# Country update **BRAZIL**


**Summary**

Brazil's new government has been hit by scandals during its first eight months of rule. Already four important government members have had to resign, including the important chief of staff Antonio Palocci. This may hit the government's ability to undertake reforms. Meanwhile, the government seems to focus its austerity efforts on the high public expenditures, instead of Brazil's low public investment, which is welcome. In August, inflation increased above the 6.5% upper end of the inflation target to 7.1%. Thanks to interest rate hikes, inflation is likely to fall somewhat, but we expect it to remain high. Growth is likely to slow, as the growing household indebtedness is likely to (or should) act as a brake on domestic demand. At the same time, Brazil's industry has been struggling, which has led to the government to announce a USD 16bn industrial policy program. Meanwhile, the heavy losses on Brazil's stock exchange during the worldwide financial turmoil in August shows how Brazil's (commodity) boom continues to be strongly influenced by global economic sentiment.

**Things to watch:**

- Global economic sentiment and its effects on the prices of Brazil's main export products.
- Efforts of the government to control public spending.
- Inflation, which is now above the target range.

Author: **Herwin Loman**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-31105
H.Loman@rn.rabobank.nl

# Brazil

| National facts | |
|---|---|
| Type of government | Federal Republic |
| Capital | Brasilia |
| Surface area (thousand sq km) | 8,514 |
| Population (millions) | 188.6 |
| 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 | | 2010 |
|---|---|---|
| *Economic size* | *bn USD* | *% world total* |
| Nominal GDP | 2088 | 3.34 |
| Nominal GDP at PPP | 2172 | 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) | 27 | 28 |
| Services (% of GDP) | 67 | 66 |
| *Standards of living* | *USD* | *% world av.* |
| Nominal GDP per head | 10945 | 111 |
| Nominal GDP per head at PPP | 11386 | 97 |
| Real GDP per head | 5725 | 72 |

| 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 $1.25 per day (PPP) | 5.2% |

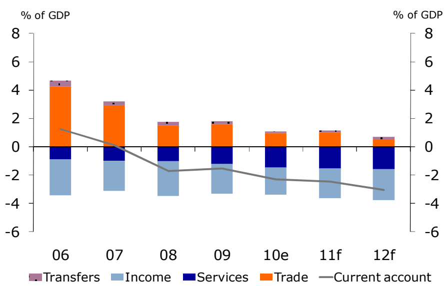
| Foreign trade | | | 2010 |
|---|---|---|---|
| *Main export partners (%)* | | *Main import partners (%)* | |
| China | 15 | US | 17 |
| US | 10 | China | 15 |
| Argentina | 9 | Argentina | 9 |
| Netherlands | 5 | Germany | 8 |
| *Main export products (%)* | | | |
| Primary products | | | 45 |
| Manufactured products | | | 39 |
| Semimanufactured products | | | 14 |
| Special operations | | | 2 |
| *Main import products (%)* | | | |
| Intermediate products and raw materials | | | 46 |
| Capital goods | | | 23 |
| Consumer goods | | | 17 |
| Fuels and lubricants | | | 14 |
| *Openness of the economy* | | | |
| Export value of G&S (% of GDP) | | | 11 |
| Import value of G&S (% of GDP) | | | 12 |
| Inward FDI (% of GDP) | | | 2.3 |

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

**Introduction and update**

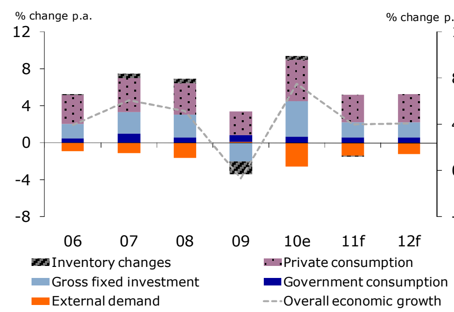
Recent political news in Brazil has been dominated by government scandals. In August, Dilma Rousseff's government, which has been in power since January, already lost its fourth important member. Furthermore, a number of lower ranked officials were also fired. Three of the high level resignations were related to (accusations of) corruption. The most prominent government member to depart was Antonio Palocci, who served as Dilma's chief of staff. He was an important dealmaker and also perceived by the markets as a promoter of market-friendly policies. The scandals show that Brazil's political system continues to be plagued by corruption. In a sense they are also good news. Firstly, it seems that Dilma Rousseff is more willing than her predecessor Lula to punish corrupt officials, even when they have high ranks. Secondly, the resignations were partially fuelled by strong indignation among the Brazilian public. It thus seems that the society has become less willing to tolerate corrupt practices. However, at the same time, the scandals show the risks of the political fragmentation, as the government needs to distribute high positions across a wide range of parties to hold its diverse coalition together. One of the smallest parties has already left the government after its minister had to resign. The resignations will make it more difficult for the government to implement policies. This has further reduced the chances of the government implementing much-needed reforms to the tax and pension systems. Nevertheless, this year, the government intends to implement budget cuts equal to roughly USD 30bn, or 1.4% of GDP. It seems that the cuts will largely hit the high public expenditures, instead of Brazil's low public investment, which is welcome. In the past, public infrastructure was the main casualty when the government had to take fiscal cuts, which partially explains the weak state of Brazil's infrastructure. However, we note that Brazil's fiscal position is still rather expansionary, as a fiscal deficit of 2.8% is expected for 2011, even as the economy has been booming and commodity prices are still very high. Meanwhile, inward FDI inflows have been surprisingly strong this year. Net FDI inflows increased to USD 38.5bn in the first seven months of 2011, against USD 14.7bn in the same period last year. They thus exceed the current account deficit, which stood at USD 28.9bn in the first seven months of 2011, against USD 28.4bn in the same period of 2010. Nevertheless, as we noted before, it is still noteworthy that Brazil has a sizeable current account deficit at all. With the prices of its main commodity exports having reached record highs, Brazil's export income has increased rapidly. However, this additional income has been matched by a rapid increase of imports of goods and services.

**Chart 1: Current account**




Source: EIU

**Chart 2: Growth performance**




Source: EIU

**Limits to growth**

The worsening of the current account shows that Brazil's economy has been growing above its potential growth rate. Indeed, it is now increasingly becoming clear that Brazil has to prepare for a period of lower economic growth. Firstly, domestic demand will have to ease, as household debt has been growing rapidly in the past years. Indebtedness has grown from 25% of net income in July 2006 to 42% in May 2011. This ratio is still not extremely high, but, thanks to Brazil's extremely high interest rates, with a debt service to net income ratio of 26%, consumers are now spending a rather large share of their income on debt. With unemployment at record low levels, there is not a direct risk of a bubble. Nevertheless, as it seems that consumers are not in a position to increase their borrowing much further, consumption growth is likely to be lower in the near future.

Secondly, Brazil's industry has been struggling recently. Industrial production declined by a seasonally adjusted 1.6% mom in June and exports of cars and airplanes fell by 8% and 14% respectively, in the first 7 months of 2011. The bad performance of industry may be puzzling at first sight, as domestic demand has remained vigorous. It seems that this puzzle can at least partially be explained by the appreciation of the *real* during 2010 and the first half of 2011. Indeed, many industrialists have been complaining that the plight of the industry is related to the high exchange rate, which makes their products uncompetitive. In the last months, the government has therefore continued to implement new capital controls to stem the rise of the *real*. Furthermore, in an attempt to restore the competitiveness of its industry, Brazil's government has also announced a new industrial policy program. The government will give USD 16bn in tax breaks, provide more financing for innovation, purchase more domestic goods and take some trade measures, such as increasing the inspections of the country of origin of imports. Given the importance of industry for employment creation and productivity growth, the move seems understandable. However, it is worth mentioning that the low competitiveness is also caused by more structural factors, such as red tape, high tax rates and bad infrastructure.

**The impact of the recent turmoil**

Meanwhile, in August and the first half of September, the *real* sharply depreciated, along with the currencies of other emerging markets, due to the turmoil on the global financial markets.. In fact, in mid-September the currency had fallen back to a level not seen for a year. This effect is likely to be welcomed by Brazil's industry. However, in the case of Brazil, the currency weakness may also be related to the recent actions of the central bank; on August 30 the bank reduced its main policy rate with 50 basis points from 12.5% to 12%. Meanwhile, inflation is now significantly above the 2.5%-6.5% target range. In the month up to 15 August, year-on-year inflation increased to 7.1%. The monetary tightening the central bank implemented earlier this year by raising its policy rate in five steps from 10.75% to 12.5% is likely to lower the inflation rate somewhat in the coming period, but the recent move still looks a bit of a gamble. It seems that the government indeed seems to want to control inflation, economic growth and the exchange rate simultaneously, like we already wrote earlier this year in our full report. As a result, inflation risk has increased., At the same time, the recent turbulence has underlined Brazil's dependence on high commodity prices. Among the emerging markets, Brazil's stock market has been the biggest loser in August 2011. In fact, trading came close to being suspended at one point. The heavy losses are partially due to the heavy weight within the index of commodity stocks such as Petrobras and Vale, which tend to respond strongly to changes in global economic sentiment. Brazil's president stressed that Brazil itself is now stronger than in 2008, as it has boosted its foreign reserves. Indeed, foreign reserves have grown. However, as we already mentioned, the current account and fiscal deficit have also increased in the meantime, just like its foreign indebtedness. During August, growth forecasts have been rapidly adjusted downwardly. Still, a crisis does not seem likely, unless Brazil faces a long period of low commodity prices.

| 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 | 4.0 | 4.1 |
| Consumer prices (average % change pa) | 4.2 | 3.6 | 5.7 | 4.9 | 5.0 | 6.6 | 5.1 |
| Current account balance (% of GDP) | 1.3 | 0.1 | -1.7 | -1.5 | -2.3 | -2.5 | -3.1 |
| Total foreign exchange reserves (mln USD) | 85156 | 179433 | 192844 | 237364 | 287056 | 338880 | 395020 |
| *Economic growth* | | | | | | | |
| GDP (% real change pa) | 3.9 | 6.1 | 5.2 | -0.7 | 7.5 | 4.0 | 4.1 |
| Gross fixed investment (% real change pa) | 9.8 | 13.8 | 13.6 | -10.4 | 22.0 | 8.0 | 8.0 |
| Private consumption (real % change pa) | 5.2 | 6.1 | 5.7 | 4.2 | 7.0 | 4.8 | 4.8 |
| Government consumption (% real change pa), SA | 2.6 | 5.1 | 3.1 | 3.9 | 3.3 | 3.1 | 3.3 |
| Exports of G&S (% real change pa) | 5.1 | 6.2 | 0.5 | -10.2 | 11.5 | 4.4 | 6.6 |
| Imports of G&S (% real change pa) | 18.3 | 19.8 | 15.4 | -11.6 | 36.3 | 14.0 | 13.6 |
| *Economic policy* | | | | | | | |
| Budget balance (% of GDP) | -3.5 | -2.9 | -1.9 | -3.3 | -2.2 | -2.8 | -2.6 |
| Public debt (% of GDP) | 56 | 58 | 57 | 62 | 55 | 54 | 54 |
| Money market interest rate (%) | 15.3 | 12.0 | 12.4 | 10.1 | 9.8 | 12.1 | 12.5 |
| M2 growth (% change pa) | 14 | 18 | 37 | 9 | 17 | 21 | 19 |
| Consumer prices (average % change pa) | 4.2 | 3.6 | 5.7 | 4.9 | 5.0 | 6.6 | 5.1 |
| Exchange rate LCU to USD (average) | 2.2 | 1.9 | 1.8 | 2.0 | 1.8 | 1.6 | 1.6 |
| Recorded unemployment (%) | 10.0 | 9.3 | 7.9 | 8.1 | 6.7 | 5.3 | 5.4 |
| *Balance of payments (mln USD)* | | | | | | | |
| Current account balance | 13643 | 1551 | -28192 | -24302 | -47365 | -62740 | -83880 |
| Trade balance | 46457 | 40032 | 24836 | 25290 | 20221 | 26060 | 14220 |
| Export value of goods | 137808 | 160649 | 197943 | 152995 | 201915 | 250490 | 271480 |
| Import value of goods | 91351 | 120618 | 173107 | 127705 | 181694 | 224430 | 257270 |
| Services balance | -9641 | -13219 | -16690 | -19245 | -30807 | -39370 | -43230 |
| Income balance | -27480 | -29291 | -40562 | -33684 | -39558 | -53100 | -59900 |
| Transfer balance | 4306 | 4029 | 4224 | 3338 | 2787 | 3670 | 5040 |
| Net direct investment flows | -9420 | 27518 | 24601 | 36032 | 36919 | 43000 | 45300 |
| Net portfolio investment flows | -5871 | 31483 | -15875 | 27168 | 32011 | 25200 | 30310 |
| Net debt flows | 9966 | 38407 | 26615 | 30417 | 70420 | 57040 | 49150 |
| Other capital flows (negative is flight) | 23722 | -4463 | 6301 | -24560 | -41949 | -10670 | 15250 |
| Change in international reserves | 32040 | 94495 | 13450 | 44755 | 50036 | 51830 | 56130 |
| *External position (mln USD)* | | | | | | | |
| Total foreign debt | 193459 | 237605 | 262140 | 276932 | 346494 | 406310 | 454390 |
| Short-term debt | 20325 | 39248 | 36652 | 39789 | 67573 | 86300 | 99760 |
| Total debt service due, incl. short-term debt | 77786 | 75270 | 95722 | 80986 | 103708 | 145420 | 176750 |
| Total foreign exchange reserves | 85156 | 179433 | 192844 | 237364 | 287056 | 338880 | 395020 |
| International investment position | -368861 | -547548 | -283614 | -600795 | n.a. | n.a. | n.a. |
| Total assets | 238874 | 372736 | 407974 | 479105 | 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 | 1.0 | 0.5 |
| Current account balance (% of GDP) | 1.3 | 0.1 | -1.7 | -1.5 | -2.3 | -2.5 | -3.1 |
| Inward FDI (% of GDP) | 1.7 | 2.5 | 2.7 | 1.6 | 2.3 | 2.2 | 2.1 |
| Foreign debt (% of GDP) | 18 | 17 | 16 | 17 | 17 | 16 | 17 |
| Foreign debt (% of XGSIT) | 115 | 118 | 106 | 143 | 141 | 135 | 140 |
| International investment position (% of GDP) | -33.9 | -40.1 | -17.2 | -37.7 | n.a. | n.a. | n.a. |
| Debt service ratio (% of XGSIT) | 46 | 37 | 39 | 42 | 42 | 48 | 54 |
| Interest service ratio incl. arrears (% of XGSIT) | 9 | 7 | 7 | 7 | 4 | 4 | 4 |
| FX-reserves import cover (months) | 8.5 | 13.6 | 10.5 | 16.3 | 14.1 | 13.6 | 14.2 |
| FX-reserves debt service cover (%) | 109 | 238 | 201 | 293 | 277 | 233 | 223 |
| Liquidity ratio | 129 | 162 | 134 | 166 | 153 | 142 | 139 |

Source: EIU, 26 August 2011