Rabobank

Country Report

BRAZIL

Summary

After posting 7.5% economic growth in 2010, the highest growth rate in 24 years, we expect the economy to grow at a slower pace in 2011. This is welcome, as inflation has been approaching the upper bound of the target range. Meanwhile, high commodity prices and capital inflows are putting upward pressure on the *real*. The government has implemented capital controls and macroprudential measures, but the macroeconomic framework is under strain, as the government seems to want to control growth, inflation and the exchange rate simultaneously. Meanwhile, the current account deficit is increasing. The low saving rate limits the domestic sources of financing Brazil's increasing investment. More government savings would be welcome, but we expect only limited fiscal reform, despite the cuts the government has recently announced. Meanwhile, inequality has gone down, as the middle class grows while the number of poor declines, which bodes well for political and economic stability.

Things to watch:

- Brazil's attempts to rein in the inflows of foreign capital.
- Inflation, which has been increasing recently.

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Brazil

National facts	
Type of government	Federal Republic
Capital	Brasilia
Surface area (thousand sq km)	8,514
Population (millions)	193.3
Main ethnic groups	White (53.7%)
	Mulatto (38.5%)
	Black (6.2%)
Main religions	Roman Catholic (73.6%)
	Protestant (15.4%)
Head of State (president)	Dilma Rousseff
Head of Government	Dilma Rousseff
Monetary unit	real (BRL)

Economy		2010
Economic size	*bn USD*	*% world total*
Nominal GDP	2029	3.25
Nominal GDP at PPP	2164	2.92
Export value of goods and services	234	1.26
IMF quotum (in mln SDR)	3036	1.40
Economic structure	*2010*	*5-year av.*
Real GDP growth (%)	7.5	3.5
Agriculture (% of GDP)	6	6
Industry (% of GDP)	26	28
Services (% of GDP)	68	66
Standards of living	*USD*	*% world av.*
Nominal GDP per head	10497	107
Nominal GDP per head at PPP	11195	96
Real GDP per head	5649	71

Social and governance indicators	rank / total
Human Development Index (rank)	73 / 169
Ease of doing business (rank)	127 / 183
Economic freedom index (rank)	113 / 179
Corruption perceptions index (rank)	69 / 178
Press freedom index (rank)	58 / 178
Gini index (income distribution)	55.02
Population below $1 per day (PPP)	5.2%

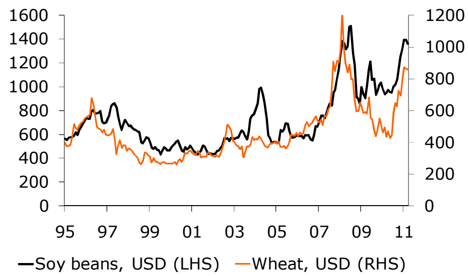
Foreign trade			2009
Main export partners (%)		*Main import partners (%)*	
China	12	US	18
US	10	China	14
Argentina	8	Argentina	10
Netherlands	5	Germany	8
Main export products (%)			2010
Primary products			45
Manufactured products			39
Semimanufactured products			14
Special operations			2
Main import products (%)			2010
Intermediate products and raw materials			46
Capital goods			23
Consumer goods			17
Fuels and lubricants			14
Openness of the economy			2010
Export value of G&S (% of GDP)			12
Import value of G&S (% of GDP)			12
Inward FDI (% of GDP)			2.4

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

Economic structure and growth

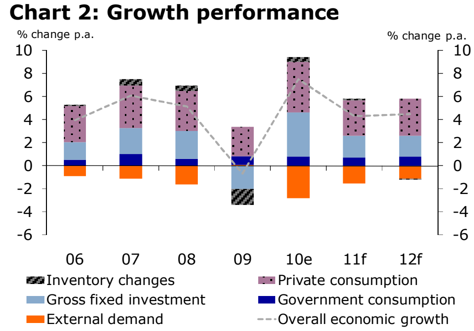
In 2010, Brazil's economy grew 7.5%, the highest rate in 24 years. The economy benefitted from strong demand for commodities, in particular by Asian countries. However, an even more important driver for growth was domestic demand, which grew at a still faster pace of 10%. The government continued the fiscal and monetary stimulus it implemented during the global crisis. Furthermore, credit grew rapidly at a rate of 20%, partially thanks to the activity of state development bank BNDES. However, growth decreased in the course of the year. While the annualized quarter-on-quarter growth rate was almost 10% in the last quarter of 2009 and the first quarter of 2010, it was only 1.6% in the third quarter of 2010 and 3% in the last quarter of 2010. This growth slowdown is welcome, as the Brazilian economy is now operating close to full capacity. According to the National Confederation of Industries, industrial capacity utilization in February 2011 approached the record pre-crisis levels which were reached in January and February 2008. Moreover, seasonally adjusted unemployment decreased below the pre-crisis level to 6.0% in March 2011, a historic low. Furthermore, there are now not only reports of a shortage of high-skilled workers, but also, at least in some sectors such as the construction industry, of a shortage of low-skilled workers. Meanwhile, inflationary pressures have risen, with the inflation approaching the upper bound of the inflation target range. The contribution of investment in growth declined in the course of 2010, with growth becoming more and more consumption driven. Keeping up investment is very important for Brazil. Traditionally, Brazil has a low savings and low investment economy, which limits the growth potential of the country. In particular public investment used to be extremely low, which resulted in an inadequate provisioning of infrastructure. However, in recent years investment has been going up. Nevertheless, with total investment amounting to no more than 19% of GDP in 2010 the level of investment remains rather low. Despite very high real interest rates - which are partially caused by tight regulation, taxation and a lack of savings - the savings rate remains very low at 16% of GDP in 2010. Why the saving rate is so low is not totally understood, although a government pension system disfavoring private saving, a strong consumption culture and Brazil's inflation history may be partial explanations. Low investment and a lack of adequate infrastructure are not the only factors that are holding back the growth of the Brazilian economy. Taxes are another. Brazil's tax rates are rather high, especially for a middle income economy. Furthermore, the tax structure is very difficult, which leads to numerous inefficiencies and distortions. The same applies to regulation in general. Courts are in most cases fair, but also very slow. Corruption is also still a problem, though Brazil scores now better than China, India and, in particular, Russia. Finally, crime in Brazil is relatively high, though generally the country seems to have become somewhat safer in recent years.

Chart 1: Commodity prices



Source: EIU

Chart 2: Growth performance



Source: EIU

Although the weaknesses stated above are serious, it is important to state that they are constraints to the faster growth, rather than direct threats to economic development. Moreover, Brazil also possesses a number of structural strengths. Firstly, Brazil's economy is quite diversified, with the country not being dependent on one single sector or export market. Secondly, the country is a very important commodity producer, which enables it to benefit from the increased commodity demand created by the rise of new economic powers. In particular the agricultural sector is very competitive, and Brazil is the world's largest or second largest producer of several agricultural products. Even as production and productivity grew rapidly in the past years, Brazil is one of the few countries in the world where the agricultural production can still grow rapidly as there is still an abundance of un(der)used land (outside the Amazon). Brazil is also likely to become a (much) big(ger) oil producer, as the country may start to tap the enormous offshore oil reserves in the Atlantic in the medium term. Thirdly, the demographic profile of Brazil is favorable in the coming twenty years, as Brazil will have a relatively large working age population, as the part of the population that is at school age is set to decline. Starting from 2030 however, Brazil will also have to deal with the consequences of the aging of its population. Fourthly, the country is one of the most politically stable countries in Latin America and has made great progress in achieving macroeconomic stability, even as the country is now facing a number of serious macroeconomic challenges (see Economic policy chapter). Brazil's banking sector is rather sound, thanks to good capital ratios and strict central bank regulation. Fifthly, thanks to high growth and social policies, the number of poor people has rapidly declined in recent years. At the same time, the middle class, which was traditionally only a small part of a socially stratified society, has been rapidly growing.

Political and social situation

On 1 January 2011 Dilma Rousseff became Brazil's first female president. While her support base resembles that of her predecessor Lula da Silva, her style is rather different. Unlike the still extremely popular Lula, Rousseff has so far ruled Brazil more in the style of a manager. She will have to be a competent manager, as she has to manage a coalition which started with no less than eleven parties. The most important parties in the coalition are Workers Party (PT), which is the party of Rousseff and Lula, and the Brazilian Democratic Movement Party (PMDB). Meanwhile, the opposition Brazilian Social Democratic Party (PSDB) holds the largest number of state governorships, including those of the important states Sao Paulo and Minas Gerais. The government has a large majority in Congress: three–quarters of the members of the lower house and the senate support the government. So far Rousseff has managed this coalition rather well.
The increased demand for commodities, the BRIC-label and former president Lula's popular appeal have all helped to increase Brazil's political standing in the world. The country is recognized as an upcoming power and acts like a regional leader. Lula was active in promoting South-South cooperation. While Dilma Rousseff is unlikely to totally break with Lula's foreign policies, she looks a bit more pragmatic and has so far been more critical about Brazil's relations with controversial governments like Iran's. The fact that Dilma Rousseff chose China as the destination for her first foreign visit in April 2011 underlines the importance of that country, which has become Brazil's largest export market in 2009 and also Brazil's most important foreign direct investor in 2010.
As we already mentioned, a noteworthy social development of the last years is the emergence of the middle class. Brazil used to be one of the most unequal societies on earth. However, the Gini index, a frequently used index for income inequality, has dropped from 0.60 in 2001 to 0.54 in 2009. In this period the income of the poorest ten percent of the population grew with 7% per year, while the income of the richest ten percent grew with 1.7%. The decline in inequality was primarily the result of low inflation, economic growth and targeted social policies. Nonetheless, even at its current level, inequality remains high and to achieve a further decline the government may need to take unpopular measures, such as reducing expensive higher and middle class privileges. The inequality in Brazil partially has a regional character, with the Northeast staying far behind the Southeast of the country. Even as Brazil has become a heavily urbanized country, land remains an issue, in particular in the Northeast, as poverty in the countryside is much higher than in urban areas. In contrast to the United States, where the 1862 Homestead Act allowed the ordinary man to obtain land relative easily, Brazil's political elite designed laws and taxes which practically restricted the access to new land to large landowners. In the last decade the government implemented some agrarian reforms which resulted in more small farmers owning their land. Nevertheless, land ownership remains very unequal and land occupations by the landless movement *Movimento Sem Terra* occur from time to time.
Brazil's constitution guarantees universal healthcare. However, in practice the healthcare system lacks financial resources and is inefficient. The educational system suffers from similar problems. Almost all children now receive primary education, but access to secondary education is much more restricted. Furthermore, the quality of education is often rather low. There are wide differences between the regions regarding the quality of health and education, with the Northeast again staying behind.

Economic policy

The stabilization of Brazil's macro economy in the nineties after the introduction of the *Plano Real* was followed by a period of decent economic growth after 2002, when the country benefitted from increasing demand for its commodities. Although the country is in a much better situation than in the early nineties, the government is several macroeconomic challenges.

Firstly, the *real* has for some time been under strong upward pressure, while the currency has already appreciated almost 60 percent against the dollar since late 2008. This is partially the result of the improving terms of trade, as commodity prices have strongly increased. However, the strong *real* is also a result of the special situation in which the global economy finds itself. On the one hand, the still ultra low interest rates in the developed countries should lead to a depreciation of the currencies of these countries versus the emerging markets and developing countries as capital flows to the latter. However, as many Asian countries, in particular China, hardly allow their currencies to appreciate, Latin American countries such as Brazil, with more open capital accounts and more flexible currencies, are receiving even more foreign capital. As a result they are facing even more upward pressure on their currency. The Brazilian authorities fear that too much appreciation may lead to Dutch disease, whereby real appreciation would make the manufacturing sector less competitive. As the manufacturing sector generally creates more productivity growth and employment, this could damage the economy in the long run. Furthermore, there are also fears that the inflow of capital could lead to a boom in credit and a deterioration of the current account. This could make the country more vulnerable to a financial and/or current account crisis. It should be noted that credit has already grown relatively quickly and that Brazil's current account has already been deteriorating in Brazil.

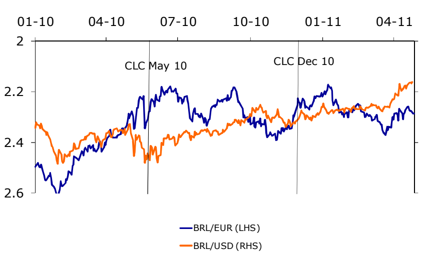
Secondly, inflationary pressures are rising in Brazil. This can partially be attributed to the rising prices of food and fuel. However, as noted before, the economy is now operating at close to full capacity, with the unemployment at historically low levels. To reduce inflation the central bank has reacted though with some monetary tightening, with the main policy rate increasing from 10.75% to 12%. However, the tightening has been very modest, as the central bank fears that higher rates would attract even more foreign capital inflows. Therefore, the government has introduced important new elements within the macroeconomic policy framework. Firstly, the central bank introduced macroeconomic prudential measures, such as higher capital requirements for long-maturity loans and higher bank reserve requirements. Both measures are aimed at limiting the credit growth which would help to contain inflation. Secondly, the government has implemented a number of new controls on the inflow of foreign capital. After an increase of the tax on fixed income portfolio inflows in the second half of 2010, the government took new measures in early 2011. For example, the government is now taxing all foreign borrowing with a tenor of up to 2 years at a rate of 6%. Despite all the measures the *real* has so far continued to rise (see chart 3). Given the extraordinary global circumstances we think there is a rationale for the introduction of these non-traditional measures. However, there is a risk that the central bank's almost impossible attempt to control inflation, the exchange rate and growth at the same time may lead to a weaker stance towards inflation in the short term, which might necessitate more forceful monetary action in the medium term.

In the end, the fact that Brazil needs very high real interest rates to control inflation is related to its low level of domestic savings. Therefore, a lower government budget deficit, and thus more government savings, would be very welcome. According to a central bank study, a fiscal tightening of 1% of GDP would be the equivalent in the effects on the economy of a 125bps interest rate hike. Thus, a fiscal tightening would allow the central bank to decrease the interest rate. Despite the announcement by the government of USD 30bn in budget cuts, and a rather modest increase in the minimum wage in 2011 (which limits public spending), we remain skeptical about the fiscal outlook. We note that public expenditure in real terms has grown rapidly in the preceding years at rates above real GDP growth. Although real expenditure growth is likely to remain below GDP growth in 2011, it is set to rise above it once again in 2012. Moreover, we note that there is no mid-term fiscal strategy, and that there are not many fiscal hawks in Brazil. Illustrative in this respect was the fact that the right-wing opposition was pressing for a bigger increase of the minimum wage than the government.

Furthermore, it is not only the amount of spending but also the composition of spending which is problematic. As noted before, public investment is low, although investment in infrastructure has started to grow, from 2% of GDP to 2.5% of GDP in 2010. It is expected to grow further in the coming years to 3- 3.5% of GDP. This will help to avoid a total gridlock of traffic, but infrastructure is likely to remain a bottleneck for growth. Meanwhile, expenditure on pensions is very high in Brazil. In fact, as a percentage of GDP spending on pensions already equals spending on pensions in the developed countries, even as the Brazilian population is much younger. This is partially due to a low retirement age and very high pensions. As the number of elderly will increase from 20mln in 2005 to 65mln in 2050, the current pension policies clearly need to be changed. However, as Dilma Rousseff's electoral platform lacked any mentioning of pension reform, we do not expect the government to implement broad reforms in the coming years. Furthermore, the quality of government services is often low. Despite the fiscal challenges, in the short- to medium-term the government should be able to refinance its debt, even as about 25% of debt needs to be refinanced in 2011. The government has bought many bonds maturing in 2011 and 2012 and is able to easily issue domestic debt.

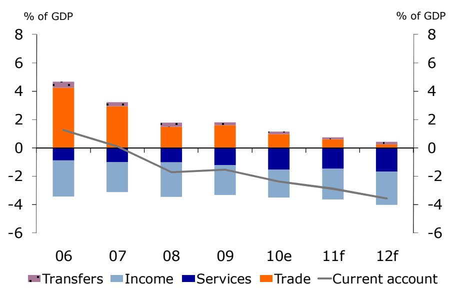
Brazil employs industrial policy in a number of sectors it considers strategic. For example, state-owned oil giant Petrobras will be responsible for the development of the enormous offshore large Tupi oil fields. The same applies to the mining sector. The leadership of Vale, the world's second-largest mining company, will finally change after the management had been under sustained government criticism for some time. Without success, former President Lula urged Vale to build industrial plants in Brazil. The government also criticized Vale's decision to buy ships in China, instead of buying Brazilian ships. In the past six months, Brazil's newspapers already reported that the government was pushing Vale, in which it has a direct and an indirect stake, to name a new CEO.

Chart 3: Exchange rate



Source: EIU

Chart 4: Current account



Source: EIU

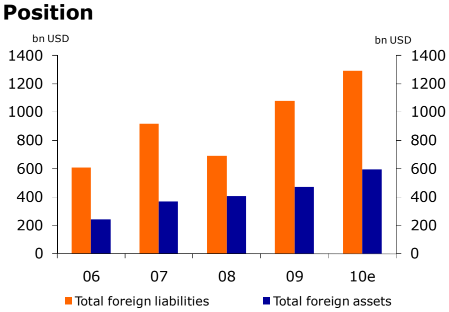
Balance of Payments

Already before the global financial crisis, Brazil's current account balance turned into deficit, and the current account balance has deteriorated ever after, except in 2009, when the global crisis led to a strong fall in imports (see chart 6). The deterioration can be explained by the rapid growth of domestic demand, which resulted in strong growth of imports and of a decline of the services balance. Moreover, the strong growth of the economy resulted in huge profits for foreign firms, which in turn resulted in large outflows on the income account through repatriations. Thus, foreign direct investors repatriated USD 24.5bn in profits and dividends in 2010. Partially through the good profitability of investment in Brazil, the past years, Brazil attracted significant amounts of FDI. We consider this a risk mitigant, as foreign direct investment flows are less volatile and result in the reflows to follow the ups and downs of Brazil's economy. Thanks to the renewed increase in commodity prices and the scepticism of market participants regarding the government's ability to resist the appreciation of the *real*, Brazil once again attracted large inflows of foreign currency in the beginning of 2011. In total the country received net financial inflows of USD 31bn in the first three months of 2011. A prolonged period of low commodity prices is the biggest risk for Brazil's balance of payment position. However, this risk is partially mitigated by the fact that at 24% of GDP, trade (i.e. exports and imports of goods and services) is relatively small. This means that a trade shock will have a relatively small effect on the Brazil's total economy. At the same time, this low trade to GDP ratio would make a further increase of the current account deficit a cause for some concern. Should foreign capital suddenly stop to flow into Brazil, then exports and imports will have to adjust relatively drastically to allow the current account to return to balance.

External position

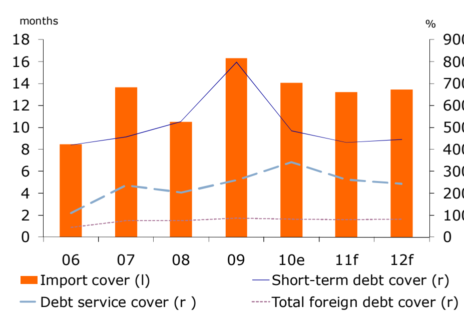
Thanks to high reserve holdings, Brazil's external position is rather strong. Reserve growth was high in the first months of 2011, when the central bank tried to reduce the upward pressure of the large capital inflows on the *real*. Total international reserves grew to USD319bn in early April 2011, up from USD 288bn in December 2010. At the same time, foreign debt has also increased, but the total amount of short-term debt has remained rather low. Meanwhile, the sterilized intervention policy is very expensive, as it boils down to buying low interest rate foreign currency assets, while selling high interest rate *real* liabilities. Indeed, the total yearly cost may amount to USD 30bn a year, or about 1.5% of GDP. At the same time the high reserve holdings have a countercyclical effect on the balance sheet of the total government: with foreign reserves more than twice the size of the public external debt, a lower *real* improves the balance sheet of the government. Public external debt is low, as more than 90% of the debt of the Brazilian government is domestic. At first sight, Brazil's strongly negative International Investment Position (see chart 5) might be a cause for concern. However, of the USD 1,293bn of foreign liabilities per December 2010, USD 473bn consisted of foreign direct investment and USD 430bn of portfolio investment in equities. As the cost of these types of capital depends on the profitability of the investment, they tend to decrease in times of crisis. Furthermore, foreign direct investment flows are less volatile than other types of capital.

Chart 5: International Investment Position



Source: IMF, BACEN

Chart 6: External liquidity



Source: EIU

Brazil

Selection of economic indicators	2006	2007	2008	2009	2010e	2011f	2012f
Key country risk indicators							
GDP (% real change pa)	3.9	6.1	5.2	-0.7	7.5	4.3	4.5
Consumer prices (average % change pa)	4.2	3.6	5.7	4.9	5.0	6.2	4.8
Current account balance (% of GDP)	1.3	0.1	-1.7	-1.5	-2.3	-2.9	-3.6
Total foreign exchange reserves (mln USD)	85156	179433	192844	237364	287056	326770	372170
Economic growth							
GDP (% real change pa)	3.9	6.1	5.2	-0.7	7.5	4.3	4.5
Gross fixed investment (% real change pa)	9.8	13.8	13.6	-10.4	21.6	9.5	8.5
Private consumption (real % change pa)	5.2	6.1	5.7	4.2	6.8	4.9	4.9
Government consumption (% real change pa), SA	2.6	5.1	3.1	3.9	4.0	3.8	4.2
Exports of G&S (% real change pa)	5.1	6.3	0.4	-10.3	10.5	8.6	8.1
Imports of G&S (% real change pa)	18.3	19.9	15.3	-11.5	37.0	18.4	13.6
Economic policy							
Budget balance (% of GDP)	-2.9	-2.8	-2.0	-3.4	-2.2	-2.5	-2.5
Public debt (% of GDP)	56	56	59	58	57	56	55
Money market interest rate (%)	15.3	12.0	12.4	10.1	9.8	12.0	11.6
M2 growth (% change pa)	14	18	37	9	15	22	15
Consumer prices (average % change pa)	4.2	3.6	5.7	4.9	5.0	6.2	4.8
Exchange rate LCU to USD (average)	2.2	1.9	1.8	2.0	1.8	1.7	1.8
Recorded unemployment (%)	10.0	9.3	7.9	8.1	6.7	5.9	5.8
Balance of payments (mln USD)							
Current account balance	13643	1551	-28192	-24302	-47518	-67560	-86160
Trade balance	46457	40032	24836	25290	20267	14180	5900
Export value of goods	137808	160649	197943	152995	201915	240150	260480
Import value of goods	91351	120618	173107	127705	181649	225970	254580
Services balance	-9641	-13219	-16690	-19245	-31071	-33990	-40110
Income balance	-27480	-29291	-40562	-33684	-39558	-51290	-56560
Transfer balance	4306	4029	4224	3338	2845	3540	4610
Net direct investment flows	-9420	27518	24601	36032	36962	30500	32000
Net portfolio investment flows	-5871	31483	-14875	31283	37163	36130	37930
Net debt flows	9984	38412	26667	18848	76683	58730	46530
Other capital flows (negative is flight)	23704	-4469	5249	-17106	-53254	-18080	15090
Change in international reserves	32040	94495	13450	44755	50036	39710	45400
External position (mln USD)							
Total foreign debt	193516	237472	255614	273608	349107	406610	450590
Short-term debt	20325	39248	36652	29745	59223	75850	83640
Total debt service due, incl. short-term debt	77758	75654	94682	91740	84069	125240	152750
Total foreign exchange reserves	85156	179433	192844	237364	287056	326770	372170
International investment position	-368861	-550396	-283800	-605661	n.a.	n.a.	n.a.
Total assets	238874	369888	407788	474239	n.a.	n.a.	n.a.
Total liabilities	607735	920284	691588	1079900	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	4.3	2.9	1.5	1.6	1.0	0.6	0.2
Current account balance (% of GDP)	1.3	0.1	-1.7	-1.5	-2.3	-2.9	-3.6
Inward FDI (% of GDP)	1.7	2.5	2.7	1.6	2.4	1.8	1.9
Foreign debt (% of GDP)	18	17	15	17	17	17	19
Foreign debt (% of XGSIT)	115	118	104	141	142	139	142
International investment position (% of GDP)	-33.9	-40.3	-17.2	-38.0	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	46	38	38	47	34	43	48
Interest service ratio incl. arrears (% of XGSIT)	9	7	6	6	4	4	5
FX-reserves import cover (months)	8.5	13.6	10.5	16.3	14.1	13.2	13.5
FX-reserves debt service cover (%)	110	237	204	259	341	261	244
Liquidity ratio	129	162	134	159	158	142	137

Source: EIU

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