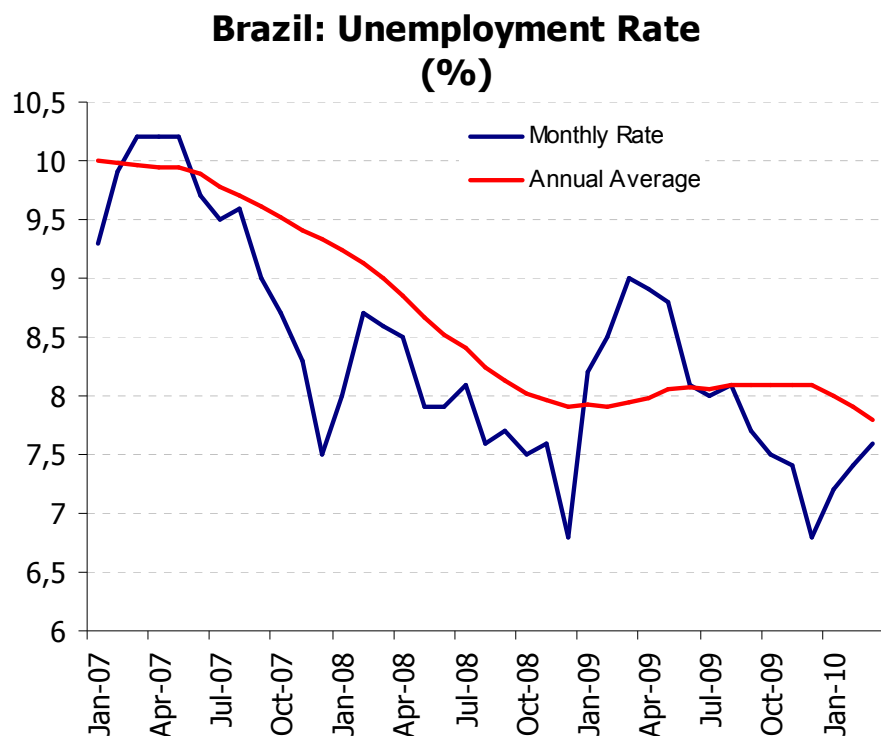
**GDP Forecasts: demand components
(%)**



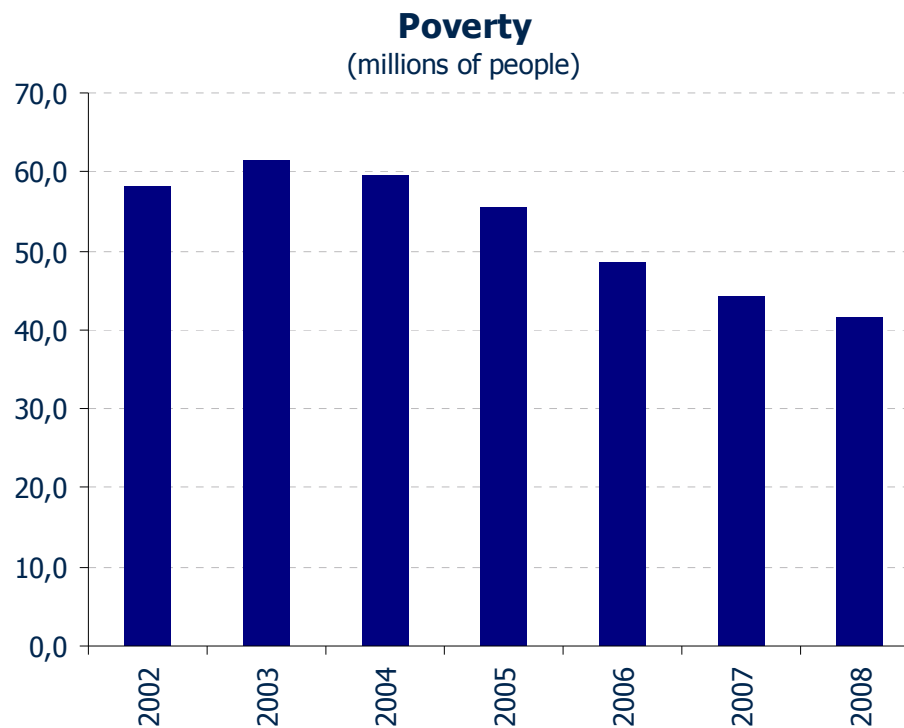
Source: BBVA

The main driver of the GDP performance will be private consumption and investments which account for around 63% and 19% of the GDP respectively.

The robustness of the domestic demand is being supported by a diverse set of factors.



Source: IBGE

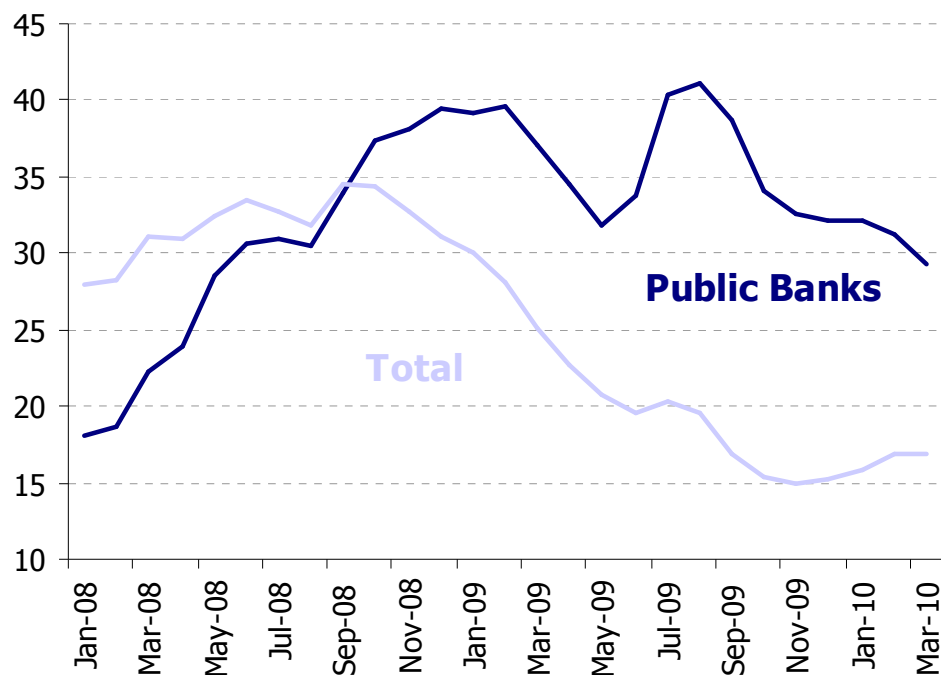


Source: IPEADATA

Labor markets are surprising positively due to a reduction in informality and other structural advances. Better-targeted social policies and macro stability are allowing millions of people to leave poverty condition and to enter consumption markets.

In addition, domestic demand is benefitting from exceptionally expansive monetary and fiscal policies.

**Credit Expansion
(y/y %)**



Source: Central Bank of Brazil

**Lending Interest Rates to Individuals
(yearly rate)**

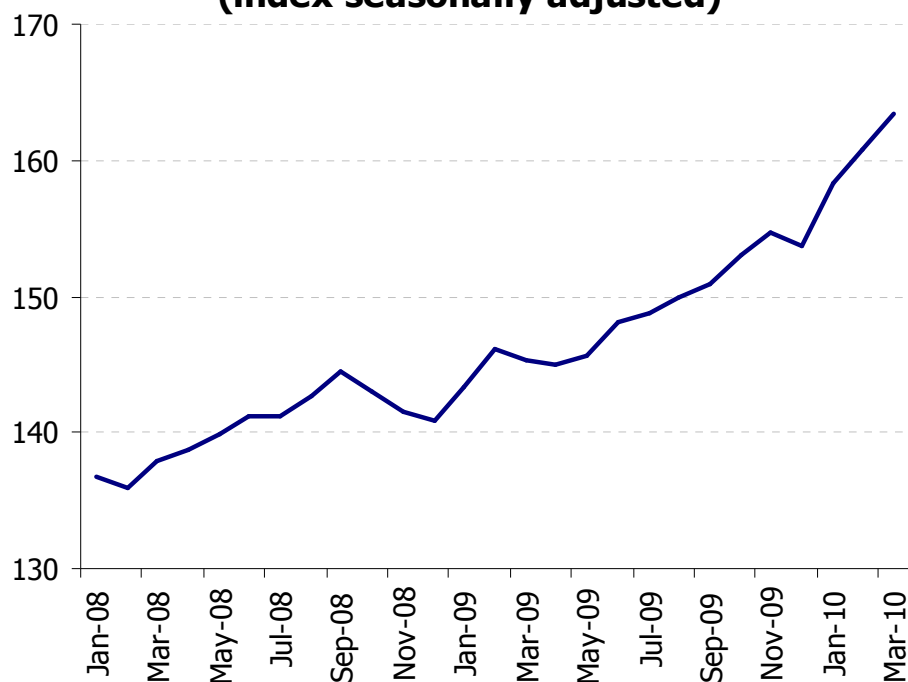


Source: Central Bank of Brazil

On the fiscal front, public expenditures continue increasing strongly and tax incentives introduced during the crisis are still being withdrawn. Credit conditions are also very supportive due to the monetary easing implemented during the crisis and to the expansion of public credit.

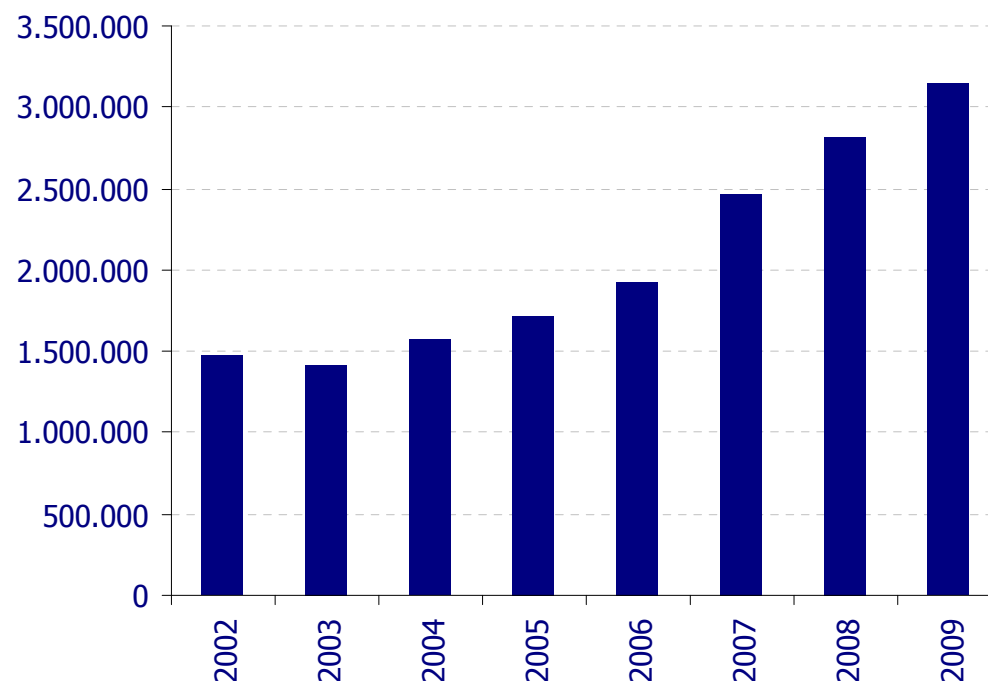
Driven by all these factors, private consumption was barely hit by the crisis...

Brazil: Retail Sales
(index seasonally adjusted)



Source: IBGE

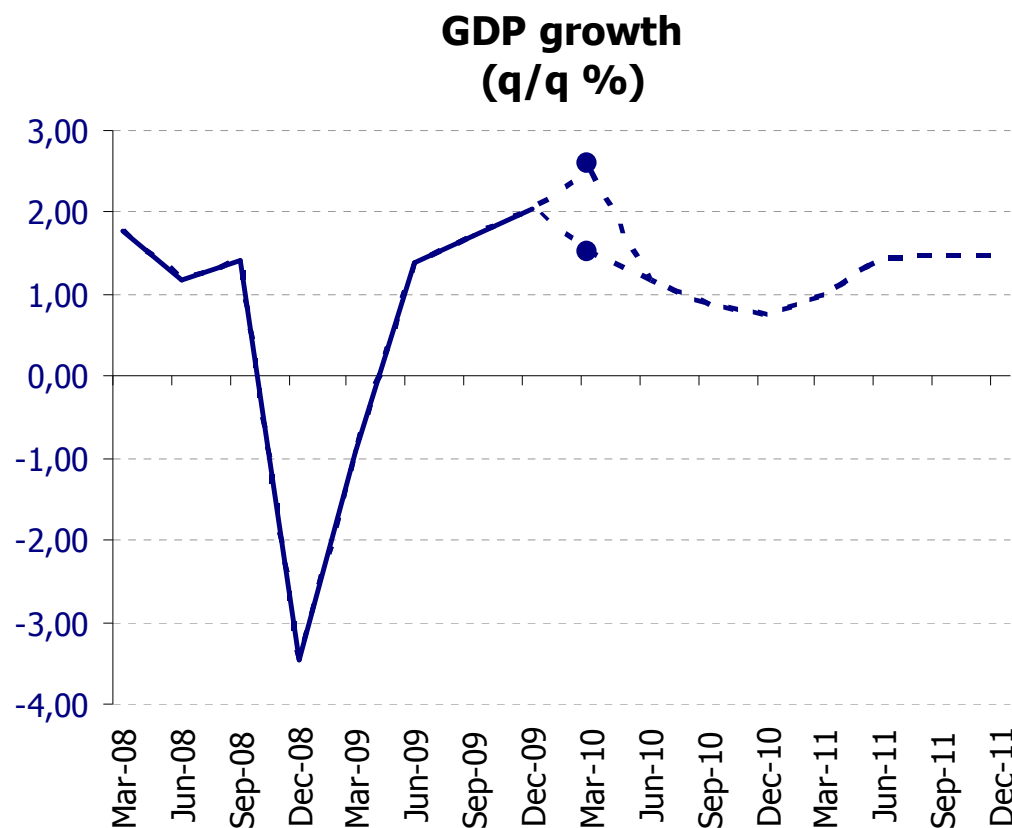
Car Sales
(units)



Source: Bloomberg

And although some moderation should be observed soon, private consumption will remain strong.

Recent activity data suggests GDP in the first quarter could accelerate instead of moderate as expected some months ago. Anyway, both the withdrawing of tax incentives and the monetary tightening cycle should moderate growth from Q2 on

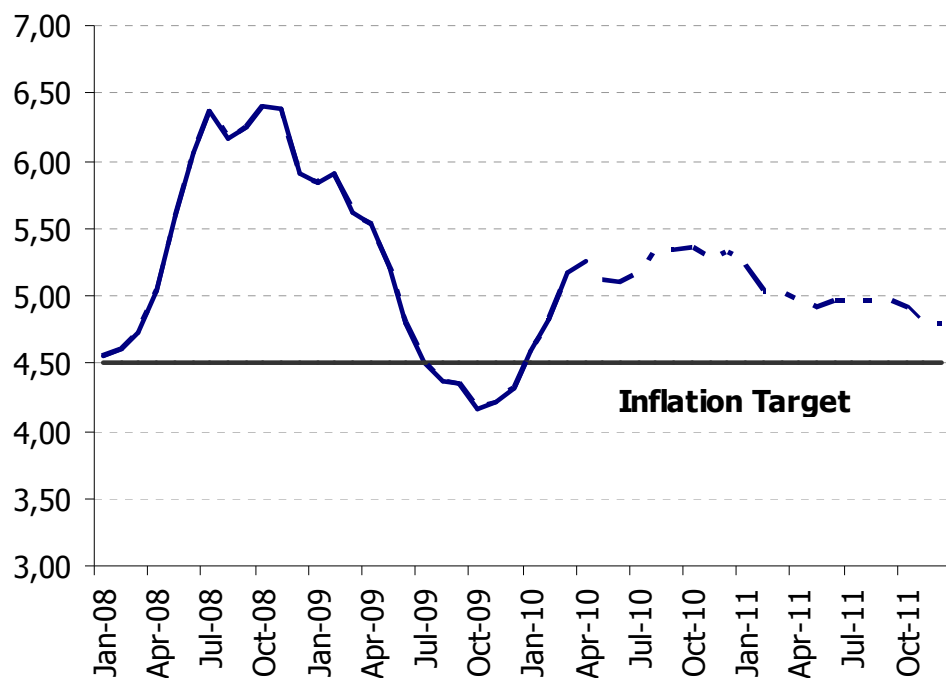


Source: BBVA

In the case GDP surprises to the upside in Q1 10, economic growth could easily exceed 6% in 2010 and as the impact of the problems in Europe should be limited this year.

The strength of the domestic demand and the concerns regarding the timing of exit strategies have been driving up both observed inflation and markets' expectations.

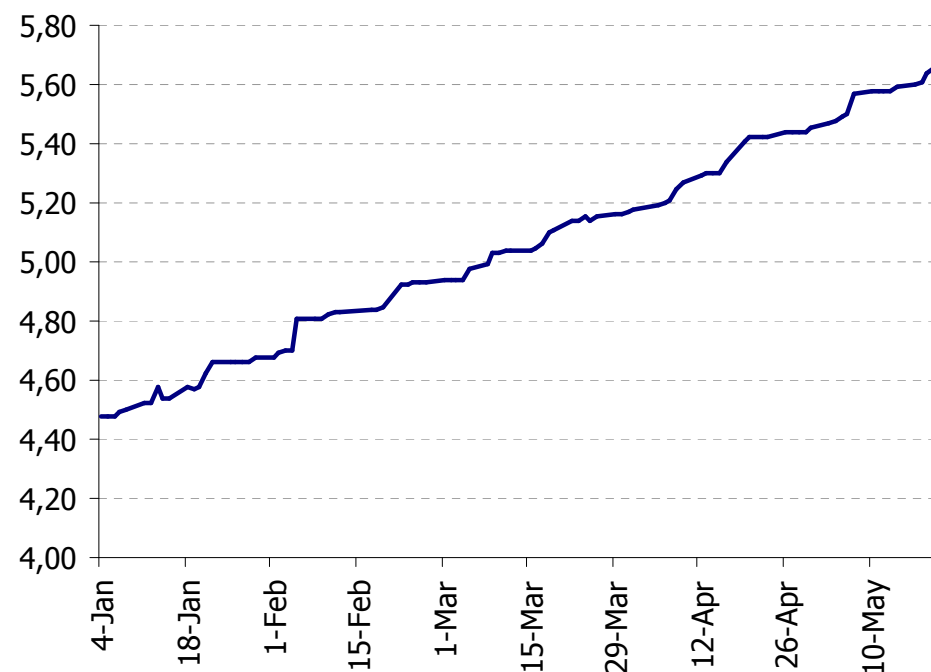
**Inflation
(y/y %)**



Inflation Target

Source: BBVA, IBGE

**Inflation: Market Expectations for the
End of 2010 (y/y %)**

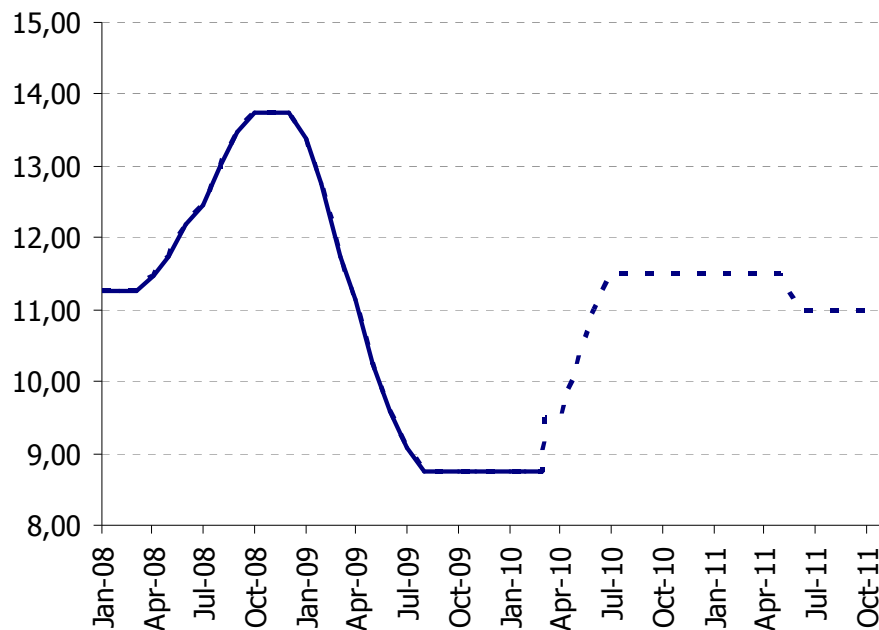


Source: Central Bank of Brazil

The expected moderation in economic activity, the beginning of the monetary tightening cycle and a downward correction in commodity prices due to the crisis in Europe should help inflation to stabilize in coming months. Risks are, however, still to the upside.

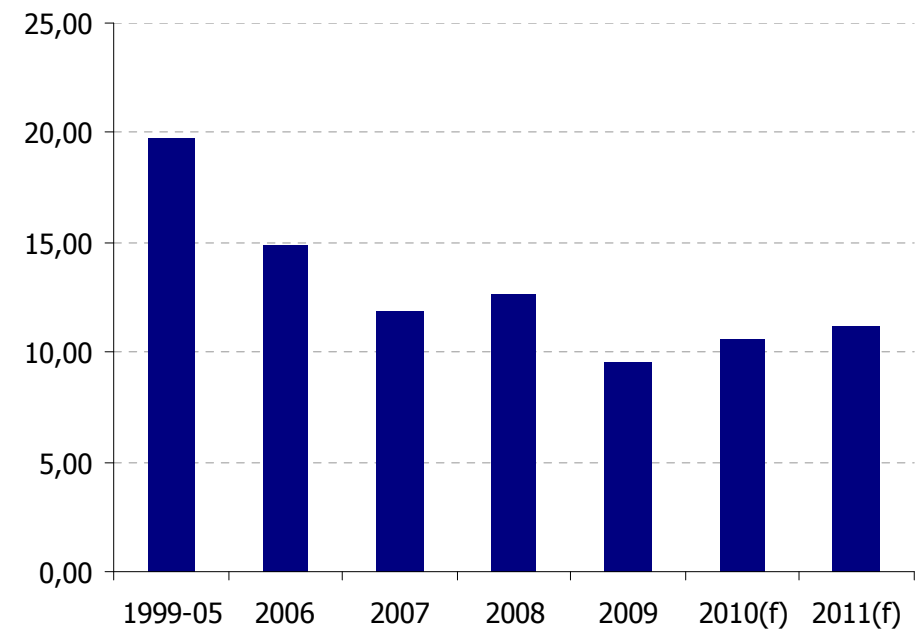
Given the dynamism of activity and the surge in inflation, the Central Bank was forced to adjust rates up by 75bps to 9.5% in April. We expect the CB to raise rates by 75 bps in each one of the next meetings and then by 50 bps more before the end of the year.

**Interest Rates - SELIC
(yearly rate)**



Source: BBVA

**Interest Rates - SELIC
(yearly averages)**

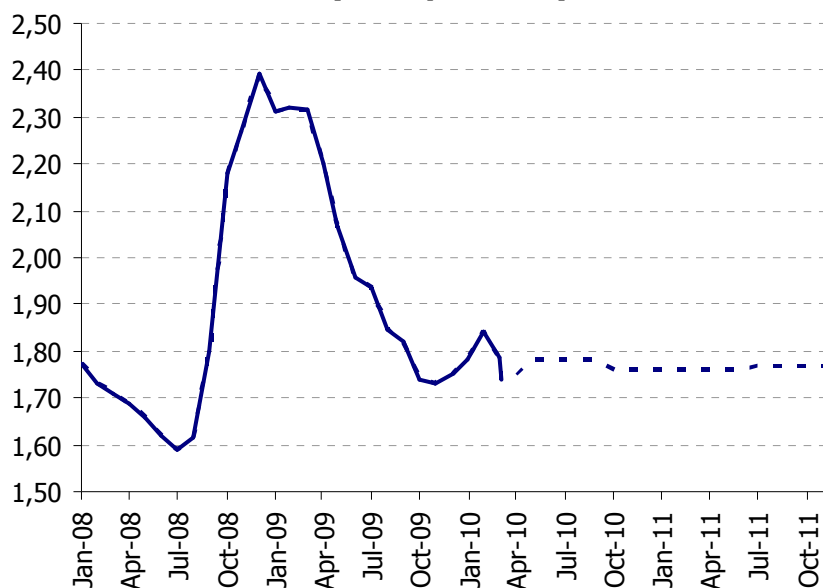


Source: Central Bank of Brazil; BBVA

This view incorporates a less aggressive adjustment than markets are currently discounting as growth should moderate and as decisions might be influenced by the local political cycle and by the turbulences in Europe. It is also likely that the CB will try to make part of the adjustment through other monetary measures.

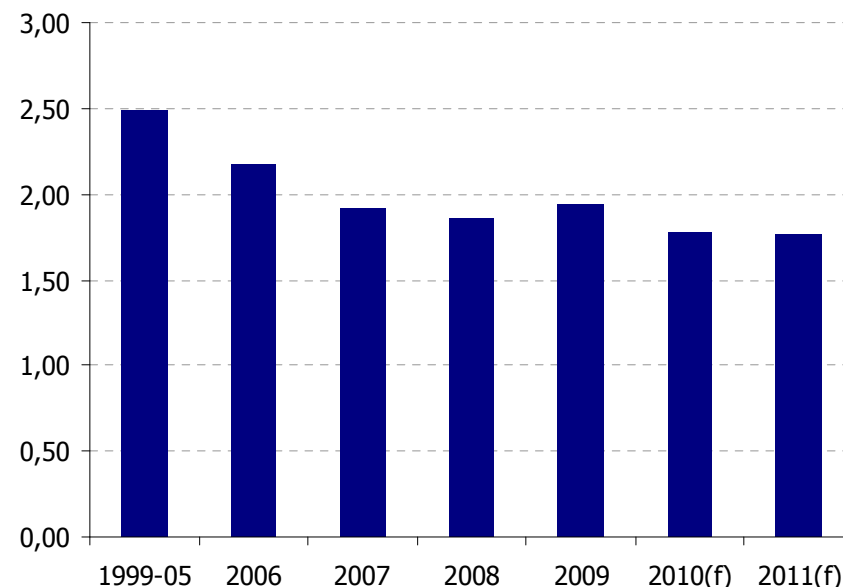
The growth scenario and the monetary tightening cycle will continue putting appreciatory pressures on the Real. However, intervention in FX markets either by the Central Bank or by the Treasury should help to avoid a sharp appreciation of the currency from now on.

**Exchange Rate
(Real per USD)**



Source: BBVA

**Exchange Rate
(Real per USD)**

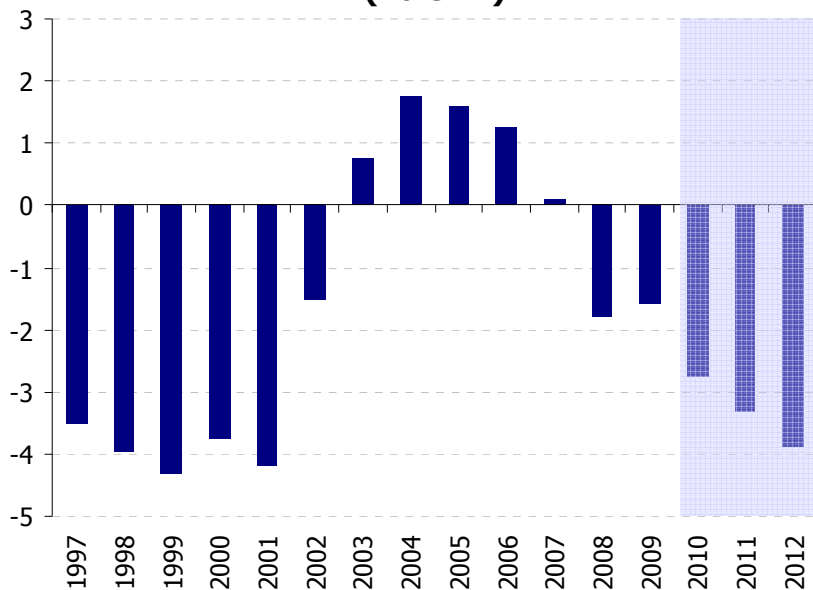


Source: Central Bank of Brazil; BBVA

We expect the Real to be at 1.76 by the end of the year, close to its equilibrium value. The problems in Europe clearly create depreciatory risks on the Real. Both the turbulences in international markets and domestic factors (increasing current account deficits, elections, recent authorization given to the Treasury to intervene in FX markets...) could exacerbate the volatility in FX markets.

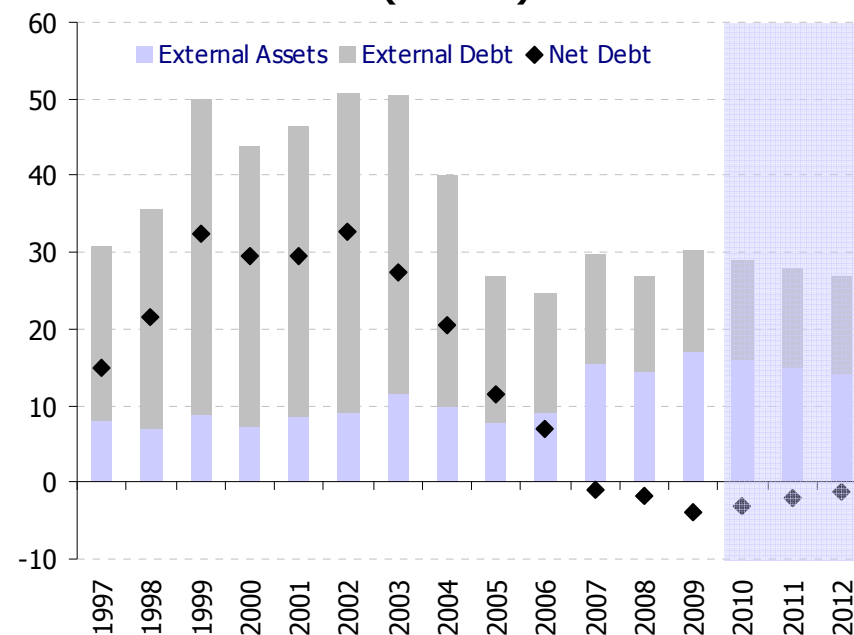
The dynamism of both public and private domestic demand in Brazil has been leading to a deterioration of external accounts. The current account deficit has started to rise and in 2010 it could easily reach 3% of the GDP

**Current Account
(% GDP)**



Source: Central Bank of Brazil; BBVA

**External Accounts
(% GDP)**



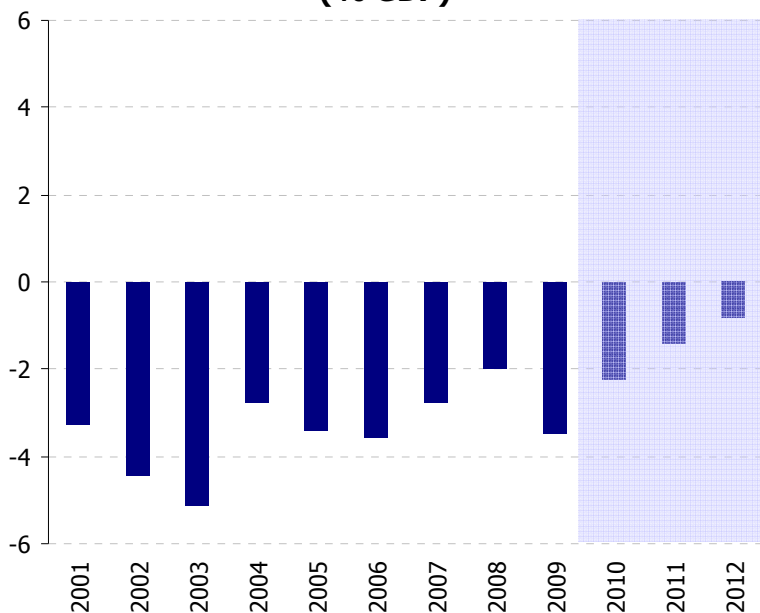
Source: Central Bank of Brazil; BBVA

External solvency is not a risk in the short-term, as the country is currently a net creditor due to its large international reserves. Up to now foreign capitals have been very pleased to finance Brazil's external deficit, but if the mood changes, foreign inflows could slowdown and then the exchange rate would depreciate.

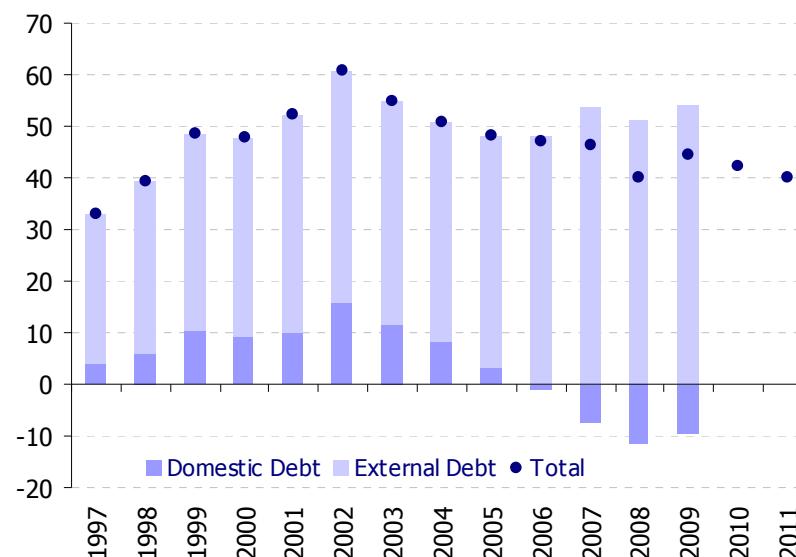
Fiscal policy remains expansive

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

**Fiscal Accounts - Nominal Result
(% GDP)**



**Public Debt - Net
(% GDP)**



Source: Central Bank of Brazil; BBVA

Solvency is not a concern, at least in the short-term, but the mix of fast rising expenditures and high taxes creates an inefficient fiscal environment. Increase in current expenditures fuel current account and inflationary pressures and high taxes represent a heavy burden for the private sector

- The current mix of macroeconomic policies is clearly inefficient. On one hand the Central Bank is tightening monetary policy to avoid overheating and on the other the government continues implementing an expansive fiscal policy.
- Recent events show that there are increasing - although still limited - risks regarding mismanagement of fiscal policies. Example of such events: allowing all the investments in the PAC to be excluded from primary surplus goals; issuance of public bonds at market rates to capitalize the BNDES (to allow the Development Bank to lend at subsidized rates).
- The intervention of the public sector in the economy has been increasing since the beginning of the crisis. Signs of larger interventionism: public banks have now a higher share of total credit; tax on foreign flows; intervention on FX markets; public sector's higher role in oil sector production and regulation; emergence of an explicit industrial policy...

Section I

Economic Scenario

Section II

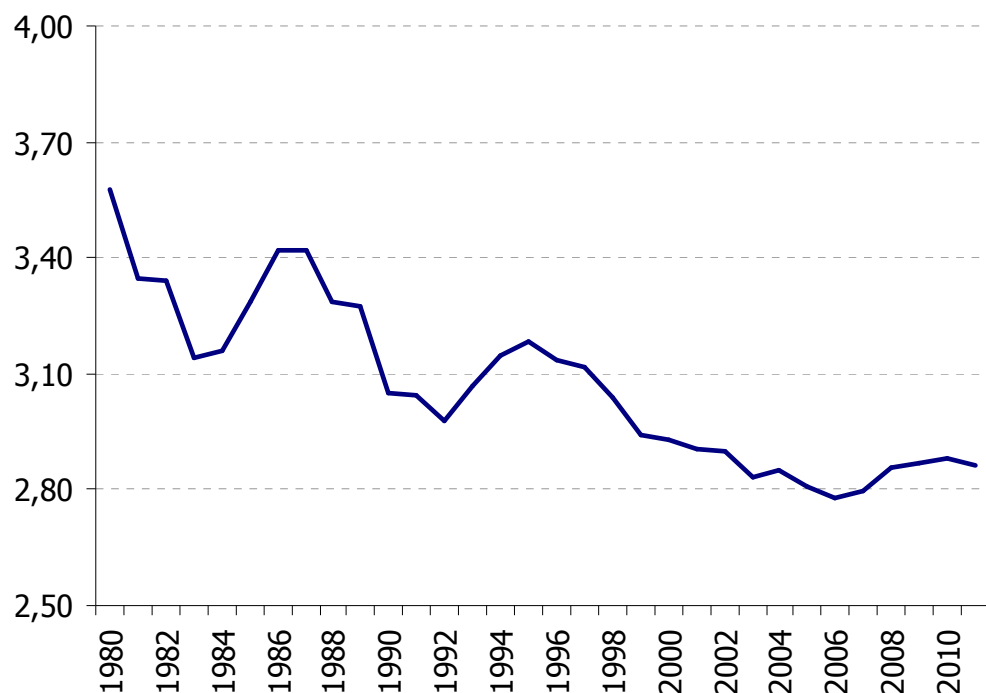
Structural Characterization

Section III

Strengths, Risks and Challenges

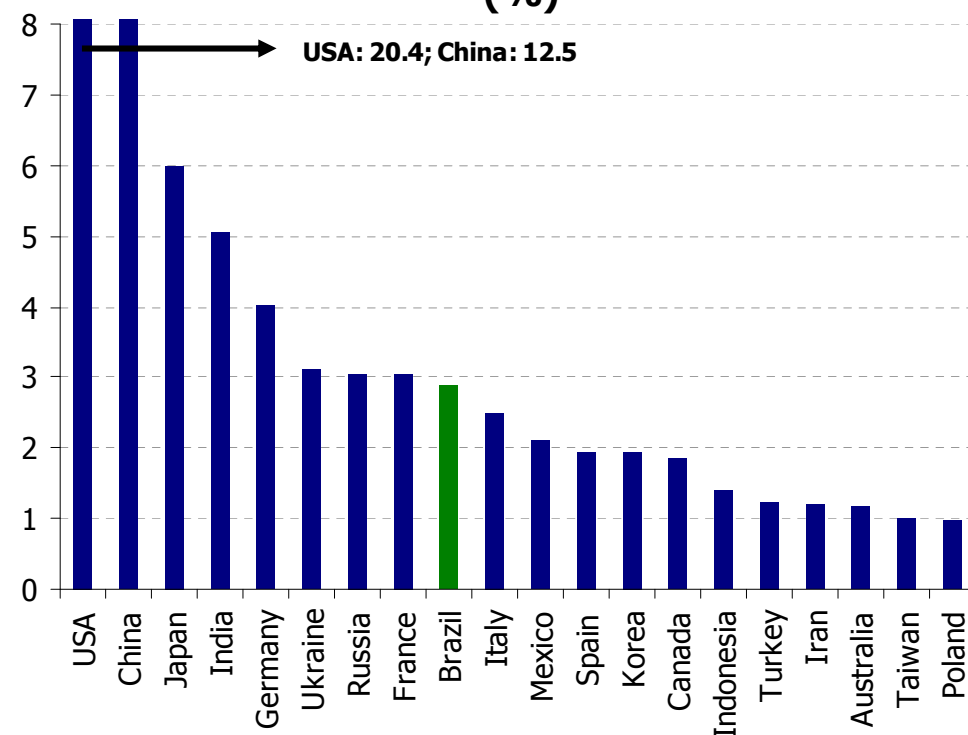
In spite of the downward trend displayed in the last decades, Brazil's GDP remains among the highest in the world

Brazilian Share in World GDP (%)



Source: IMF

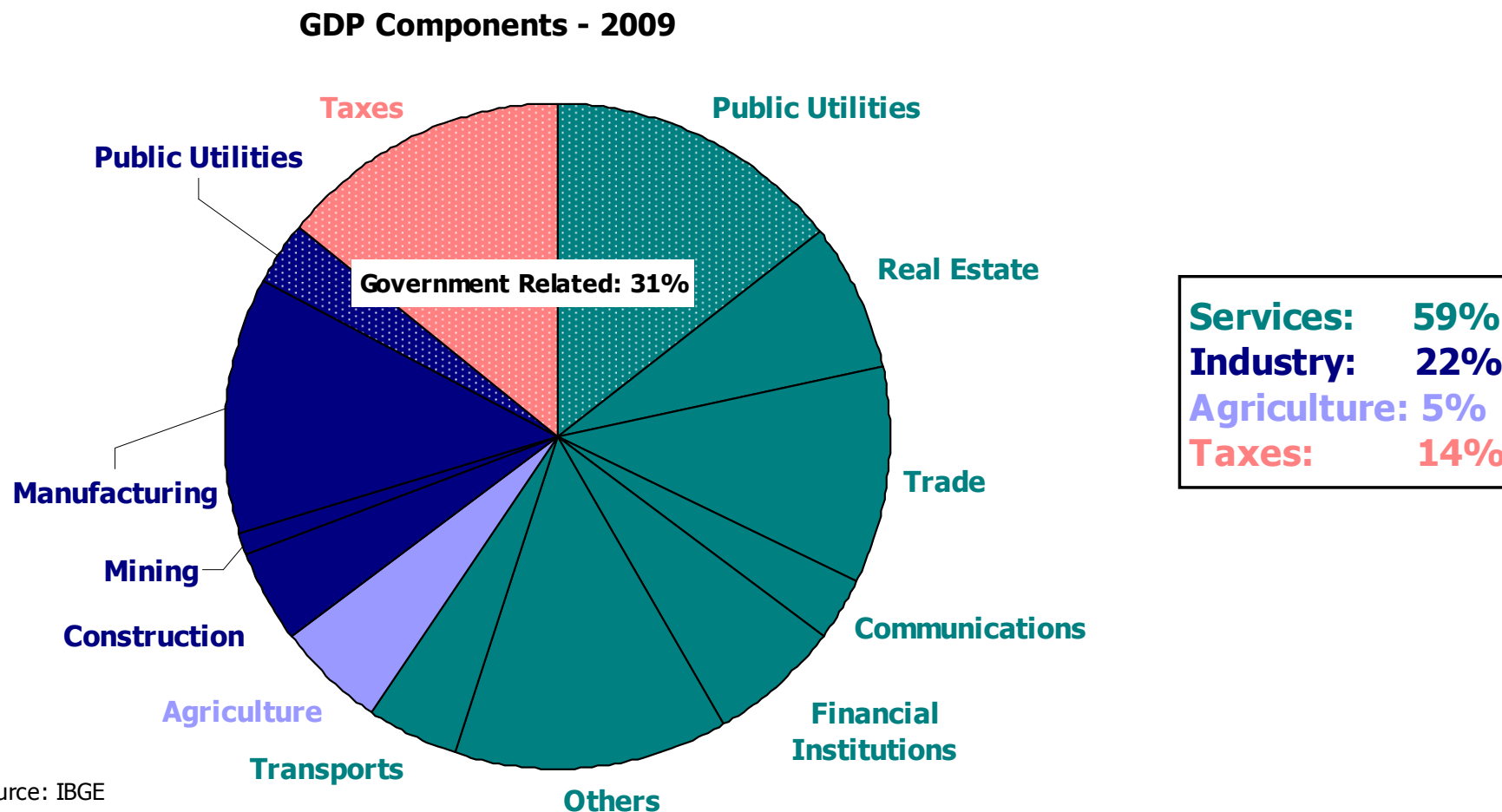
Share in World GDP (%)



Source: IMF

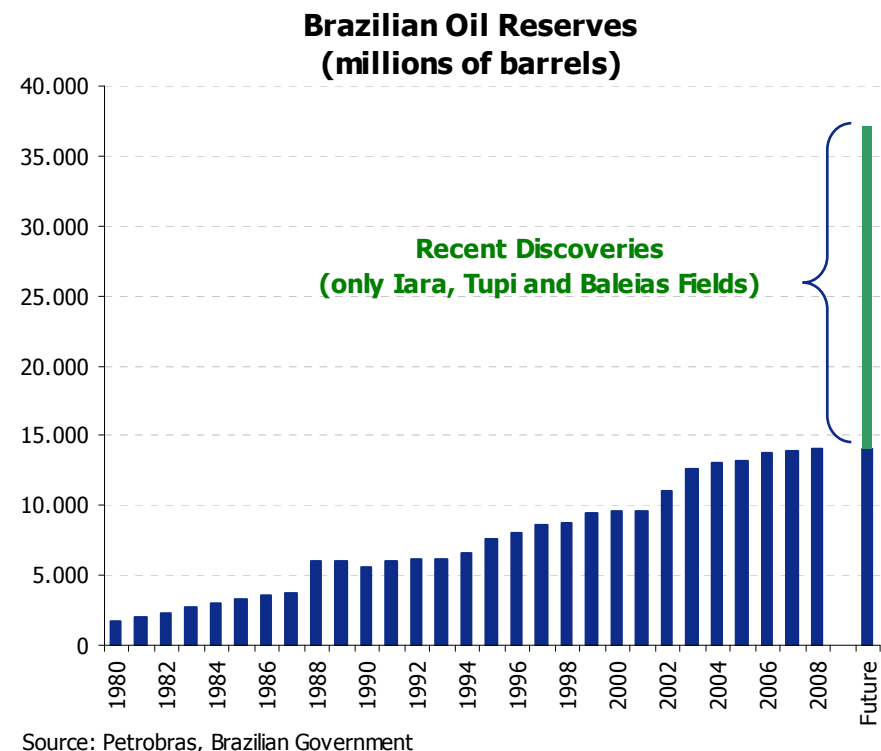
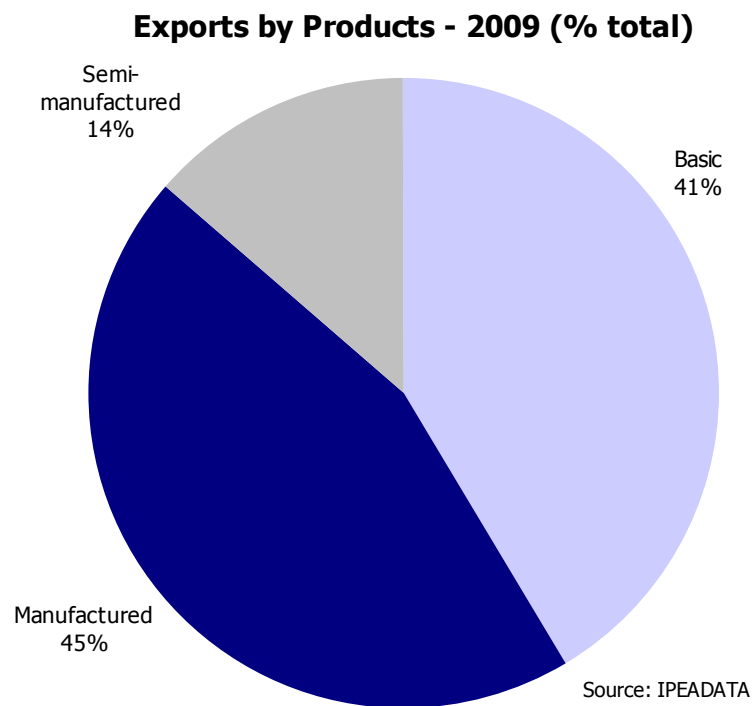
In the last years, the importance of the country has been increasing, not only in economic terms and an important player in global forums

Brazil has a relatively well-diversified economy. Although commodities-related sectors play an important role, other sectors have also a significant share of the productive structure.



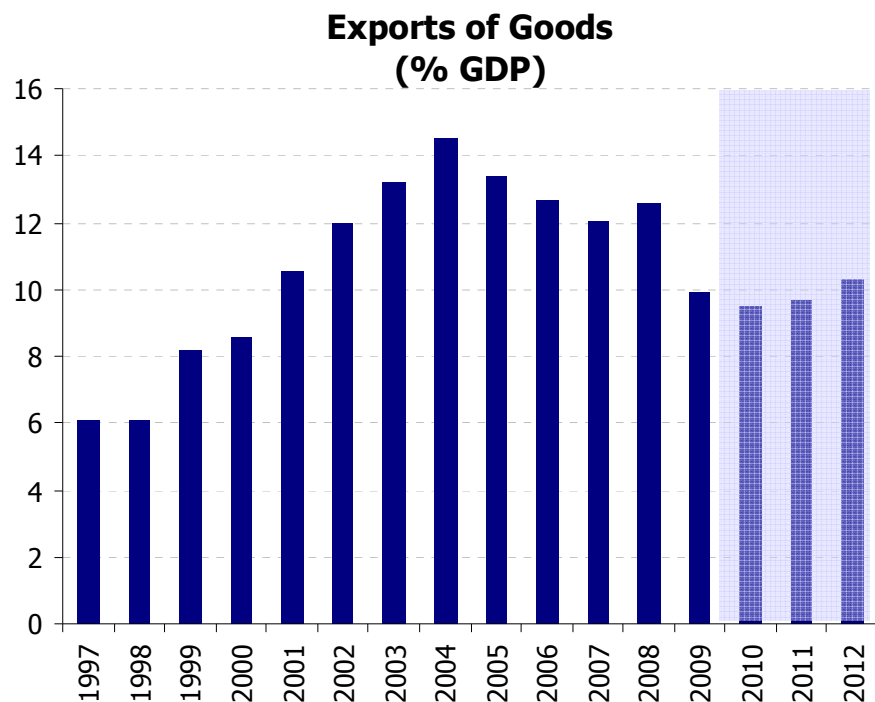
Another feature of the Brazilian economy is the significant weight of the government.

The composition of Brazil's exports show more clearly the importance of non-manufactured products for the economy. In the last years the share of basic products in total exports is increasing and this trend is likely to continue as the country will continue to feed the Chinese appetite.

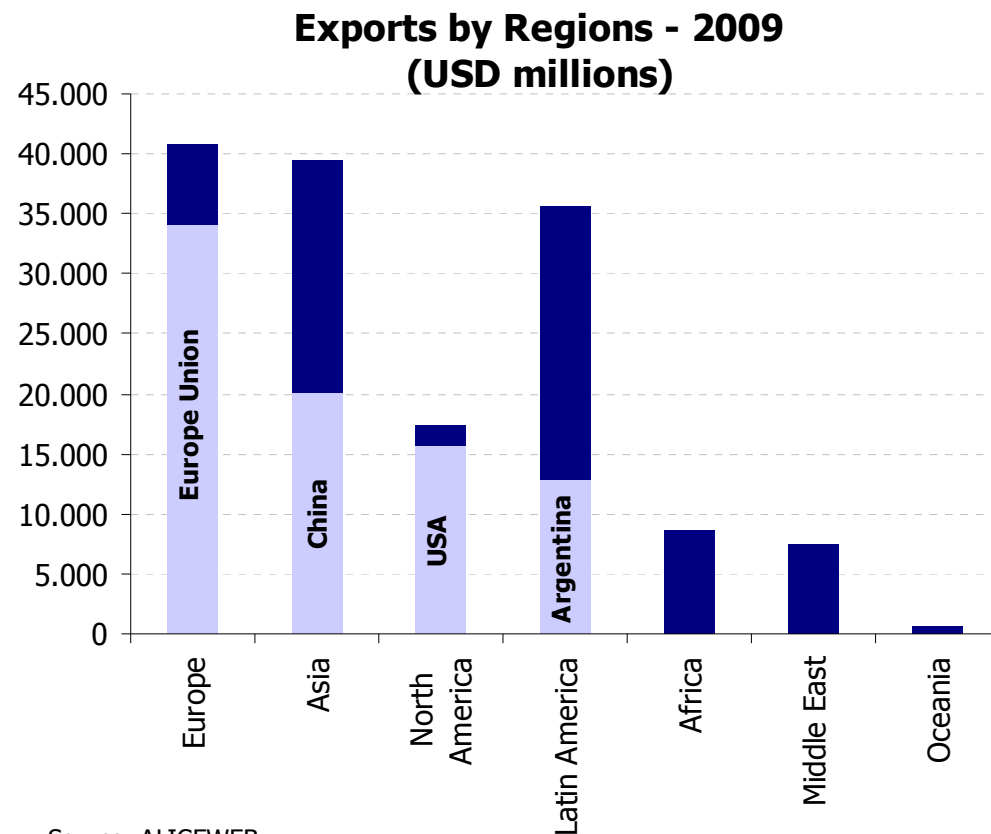


The perspectives of becoming an important oil exporter also contribute to the “commodity specialization” risk. Management issues will be especially important as the country will benefit from increasing oil resources which will require an active attitude to prevent rent-seeker activities and to accommodate the interests of different players

Brazilian exports represent only around 10% of the GDP. Although they are concentrated in terms of products, they are very well diversified in geographic terms.



Source: Central Bank of Brazil; BBVA

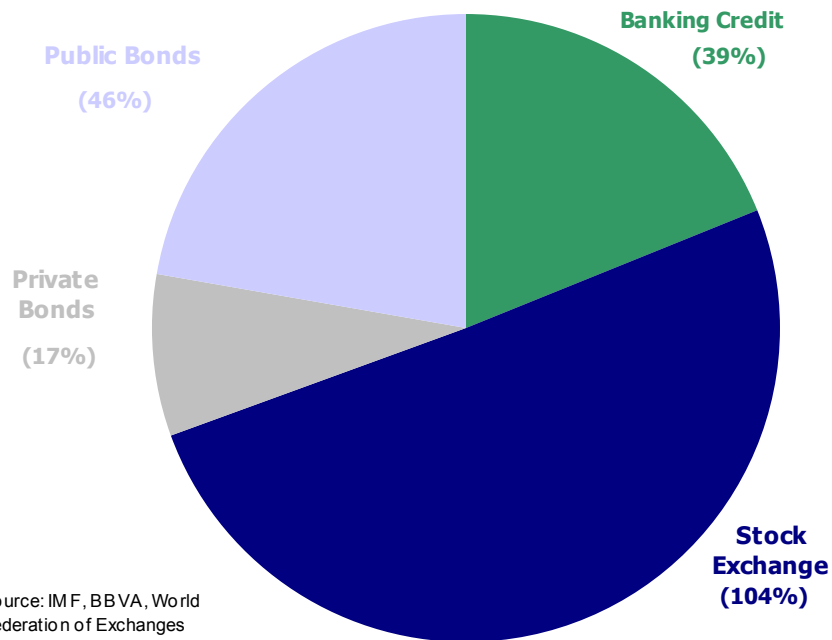


Source: ALICEWEB

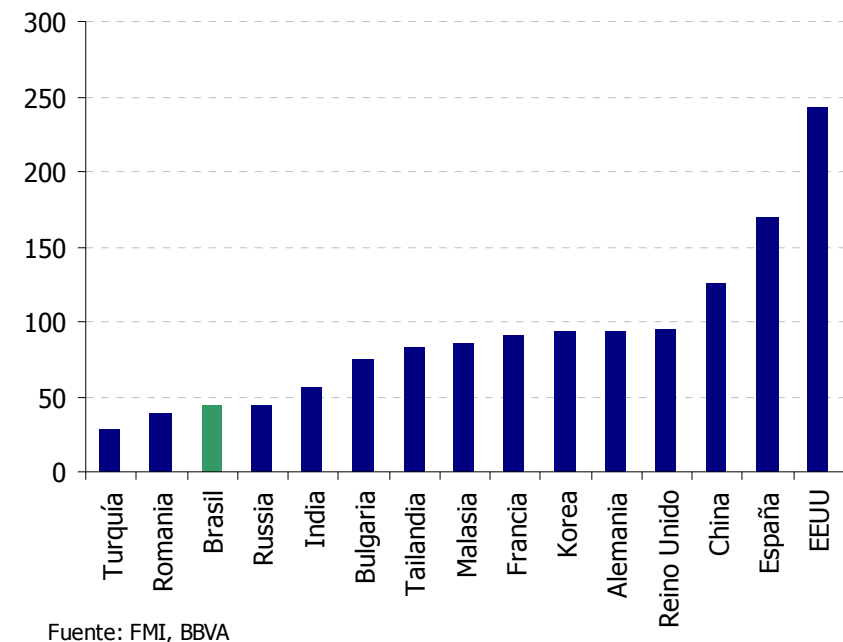
Exports to China expanded significantly in the last years while the country was able to maintain its sales to USA, Europe and Latin America (where the Chinese competition is an increasing threat).

The Financial System is now more developed than in the past due to institutional and macroeconomic advances. In a recent past banking credit and self-financing were the predominant options for Brazilian companies. Nowadays, equity and fixed income are important sources of corporate funding.

Financial Markets
(% GDP; 2007)



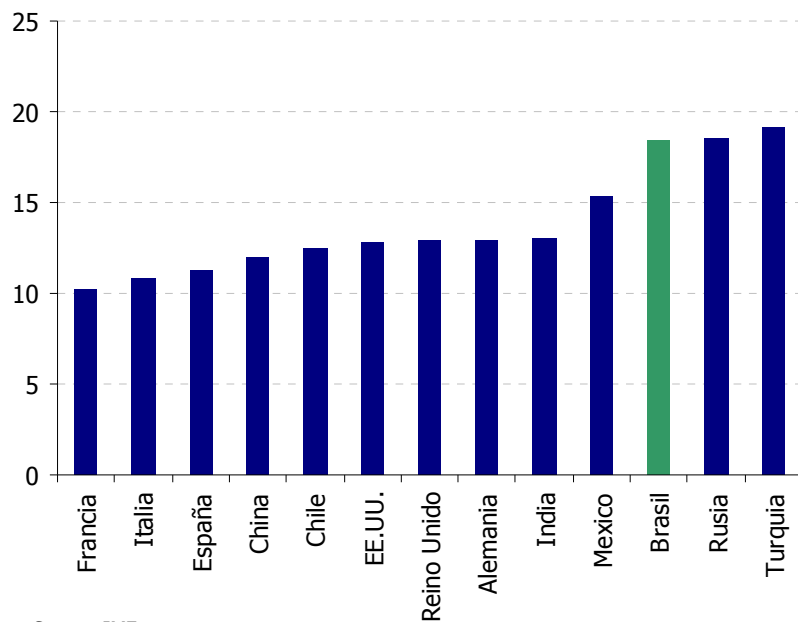
Credit to Private Sector
(% GDP)



In spite of the positive evolution observed in the last years, financial markets have still to progress. Credit in % of the GDP has expanded but remains relatively low.

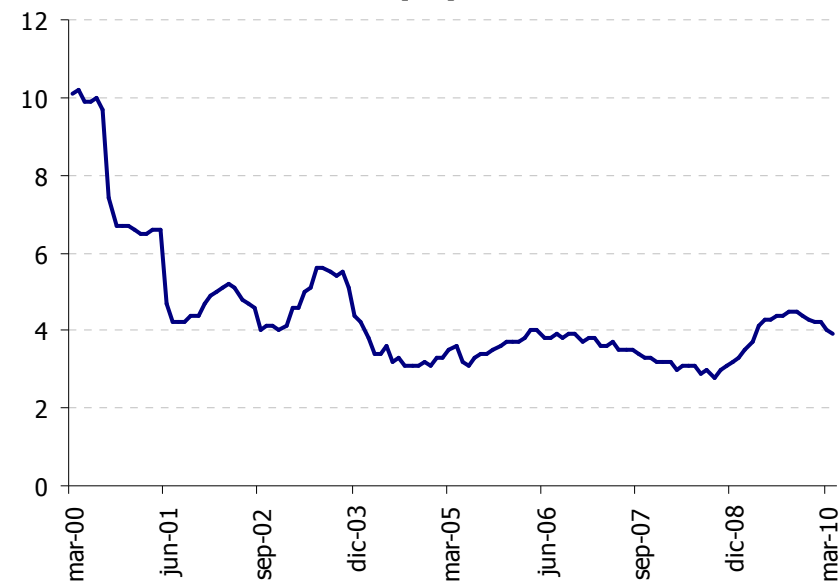
The banking system displays high capitalization, solvency and profitability indices. Current liquidity levels are adequate, but during crisis periods smaller banks are much more exposed than the big ones due to their relatively large dependence on non-deposit funding.

Basel Index



Source:IMF

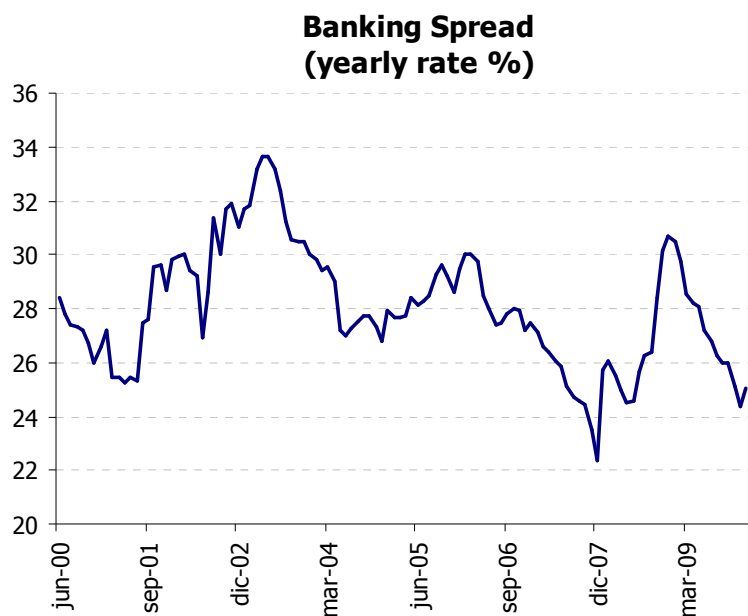
Non-Performing Loans (%)



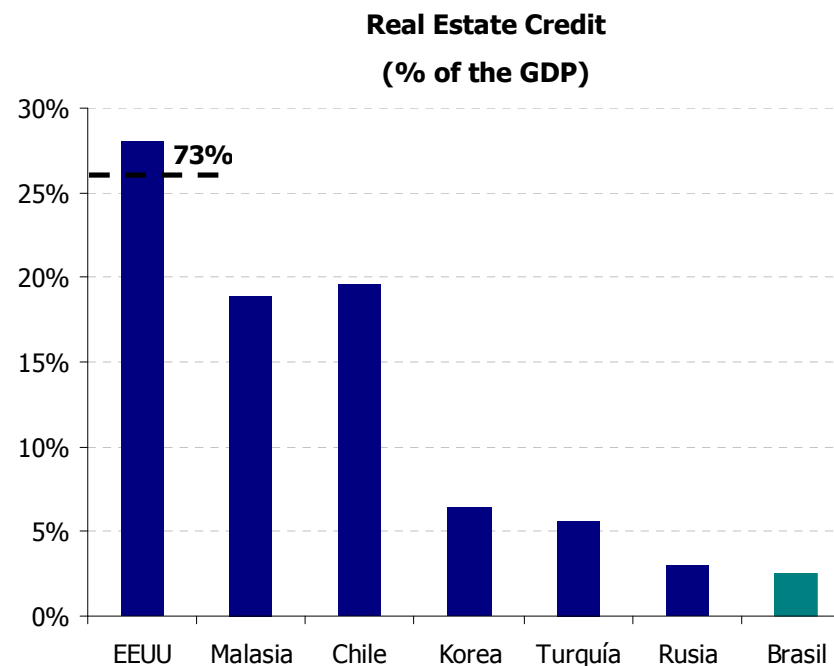
Source; Central Bank of Brazil

NPL remained under control even during the worst of the crisis and are moving downwards recently.

Interest rates remain at very high rates and its reduction is likely to be among the main policy goals for the coming years.



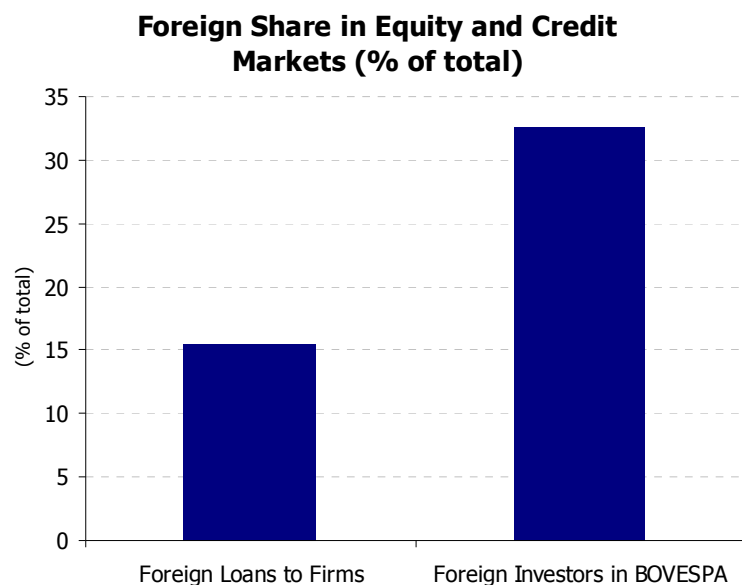
Source; Central Bank of Brazil



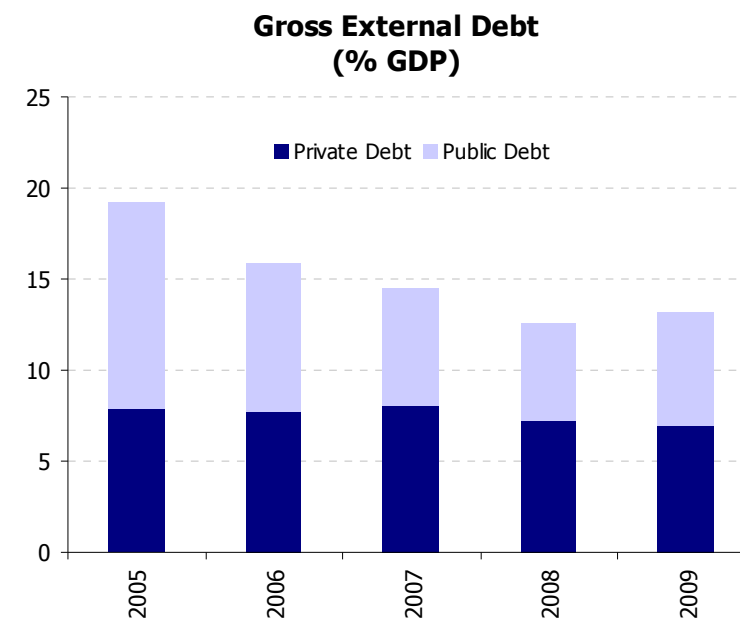
Fuente: BBVA. * Último dato disponible de 2009

The expansion of long-term credit is a clear challenge for the future.

The main external risks are related to Brazil's dependence of foreign funding as evidenced by the last crisis.



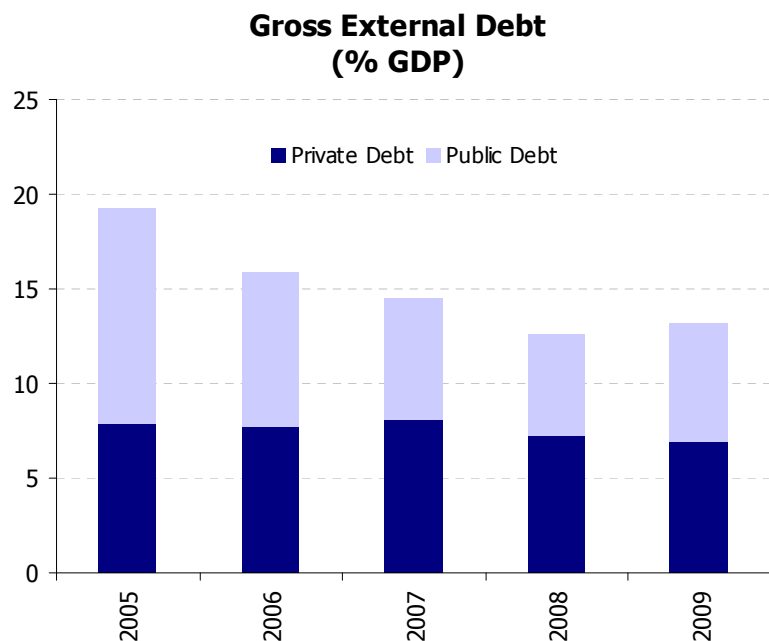
Source: BOVESPA; Central Bank of Brazil



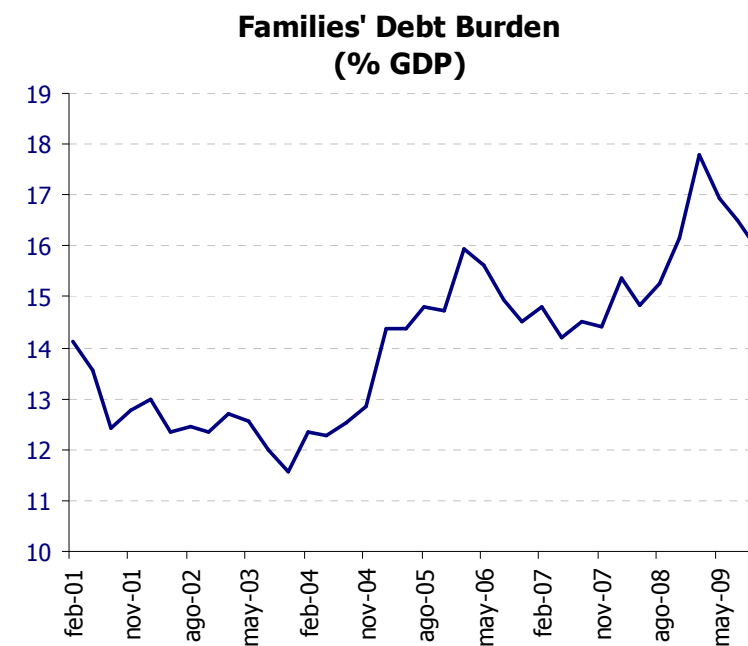
Source: Central Bank of Brazil

Foreign investments in the BOVESPA, for example, represent already one third of the total. The share of foreign loans is around 15% and private external issuance has increased significantly in the last years.

Private sector vulnerability to financial shocks: the private sector holds an increasing share of the Brazilian external debt. This and the still precarious management of FX risks (as shown by the recent problems related to exposition to FX derivatives) could be a future source of problems.



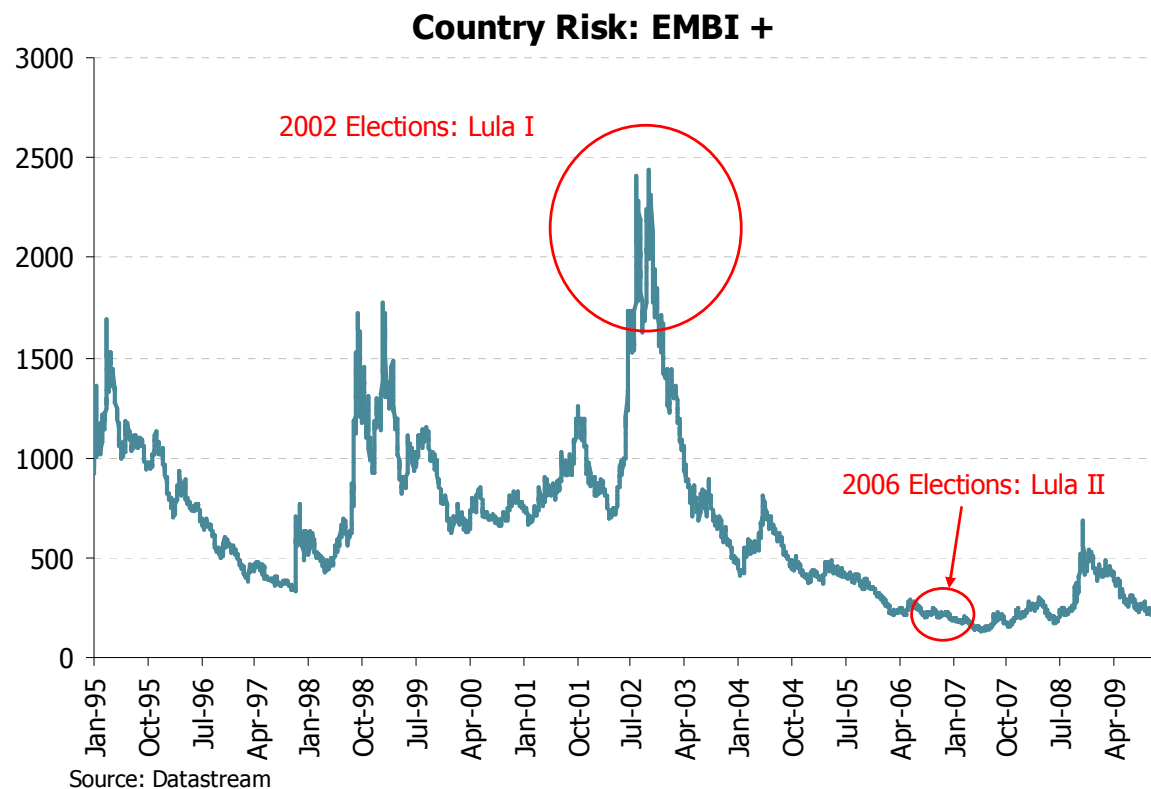
Source: Central Bank of Brazil



Source: BBVA; Central Bank of Brazil

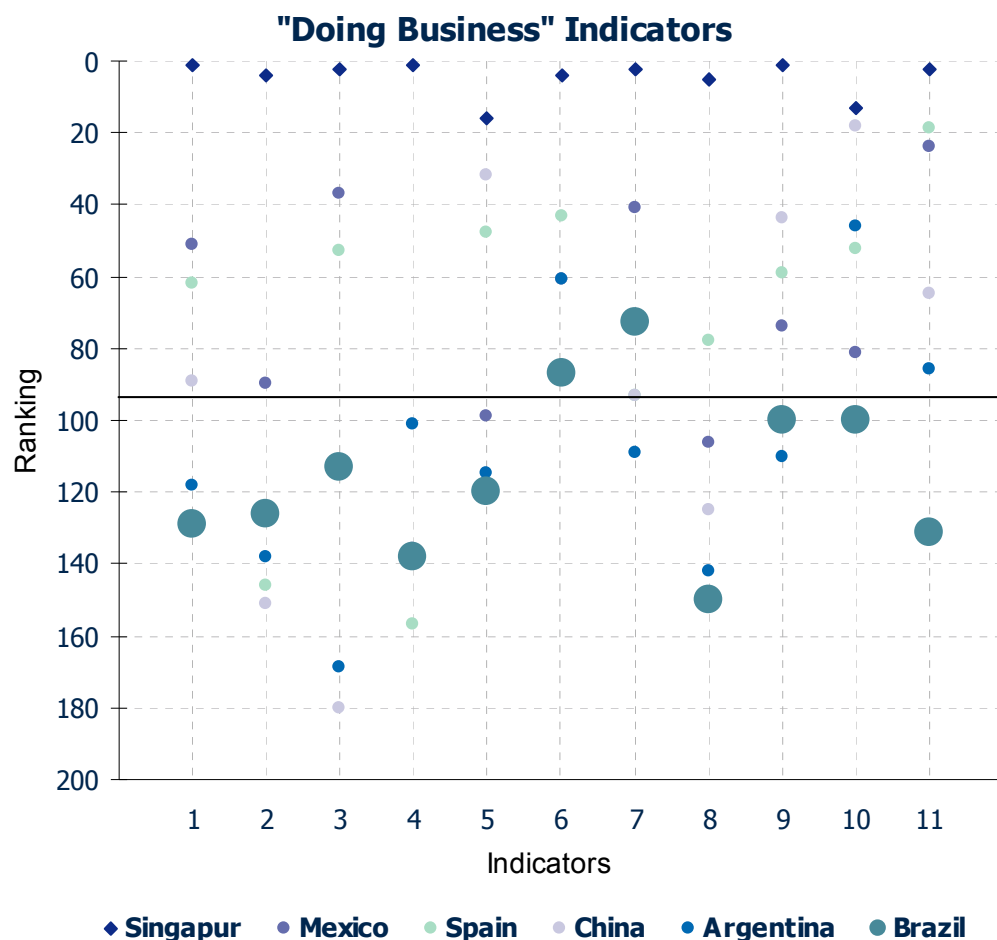
On another front, despite increasing disposable income, families' debt burden is higher than in the recent past as lending rates continue at very high levels (more than 40% in yearly terms) and as credit continues expanding significantly.

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



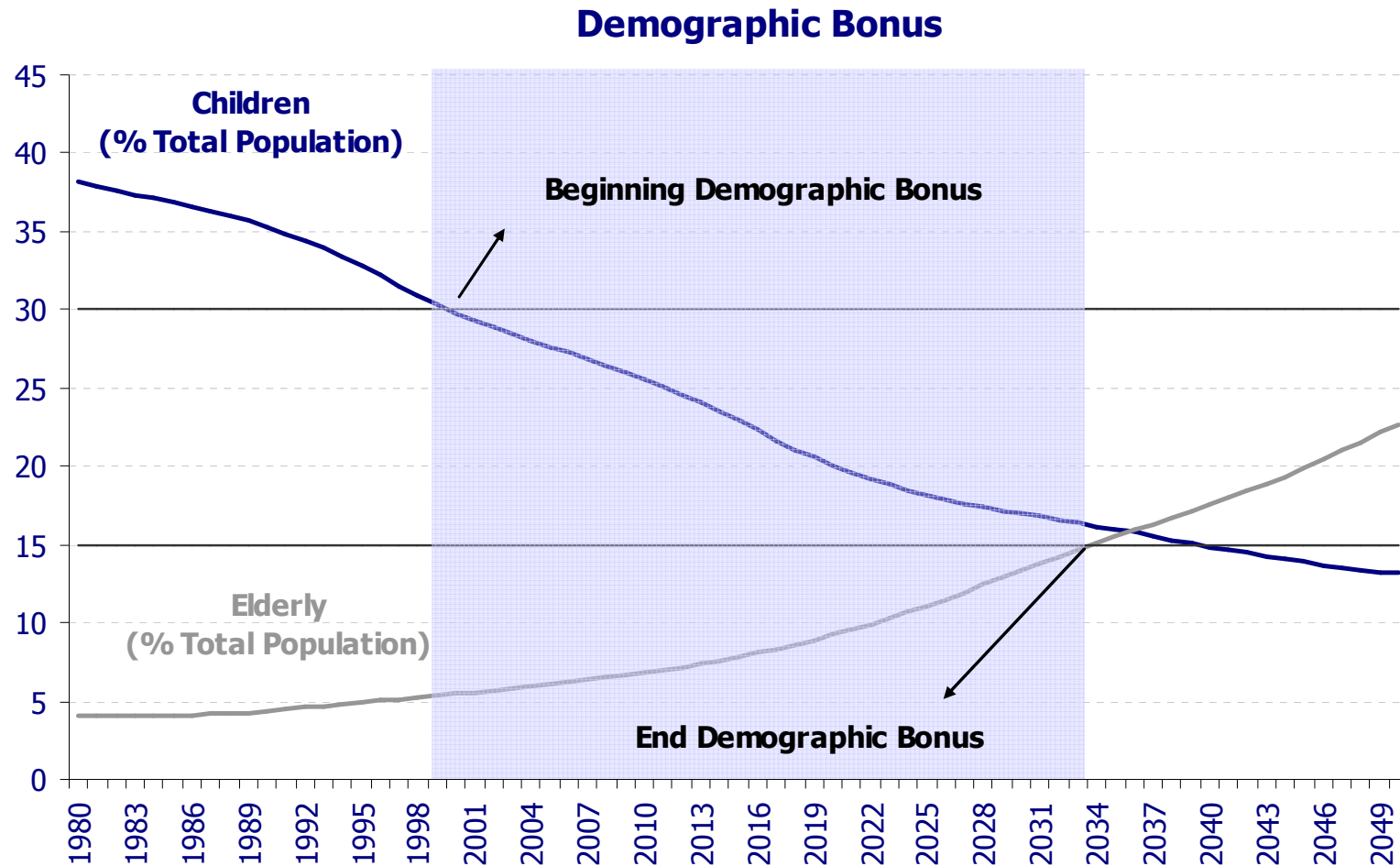
On the economic front, the positive performance of the Brazilian economy in the last years is a direct consequence of the option for implementing orthodox economic policies (basically inflation target, a flexible exchange rate and a fiscal discipline).

Slow progress of economic reforms: the optimism regarding the country seems to have taken the attention away from the needed reforms (tax system, political system, pension system, judiciary system...) Some progress has been made, but at a slow rate...



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

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

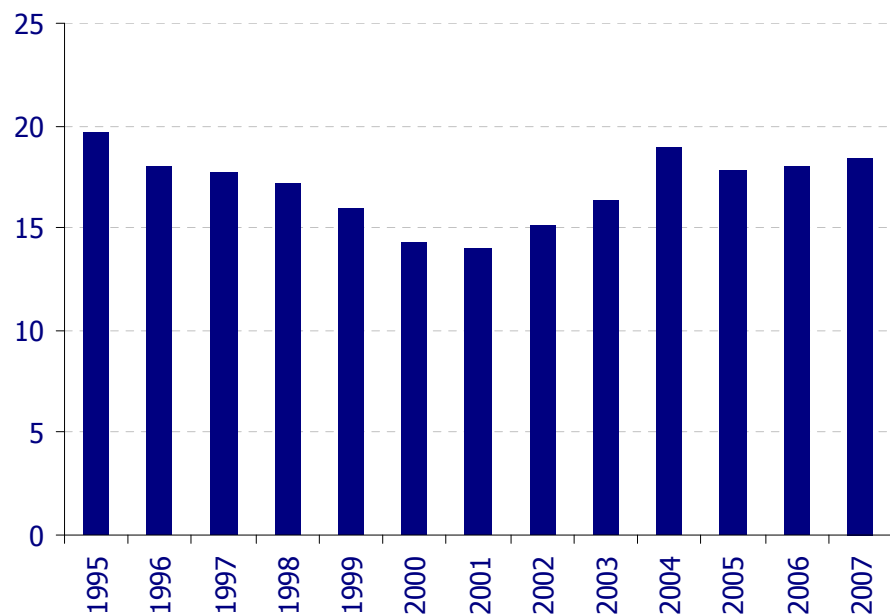


Source: IBGE

Public and private consumption rates are very high and therefore domestic saving rates are small and make more difficult a significant expansion of investment levels.

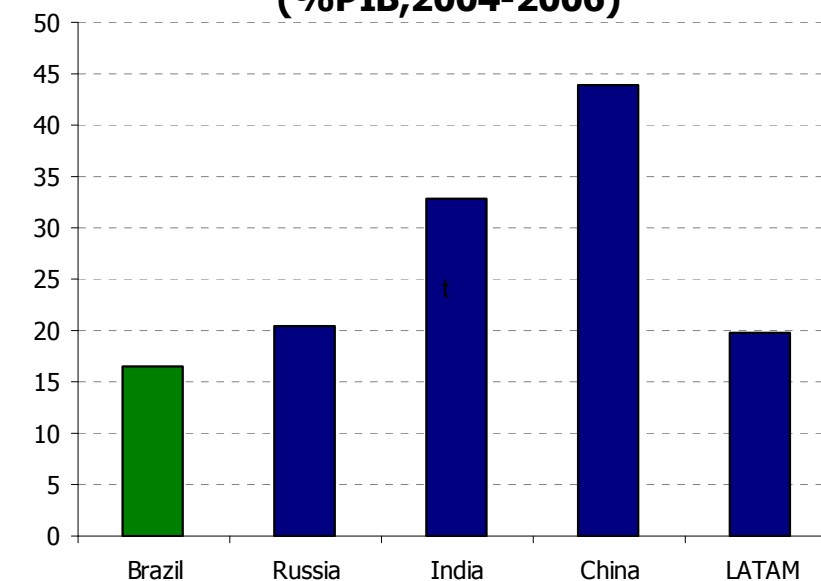
External savings arises as an alternative, but it increases the dependence of external capital inflows...

**Saving Rate
(% GDP)**



Source: IPEADATA

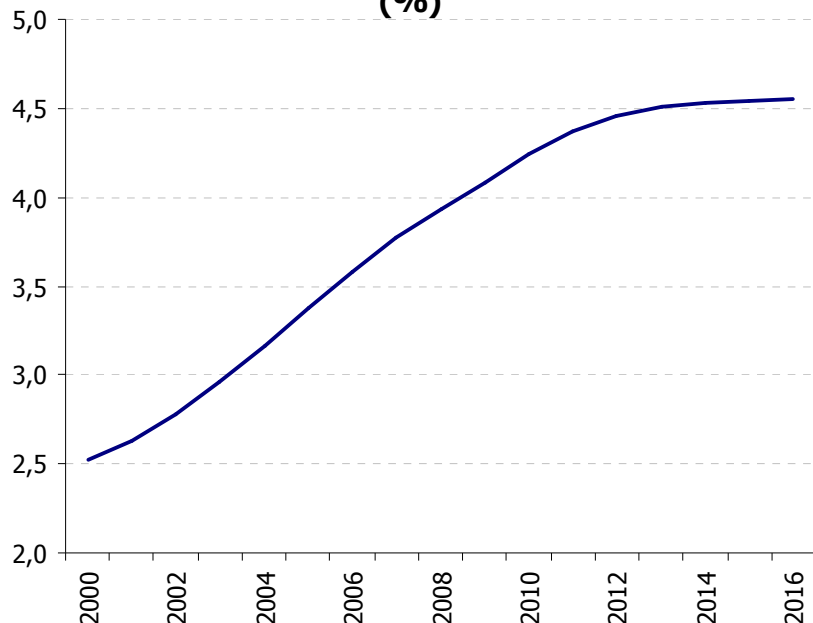
**Gross Fixed Capital Formation
(%PIB, 2004-2006)**



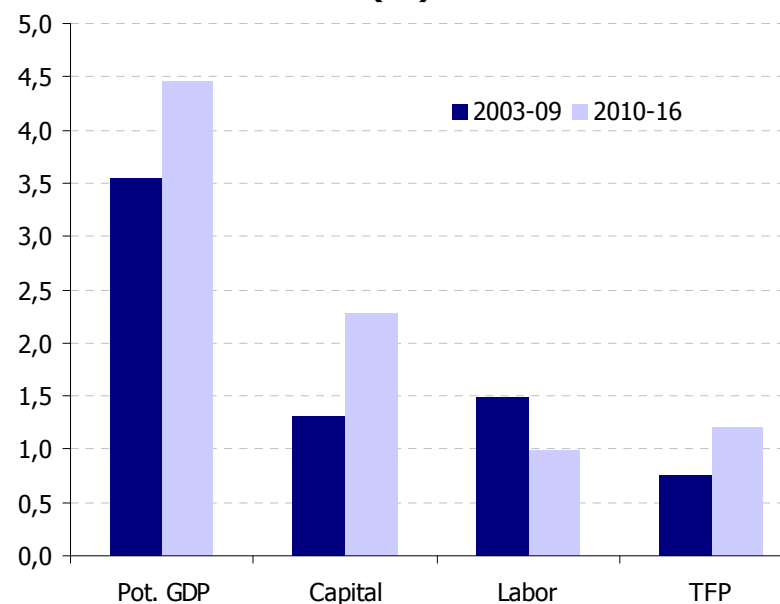
Source: World Bank

Potential GDP will continue growing gradually in the next years until it reaches 4.5%. Macro and political stability will allow both productivity and capital to contribute more to a higher GDP. The labor factor will contribute less due to demographic issues

Brazil: Potential GDP (%)

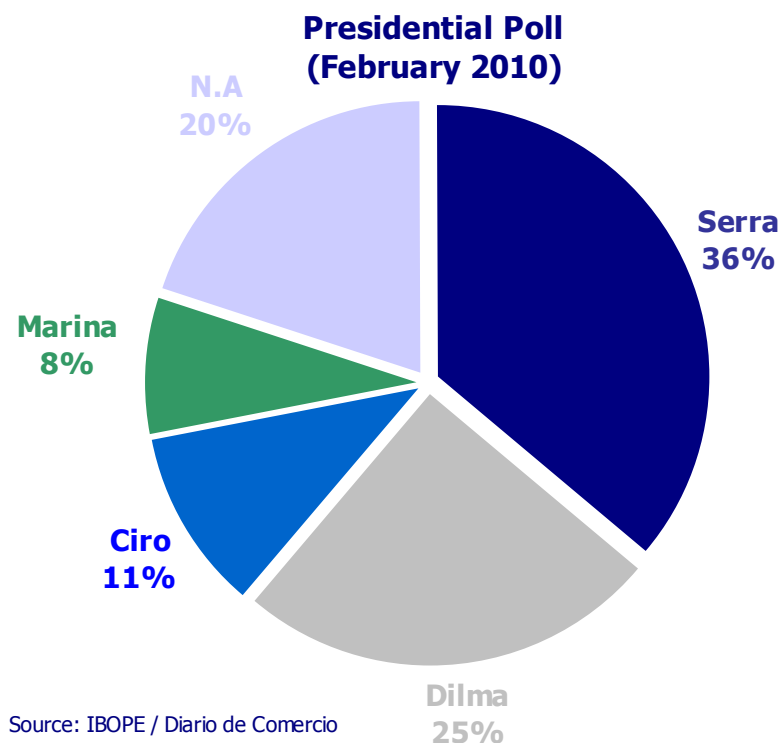


Potential GDP by Components (%)



Despite the positive evolution, Brazilian potential GDP look relatively small in comparison to other emerging economies – especially the Asian ones. Higher levels will not be feasible unless the country implements important economic reforms. At the time being, these reforms seems unlikely.

Presidential elections will be held in October of 2010. The risks associated to presidential elections are not null, but they have diminished compared to the past thanks to a growing consensus about main economic policies.



On the other hand it is not clear whether any candidates will be able to implement the economic reforms that are still needed.

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Strengths, Risks and Challenges

Strengths: Strengths, risks and challenges

- macroeconomic and political stability (which will be once more tested during next elections)
- size of the domestic market and the strong expansion of consumption markets
- soundness of the financial sector
- strategic position as a commodity producer (including the new opportunities related to the oil sector and the country's privileged endowment of land and water)
- diversification of external markets.

Risks and challenges:

- management of oil resources (Dutch disease, rent-seeking...)
- interventionism trend
- private sector imbalances (management of external debt, families' debt burden)
- some macroeconomic disequilibria (inflation and current account)
- lack of economic reforms, low human capital levels, poor business environment...

Overall the balance of risks is positive, but the optimism towards the

BBVA Research

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May 31st 2010