Country update **BRAZIL**

Summary

Brazil's economic growth has been disappointing, with growth falling to 2.7% in 2011 and an expected 2% (at most) in 2012 from 7.5% in 2010. The slowdown has been partially caused by monetary tightening in the first half of 2011, and a drought in early 2012, but is also related to Brazil's structural weaknesses. The central bank has been lowering its policy rate to a record-low 7.5% in August 2012. The central bank is hoping that this will cause the economy to regain some traction in the second half of 2012. Through the implementation of capital controls and its own strong commitment the government has been able to let the *real* depreciate against the US dollar. Meanwhile, unemployment has remained at record lows. A recent announcement by the government of a new infrastructure program sets the encouraging signal that the government is more willing to address the structural constraints to growth.

Things to watch:

- Deterioration of the Eurozone crisis.
- Sharp slowdown in China.

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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 (15.4%)	
Main ehtnic 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	3.58
Nominal GDP at PPP	2295	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	11904	96
Real GDP per head	5841	72

Social and governance indicators	rank / total
Human Development Index (rank)	84/ 187
Ease of doing business (rank)	129/ 183
Economic freedom index (rank)	113/ 179
Corruption perceptions index (rank)	73/ 182
Press freedom index (rank)	99/ 179
Gini index (income distribution)	54.7
Population below $1 per day (PPP)	3.8%

Foreign trade			2011
Main export partners (%)		*Main import partners (%)*	
China	15	US	16
US	10	China	15
Argentina	9	Argentina	8
Nehterlands	5	Gemrany	7

Main export products (%)	
Primary products	48
Manufactured products	36
Semimanufactured products	14
Special operations	2
Main import products (%)	
Intermediate products and raw materials	43
Capital goods	20
Fuels and lubricants	17
Consumer goods	15
Openness of the economy	
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.

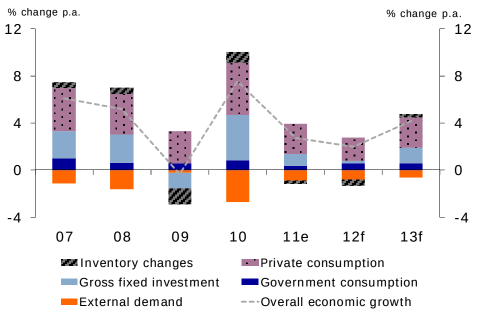
Introduction and update

Brazil's recent economic performance has disappointed. After falling from 7.5% in 2010 to 2.7% in 2011, economic growth is likely to fall further this year to 2% at most. On a quarter-on-quarter basis the economy has recovered weakly, with growth of 0.4% in the second quarter of 2012, against 0.1% growth in the two previous quarters. Especially the performance of the industrial sector has been very weak. Growth was affected by some one-off factors, such as a drought and new environmental regulations which resulted in a much lower production of buses and trucks. At the same time, with an unemployment rate of 5.8% in May, Brazil's labor market has remained very tight, which suggest that the slowdown of growth is also related to structural constraints. Partially thanks to the strong monetary easing implemented in the past year (see next chapter) and better agricultural conditions , growth is nevertheless likely to gain some strength in the coming quarters. Despite the low growth, it seems that Brazil has not lost its attractiveness for foreign direct investors, as FDI inflows have remained strong. These inflows are likely to continue to (to a large extent) cover the current account deficit. This mitigates balance of payments risks. Meanwhile, probably thanks to the low unemployment rate, the popularity of president Dilma Rousseff has reached record-highs, with 75.7% of the voters approving of her presidency, according to survey released in August.

Varies policies applied to kick-start growth

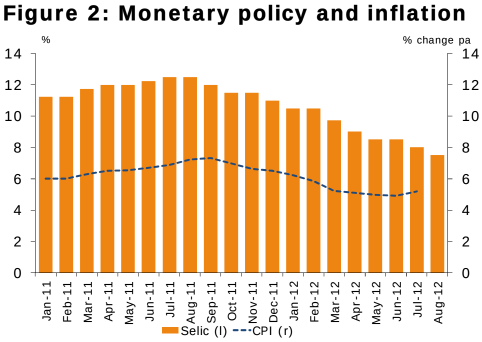
The public sector has tried to counter the slowdown in growth in various ways. First, in late August Brazil's central bank lowered its main policy rate to a record low 7.5%. In the past year, the rate has thus been lowered 500 basis points (see figure 2). After breaching the 2.5%-6.5% central bank's target range in late 2011, inflation has fallen, before increasing somewhat to 5.2% year-on-year in July 2012. It seems that the central bank in practice no longer aims for 4.5% inflation, but instead wants inflation to be between 4.5% and 6.5%. Second, the government tried to make borrowing cheaper by lowering the spread between the lending and borrowing rates of public banks. As these banks account for almost half of Brazil's banking market, private sector banks afterwards also lowered their rates. Third, partially in an attempt to help the struggling industrial sector, the government also tried to lower the exchange rate of the *real*. Partially thanks to central bank intervention and capital controls the *real* depreciated strongly until May and has remained close to the 2 *real* per USD exchange rate the government wanted to maintain afterwards. It seems that the capital controls introduced in the past years, the willingness of the central bank to execute large-scale foreign exchange interventions and the strong commitment of the government to maintain the exchange rate at that level has scared off investors that bet on short term currency volatility. Even more than before, Brazil thus now has a strongly managed floating exchange rate. Fourth, the government has also implemented a number of tax initiatives, such as a scheme to promote the sale (and production) of vehicles. Although most of the policies described may provide some short term relief, they do not do much to deal with Brazil's structural issues. However, the launch of a new infrastructure initiative suggests that the growth slowdown may have convinced the government to do more about structural issues, as well.

Figure 1: Growth performance



Source: EIU

Figure 2: Monetary policy and inflation



Source: EIU

Government launches new infrastructure initiative

The launch of the *Plano Nacional de Logística Integrada* infrastructure initiative by president Dilma Rousseff on 16 August seems good news. As we have mentioned many times before, Brazil's infrastructure is a critical constraint to its economic growth, with the country scoring worse in this respect than China, India and Russia. The low level of development of Brazil's (air)ports, roads and railways increases the costs of doing business in Brazil and limits the trade potential of the country. After decades of underinvestment, the Lula government launched an initiative to boost investment, but this program suffered from the government's inability to implement transport programs. Especially the procurement process has been very problematic. The new initiative tries to avoid these pitfalls by envisioning a more extensive role of the private sector. There will be concessions for about 7500 km of new roads and 10,000 km of new railroads, whereby the government will try to attract private investment by offering cheap funding from state development bank BNDES. Thus about USD 65bn in investment should be generated, of which 60% in the coming 5 years. All new contracts have to be signed in September 2013, but there is a risk of delays, as Brazil's extensive bureaucracy may slow down the implementation of the program. Although the impact in the short run will be limited, we expect the program to help raise the medium-term growth potential of Brazil's economy. Moreover, it also signals that the government is now more willing to address structural constraints to growth. Rousseff's PT party has long been against privatizations and the fact that she is now going against the ideological leanings of her party shows the willingness of Dilma Rousseff to follow a pragmatic course.

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	2.0	4.2
Consumer prices (average % change pa)	3.6	5.7	4.9	5.0	6.6	5.1	5.0
Current account balance (% of GDP)	0.1	-1.7	-1.5	-2.2	-2.1	-2.8	-3.1
Total foreign exchange reserves (mln USD)	179433	192844	237364	287056	350356	391660	410440
Economic growth							
GDP (% real change pa)	6.1	5.2	-0.3	7.6	2.7	2.0	4.2
Gross fixed investment (% real change pa)	13.8	13.6	-6.8	21.5	4.8	1.0	6.5
Private consumption (real % change pa)	6.1	5.7	4.4	6.9	4.1	3.0	4.0
Government consumption (% real change pa), SA	5.1	3.1	3.1	4.2	2.0	3.0	3.0
Exports of G&S (% real change pa)	6.2	0.5	-9.1	11.5	4.5	2.2	4.7
Imports of G&S (% real change pa)	19.9	15.4	-7.8	36.0	10.0	6.7	7.5
Economic policy							
Budget balance (% of GDP)	-2.9	-1.9	-3.2	-2.1	-2.6	-2.8	-2.6
Public debt (% of GDP)	58	57	61	53	54	55	54
Money market interest rate (%)	12.0	12.4	10.1	9.8	11.7	8.7	8.0
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	5.1	5.0
Exchange rate LCU to USD (average)	1.9	1.8	2.0	1.8	1.7	1.9	2.0
Recorded unemployment (%)	9.3	7.9	8.1	6.7	6.0	6.2	6.3
Balance of payments (mln USD)							
Current account balance	1551	-28192	-24302	-47273	-52480	-65130	-78530
Trade balance	40032	24836	25290	20147	29807	17220	12840
Export value of goods	160649	197943	152995	201915	256040	256030	271810
Import value of goods	120618	173107	127705	181769	226233	238810	258970
Services balance	-13219	-16690	-19245	-30835	-37952	-41280	-44710
Income balance	-29291	-40562	-33684	-39559	-46855	-44320	-50170
Transfer balance	4029	4224	3338	2902	2984	3250	3510
Net direct investment flows	27518	24601	36032	36918	75957	51660	52330
Net portfolio investment flows	31483	-15875	27168	30627	-11897	8500	12410
Net debt flows	38405	26624	30382	78459	33195	25560	31090
Other capital flows (negative is flight)	-4462	6292	-24524	-48695	18660	20720	1490
Change in international reserves	94495	13450	44755	50036	63435	41300	18780
External position (mln USD)							
Total foreign debt	237605	262151	276910	346978	382501	405330	435560
Short-term debt	39248	36652	39789	65496	77042	80480	87160
Total debt service due, incl. short-term debt	75270	95722	81258	85609	140268	157250	165200
Total foreign exchange reserves	179433	192844	237364	287056	350356	391660	410440
International investment position	-540495	-283385	#N/A	#N/A	n.a.	n.a.	n.a.
Total assets	379789	408203	#N/A	#N/A	n.a.	n.a.	n.a.
Total liabilities	920284	691588	#N/A	#N/A	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	0.5
Current account balance (% of GDP)	0.1	-1.7	-1.5	-2.2	-2.1	-2.8	-3.1
Inward FDI (% of GDP)	2.5	2.7	1.6	2.3	2.7	2.4	2.5
Foreign debt (% of GDP)	17	16	17	16	15	18	17
Foreign debt (% of XGSIT)	118	106	143	141	123	129	131
International investment position (% of GDP)	-39.6	-17.1	#N/A	#N/A	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	37	39	42	35	45	50	50
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	14.8	14.3
FX-reserves debt service cover (%)	238	201	292	335	250	249	248
Liquidity ratio	162	134	166	161	146	147	144

Source: EIU