

Brazil

Economic Outlook

Second Quarter of 2010

Economic Analysis

- Domestic demand will support a robust GDP growth, but will also threaten a rise in inflation and the current account deficit.
- Fiscal policies will remain expansive while the Central Bank tightens monetary policy, creating some macroeconomic distortions.
- International volatility and domestic factors will create risks of higher exchange rate volatility.



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Closing date: May 18, 2010

1. Challenges ahead for a sustained recovery

The cyclical situation has improved significantly over the last few quarters, driven by the recovery in emerging market economies and the US. Global trade is growing at 7% and we forecast a 4.2% global growth for 2010. At the same time, there are doubts about the ability of the European Monetary Union within its current decision-making framework to deal with the high level of indebtedness of some of its countries. These doubts have given rise to widening spreads and renewed financial stress. These developments may impinge first on the European economy with possible spillovers into the rest of the world. The timing and the extent of these adverse impacts will crucially hinge on the effectiveness and lasting effects of the announcement of the rescue package agreed upon by the European Council on May 9 and the exceptional measures adopted by the ECB. While the package has stabilised market conditions in the short run, uncertainties remain on three fronts: i) the implementation of the rescue package in the months to come, ii) the credibility of further fiscal consolidation yet to be adopted by some EU countries and iii) EMU core countries' medium-term commitment to the package.

While economic recovery at the beginning of 2010 is widespread, its intensity varies a great deal across countries. This is the result of the different degrees to which their fiscal and monetary policies have been eased. These policies have been particularly instrumental in providing impulses to the cyclical upturns in China and the US. At the same time, emerging economies are benefiting from the strength of their own domestic demand. As a result, in these economies the recovery looks more sustained. Conversely, in developed countries, as expansionary policies fade away, doubts about the sustainability of the recovery beyond 2010 are growing.

A very gradual path of interest rates hikes by the Fed is envisaged. Early rate hikes by the Fed are expected by the beginning of 2011 with rates slightly above 1% at the end of 2011. There are major differences in the economic backgrounds in the US and Europe that will lead to different monetary developments in both areas. Although economic growth may prove sluggish in 2010 and later, the risk of a major reversion of the current dynamics is rather limited in the US, with incipient inflationary pressures looming. Conversely, in Europe, in addition to a far more fragile financial situation, the upturn looks more uncertain and inflationary pressures are absent. In the case of emerging economies' monetary policies, there is no doubt about the need for a tightening stance. Given their cyclical divergences, exit strategies will vary across countries. In some countries, if the tightening of monetary policy and other measures are not implemented soon, imbalances will build up.

In regimes averse to heightened risk, financial markets exacerbate its forward-looking behaviour. Financial markets are particularly good at tracking inconsistent macroeconomic policies, which are overlooked at normal times. Despite the huge rescue package in Europe, substantial risk premiums should prevail in the market amid uncertainty of the fiscal consolidation path. Increasing contagion has been a clear result of the fragility of the current scenario. Economic history is fraught with examples of undue contagion from some countries spreading to others in the aftermath of a crisis. In these cases, geographical linkages or cyclical similarities matter more than the differences in fundamentals. In fact, the current episode of contagion is not fully justified either by the direct financial channel triggered by the Greek crisis or by any similarity in fundamentals. Though its justification may be open to discussion, to cope with pressures from international investors, there is a compelling need for some countries to enhance credibility.

There are growing concerns about the long-run consequences of rising public debt levels. This will inevitably give rise to upward pressures on real interest rates and increase risk premiums for a protracted period. Even if recent contagion gradually fades away, increasing discrimination across countries depending on the credibility of their fiscal stance will prevail.

Uncertainty stemming from the financial sector is principally twofold. The sluggish restructuring of the financial industry, particularly in Europe, will lead to a creditless recovery. This is a growing concern since both historical episodes and empirical evidence show the importance of credit channels in the early stages of economic upswings. There is also lot of uncertainty regarding the ongoing regulatory reform. The most likely outcome is one requiring significant increases in capital and liquidity requirements. This could hinder the ability of the banking sector to provide credit in coming years.

2. Faster growth threatens a rise in inflation and the current account deficit

Brazilian GDP is expected to grow 5.9% this year. The strength of domestic demand will be the main driver of growth, but Brazil will also benefit from the recovery in the US, robust growth in China, high commodity prices and, on the domestic front, from a relatively non-turbulent electoral period.

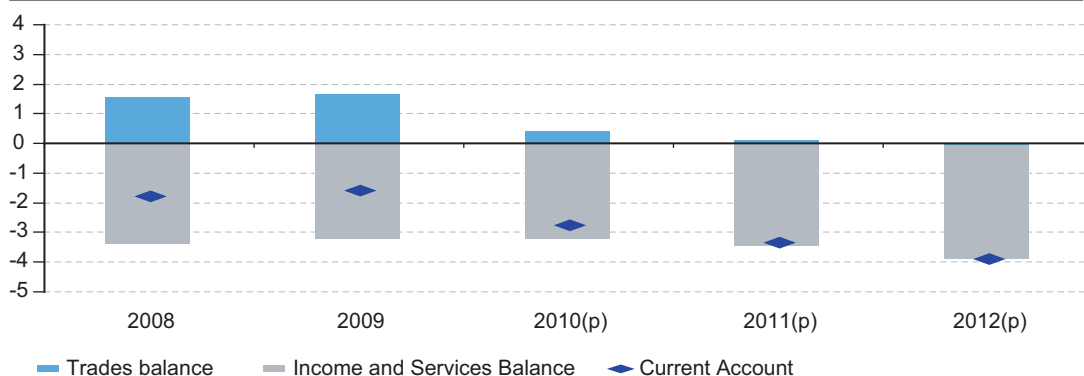
Aggregated consumption, which accounts for 86% of GDP, is forecasted to grow by 5.4%. Private consumption will expand 6.7% supported by rising formal employment, better targeted social transfers and by exceptionally expansive monetary and fiscal conditions. After tumbling 10% last year, gross fixed investment is expected to increase around 18%.

The economy continued to grow at very high pace in the first quarter instead of moderating as expected some months ago. Our Synthetic Activity Indicator, based on high-frequency data, suggests that GDP could grow more than the 2%q/q in Q12010. Although the activity could surprise to the upside in the first quarter (and create an upside bias in our GDP forecasts), the withdrawing of fiscal incentives and the beginning of a monetary tightening cycle should impact the economy in the coming quarters. In addition, the high and still increasing debt burden of households should reduce the margin for further consumption expansions.

A recurrent feature of the Brazilian economy is the fast and strong deterioration of the current account and of inflation whenever domestic demand starts to grow more vigorously. Things are not different this time. Imports of goods are expected to rise around 26% this year while exports of goods will expand just 13%. The contribution of external demand to GDP this year will be -2.0%. The current account deficit should reach 2.8% of GDP in 2010 and rise over time as showed in Figure 1. The external deficit has already jumped to 1.8% of GDP in the first quarter. The funding of external deficits, however, should not be a problem. International reserves will remain at very high levels (around 14% of GDP in 2010) and we expect enough capital inflows to compensate for these deficits in the coming years (3.4% of GDP in 2010 and 2011 and 4.0% in 2012).

Chart 1

Current Account (%GDP)



Source: BBVA Research

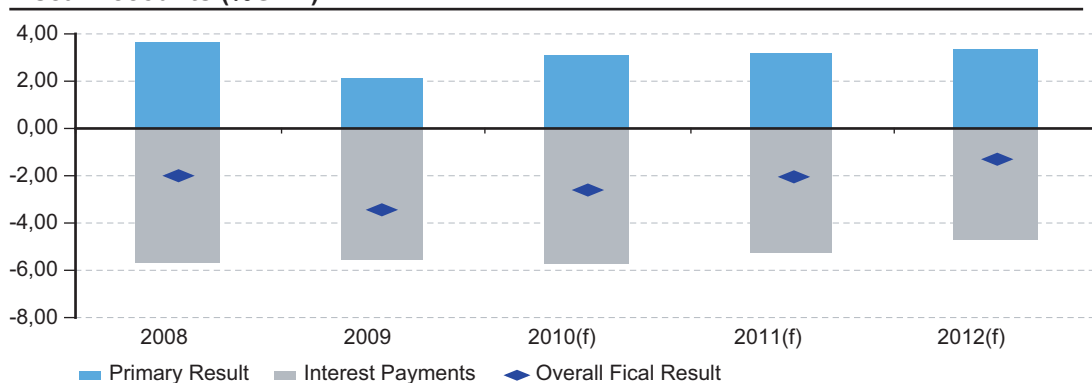
Inflation is also rising due to the strong dynamism of the domestic demand, although supply-shocks have also played a role in the recent domestic prices performance. Inflation reached 5.3% y/y in April after expanding six months in a row. We expect inflation to stabilize and to close the year at 5.3%y/y.

Given the dynamism of activity and the surge in inflation, the Central Bank was forced to adjust interest rates up by 75bps to 9.5% in April. This adjustment – that came late because there were very clear signs of activity strength and rising inflation since the end of 2009 – will continue in the next months. We expect the monetary authority 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. The SELIC by the end of this year would, therefore, be at 11.5%. This view incorporates a less aggressive adjustment than markets are currently discounting because in our opinion growth should moderate along the year and because Central Bank decisions might be influenced by the local political cycle as well as by the turbulences in Europe. In addition, it is also likely that the Central Bank will try to make part of the adjustment through other monetary measures, such as an increase in reserve requirements.

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. Recently, the Central Bank intensified dollar purchases when the exchange rate dropped below the 1.75 mark in a clear sign of unwillingness to cope with a more appreciated Real. Also, every time the Real nears this mark, Treasury's authorities comment on the possibility of new measures (late in 2009, for example, a tax on foreign inflows was introduced). In addition, the increasing current account deficit should create a self-correcting mechanism to limit pressures for appreciation. All in all, we expect the exchange rate to be at 1.76 by the end of the year, close to its equilibrium value.

After deteriorating in 2009, fiscal accounts are expected to resume trending positively in coming years. Despite the expansive tone of public expenditure, a robust GDP growth should boost fiscal revenues and allow primary surpluses to be slightly higher than 3% in coming years (higher than in 2009, but lower than the 3.6% average observed in the 2004-08 period). Although the SELIC will rise with respect to end of 2009 levels, it will remain significantly lower than the 2004-08 average (15.7%) and will, therefore, allow interest payments to be a declining burden for fiscal accounts. More precisely, interest payments averaged 6.5% of the GDP in the 2004-08 period (5.6% in 2009) and should amount to 5.7% in 2010 and less than that in coming years, as illustrated by Figure 2. All in all, the nominal deficit should be around 2.6% of GDP in 2010 and should decline further in the next years. After rising from 40% in 2008 to 45% in 2009, the total net debt should gradually moderate in coming years (42% of GDP in 2010, 41% in 2011 and 38% in 2012) thanks to declining fiscal deficits.

Chart 2

Fiscal Accounts (%GDP)

Source: BBVA Research

In October, presidential elections will be held. Although they can add some volatility to the markets and despite main candidates' recent comments suggesting they could implement some "adjustments" in the economic policy (meaning more intervention in exchange rate and monetary policies), the risks in the political front are limited, especially in comparison to previous elections. We, therefore, expect strong growth in the coming years – 4.6% in 2011 and 5.2% in 2012 - while inflation expectations should remain well-anchored and exchange rate to fluctuate around the 1.75 mark in real terms.

3. The exchange rate risk

Following the deterioration of the situation in Europe, the Real fell with respect to the USD from 1.72 to 1.84 in just a few days. In the same period the IBOVESPA lost more than 6% and the Brazilian's EMBI increased by more than 50 bps. Although these movements were smoother than those at the worst of the global crisis, they show that Brazil is not exempt from contagion. The claim that countries like Brazil could benefit from the increasing tensions in Europe by attracting the capital diverted from problematic regions is not supported by recent data, even though it might be too early for a firm judgement on this matter. This is consistent with statistical estimations, that show, for example, that the current account deficit as a share of the GDP would increase by 20bps and fiscal deficit by 15bps if commodity prices drop 10% and also that fiscal deficit rise by 40bps if risk aversion increase 100bps.

Although the transmission of global turbulences through the commercial channel is relatively small, the Brazilian economy is highly integrated to financial markets and highly dependent on the external risk aversion. For instance, foreign capitals account already for one third of the investments in BOVESPA and foreign loans account for 15% of the loans for Brazilian companies.

Risks related to external shocks are especially high for the private sector which holds an increasing share of the external debt (52% in 2009) and given the still precarious management of FX risks as the losses with FX derivatives at the end of 2008 show. On the other hand, huge international reserves hedge the public sector against exchange rate fluctuations and could be used to support the private sector in case it is needed, which limit exchange rate risks.

Apart from the turbulences in international markets, the volatility of exchange rate markets could be exacerbated by some domestic factors. In a country where activity is substantially driven by domestic demand, the current account and the exchange rate become naturally more volatile. The need to finance high current account deficits will increase the dependency of foreign capital which should also generate more volatility. In addition, the uncertainties regarding the interventions of the Treasury, which was recently authorized to use the resources of the Sovereign Wealth Fund to intervene in FX markets, could also add volatility to the markets instead of generating stability. An important question regarding Treasury's likely interventions is how coordinated they will be with Central Bank's interventions. Finally, elections also have the potential to increase the volatility in exchange rate markets.

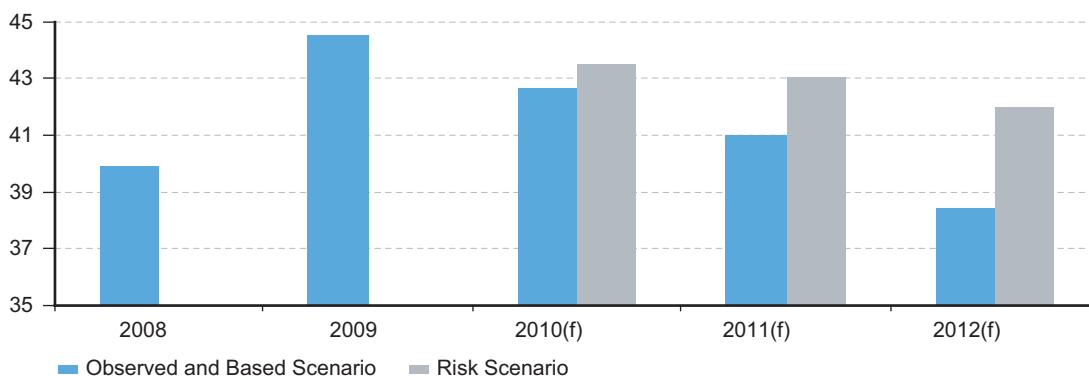
4. Sub-optimal mix of economic policies

The current mix of macroeconomic policies is clearly inefficient: on one hand the Central Bank is starting to tighten monetary policy to avoid overheating, and on the other the government continues implementing a very expansive fiscal policy (primary surplus dropped 22%/y while expenditures expanded 19%/y in the first quarter). This policy mix is clearly not optimal as the intense growth could be curbed by less aggressive monetary adjustment if the fiscal policy were less expansive. In this case there would be less appreciatory pressures over the Real and the impact on fiscal accounts would be weaker as public sector's interest rates expenditures could decline, bringing the deficit down.

As commented before we expect both public debt and the overall deficit to decline as a fraction of GDP in coming years. In our base scenario for the Brazilian economy we see continuity in fiscal policies and low insolvency risks, but also a very small probability of structural improvements – i.e. reducing taxes and improving the composition of expenditures.

Regarding the chances of correction in the quality of fiscal policies, overheating concerns are not expected to drive structural changes even though they can trigger some small corrections as the just announced 0.3% cut in federal expenditures. According to our estimations, a negative external shock caused by the deterioration of the situation in Europe should deteriorate public net debt as depicted by Figure 3. But, in our view, not even such event should, in the case of Brazil, prompt policy makers to change the current tone of fiscal policy. There might be an improvement in the quality of fiscal policies – which could allow, for example, a structural decline in interest rates - if the presidential candidate from the opposition wins, although in this case the risks of an intervention in monetary policy are higher.

Chart 3

Net Public Debt (%GDP)

Source: BBVA

On the other hand, recent events show that there are increasing - although still limited - risks regarding mismanagement of fiscal policies. By allowing, for example, all the investments in the PAC (the Growth Acceleration Plan of the Federal Government) to be excluded from primary surplus goals, the government flexibilized fiscal objectives and put public accounts credibility in question as any investment can be labelled as "PAC investment" and therefore not considered for the purpose of reaching fiscal goals. On another front, the government has been issuing public bonds at market rates to capitalize the BNDES (total injection should reach more than USD 100 billions) and allow the Development Bank to lend at subsidized rates, with a clear negative impact in public accounts. Another concern is the recent change in the composition of the public debt. The share of bonds linked to the SELIC increased to 65% from 47% in 2007. This is a consequence of the sterilization of the international reserves which is implemented by exchanging SELIC-indexed short-term debt for dollars. This clearly increases the costs during a monetary tightening cycle like the current one. In the case these risks materialize, the costs in terms of more aggressive monetary policy and larger macroeconomic distortions (such as higher inflation and higher current account deficit) can increase significantly. But still in this stress-scenario insolvency risks should remain limited.

5. Tables

Table 1

Macroeconomic Forecasts Quarterly

	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11
GDP (% y/y)	-2.13	-1.63	-1.22	4.29	6.80	6.58	5.71	4.39	3.88	4.17	4.78	5.51
Inflation (% y/y)	5.78	5.18	4.40	4.23	4.86	5.12	5.27	5.32	5.09	4.94	4.96	4.84
Exchange Rate (vs. USD)	2.32	2.08	1.87	1.74	1.80	1.76	1.78	1.77	1.76	1.76	1.77	1.77
Interest Rate (%)	12.62	10.33	8.86	8.75	8.75	9.75	11.33	11.50	11.50	11.50	11.00	11.00

Source: BBVA Research

Table 2

Macroeconomic Forecasts Annual

	2009	2010	2011
GDP (% y/y)	-0.2	5.9	4.6
Inflation (% y/y, average)	4.9	5.1	5.0
Exchange Rate (vs. USD, average)	2.0	1.7	1.7
Interest Rate (% , average)	10.1	10.3	11.3
Private Consumption (% y/y)	4.0	6.7	4.8
Government Consumption (% y/y)	3.7	2.0	2.3
Investment (% y/y)	-9.9	17.8	10.1
Fiscal Balance (% GDP)	-3.5	-2.6	-2.1
Current Account (% GDP)	-1.6	-2.8	-3.4

Source: BBVA Research

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