BBVA

Brazil Watch

Economic Research Department

First semester 2009

Economic activity: slow recovery after a sudden fall

Interest rates at historical lows and still going down

Lower primary surplus goals will neither create much space for counter-cyclical policies nor put in risk public debt sustainability

How will NPL evolve during next quarters?

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Closing date: June 12th, 2009

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Editorial

Instead of decoupling from the international crisis, Brazil was suddenly and sharply impacted by global turbulences. The country entered technically in a recession as the GDP fell 3.6% q-o-q in the last quarter of 2008 and 0.8% q-o-q in the first quarter of this year. However, signs of recovery are already popping up and the main uncertainty at this moment is not whether a recovery has already started but rather what is the pace of this recovery.

We think that the recovery will be slow, as labor markets will probably continue deteriorating, as the space for effective fiscal policies is very limited and as foreign demand will remain weak. Even tough the Brazilian economy will begin to show higher rates of growth in the second half of 2009, for the year as a whole we still expect GDP to fall temporarily. A positive expansion is expected for 2010.

To alleviate the impact of the crisis, the Central Bank has already cut the official interest rates (SELIC) by 450 bps and we expect them to drop 75 bps more in the remainder of the year and close 2009 at 8.50%. This marks a major departure form from previous recessions, when interest rates had to move upward to shore up the currency. For instance, in 2001 the SELIC was increased by 325 bps while GDP contracted. The same happened in 2003, the most recent recession period, when the interest rate was increased by 100 bps.

The SELIC is now at historical lows. Moreover, some changes that could allow the recent reductions to be permanent are starting to happen. The government recently presented a project to let saving accounts to depend on the SELIC. Currently they have a fixed return and this creates distortions in the allocation of investment resources when interest rates are lower.

The stronger recovery of the economy expected to be seen in 2010 will challenge SELIC low levels but the government and the Central Bank will likely try to pave the way to make the recent reductions permanent.

On the fiscal side this crisis also differs from previous ones. For the first time the government has room to implement a countercyclical fiscal policy. During previous crises, public accounts usually deteriorated due to higher interest rates and because a significant share of the debt was denominated in dollars. This is not the case this time. However, there is limited room for fiscal policies. The country has not in the past saved enough to accumulate resources for the bad times and the generation of higher public deficits is not a good option because the public debt is still at high levels.

These positive developments in macroeconomic policy are a consequence of a major structural improvement in fiscal accounts: The Brazilian public sector is now a net creditor in foreign exchange. This comes as a result of a reduction of the public foreign debt as a fraction of GDP, as well as significant build up of international reserves. The latter is one of the reasons why the Central Bank has room to relax monetary policy. The other, is the credibility gained in battling inflation. All these fundamental changes are here to stay, and will make the Brazilian economy more resilient to adverse shocks in the future.

The crisis has created some space for policy slippage but the measures adopted by the government and the Central Bank continue to go on the right direction and, therefore, strengthen the view that the country will leave the crisis stronger.

International environment

Following a complex year start, with high financial tensions and strong falls in activity, the second quarter has seen an easing of pressures

From the beginning of the year, the global environment continued to be characterized by high levels of tension in the financial markets, even though several indicators have shown considerable improvements over the last month. Thus, in May US bank CDS reached the lowest level since the fall of Lehman Brothers, while European CDS –which have remained below their American equivalents- fell to their minimum level since November 2009. In addition, significant corrections have also taken place in the interbank markets, with the 3-month OIS spread in the US and the EMU reaching its lowest point since the beginning of 2008.

In the first months of the year, contraction of the global economy was a fundamental element maintaining these high rates of risk aversion. The data for 1Q09 showed a strong drop in activity in the US (-1.6% quarterly rate), with a rate of decline very similar to that of 4Q08. In Europe, the indicators maintained an extraordinarily negative tone, with a quarterly GDP drop of 2.5% in 1Q09, higher than the 1.6% fall in 4Q08. However, the general tone of the economic activity indicators with the April and May data is less negative. This means that the rate of squeeze on activity may be slowing, although there will still be negative growth in the short term. The markets reacted very positively to this likely turning point, although because of the uncertainty surrounding the duration of the crisis, this move may have vulnerable foundations.

New public measures to stabilize the situation

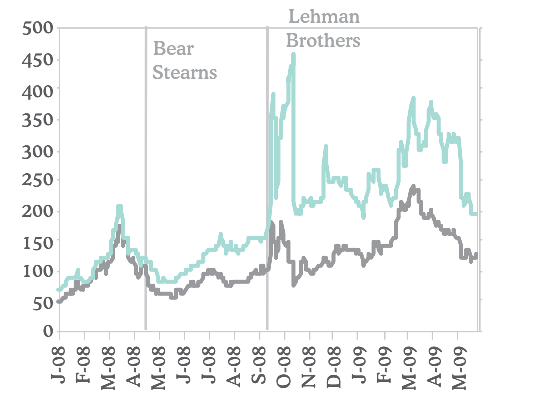
In this context, governments have bolstered the measures to tackle the global financial crisis. US remains the economy that has made most progress in the adoption of these policies, with a new package of measures aimed at stabilizing the financial system. One key element of this program was the conducting of stress tests on the balance sheets of the major banking institutions, which revealed the system's capital needs. As a result, 10 of the largest American financial institutions must raise $75 billion of additional capital within 6 months. These results were well received by the market and were responsible for a large part of the recent lessening of financial tensions. A second pillar is the Public-Private Investment Program, which has been set up to attract private investors who buy toxic assets from banks through funds in which the capital will be supplied jointly by the private and public sectors, with a highly significant level of leveraging. Finally, the Obama administration has implemented a plan to ease access to housing, which includes greater facilities to refinance mortgages and subsidies for those financial institutions that change the terms of the mortgages of families facing default risk. Our assessment of the banking stabilization strategy is positive, even though implementation of the approved plans seems highly complex, and its impact could be limited unless all the elements are combined properly.

The Federal Reserve has also played a crucial role in the financial stabilization process and is confronting the deflationary risk mainly through asset acquisition. Thus, the Federal Reserve has implemented a program to purchase $1,250 billion in mortgage bonds, and up to $300 billion in public debt. The Federal Reserve also plans to participate actively in funding the Public-Private Investment Program through the Term Asset-Backed Securities Loan Facility (TALF) program, which could reach around $1,000 billion.

Indicator of Financial Tension

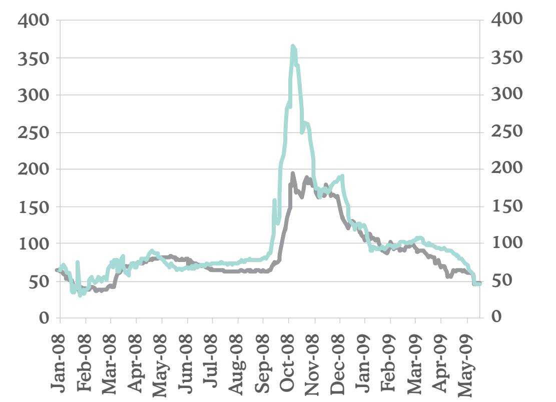
Source: Research Department
The first standardized principal component of the OIS spread series, implicit stock market volatility, bank, corporate and sovereign (in the case of Europe) CDSs.

Banks: CDS debt senior 5 years (bp)



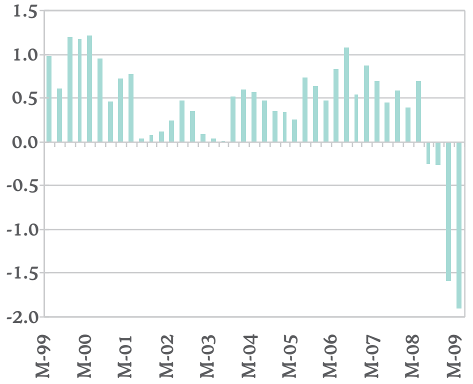
Source: Bloomberg
* Banks included: Barclays, RBS, lloyds, HSBC, Alliance & Bingley, Standard Chartered, Allied Irish Bank, BNP, Deutsche Bank, ING, Unicredito, UBS, Credit suisse, Credit agricole, Societe Generale, Intesa, BBVA, Santander

Interbank markets: 3-month OIS spread
(3M LIBOR - 3M OIS)

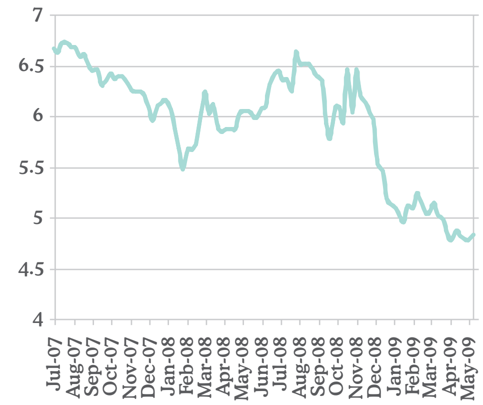


Source: Bloomberg

EMU: GDP growth (quarter-on-quarter)

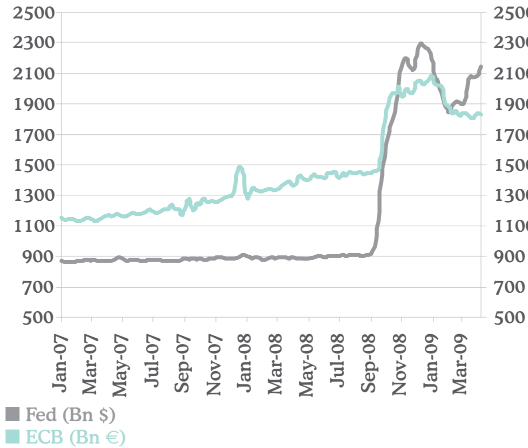


Interest rate of an average 30-year mortgage in the US



Source: Bloomberg

Central Banks: Total Assets



Source: Datastream

In Europe, the financial stabilization efforts have been mainly at national level, with very different initiatives in each country. Thus, Germany and Ireland are putting the final touches to a "bad bank" which will buy banks' toxic assets. The ECB continued with its process of lowering the interest rate, which is now at 1%. The European monetary authority has decided to continue with its weekly liquidity auctions through the fixed rate full-allotment system for as long as necessary, and in any case beyond 2009, and the term for ECB loans has been extended to 12 months. Apart from this, in May it was announced that ¸60 billion of bank bonds would be purchased, although details of this plan are not yet known.

The adoption of these measures is justified, as in the short term the key risk is that the persisting weak economic situation will maintain negative inflation rates for too long. In addition, although the balance sheets of the central banks are expanding rapidly, particularly in the case of the Federal Reserve, the central banks should not have any difficulties in draining liquidity quickly when the time comes, as the Bank of Japan did with the implementation of its non-conventional monetary policy program.

Despite stabilization and the measures taken, recovery remains uncertain

The effectiveness of the policies aimed at streamlining the financial systems on the one hand, and the fiscal policies designed to boost demand on the other hand, will be the focus of attention in coming months. Their success will depend to a great extent on the answers to three questions: when will the recovery begin? How fast will the recovery be? And which economies will prove more dynamic?

Despite the fact that these measures are having a favorable impact on the economy, the elements of a possible recovery in 2010 are still uncertain. Recent data seem to suggest that the recession has hit rock bottom, and so it is likely that GDP falls in the next few quarters will not be as sharp. However, we believe that if the economy emerges from recession in 2010, it will still be with very moderate growth rates below its potential growth. In addition, any recovery will probably occur later in Europe because any financial stability and monetary policy measures were taken later there. These uncertainties will force central banks to keep the official rates low for an extended period of time.

The emerging countries are feeling the global pinch, but they are receiving considerable support

The financial indicators show a very favorable evolution in the last month, following a sharp deterioration of the financial indicators in the last quarter of the year, which continued in the first quarter. Sovereign risk spreads have undergone strong adjustment, depreciatory pressures on currencies have reversed, and even the inflows in emerging countries have returned to positive territory, leading to significant rises in the stock exchange indexes.

There is no doubt that one of the factors that have contributed to this move has been the moderation of global risk aversion. But at least two additional factors should also be mentioned. On the one hand, the recognition that the G20 summit has meant for emerging markets, with the increase in the provision of resources made available to the IMF. This was complemented by the creation of a new IMF credit line which may be used by economies with solid fundamentals, but which might undergo temporary funding problems. It is an instrument designed to prevent, rather than end a possible crisis in emerging markets. The success of this new formula has already been confirmed, with the applications by some countries such as Mexico, Poland and Colombia, and the positive reaction from the markets. Finally, but equally important, we should mention the measures adopted in the domestic scene to soften the impact of the crisis. We find that, to a different degree, a large number of emerging markets have adopted demand, fiscal and monetary policies whose impact on activity will be felt during the second half of the year, and in some economies already in 2Q09. China is clearly the most noteworthy example within the emerging world, following the approval of a substantial fiscal stimulus package (16% of GDP over two years) and the exceptional relaxation of monetary conditions, which has encouraged a reactivation of credit to the private sector. Latin America is also noteworthy, since for the first time in this crisis it has found itself with leeway to apply countercyclical policies.

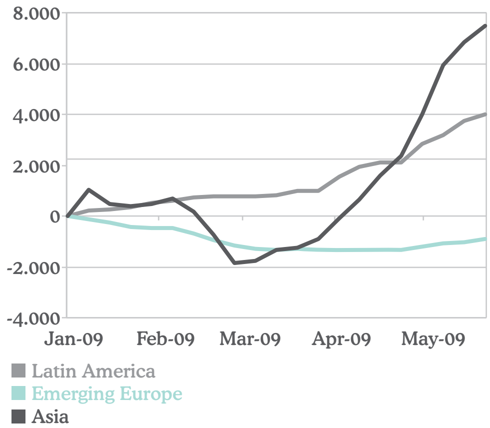
Nevertheless, the impact of the crisis on the activity in emerging countries has been significant. The GDP adjustment in 4Q08 was too sudden, basically as a result of the collapse of international trade, which led to a downward adjustment of forecasts in the first months of the year. In this respect it is important to emphasize the high degree of heterogeneity within the emerging world. The well-known vulnerabilities of emerging Europe –bulky fiscal and external imbalances, strong credit growth accompanied by high currency mismatch, and high dependence on external financing- will bring about very intense adjustments. Thus, it is estimated that the region's GDP will fall around 6%, with some economies falling up to twice this figure, which entails an element of risk for western European economies. Overall, it is expected that emerging markets, led by Asia and with very moderate GDP drops in Latin America, will grow at higher rates than the developed economies in coming years.

Despite weak worldwide demand, the commodity prices in the first quarter of 2009 rose above the historical averages. More recently, commodity prices once again rose considerably due to the significant production cuts and the perception in the financial markets that the worst of the crisis may be behind us. Recent supply cuts and the dollar's valuation prospects should limit the current upward trend in commodities, but the prices should keep supporting Latin American countries.

EMBI spreads

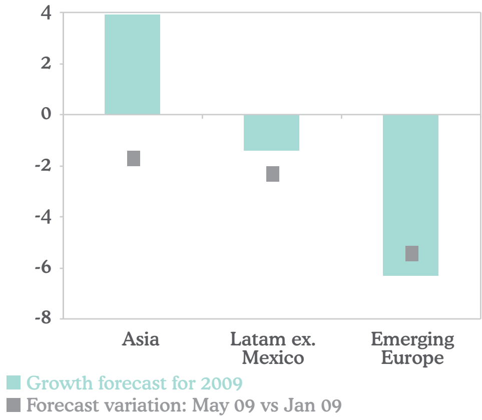
Source: Datastream and JP Morgan

Net inputs in equities (accrued, $bn)



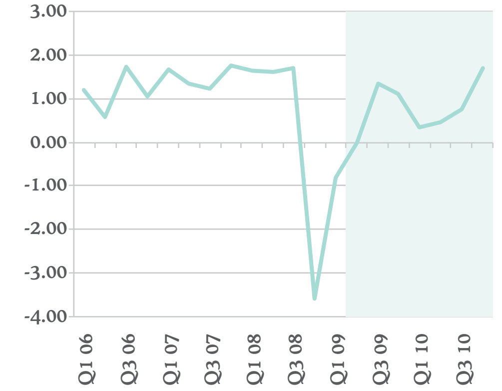
Source: BBVA and EPFR

Emerging economies: Growth forecast for 2009 and variation in forecast since January



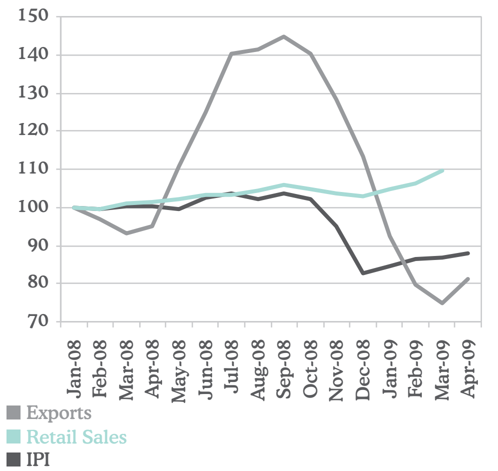
Source: BERD and BBVA

GDP
(q-o-q %)



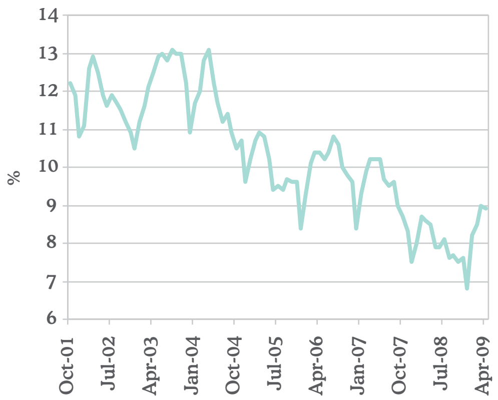
Source: Bloomberg, BBVA

Activity Indicators
(Jan 08 = 100)



Source: Bloomberg, BBVA. Seasonally adjusted IPI and Retail Sales series. 3-months average nominal exports.

Unemployment Rate



Source: IBGE

Macroeconomic environment

Economic activity: slow recovery after a sudden fall

After having dropped 3.6% q-o-q in the last semester of 2008, Brazilian GDP declined 0.8% q-o-q in the first quarter of this year and therefore the economy entered technically into a recession for the first time in the last six years.

Although the economy was relatively immune to the international financial crisis up to the third quarter of 2008, GDP declined the most in more than ten years in the last quarter of 2008 and put an end on decoupling expectations. Albeit public consumption was the only GDP component that displayed some resilience, the fall was particularly intense in capital formation and in the industrial sector[1] . The deterioration of expectations was probably the main driver of this fall, but the turbulences in financial markets and declining commodity prices have also a role to explain the GDP fall.

As the graph beside shows, the impact of the crisis was very concentrated in the fourth quarter. This concentration is a different way to understand the sharp fall observed in that quarter.

The GDP dropped again in the first quarter of 2009 (-0.8% q-o-q, -1.8% y-o-y). Despite having contracted, the GDP figure for the first quarter also signals a recovery. The drop was both much lower than in the previous quarter and much better than expected. The main support was given by private consumption, which showed to be more resilient than thought before. It expanded 0.7% q-o-q. In the last quarter of 2008 it had fell 2.0% q-o-q. The positive contribution given by private consumption was due to declining inflation and interest rates and also due to increases in minimum wage (6% in real terms). These factors outweighed the deterioration of the labor market conditions[2]. Public consumption also provided some support to the PIB in the first quarter of the year, while capital formation, exports and imports plunged[3] .

In addition to GDP numbers for the first quarter, other activity indicators also support the view that a recovery is already on track. The industrial production, for example, increased in monthly terms four consecutives times since January as the graph on activity indicators depicts[4]. The recovery is explained by the significant adjustment that was produced in December, by the support provided by some public policies (as tax cuts for automobile production and falling interest rates) and by the preliminary but already evident improvement in credit conditions.

The recovery of the industrial production is taking place basically on sectors related to durable goods production. This is associated to the still relatively good performance of the private consumption as depicted by GDP figures and by retail sales indicators[5] .

[1] Demand components (q-o-q rate): private consumption, - 2.0%; public consumption, 0.8%; investments, -9.8%; exports, -2.9%; imports, -8.2%. Supply components (q-o-q rate): industry, -7.4%; agriculture, -0.5%; services, -0.4%.
[2] The unemployment rate averaged 7.3% in the last quarter of 2008, 8.6% from January to March and was at 8.9% in April.
[3] Public consumption increased 0.6% q-o-q in the first quarter, capital formation dropped 12.6%, exports dropped 16.0% q-o-q and imports dropped 16.8% q-o-q.
[4] Industrial production dropped 9.5% q-o-q in the last quarter of 2008 and 7.9% q-o-q in the first quarter of this year. It accumulates since January three straight months of positive variations and was 4.81% higher on March than it was on December.
[5] Retail sales declined 0.7% q-o-q in the last three months of 2008 while in the first quarter they expanded 2.2% q-o-q.

After falling 3.6% q-o-q in the fourth quarter of 2008 and 0.8% q-o-q in the first quarter of 2009, GDP growth in 2009 would be -2.3% if quarterly growth were zero in the remainder of the year. Nonetheless, we believe that the quarterly growth will be positive in the next three quarters of this year and therefore GDP drop will be lower than -2.3%.

The recovery process, which has been suggested also by credit indicators and by recent financial markets moves, will receive the support of other factors. A first support comes from the fact that the inventories adjustment process is nearing an end. Secondly, the effect of the interest rates cuts and credit measures already implemented should be more effective in the second half of the year as these measures usually have a lagged effect on the economic activity. Finally, a small but positive recovery of the world economy is also expected to contribute to the Brazilian growth in the remainder of the year.

The recovery process will be, however, slowed down by the lack of fiscal resources to implement generalized tax cuts as those implemented recently for some durable goods (see section below for more details), by the expected deterioration to be seen in the labor market and finally lingering uncertainty about the world recovery.

We expect private consumption to remain relatively constant in 2009 in comparison to 2008 as the rise of unemployment should offset the gains derived from lower inflation and lower rates and from a higher minimum wage. Public consumption, on the other hand, will provide some support to activity and is expected to expand around 2.8% this year. Capital formation will be the domestic demand component more affected by the recession. This is not a surprise as investments are generally more pro-cyclical than consumption. In this case, additionally, high inventories and high investment levels observed until September expanded capacity and generated over supply leaving more unused capacity, making new investments less attractive.

The adjustment in domestic demand has been so severe that imports are expected to fall more than exports in 2009 (see Box 2 for more on this issue). This movement will also be driven by the significant depreciation of the real since the beginning of the crisis. Therefore the external sector will divert abroad part of the reduction in domestic demand, cushioning the impact on Brazilian GDP. We estimate foreign demand to contribute with 0.4% to this year's GDP, in contrast to what happened in 2008, when its contribution was -2.8%.

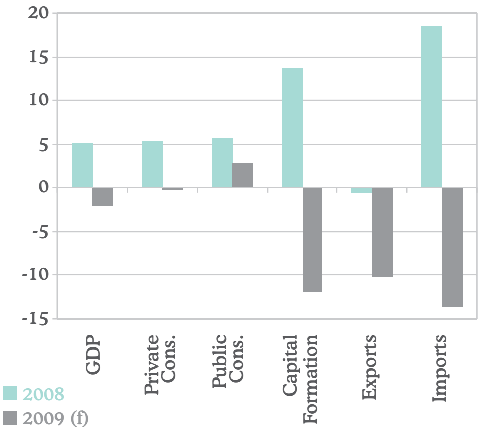
Inflation under control

The sharp moderation of internal demand and the fall of commodity prices put inflation in a downward path since the end of 2008. In October of last year, the IPCA peaked at 6.4% and from then has steadily fallen to 5.2% in May.

The moderation of inflation has been relatively slow compared to other Latin American countries and much slower than in developed economies. This is, to some extent, explained by the rigidities existent in the Brazilian economy as the public control of prices and the backward-looking price adjustment rules, for example. Although the pass-through from the exchange rate has not being strong enough to offset the impact of lower internal demand and lower commodity prices, it also helps to explain the slow moderation of inflation.

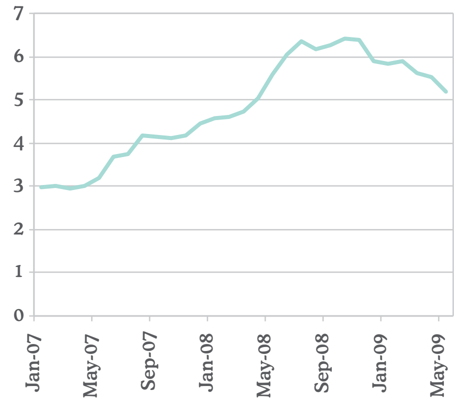
The perspectives of a slow recovery of both economic activity and commodity prices have kept inflation expectations under control and

GDP Components
(yearly %)



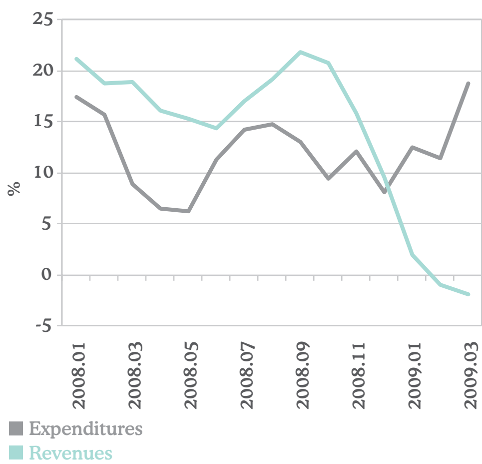
Source: Bloomberg, BBVA

Inflation - IPCA
(yearly %)



Source: Bloomberg

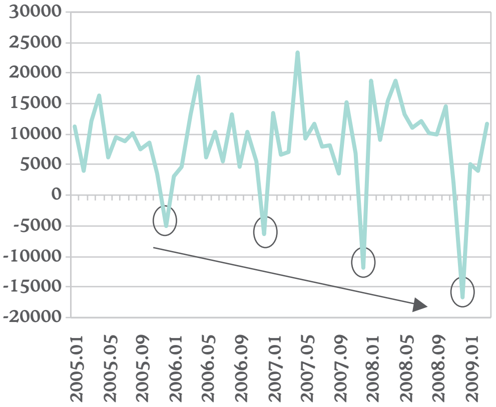
Revenues and Expenditures
Central Government - Nominal y-o-y rate (3-month moving average)



Source: IPEA, BBVA

Primary Surplus - Public Sector

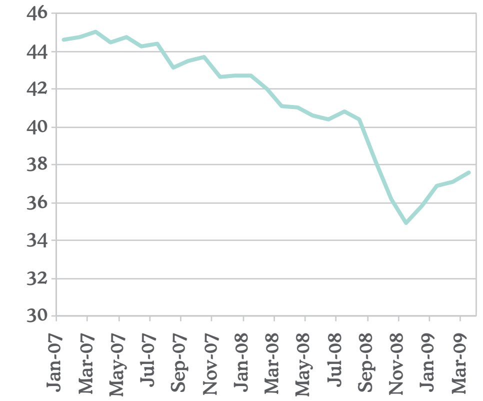
(R$ millions)



Source: Bloomberg

Net Public Debt

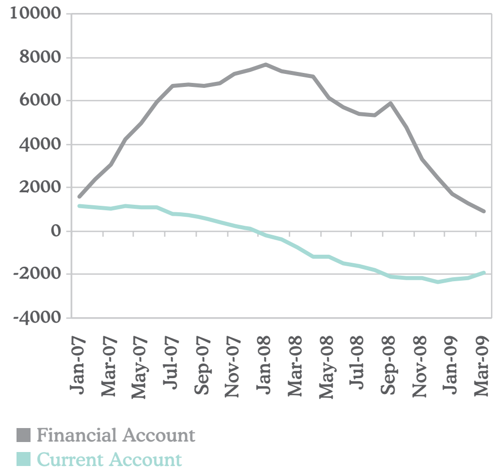
(% GDP)



Source: Bloomberg

Current and Financial Account

(USD millions, 12-month moving average)



Source: Bloomberg, IPEA, BBVA

thus opening the way for the easing of monetary policies currently under way. We expect IPCA to end 2009 at 4.2%, slightly below market expectations that are currently at 4.3%.

Lower primary surplus goals were reduced by the government. This will neither create much space for counter-cyclical policies nor put in risk public debt sustainability

Public revenues are falling fast as a consequence of both recession and tax cuts while public expenditures keep rising at high rates as observed in the graph beside[6]. The government, therefore, was left with no other alternative than cut its primary surplus goals[7]. For 2009 the goal is to have a primary surplus of 2.5% of GDP instead of 3.8%. From 2010 on, the goal is now 3.3% and not 3.8% anymore. A 0.5% cut in the goals is due to the exclusion of Petrobras from the calculations, what in the practice leave the goals from 2010 on unchanged.

In the first quarter of 2009, the accumulated primary surplus represented 3.0% of GDP, much lower than the 6.5% observed in the first quarter of 2008 and than the 4.1% for 2008 as a whole.

As the deterioration of the public accounts is likely to have continued in the second quarter of this year and as primary surpluses are seasonally higher in the first quarter as it is illustrate by the graph beside, this means that the primary surplus is at this point of the year lower than it should be to close the year at 2.5%. As we believe that the government will stick to this goal, this means that there will be very limited room to keep implementing a counter-cyclical fiscal policy in the remainder of the year[8].

Up to now, the main (and the most effective) measures implemented by the government to alleviate the impact of the crisis were the tax reductions to some durable goods (mainly cars and domestic appliances) and to civil construction related goods. Although these tax cuts are temporal and although public resources are limited, we believe they could be renewed if the signs of recovery vanish.

Other measures implemented by the government to moderate the impact of the crisis were the allocation of resources to the real estate sector and to create a fund to guarantee credit to small and medium firms. Overall, the size of the fiscal measures is estimated to be around 0.5% of GDP.

As SELIC rates will be in average lower in 2009 than in 2008, the service of the public debt (interest payments) should be lower this year, allowing the nominal public deficit to be around 2.3% by the end of 2009. This compares relatively well with a 1.5% deficit recorded in December of 2008, under current economic conditions.

As it is observed in the graph beside, net public debt increased from 36.0% of GDP in December of 2008 to 37.6% in March following the deterioration of public accounts, the appreciation of the dollar and the contraction of GDP. Despite this recent increase and the new primary surplus goals, we expect net public debt to continue following a

[6]. In the first quarter of the year, total revenues declined 1.9% y-o-y in nominal terms. In the same period, tax collection declined 4.6% y-o-y also in nominal terms. Expenditures, on the other hand, rose by 19% y-o-y.

[7] Another alternative, with a high political cost, would have been to diminish expenditures with personal.

[8] As commented in the sections below, there are much more room to implement counter-cyclical policies by using the credit expansion of public banks and by using international reserves.

sustainable path as it remains a key element of the government economic policies.

Weak internal demand drives current account deficit down while the financial account plunges

As it should be expected in cases of currency depreciation and dropping internal demand, the current account deficit is falling. When the crisis hit the country by the end of 2008, the current account deficit had reached 1.8% of GDP and made many fear larger and recurrent current account deficits. Since then, however, the deficit dropped and reached 1.4% of GDP in April. This evolution makes our 1.3% forecast for the end of the year sound relatively pessimist.

While the trade balance remains strong enough (see Box 1), the income and services deficit declined 34% y-o-y in the first four months of the year, due to a 61% y-o-y drop in profit remittances.

The financial account surplus, on the other hand, plunged 82% y-o-y in the four first months of 2009 as foreign capital left the country. Despite this important fall there are already signs of recovery. The financial account is displaying increasingly positive results after three months in negative territory in the end of 2008 as the graph beside shows. Net portfolio investment was positive in March for the first time since the beginning of the crisis.

Independently of financial account results, however, the funding of this year's current account is guaranteed by the very large international reserves (around USD 200 million, or 105% of the total external debt).

The magnitude of the reserves is actually allowing the Central Bank to make use of them to reduce the liquidity problems in dollars. The monetary authority injected more than USD 60 billion in the exchange rate markets, including USD 6 billion to the funding of exports. In addition, it created a USD 20 billion fund to help national companies to pay their external debt. Finally, the reserves level is making the country to consider a capital injection to the IMF instead of borrowing money from the institution as occurred in previous crises.

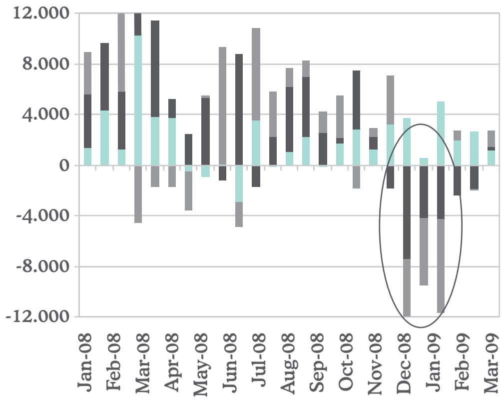
The recent optimism observed in financial markets has stimulated a significant dollar inflow into the country which is supporting the recent appreciation displayed by the real. The Brazilian currency, which reached 2.50 early in December to recover to 2.30 by the end of the year, and now hovers around the 1.95 mark. Although the Central Bank is not committed to any target for the exchange rate, the recent appreciation propelled the government to start buying dollars after operating many months as seller.

In our view, the real has not more room to continue appreciating significantly till the end of the year as part of the recent appreciation has more to do with the recent dollar debility against main other currencies and as we expect the dollar to recover part of its strength in global markets during the remainder of the year. Moreover, we are cautions with respect the recent rebound in financial markets and commodity prices, which have been helping to appreciate the real. We expect the exchange rate to close 2009 around 2.05 reais per dollar.

Interest rates are at historical lows and still going down

The Central Bank cut interest rates by 450 bps since the beginning of the year and brought SELIC rates to 9.25%, the lowest level since the creation of the inflation target system in 1999.

Financial Account
(USD millions)

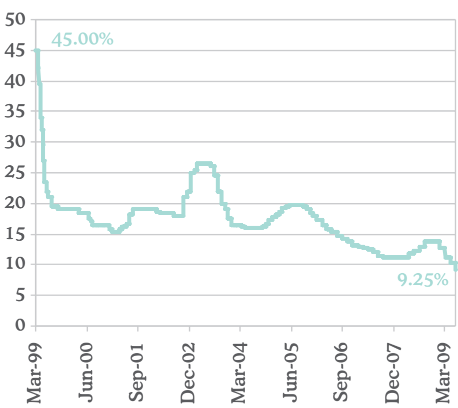


Source: IPEA, BBVA

Exchange Rate
(Real / USD)

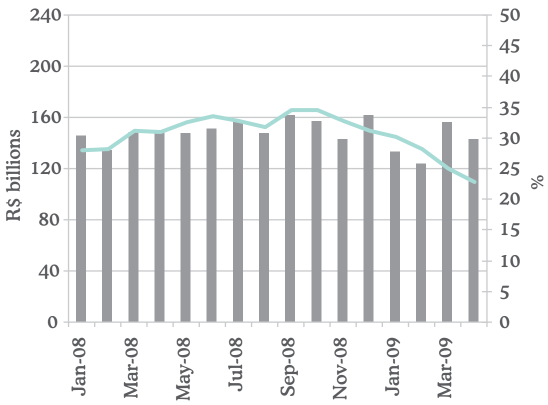
Source: Bloomberg

SELIC
(yearly %)



Source: Bloomberg

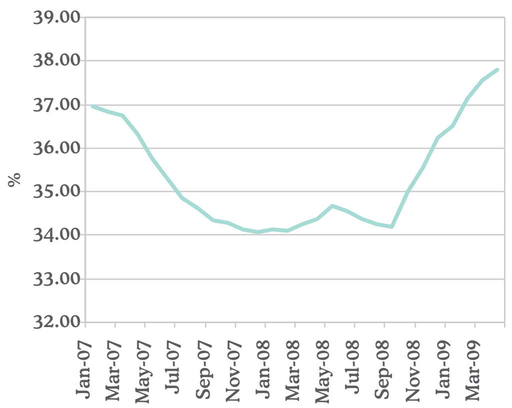
Credit growth and new credit concessions



Source: Central Bank of Brazil

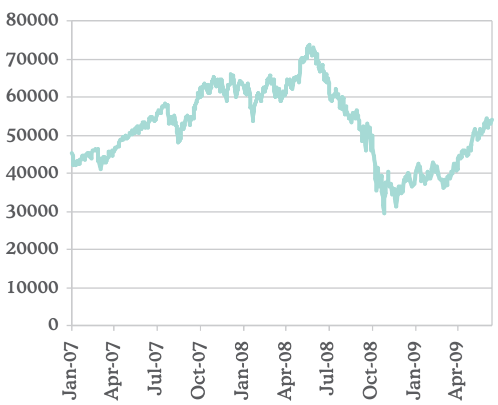
Public Credit

(share of the total credit)



Source: Central Bank of Brazil

IBOVESPA



The easing of the monetary policy during an international crisis is new in Brazil. In the past, interest rates had to ride to avoid an outflow of capitals and prevent a collapse of the currency. Now, as the country is a net external creditor and as the national debt is not denominated in dollars, there is room for monetary easing.

The interest rate adjustment is not over. We expect the Central Bank to keep cutting rates and SELIC to reach 8.50% by the end of the year. Both inflation and internal demand will continue providing room for more cuts as the recovery will be, even in the best scenario, mild.

Moreover, the government has recently started to make some institutional changes that will help the monetary authority to continue cutting rates. More precisely, the government announced recently changes in the saving account returns to make them dependent on SELIC rates[9].

The main question regarding interest rates at this moment seems to be whether the cuts made in 2009 will be permanent or temporary. Although there are many uncertainties regarding this issue, recent declarations by Central Bank authorities and the recent regulatory moves make us think that the Central Bank and the federal government will pave the way to make these cuts permanent.

Public banks prevent a sharper deterioration of credit

Credit growth rates deteriorated quickly since the beginning of the crisis as the blue line in the graph beside shows. The deterioration is due to lower demand and supply. From a supply perspective, the credit moderation follows a liquidity preference and worries about rising non-performing loans. From a demand perspective, the credit drop reflects a lower necessity of funds due to deteriorated growth perspectives, even though some firms have turned to internal funding given the closure of international sources.

Since December, the total stock of credit in the economy grew only 2% as private credit contracted by 1% and public credit increased by 6%. The share of credit granted by public institutions has, therefore, increased (see graph beside). The public sector expansion follows a natural contraction of the private sector and the government directive for public banks to continue lending. As the government has very limited space to implement countercyclical policies, it has used public banks to ameliorate economic conditions.

Although yearly credit growth rates have moderated sharply in the last months, the flow of new concessions granted monthly shows that a slow recovery is in process (see graph beside).

Although lending rates are declining since the Central Bank started cutting rates, the government seems currently ready to adopt measures to bring banking spreads further down as spreads remain high[10].

Despite lower lending rates, non-performing loans rose from 2.8% in September to 3.8% in April and are expected to keep rising due to sharp contraction in the economic activity (see Box 2 for more details).

[9] Saving accounts' return didn't depend on the SELIC while other investments did. This means that low SELIC rates would make saving accounts more attractive than other investments and therefore distort strongly incentives. In its recent announcement, the government announced that saving accounts' over R$ 50.000 will be progressively taxed.
[10] Spreads were at 30.7% in December and receded to 28.2% in April.

In another front, the recent evolution observed in Brazilian equities markets also supports the view that the worst of the crisis is over in the country. The IBOVESPA advanced around 44% since the beginning of the year and has reached pre-crisis levels. The upward movement in the stock exchange has been fueled by the inflow of foreign capitals and by commodity prices.

Country-risk, measured by EMBI + spreads, follows the recent optimism of the markets and has fallen 40% since January. It is now at end of September levels but around 85% higher than the historical low levels observed after the country was given investment grade in June of 2008.

The government capitalized on the recent good mood displayed by financial markets and sold USD 750 millions of 10-year bonds in international markets. This is the second time since the beginning of the crisis that the country issues international bonds. The first time, last January, the government sold USD 1 billion of 10-year bonds and paid 613 bps (370 bps than U.S. Treasuries). In the recent issuance, the yield paid was 580 bps (250 bps above U.S. Treasuries).

The current optimism with regards to the Brazilian markets supports our view that the country will leave the crisis stronger. The country will reap the benefits of keeping sound economic policies in the last years, especially since the beginning of this crisis when the space for policy slippery increased significantly. This will create an extra stimulus for the country during the recovery period and will also create more room for the country to implement countercyclical measures in the next economic slowdowns.

Box 1: Forecasting Non-Performing Loans

Non-Performing Loans (NPL) in Brazil reached 2.8% in September of 2008, a historical low level according to the Central Bank's series that starts in the year 2000. From then, however, NPL rose constantly and reached 3.6% in March. There are currently concerns about how high and how long this upward movement will be.

To forecast the NPL path in the remainder of the year and in 2010 we performed a simple econometric exercise. We used quarterly data from 2001 to 2008 and modeled NPL as a function of quarterly GDP growth, real interest rates and NPL observed in the previous quarter[11].

This simple model captures relatively well the past movements in NPL. It is actually able to explain around 90% of the past trajectory. The graph below shows the model's accuracy to fit the data.

NPL Model

Source: BBVA, Bloomberg, Central Bank of Brazil

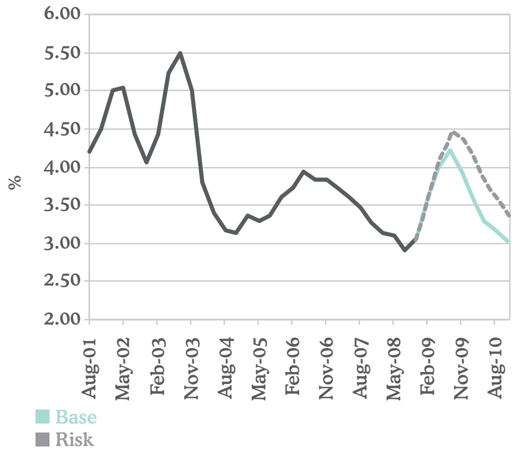
Taking the model's estimated parameters, we forecast NPL in 2009 and 2010 under some different scenarios.

First, we take the quarterly forecasts associated to our base macroeconomic scenario (GDP 09: -2.1%, GDP 10: 3.0%; SELIC 09 end-of-period: 8.5%; SELIC 10 eop: 8.50%; IPCA 09 eop: 4.2%, IPCA 10 eop: 4.4%) to calculate NPL in our base scenario. In this first simulation, NPL peaks in the third quarter of 2009 to 4.2% and recede to 4.0% by the end of 2009 and to 3.0% (close to pre-crisis levels) at the end of 2010.

Our risk NPL scenario builds on a weaker GDP growth and lower inflation and SELIC scenario (GDP 09: -3.6%, GDP 10: 1.2%; SELIC 09 eop: 8.0%, SELIC 10 eop: 8.0%; IPCA 09 eop: 4.4%, IPCA 10 eop: 4.2%). In this case, NPL would still peak at the third quarter of 2009 but would reach 4.5% instead of 4.3%. In the last quarter of this year it would decline to 4.3% and in the fourth quarter of 2010 it would be at 3.4%.

The NPL dynamics in both cases follow the dynamics observed in our macroeconomic forecasts, i.e. they deteriorate till the third quarter and start to recover gradually from then on[12].

NPL: Base and Risk Scenarios



Source: BBVA, Bloomberg, Central Bank of Brazil

NPL dynamics during the next quarters will benefit from decreasing real interest rates. This is very different from what happened in previous upward movements (Q2 01 to Q3 03; Q4 02 to Q3 03; Q4 04 to Q2 06) when real interest rates failed to ease. This is due to the fact that during this crisis, for the first time in many years, the Central Bank does not need to raise SELIC to control capital outflows. If real interest rates were kept constant during this negative cycle, NPL would peak at 4.50% and not at 4.3% and would be at 4.3% in the end of 2009 instead of being at 4.0%. This is very similar to our NPL risk scenario what means that SELIC cuts have a similar impact to growing around 150 bps less in 2009.

NPL: Base and "Constant Interest Rate" Scenarios

Source: BBVA, Bloomberg, Central Bank of Brazil

[11] We use expected real interest rate, i.e. current nominal interest rates minus 12-month expected inflation. Lending interest rates, instead of reference interest rates, and the credit average term were also tested as explanatory variables but their impact on NPL was observed to be insignificant.

[12] This is the dynamics of our y-o-y GDP forecasts and differs from our q-o-q dynamics that point to a recovery starting in the first quarter of 2009. In our models, y-o-y GDP was much more important to explain NPL than q-o-q GDP rates.

Box 2: What is behind recent trade balance behavior?

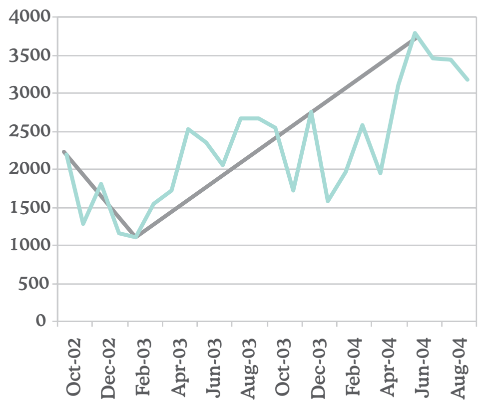
The Brazilian trade balance dropped sharply at the beginning of this year. While monthly surpluses were higher than USD 2 billions before the crisis, in January they displayed a USD 0.5 billion deficit.

This drop should not be taken as a surprise, neither as permanent. In fact it can be explained mostly by the sharp depreciation of the real and growth dynamics.

According to Economic Theory, the trade balance should display a J-curve after a strong currency depreciation takes place, because imports' value increase (volumes are practically constant due to pre-existing contracts while prices rise) and because exports take some time to react. Therefore, the trade balance fall should be both expected and temporary in nature.

The previous most recent sudden and sharp depreciation happened in September –October of 2002 when the real fell about 30%. At that time the trade balance dropped by almost 50% in a few months and recovered afterwards as shown in the graph below.

Monthly Trade Balance
(USD millions)



Source: Bloomberg, BBVA

Our econometric simulations also point to a "fall-and-then-recover" type of behavior.

We estimate import and export functions using quarterly data from 1996 to 2008 to simulate the 2009 trajectory of the trade balance.

In our econometric exercises, the real exchange rate and domestic growth were identified as the main explanatory variables to imports growth. They provided a good fit of previous imports data. With respect to exports, the real exchange rate and world growth are able to explain most of previous exports trajectory.

Taking as given our forecast for domestic and world growth and assuming that the real exchange rate stabilizes at the levels observed in the first quarter of the year, our simulations show that, in a first moment exports should fall more than imports, and then, after some months, imports start to drop more intensely than exports. Therefore, the trade balance should fall and then recover from low levels.

Exports and Imports Real Growth Rates
(q-o-q %)

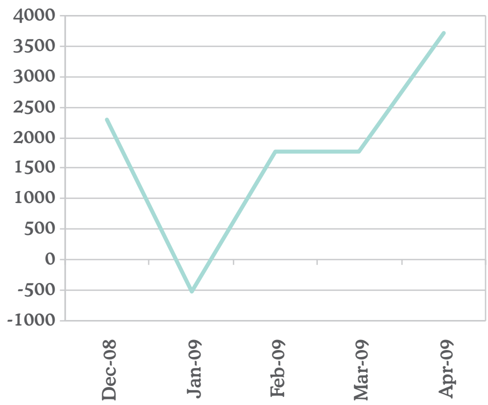
Source: Bloomberg, BBVA

Our simulations capture two types of effects that explain this trajectory. First, as exports depend on global GDP and imports on domestic GDP and as global growth started to moderate before than domestic growth, exports should have dropped before than imports. Second, we observe that exports react with some lag to exchange rate changes while imports react contemporaneously.

We also verified that the volume of credit for exports is not a significant variable to explain exports growth.

The most recent trade data released suggests that our claims are correct and reinforce our view that trade balance this year should not be significantly lower than the USD 25 billions observed in 2008.

Monthly Trade Balance
(USD millions)



Source: Bloomberg

Statistic and forecasts

Brazil

Economic Indicators	2007	2008	2009	2010
Activity				
Nominal GDP (Real, Billion)	2,598	2,890	2,967	3,185
Nominal GDP (USD Billion)	1,314	1,573	1,426	1,530
Real GDP (% variation)	5.9	5.1	-2.1	3.0
Inflation, end of period				
CPI (%)	4.5	5.9	4.2	4.4
Interest and Exchange Rates, end of period				
SELIC	11.25	13.75	8.50	8.50
Exchange Rate	1.78	2.31	2.05	2.10
Public Accounts				
Fiscal Surplus/Deficit (% GDP)	-2.3	-1.7	-2.3	-1.4
Total Net Public Debt (% GDP)	42.7	35.8	39.5	38.5
External Sector				
Exports (USD billion)	160.6	197.5	174.0	184.0
Imports (USD billion)	120.6	173.1	152.0	164.0
Trade Balance (USD billion)	40.0	24.4	22.0	20.0
Current Account (% GDP)	0.12	-1.79	-1.25	-1.40
International Reserves ($ billion)	180.3	193.8	200.0	200.0

International Context

Commodities (end of period)	2007	2008	2009		2007	2008	2009
Brent (USD/barril)	93.9	45.6	56.3	**Soybean (USD/t.)**	423.2	343	370.0
Copper (USD/t)	6,675	3,070	3,638	**Corn (USD/t.)**	161	144	170.0
Gold (USD/troyoz.)	833.9	882.1	875.0	**Weath (USD/t.)**	312	216	210.0

	Real GDP (%)				Inflation (%, end of period)*			
	2007	2008	2009	2010	2007	2008	2009	2010
USA	2,0	1,1	-2,0	1,1	2,9	3,8	-0,3	1,5
EU	2,6	0,6	-3,3	-0,1	2,1	3,3	0,3	1,0
Japan	2,0	-0,7	-3,0	0,6	0,5	1,0	0,3	0,6
China	13,0	9,0	8,1	8,4	6,5	2,0	0,0	2,0
Latin America								
Argentina	8,7	7,0	-1,8	0,7	8,5	7,2	7,5	10,0
Brazil	5,9	5,1	-2,1	3,0	4,5	5,9	4,2	4,4
Chile	4,7	3,2	-1,2	2,1	7,8	7,1	0,2	1,8
Colombia	7,5	2,5	-0,5	1,1	5,7	7,7	4,3	3,8
Mexico	3,3	1,4	-6,3	1,7	3,8	6,5	3,8	3,9
Peru	8,9	9,8	2,4	3,6	3,9	6,7	2,1	2,0
Venezuela	8,4	4,8	-0,5	-2,9	22,5	31,9	42,3	49,2
LATAM [1]	4,9	4,1	-2,4	1,9	6,0	8,0	6,6	7,3
LATAM Ex-México	6,8	5,1	-1,4	1,8	7,1	8,6	7,5	8,7

1 Average of 7 mentioned countries
* USA and EU Inflation: Average of period

	Public Sector Balance (% GDP)				Current Account Balance (% GDP)			
	2007	2008	2009	2010	2007	2008	2009	2010
USA	-1,2	-4,6	-12,7	-8,4	-5,3	-4,8	-3,0	-2,9
EU	-0,6	-1,9	-5,4	-6,0	0,5	-0,1	-0,3	-0,4
Japan	-6,2	-5,8	-5,1		4,8	3,3	2,8	
China	0,7	-1,4	-0,9		10,1	6,8	6,1	
Latin America								
Argentina [2]	3,2	1,4	0,1	0,8	2,7	2,3	1,9	2,0
Brazil	-2,3	-1,7	-2,3	-1,4	0,1	-1,8	-1,3	-1,4
Chile [2]	9,9	4,9	-4,2	-3,8	4,4	-2,0	-3,1	-4,6
Colombia	-2,7	-2,3	-4,2	-3,5	-2,8	-2,8	-4,0	-2,7
Mexico	0,0	-0,1	-1,8	-1,8	-0,8	-1,4	-1,9	-2,1
Peru	3,1	2,1	-1,2	-1,1	1,1	-3,3	-3,3	-3,2
Venezuela [2]	3,0	-0,2	-6,0	-6,6	8,7	13,1	0,7	2,4
LATAM [1]	0,1	-0,4	-2,3	-1,3	0,7	-0,4	-1,8	-1,7
LATAM Ex-México	0,4	-0,4	-2,6	-1,9	1,3	-0,1	-1,2	-1,0

[1] Average of 7 mentioned countries; [2] Central Goberment

	Exchange Rate (vs $, end of period)				Official Rate (%, end of period)			
	2007	2008	2009	2010	2007	2008	2009	2010
USA					4,25	0,25	0	0
EU ($/€)	1,5	1,3	1,2	1,1	4,00	2,50	0,75	0,50
Japan (yenes/$)	113	96	96	93	0,77	0,10	0,20	0,70
China (cny/$)	7,3	6,8	6,8	6,6	7,47	5,31	4,50	3,96
Latin America								
Argentina	3,1	3,4	4,1	4,5	13,50	19,08	17,00	15,03
Brazil	1,8	2,3	2,1	2,1	11,25	13,75	8,50	8,50
Chile	499	649	560	566	5,90	8,25	0,75	2,00
Colombia	2015	2244	2343	2586	9,50	9,50	5,00	5,00
Mexico	10,9	13,7	13,0	12,4	7,50	8,25	4,50	4,50
Peru	3,0	3,1	3,2	3,2	5,00	6,50	2,00	2,00
Venezuela	2,2	2,2	2,7	3,5	11,70	17,60	16,00	14,50

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