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Atradius Country Report

Brazil – December 2011

Overview

General information

Capital: Brasilia
Government type: Federal republic
Currency: Real (BRL)
Population: 198.7 million
Status: Upper middle income country (GDP/capita: US$ 12,391 in 2011)

Most important sectors (2010, % of GDP)

Services: 67 %
Industry/mining: 27 %
Agriculture: 6 %

Main import sources (2010, % of total)

China: 14.1 %
USA: 12.0 %
Argentina: 7.9 %
Germany: 6.9 %

Main export markets (2010, % of total)

China: 15.2 %
Argentina: 9.2 %
The Netherlands: 5.1 %
USA: 4.6 %

Main expenses of foreign exchange

Intermediate products (46 %), capital goods (22 %)

Main sources of foreign exchange

Manufactured products (53 %), primary products (44 %)

Key indicators

	2008	2009	2010	2011*	2012**
GDP (US$ million)	1,653,323	1,593,041	2,088,997	2,447,305	2,648,824
Real GDP growth (%)	5.2	-0.7	7.6	3.6	3.8
GDP per capita (US$)	8,612	8,223	10,690	12,391	13,297
Inflation p.a. (%)	5.6	4.9	5.0	6.7	5.5
Fiscal balance (% of GDP)	-1.9	-3.3	-2.2	-2.8	-2.7
Total foreign debt (US$ million)	262,139	276,932	346,531	409,178	461,947
Foreign debt/GDP (%)	16	17	17	17	17
Foreign debt/XGS (%)	109	146	144	137	147
Short-term debt/inter. reserves (%)	19	17	24	25	27
Debt service ratio (%)	23	23	26	26	29
Current account balance (US$ m.)	-28,192	-24,302	-47,364	-52,119	-68,931
Current account/GDP (%)	-1.7	-1.5	-2.3	-2.1	-2.6
Nom. exchange rate to US$ (average)	1.83	2.00	1.76	1.67	1.70
International reserves (US$ million)	197,890	233,533	284,442	358,206	392,696
In months of merchandise imports	13.0	21.0	17.8	21.3	20.5

*estimate ** forecast Source: Economist Intelligence Unit (EIU), International Monetary Fund (IMF)

Political situation: Stable

Head of state/government: President Dilma Roussef (Workers' Party)
Form of government: A broad coalition, comprising the left-wing Workers' Party (PT) and the centrist Democratic Movement Party (PMDB)

President Rousseff has to deal with a heterogeneous coalition and corruption charges

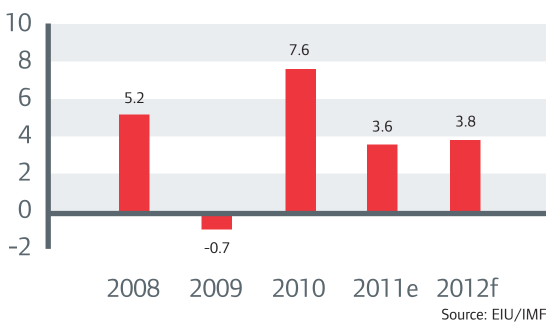
After a convincing victory in the October 2010 presidential elections, on 1 January 2011 former Chief of Staff Dilma Roussef succeeded the popular Lula da Silva, who had been head of state for eight years and could therefore not run for a third term. Roussef leads a coalition of 10 parties that enjoys a large majority in Congress, but is also a fragile alliance of ideologically-diverse forces. As a result, as under Lula's leadership, this coalition will have to contend with low party discipline and coalition loyalty. Additionally, since Roussef took office, seven ministers have had to resign amid allegations of corruption.

Stable international relations

International relations are mainly stable, with a pragmatic attitude towards the US and South American states, including Bolivia and Venezuela. Brazil is increasingly seeking to bring its growing political and economic strength to bear on a global level: for instance, in its role as a member of the G20.

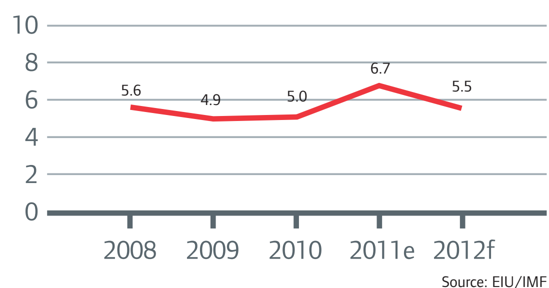
Internal economic situation: Lower economic growth

Real GDP growth (%)



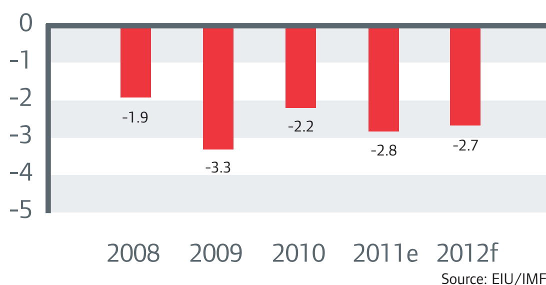
Source: EIU/IMF

Inflation p.a. (%)



Source: EIU/IMF

Fiscal balance (% of GDP)



Source: EIU/IMF

2010: strong rebound from the 2009 recession

In 2009, Brazil's economy experienced a mild recession (0.7 % GDP contraction), due mainly to falling industrial output (-7.4 % year-on-year) caused by a sharp drop in exports and investments (-10 %). However, since Q4 of 2009, the country has seen a strong and broad-based recovery, thanks to a rebound of exports to Asia, investments and buoyant consumer demand. Industrial output and exports grew 11.5 % year-on-year in 2010 and retail sales generally were exceptionally strong last year, increasing in volume by 10.9 % year-on-year as a result of labour market improvements, with many new jobs – both temporary and permanent – being created. Credit conditions remained flexible and financing costs reached historic low levels, providing a stimulus to household consumption, which increased 7.0 % in 2010. While exports of goods and services increased 11.5 % last year, imports rose substantially more: by 36.2 %. For the whole of 2010 output grew 7.6 % year-on-year.

2011: Slowdown of growth due to monetary measures

This strong rebound slowed down towards the end of last year and into 2011: After a 4.2 % year-on-year growth in Q1, GDP grew 3.1 % in Q2 of 2011. Growth in industrial production decelerated sharply in the first half of 2011 compared of the same period in 2010, and actually decreased by 1.6 % year-on-year in September and by 0.6 % in October 2011: a reflection of the drop in competiveness caused by a stronger real and decreasing global demand.

According to the National Statistics Agency, in Q3 of 2011 growth expanded by just 2.1 % year-on-year, and contracted slightly (0.04 %) on the previous quarter: the first contraction since Q1 of 2009. Apart from agriculture, all main contributors (industrial production, services, private consumption, and investments) shrank in comparison to the previous three months.

However domestic demand is expected to remain quite robust in Q4, also sustained by a lower unemployment rate (5.8 % in October 2011) and economic growth for the whole of 2011 will still be robust with 3.6 %, despite a downward revision from the 4.3 % forecast this summer.

The main reasons for the slowdown were cooling demand from developed economies and measures to avoid an economic overheating: In order to slow down credit growth (which grew 20 % between April 2010 and April 2011), the central bank has imposed stricter reserve requirements for banks and the government increased taxes on consumer credit. There were signs that the credit cycle is building up pressure, leaving commercial banks with a rapidly rising proportion of disputable debts in their portfolios. At the same time the Central Bank raised the SELIC benchmark interest rate (its overnight lending rate) several times in the first half of 2011, to 12.50 % in July 2011(3.75 basis points higher than in April 2010).

But still high inflation persists

One of the side effects of the boom has been rising inflation, which has increased steadily since September 2010 and, with strong domestic demand and higher food prices, rose to 7.3 % year-on-year in September 2011: above the Central Bank's target of 4.5 %. In October inflation still stood at 7 % and, for the whole of 2011, consumer price inflation is forecast to increase 6.7 % on the previous year.

A surprising monetary policy turnaround since August 2011

With inflation still high, it came as a surprise that, in August, the Central Bank lowered the SELIC benchmark interest rate for the first time in two years. This was followed by two more decisions to cut the rate, which at the beginning of December 2011 stood at 11 %.

The Central bank probably lowered the SELIC rate because of signs that the economy was cooling off too much. In particular, the two recent rate cuts in October and November were aimed at shielding the economy from the deepening Eurozone crisis and the slowdown in global demand.

Another reason for the interest rate cuts was to discourage foreign investors from buying assets/property in Brazil, in an attempt to improve the exchange rate of the real. Before this step, the high interest rates were attracting more short-term investment capital, and these capital inflows, coupled with higher inflation, forced the real exchange rate to appreciate. Between mid-2009 and mid-2011 the real gained nearly 50 % against the US$, favouring imports but causing increasing worries for Brazilian exporters of manufactured goods because of their waning competiveness. In that respect the monetary easing has so far been successful as, since August, the real has lost some of its appreciating trend of 2010/2011.

A more expansive fiscal policy

The Central Bank's monetary easing comes at a time when the fiscal policy is quite expansionary. Investment to exploit the huge offshore oil fields and forthcoming sport events (the 2014 World Cup and 2016 Olympics) are fuelling public sector spending. In early December, the government introduced tax cuts worth 2.8 billion real (US$ 1.6 billion) on consumer credits, food staples, home appliances and foreigners´ stock purchases, to spur 2012 growth in the more unfavourable global environment. These stimulus measures will increase further the budget deficit.

In general Brazil's budgetary policy is prudent, but the primary surpluses (i.e. before interest payments) have been below the government's target rate of 3 % of GDP. In view of the still high public debt (56 %), the government should implement more public sector austerity measures to reduce the fiscal deficit and to prevent the public sector debt from rising further. Measures to do so could include a reform of the complicated tax system and the current generous pensions, but progress in both those areas is unlikely.

Qualification of economic management - a mixed picture

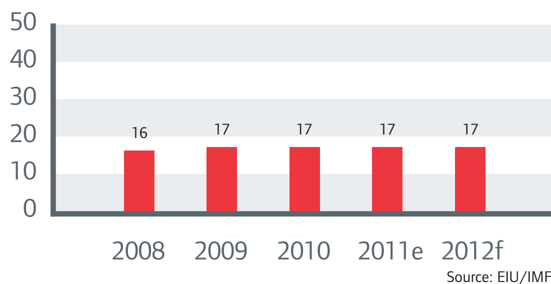
On the whole, Brazil's macroeconomic policy has so far been sound, but many structural deficiencies, such as a complex and burdensome tax regime, fiscal inflexibility, rigid labour laws and overregulation, remain untouched, although they massively hamper economic development in the long term. Shortfalls in Brazil's overall political and party system (e.g. the lack of coalition and party discipline) are the main reason for the lack of effort towards structural reform.

Energy situation: very large oil reserves

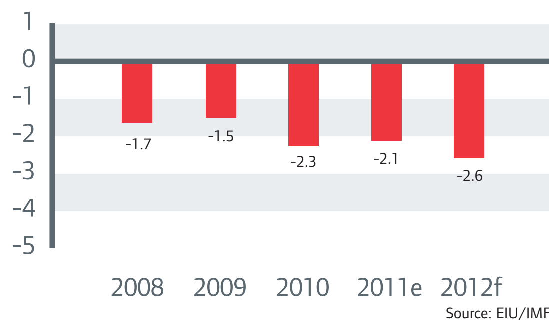
There are large offshore pre-salt oil reserves which are estimated at 50 billion barrels. The increasing exploration of those resources could turn Brazil into one of the largest oil producers in the world. In July 2011 Brazil's state-controlled oil producer Petrobras announced to invest US$ 225 billion through 2015 in order to increase daily output from 2.6 million barrels per day to 4 million barrels in 2015 and 6.4 million in 2020.

External economic situation: Good international liquidity and solvency position

Foreign debt/GDP (%)



Current account/GDP (%)



Foreign debt

Level:	Reasonably low: (17 % of GDP and 137 % of exports of goods and services in 2011)
Structure:	Reasonable – short-term share approx. 20 %
Debt service ratio:	Rather high (26 % in 2011) despite a decline from 38 % in 2006; including short-term obligations approx. 50 %.

Remarks:
In the past Brazil has reduced the level of public foreign debt considerably and improved its public sector debt profile by bond swaps, issues of real-denominated bonds to foreign investors, pre-payments (US$ 15.6 billon to the IMF and US$ 2.6 billion to the Paris Club) and debt buy-backs (Brady bonds worth US$ 6.6 billion). As a result, there is a longer debt maturity and much less currency risk, as government debt is denominated mainly in real. Private sector (corporate/banking) debt now accounts for two-thirds of total foreign debt. However, heavy borrowing by Petrobras for its ambitious investment plans (see above) may increase public foreign debt significantly in the coming years.

Brazil enjoys sovereign investment grade ratings by S&P (BBB-, outlook positive), Fitch (BBB-, outlook positive, upgrade in April 2011) and Moody's (Baa2 - outlook positive, upgrade in July 2011)

Balance of payments

Trade balance:	Positive
Current account:	Deficits (2011: 2.1 % of GDP)
Capital account:	Positive (based on FDI, portfolio capital)
Total Account:	Large surpluses

Remarks:
The large trade surpluses are set to decline, as imports are increasing even faster than exports in 2011 and 2012. As a result, the current account deficit on the balance of payments will reach 2.1 % of GDP in 2011 and 2.6 % next year. However, those deficits are easily financed by abundant capital inflows, both investment and portfolio (foreign direct investment to Brazil amounts to more than US$ 40 billion in 2011). These capital inflows and higher inflation have forced the real exchange rate to appreciate significantly in 2010 and H1 of 2011. However, since mid-2011 the currency has started to depreciate again, mainly due to SELIC interest rate cuts and more volatility in the international financial markets.

International reserves

In months of imports (cif):	Risen strongly to US$ 350 billion (more than 21 months of import cover) in 2011, due to massive capital inflows.

Prospects: Good

Political system remains an obstacle for structural reforms

The outcome of the presidential and parliamentary elections has brought continuity but has not changed the political fragmentation and the poor legislative progress in Brazil. Low party discipline and lack of coalition loyalty in Brazil's political system still hamper decision making. This is a major obstacle for urgent reforms to strengthen the structure of the domestic economy in the long-term.

Economic growth will remain robust

GDP growth is expected to remain robust in 2011 (3.6 %) and 2012 (3.8 %), although the forecast has been revised downwards since the summer (from 4.3 % for 2011 and 4.7 % for 2012). Growth is still driven by domestic demand, investments and exports, mainly to Asia. Inflation is expected to slow down to 5.5 % next year, although this remains above the target rate of 4.5 %.

The banking sector is in reasonable condition with strong regulation and supervision. However, the state-owned development bank BNDES is in a less comfortable financial position, which could turn into a major potential risk to public sector accounts.

Good external solvency and liquidity positions remain

Abundant capital inflows contribute to Brazil's excellent international liquidity position: more than 20 months of import cover. Solvency is also solid, giving rise to the stable investment ratings on the international markets. These are a guarantee that Brazil's very large external financing requirements can be covered quite easily. Exports from Brazil's huge offshore oil reserves could underpin the external position in the longer term.

The problems of fiscal tightening

Further fiscal tightening is necessary in the mid-term to reduce the public sector deficit, but the government faces the fact that less than 10 % of the yearly budget consists of items that can be cut, while payroll, health care and education spending are fixed. One measure could be a reform of the complicated tax and the generous pensions systems, but this seems improbable due to the political circumstances.

Infrastructure improvement is essential for sustained long-term growth (the poor state of many roads, airports and harbours and overstretched power supply systems have already prevented additional growth). To accomplish such improvements, however, the government would have to implement additional public sector investments.

Brazil's oil wealth: Blessing or curse?

Exports from Brazil's huge offshore oil reserves (see above) will underpin the external position in the longer term. However, the exploration also poses a challenge for the country: to manage these reserves skilfully without letting the competitive position of non-oil exports be overly weakened by a strong currency (a phenomenon often referred to as the "Dutch disease").

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