Country report **BRAZIL**

Summary

Brazil's economy grew by only 2.7% in 2011, after the high 7.5% growth of 2010. In particular industry has been under pressure, as the competitiveness of the sector has been hit by the appreciation of the *real*. The government has tried to stem the appreciation by further tightening its capital controls. The sudden way in which the central bank thereby changed trade finance regulations bodes ill for policy predictability. Meanwhile, the central bank has aggressively eased monetary policy by reducing its main policy rate from 12.5% to 9%. After breaking the upper bound of the inflation target range during 9 months in 2011, inflation has fallen back within the range. However, the labor market remains very tight. Brazil's current account deficit may grow somewhat in the coming years, but the foreign exchange reserves have grown further during 2011. Meanwhile, the government of Dilma Rousseff is popular, partially thanks to the president's reputation of being a competent manager.

Things to watch:

- Possibility of new capital controls.
- Prices of commodities.

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Brazil

National facts	
Type of government	Federal Republic
Capital	Brasilia
Surface area (thousand sq km)	8,514
Population (millions)	190.8
Main religions	Roman Catholic (74%)
	Protestant (15%)
Main ethnic groups	White (54%)
	Mulatto (39%)
	Black (6%)
Head of State (president)	Dilma Rousseff
Head of Government	Dilma Rousseff
Monetary unit	real (BRL)

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	2474	3.59
Nominal GDP at PPP	2282	2.89
Export value of goods and services	294	1.34
IMF quotum (in mln SDR)	3036	1.40
Economic structure	*2011*	*5-year av.*
Real GDP growth (%)	2.7	4.5
Agriculture (% of GDP)	6	6
Industry (% of GDP)	28	28
Services (% of GDP)	67	67
Standards of living	*USD*	*% world av.*
Nominal GDP per head	12829	119
Nominal GDP per head at PPP	11836	96
Real GDP per head	5841	72

Social and governance indicators	rank / total
Human Development Index (rank)	84 / 187
Ease of doing business (rank)	126 / 183
Economic freedom index (rank)	99 / 179
Corruption perceptions index (rank)	73 / 183
Press freedom index (rank)	99 / 178
Gini index (income distribution)	53.9
Population below $1.25 per day (PPP)	6.1%

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
China	15	US	17
US	10	China	15
Argentina	9	Argentina	9
Netherlands	5	Germany	8
Main export products (%)			
Primary products			45
Manufactured products			39
Semimanufactured products			14
Special operations			2
Main import products (%)			
Intermediate products and raw materials			46
Capital gppds			23
Consumer goods			17
Fuels and lubricants			14
Openness of the economy			*2011*
Export value of G&S (% of GDP)			12
Import value of G&S (% of GDP)			12
Inward FDI (% of GDP)			2.7

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

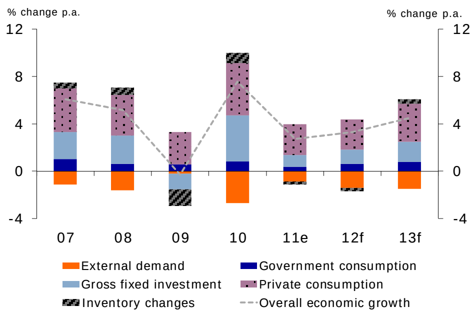
Brazil's economic growth strongly decelerated in 2011, with the growth rate falling from 7.5% in 2010 to 2.7% in 2011. In the fourth quarter of 2011, the economy grew by a meager 0.3% quarter-on-quarter only. The weak growth was partially the result of efforts by the central bank in early 2011 to control inflation, and the problems in the euro zone. In particular Brazil's manufacturing sector suffered, as the appreciation of the *real* reduced the competitiveness of its products. As a result, the manufacturing sector grew only by 0.1% in 2011, against 1.6% for the industrial sector as a whole, while the services sector grew by 2.7% and the agricultural sector by 3.9%. Helped by a strong fall in interest rates during the second half of 2011 and some improvement in global economist sentiment, we expect a modest recovery in 2012.

Although a fall of GDP growth of almost 5 percentage points may look dramatic, it primarily shows that Brazil's structural growth rate lies at about 4%. This is due to a number of factors. First, there are strong human capital constraints. Even after a year of disappointing growth, the labor market has remained extremely tight, with particularly the demand for higher educated people being very strong. Supply is held back by Brazil's educational system (see also Political and social situation chapter). Another important constraint is Brazil's infrastructure. Recently, investment in infrastructure has grown somewhat, but the country is still struggling with the effects of decades of underinvestment. Other factors that are holding back growth in Brazil are the tax system, with its high rates and its extremely complicated structure, and bureaucracy.

Luckily, Brazil also has a number of powerful strengths. The country is a global commodity powerhouse. It is already a very important agricultural producer and agricultural production can still be raised strongly, even without using more land. Brazil is also a very important producer of iron ore. Meanwhile, Brazil's role in the oil industry is expected to increase strongly in the coming years, as the country hopes to bring large pre-salt fields into production. However, this will require massive investment and a lot of advanced technology.

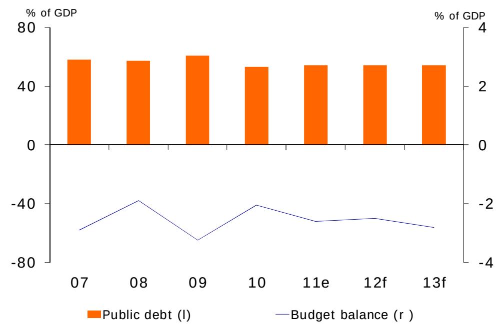
Partially thanks to the growth of the middle class, Brazil also has a rapidly growing domestic market and consumption has boomed in the past decade. However, as consumers have seen debt payments increase strongly, there are clear limits to consumption growth. Despite this increasing repayment burden, the overall health of the financial sector remains good. The sector is well regulated and the capital ratios and liquidity are good. However, the attempts by the government to reduce the lending spreads (see also Economic policy chapter) are likely to result in lower profitability.

Figure 1: Growth performance



Source: EIU

Figure 2: Public finances



Source: EIU

Political and social situation

Dilma Rousseff, who succeeded Lula da Silva as Brazil's president more than a year ago, has so far managed to be a popular president. In a recently published poll, 64% of the respondents said that they considered her government to be good or very good. This makes Rousseff the most popular president after 15 months being in office, although a majority of the people polled also indicated that they would like Lula da Silva to succeed her in 2014. Rousseff thanks her popularity to a large extent to her image of being a capable manager.

We consider this image to be well deserved. First, she has skillfully held together a multiparty coalition, despite the fact that already eight cabinet ministers have resigned. Out of these resignations, seven were due to corruption. The hardline approach of Rousseff against corruption is a welcome break with the policy of Lula in this field. However, making politics less corrupt is extremely difficult, as coalitions in Brazil rely on many parties, who tend to consider the ministries they run as personal fiefdoms. Nonetheless, the president has tried to reduce the power of parties over key cabinet appointments. This has led to the departure of a party from her coalition, but it could help to make Brazil's politics cleaner. Meanwhile, partially thanks to the support of a newly formed center party, the government has historically high levels of support in both the lower and the upper house. Second, Rousseff has been able to take a number of reforms. Although she has avoided sweeping reforms, she has been able to tackle a number of issues in a gradualist way. For example, recently, she managed to implement a controversial reform to the public sector pension system.

Meanwhile, income inequality has continued to fall. According to the CIA, Brazil's Gini index fell to 51.9 in 2012. Brazil has traditionally been a society with a high level of inequality. This high inequality is often associated with crime, which indeed is also traditionally high in Brazil, and less political stability. The Gini index peaked at an extremely high level of 63.3 in 1989, but has fallen afterwards. In particular in the last decade it has declined steadily. If the current trends continue, Brazil may thus become a less unequal country than China or the USA in the medium term. The decline in inequality has meant a strong fall in the number of poor, while the middle class has grown strongly. The decrease in inequality has not been limited to income only, as the access to health and education has also improved markedly in the past decade. Nevertheless, the quality of the public health and education systems is often still poor and there is a lot of inefficiency and wasteful spending.

Economic policy

Attempts to boost growth, in particular in the industrial sector, have dominated Brazil's policy agenda recently. In early 2012, the government intensified its fight against the appreciation of the *real* by tightening its controls on capital inflows a number of times. The last tightening round was a rather dramatic one, as the central bank not only decided that all foreign loans of Brazilian companies with a maturity up to five years have to be taxed, but it also suddenly changed trade finance regulations. The sudden and drastic way in which the central bank implemented these measures has raised fears about Brazil's policy predictability. So far, it seems that the measures have been effective, as the *real* has depreciated recently (see figure 5), although part of the depreciation also seems linked to the recent decline of global economic sentiment as result of the return of some stress in the euro zone.

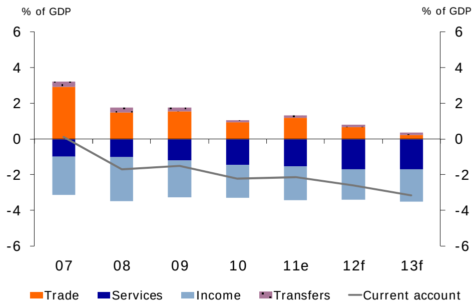
President Dilma Rousseff also personally got involved in to so called "currency wars", as she recently accused developed countries of engaging in "the fiercest protectionism that exists" through their easy monetary policies, as these result in upward pressure on the *real*. However, the high *real* might be here to stay, as the prices of Brazil's export commodities may remain high and Brazil is set to become an important oil producer in the coming years.

Meanwhile, the government has also introduced some protectionist measures, reduced payroll taxes for struggling sectors and increased subsidized lending. Although the fiscal costs of these measures are limited, we think broader tax and red tape reform would be much more effective. However, as we already explained in the previous chapter, only some limited gradual reform at best can be expected. Brazil will therefore remain a country with a high level of taxation and a high level of public expenditure in the near future. Public debt equaled 54% of GDP in 2011, and is expected to stay at roughly that level in the coming years. The government has been under strong pressure from congress to increase spending, but it still managed to increase Brazil's primary surplus somewhat to 3.1% of GDP in 2011. This positive trend has continued in the first months of 2012, as the government posted a primary surplus of 3.3% of GDP in the 12 months ending in February, against a target of 3.1% of GDP for the whole of 2012.

Meanwhile, the central bank has tried to boost growth by aggressively easing monetary policy. The latest ease of policy took place in mid-April, when the central bank lowered its main policy by 75 basis points to 9%. Last year the rate reached a peak of 12.5%, but the interest rate is now nearing the all-time low of 8.75%. Thus, the new central bank president Alexandre Tombini seems less of an inflation hawk then his predecessor, Henrique Meirelles.

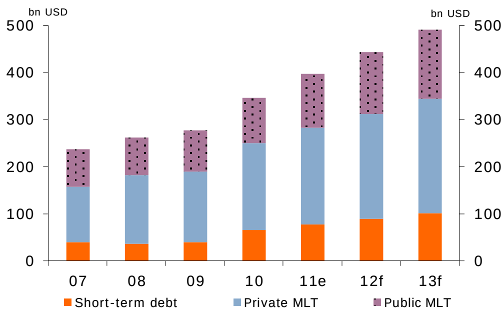
Some monetary easing was possible though, as inflation went down in late 2011. After breaking the inflation target range during nine consecutive months in 2011, inflation has fallen back within the 2.5%-6.5% inflation target range. Year-on-year inflation has fallen from a peak of 7.3% in September to 5.9% in February 2012. However, we note that Brazil's labor market has remained very tight despite a year of low growth, which implies that the extent to which the central bank can boost growth without raising the inflation rate seems limited. The government has also tried to boost growth by pressing banks to lower their spread between lending and borrowing. The government has forced state banks to lower their lending rates and private banks have recently lowered their rates as well. Traditionally this spread has been extremely large in Brazil.

Figure 3: Current account



Source: EIU

Figure 4: Debt-creating inflows



Source: EIU

Balance of Payments

Thanks to the commodity boom of the past years, Brazil has become increasingly reliant on exports of primary products, with primary products accounting for 45% of all exports in 2010, up from 29% in 2006. Therefore, we consider a large and sustained fall of commodity prices, for instance as a result of a strong decrease of growth in China, as the biggest risk to Brazil's balance of payments position. Nevertheless, compared to other important commodity exporters, Brazil's exports remain relatively diversified, as a significant share of exports still consists of manufactured products, while the range of the commodities the country exports is also very wide.

Meanwhile, the boom of the domestic economy and the appreciation of the *real* have resulted in a strong growth of imports of goods and services. Thus, Brazil's current account has deteriorated in the past five years (see figure 3). Thanks to the strong slowdown of growth in 2011, the current account deficit decreased somewhat between 2010 and 2011 by falling from 2.2% of GDP to 2.1% of GDP, but it is expected to grow once again in the coming years. In 2011 Brazil's current account deficit could easily be financed by FDI inflows, as inward FDI grew to 2.7% of GDP. However, in the coming years the current account deficit is expected to be larger than the inward FDI flows.

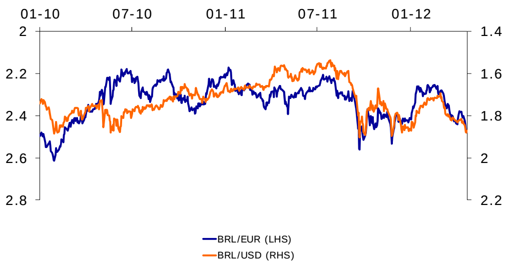
Brazil's current account deficit points at a structural weakness of the economy: a lack of savings. With a gross national savings rate of only 17% of GDP, Brazil needs foreign money to bring its gross fixed investment to a still very low level of 19% of GDP.

External position

Brazil has large and growing holdings of foreign reserves, with the total reserves increasing from USD 287bn in 2010 to USD 350bn in 2011. This means that Brazil's foreign debt, which totaled USD 397bn in 2011, is almost fully covered by foreign reserves. As Brazil's government debt has almost fully been issued in local currency, the government is a net external creditor.

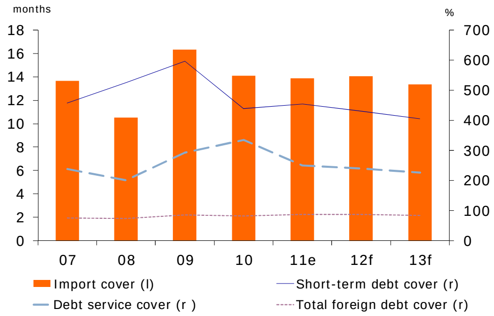
Meanwhile, the external liquidity of Brazil has also remained good. The large foreign reserves stock was equal to almost 14 months of imports in 2011. Brazil's liquidity ratio was a comfortable 146% in the same year. The weakness of Brazil's external position is its negative net international investment position of 41% of GDP in 2010. However, the risks due to this position are strongly mitigated by the fact that most of Brazil's foreign assets are highly liquid, while a large part of Brazil's foreign liabilities are in the form of FDI stock. In total, in 2010, 45% of foreign liabilities were in the form of FDI stock, while 44% consisted of portfolio investments. More than half of the strong increase of foreign liabilities between 2009 and 2010 was accounted for by FDI.

Figure 5: Exchange rate



Source: EcoWin

Figure 6: External liquidity



Source: EIU

Brazil

Selection of economic indicators	2007	2008	2009	2010	2011e	2012f	2013f
Key country risk indicators							
GDP (% real change pa)	6.1	5.2	-0.3	7.6	2.7	3.3	4.5
Consumer prices (average % change pa)	3.6	5.7	4.9	5.0	6.6	5.5	5.2
Current account balance (% of GDP)	0.1	-1.7	-1.5	-2.2	-2.1	-2.6	-3.1
Total foreign exchange reserves (mln USD)	179433	192844	237364	287056	350356	384290	408470
Economic growth							
GDP (% real change pa)	6.1	5.2	-0.3	7.6	2.7	3.3	4.5
Gross fixed investment (% real change pa)	13.8	13.6	-6.8	21.5	4.8	6.0	8.0
Private consumption (real % change pa)	6.1	5.7	4.4	6.9	4.1	4.0	4.9
Government consumption (% real change pa), SA	5.1	3.1	3.1	4.2	1.9	3.0	4.0
Exports of G&S (% real change pa)	6.2	0.5	-9.1	11.5	4.5	5.9	6.4
Imports of G&S (% real change pa)	19.8	15.3	-7.7	35.9	9.9	13.8	13.6
Economic policy							
Budget balance (% of GDP)	-2.9	-1.9	-3.2	-2.1	-2.6	-2.5	-2.8
Public debt (% of GDP)	58	57	61	53	54	54	54
Money market interest rate (%)	12.0	12.4	10.1	9.8	11.7	9.4	10.3
M2 growth (% change pa)	18	37	9	17	19	16	18
Consumer prices (average % change pa)	3.6	5.7	4.9	5.0	6.6	5.5	5.2
Exchange rate LCU to USD (average)	1.9	1.8	2.0	1.8	1.7	1.8	1.7
Recorded unemployment (%)	9.3	7.9	8.1	6.7	6.0	6.2	6.0
Balance of payments (mln USD)							
Current account balance	1551	-28192	-24302	-47323	-52612	-66750	-88450
Trade balance	40032	24836	25290	20147	29796	17180	6380
Export value of goods	160649	197943	152995	201915	256040	261460	280160
Import value of goods	120618	173107	127705	181769	226243	244280	273780
Services balance	-13219	-16690	-19245	-30771	-37906	-43280	-47300
Income balance	-29291	-40562	-33684	-39559	-46855	-44090	-51310
Transfer balance	4029	4224	3338	2787	2816	3440	3770
Net direct investment flows	27518	24601	36032	36918	75957	51660	52330
Net portfolio investment flows	31483	-15875	27168	30627	-26897	-7490	-5050
Net debt flows	38405	26624	30382	78459	48177	48530	49180
Other capital flows (negative is flight)	-4462	6293	-24524	-48645	18810	7850	16180
Change in international reserves	94495	13450	44755	50036	63435	33800	24180
External position (mln USD)							
Total foreign debt	237605	262151	276910	346978	397474	443280	490970
Short-term debt	39248	36652	39789	65496	77024	89430	100890
Total debt service due, incl. short-term debt	75270	95722	81258	85609	140268	160170	180130
Total foreign exchange reserves	179433	192844	237364	287056	350356	384290	408470
International investment position	-540495	-283385	-600795	-887106	n.a.	n.a.	n.a.
Total assets	379789	408203	479105	616254	n.a.	n.a.	n.a.
Total liabilities	920284	691588	1079900	1503360	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	2.9	1.5	1.6	0.9	1.2	0.7	0.2
Current account balance (% of GDP)	0.1	-1.7	-1.5	-2.2	-2.1	-2.6	-3.1
Inward FDI (% of GDP)	2.5	2.7	1.6	2.3	2.7	2.2	2.2
Foreign debt (% of GDP)	17	16	17	16	16	17	17
Foreign debt (% of XGSIT)	118	106	143	141	128	138	142
International investment position (% of GDP)	-39.6	-17.1	-37.0	-41.4	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	37	39	42	35	45	50	52
Interest service ratio incl. arrears (% of XGSIT)	7	7	7	6	4	4	4
FX-reserves import cover (months)	13.6	10.5	16.3	14.1	13.9	14.1	13.4
FX-reserves debt service cover (%)	238	201	292	335	250	240	227
Liquidity ratio	162	134	166	161	146	144	137

Source: EIU