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Brazil: Stability Pays off – Strong Growth, but also Major Challenges Ahead

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Brazil: Stability Pays off – Strong Growth, but also Major Challenges Ahead

As recently as ten years ago, hardly anyone would have believed that overall, Brazil would emerge relatively unscathed from a crisis on the scale of the latest global economic and financial problems. In previous periods of crisis, no matter whether caused by external shock or due to home-made problems, the largest economy in Latin America has more than once been on the brink of default. The key factor in this rising ability to cope with crisis is the stability-oriented economic policy of the past decade. The foundations of this policy were laid by Fernando Henrique Cardoso, initially during his term in office as Finance Minister (1992-1994) and subsequently as President (1994-2002). The current President, Luiz Inácio Lula da Silva, has carried on the policy of his predecessor. Lula's second term in office finishes at the end of this year and the constitution stipulates that he may not run for office again.

Cornerstones of Brazilian economic policy

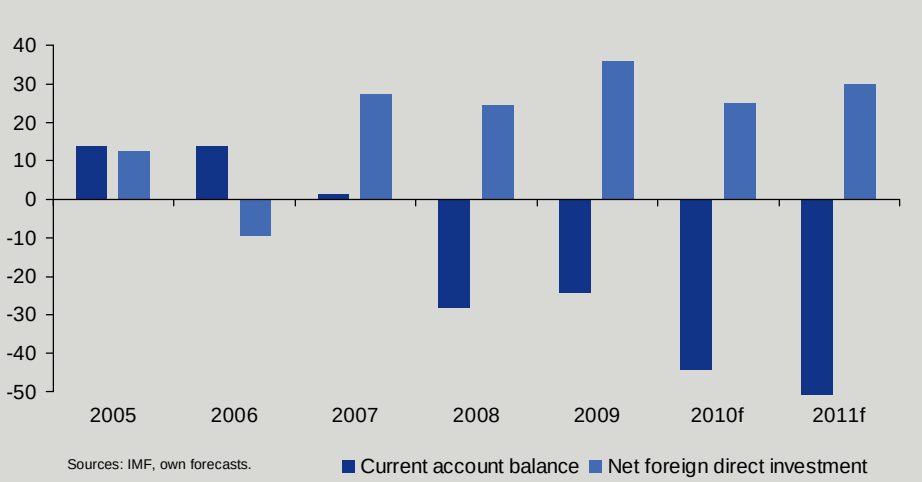
The key elements of this stability-oriented economic policy are fiscal discipline, a monetary policy that is required to achieve a pre-defined inflation goal ("inflation targeting") and a flexible exchange rate. In the context of public finances in particular, Brazil has made considerable progress in recent years. Thanks to moderate budget deficits, total public debt in relation to gross domestic product (GDP) has gone down significantly, from about 86% in 2002 to less than 60% in 2007. This ratio has nevertheless risen again somewhat (due to the crisis) in the last two years, most recently to 67% of GDP.

The structure of government debt has also improved considerably. For a long time a substantial portion of public debt was denominated in foreign currency or was at least dollar-indexed. As a result, the exchange rate was automatically a major conductor of financial market shocks: any depreciation of the Brazilian *real* would bloat the public debt in terms of the national currency. This in turn generally gave rise to doubts on the financial markets about the sustainability of public finances, which put the currency under more pressure. Most Brazilian public debt is now denominated in the local currency. In fact, Brazil currently has more assets in foreign currency than liabilities, putting it in a net creditor position. As a result and unlike in the past, any depreciation of the *real* acts as a macroeconomic stabilizer since it has a positive impact on debt momentum.

The appreciable improvement in the foreign currency liquidity position has also made a significant contribution to stabilizing the macroeconomic environment in Brazil, with the trend in commodity prices playing a major role. For years, Brazil generated fairly substantial current account surpluses. The inflow of net foreign direct investment more than compensated for the deficits recorded in the last two years. As a consequence, foreign exchange reserves, which constitute a natural safety cushion for a possible crisis situation, have continued to rise until recently. At the end of April 2010 they amounted to USD 246bn, equivalent to more than twelve months worth of imports – a high figure by international standards.

Direct investment covers bulk of the current account deficits

Current account balance & inflow of net foreign direct investment, in USD bn



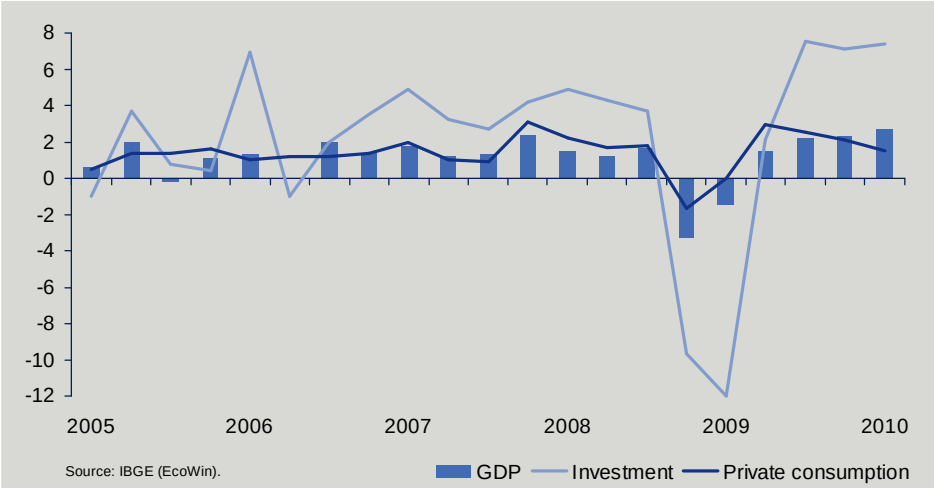
Economic boom after a short but sharp recession

Brazil has of course also felt the effects of the global economic and financial crisis. In the fourth quarter of 2008, real GDP posted a 3.3% decline against the previous quarter, after seasonal adjustments. Economic output fell again by 1.5% in the first quarter of 2009. Investment was hit particularly hard, plummeting about 20% over the two quarters of the recession combined. Thanks to the stable macroeconomic framework and the associated high credibility of the economic policy, however, policymakers were able to respond swiftly to the crisis with anticyclical measures. The government approved an extensive economic stimulus package including temporary tax cuts, subsidies and other increases in expenditure. The monetary policy response was also aggressive: between January and July 2009 the Brazilian central bank cut its key interest rate in several steps by a total of 500 basis points to 8.75%, a very low interest rate level by Brazilian standards.

This economic policy stimulus proved effective. Brazil's recession came to an end as early as the second quarter of 2009, when the economy grew by 1.5% in comparison with the previous quarter. Since then the economic momentum has continued to pick up speed. In the first quarter of 2010 GDP climbed by 2.7%. This is the strongest quarterly rise in six years. Growth was once again driven by private consumption and investment, with the latter up 7.4% on the preceding quarter.

First a short but sharp recession, followed by an economic boom

GDP components, percentage change over previous quarter, seasonally adjusted

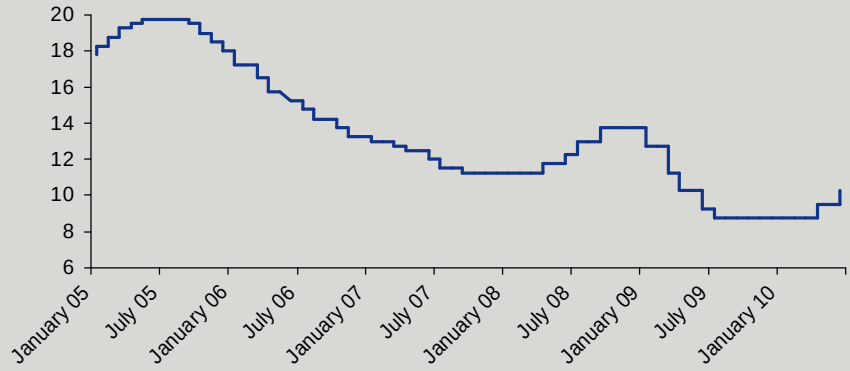


The robust economic trend looks set to continue for the time being, as suggested by the latest indicators for Q2. Industrial production registered a seasonally-adjusted drop of 0.7% in April on the previous month, but this decline must be seen in the context of the strong 3.4% rise in March and should therefore not be overrated. Despite the latest drop the current production level still exceeds the average of the first quarter by a good 2%. Capacity utilization in industry now stands at 83%, back above the long-term average of 81% (January 2003 to April 2010), which in turn points to brisk investment activity in the coming quarters.

As a counter-measure against overheating of the Brazilian economy the government announced expenditure cuts in May, for the second time within a few months. Previously it had already withdrawn parts of its crisis-based fiscal package, such as temporary subsidies and tax breaks, in order to avoid heating up domestic demand even more. Monetary policy also responded to the strong growth and rising inflationary pressure. After the key interest rate had remained at 8.75% since July 2009, the central bank increased it at the end of April and the beginning of June in each case by 75 basis points to its current level of 10.25%. Further steps are very likely in the coming months. By the end of 2010, we expect to see the key interest rate at 11.5% to 12%. Inflation is likely to average about 5% this year (May 2010: 5.2%).

Brazilian central bank starts tightening interest rates

SELIC target rate, in percent



Source: BCB (EcoWin).

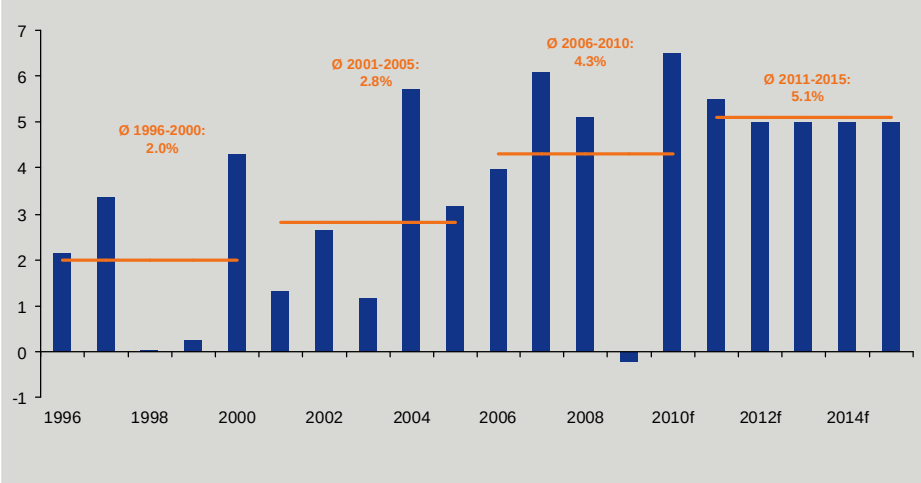
After a buoyant first half-year we expect economic momentum to ease somewhat during the rest of this year, not least against the background of an economic policy that has an increasingly dampening effect. In real terms the Brazilian economy should grow by 6.5% overall in 2010, after a slight decline of 0.2% in 2009. We then expect a rise of 5.5% for next year. This means that the largest economy in Latin America would grow more strongly than the region overall in the foreseeable future, for which we forecast growth of 4.6% this year and 4.4% next.

Buoyant growth momentum and restrained reform zeal

Thanks not least to its successes on the economic policy front and the resulting stability, Brazil was able to notch up significantly higher growth in the past five years than in the previous decade. The following chart illustrates this strikingly. Over the next five years we expect an even more dynamic trend with average GDP growth of around 5% a year, before growth rates level off at about 4.5% from 2016 onwards. A key factor in the quite positive outlook up to 2015 is the fact that extensive investment projects, especially in infrastructure, are expected ahead of the major sporting events held in Brazil (the FIFA World Cup in 2014 and the Summer Olympic Games in 2016), which will of course boost growth. The infrastructure itself is currently still one of the major bottlenecks in the Brazilian economy. For example, many of the commodities such as soya destined for export must be transported to the ports by truck as the rail network is underdeveloped.

Trend growth has been rising for years

Real GDP growth compared to previous year, in percent



Congressional and presidential elections will be held in Brazil in October of this year. The most promising candidates for the presidency are Dilma Rousseff, the former Chief of Staff and therefore the right hand of President Lula, and Jose Serra of the PSDP. Regardless of the election outcome, a radical change of course is not expected from either of them. The current economic policy has proved its worth too much, especially in the financial and economic crisis, for a new president to gamble with these successes. On the other hand, however, noteworthy structural reforms, e.g. in social security and the labor market, are not really likely since they could probably not be pushed through given the difficult majority situation in congress and the great influence exerted by the governors of the federal states. Moreover; pressure for reform is also considered to be relatively low overall, given the backdrop of high growth rates.

As a result our medium and long-term GDP forecast is based on the assumption that there will be no major structural reforms in Brazil in the next few years. Nor do we expect an appreciable rise in the relatively low savings rate. If there were positive surprises in this respect in the coming years, the Brazilian economy could also grow significantly more strongly than we have assumed in our base scenario.

In conclusion, two major "works in progress" are presented at this point by way of example. The incoming government should direct their attention to these in the next few years – not least in order to ensure dynamic economic performance over the long term.

Public finances

Despite the progress made with public finances as described above, two major structural challenges remain in this respect. The first involves the uninterrupted upward trend of government expenditure. Public-sector expenditure last year was probably around 45% of GDP. Ten years ago it was just 36%. This means that the primary surpluses of past years were achieved principally through higher taxes and not through discipline in terms of expenditure. The tax burden did indeed rise to 35% of GDP in 2009, from 27% in 1998. A higher tax burden and the complexity of the Brazilian tax system are increasingly acting as growth inhibitors. The second structural challenge lies in the rigidity of the state budget. About 75% of revenue is consumed by fixed budget items such as social security payments and transfers to regional authorities. This naturally restricts a government's discretionary room for maneuver to a very large extent.

Investment

Even though the investment trend has been upwards in recent years, investment does remain at quite a low level in an international comparison. In 2009, gross capital investment was 16.5% of GDP. In other emerging markets, especially in Asia, the corresponding figure is often more than 30%. Both government and private investment levels are too weak for a country that is in the process of catching up economically. The low level of private investment could be rooted chiefly in the considerable tax burden and in the still high cost of finance (i.e. high interest rates in real terms). How could investment be boosted? A conceivable approach would be to reduce public expenditure – not in absolute terms, but in relation to GDP. The resulting leeway could be used to reduce debt or cut taxes. Debt reduction could result in falling interest rates. As in the case of tax cuts, this would also have a positive effect on the private sector's willingness to invest.

These assessments are, as always, subject to the disclaimer provided below.