BBVA | RESEARCH

Economic Outlook

Brazil

First Quarter 2013
Economic Analysis

- **Global economic outlook is improving** due to the lower financial tensions in Europe, the agreement avoiding the "fiscal cliff" in the US and the resilience of emerging economies. Global growth is set to rise from 3.2% in 2012 to 3.6% in 2013 and 4.1% in 2014.
- **In Brazil, the macroeconomic environment has deteriorated somewhat in recent months,** including lower growth, higher inflation and increasing idiosyncratic risks. However, we continue to expect growth to rebound and inflation to remain within the official target range in 2013 and 2014.
- **GDP should grow around 3.6% this year and 4.0% in 2014, after expanding by only 0.9% in 2012.** Economic recovery is already underway, but it is still slow and fragile.
- **Inflationary pressures will not recede this year,** in spite of government's strategic management of tax cuts and administered prices. We expect inflation close to 6.5% in the first half of the year and then decrease to 5.6% by the end of the year.
- **We reinforce our call for a stable SELIC through 2013 and 2014.** This will reduce government's interest payments and allow for a reduction in fiscal targets, which should not jeopardize the solvency of public debt, but could add to inflation risks.

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Closing date: February 13, 2013

1. Summary

The global economic outlook improved in the last quarter thanks to the continual decline in global financial tensions, especially in Europe, and the agreement avoiding the so-called "fiscal cliff" in the US. As a result, confidence indicators have picked up across all major economic areas and real data for output and spending continue to point to limited global growth. Global growth is set to rise from 3.2% in 2012 to 3.6% in 2013 and 4.1% in 2014 - almost the same forecast as three months ago.

In Brazil, the macroeconomic environment has deteriorated somewhat in recent months, including lower growth, higher inflation and increasing idiosyncratic risks. Growth was much lower than expected in the second half of 2012. While private consumption remained relatively robust, supported by the strength of the labor market, investment continued to contract and to undermine the recovery. We have revised our estimate of GDP growth for 2012 from 1.6% to 0.9%. On the other hand, inflation has been surprising to the upside: it closed 2012 at 5.8% and is currently above 6%. In our view, both lower growth and higher inflation, together with the overall macroeconomic management, heightened domestic risks.

However, we continue to see a gradual recovery in activity with inflation within the official target range (2.5% - 6.5%) as the most likely scenario for the Brazilian economy. Growth is still low and fragile, but we expect the recovery to gain momentum and GDP to expand 3.6% in 2013. Moreover, the consolidation of a more positive growth momentum should sustain GDP close to 4.0% in 2014. Inflation pressures are not expected to recede in 2013. We forecast inflation to be between 6.0% and 6.5% in the first half and then to recede to around 5.6% by the end of the year. The government's management of tax cuts and administered prices will be the main policy tool to prevent prices from running out of control. We expect inflation to average 5.5% in 2014.

The BCB maintains monetary conditions stable, trapped between high inflation and low growth. We expect inflation pressures to trigger some policy reaction, such as allowing some appreciation of the currency or even adjusting public expenditure, in addition to the introduction of more tax cuts, but not a hike in the SELIC, which we expect to remain at 7.25% over 2013-14.

We expect the government to continue to use the room created by significantly lower interest payments to ease formally its current fiscal target. The government introduced some adjustments in the fiscal target in the 2013 budget bill it sent to Congress, which in practice reduces the primary surplus target from 3.1% to 1.8% of GDP. This should not jeopardize the solvency of public debt, but could add to inflation risks.

Authorities face a dilemma in the management of the exchange rate: either support competitiveness or take some pressure off inflation. Focusing on competitiveness issues, the government managed to weaken the Brazilian Real (BRL) to something within the 2.0 – 2.1 range last year. However, recent concerns on inflation triggered the adoption of measures to favor a moderate appreciation of the BRL. We expect the exchange rate to the USD to continue around 2.0, temporarily below this mark in 2013. We regard a stronger appreciation very unlikely.

We expect the current account deficit to widen in 2013 and 2014. Our forecast is for the trade surplus to continue to decline and service and income account deficits to widen more, which would then take the current account deficit to 2.6% this year and to 2.9% in 2014, from 2.4% in 2012.

Higher domestic risks offset lower external perils. Global turbulence has moderated in the last few months, reducing the chance of an "extreme event" in developed economies and reinforcing our baseline scenario for the Brazilian economy. However, there some idiosyncratic factors (rising inflation, exhaustion of the current growth model, exaggerated public credit growth, the government's excessive interventionism…) that could prevent the economy from performing as we expect; and in comparison to three months ago, we think these factors are now more significant.

2. Global economic outlook improves

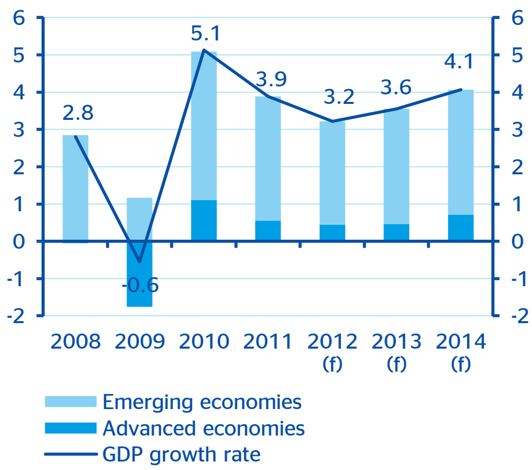
The global economic outlook improved in the last quarter thanks to the continual decline in global financial tensions, especially in Europe, and the agreement avoiding the so-called "fiscal cliff" in the US

Confidence indicators have picked up across all major economic areas and data for output and spending continue to point to limited global growth. Europe has seen financial tensions ease for six months now, with markets gradually, albeit not fully, offering funding to financial and non-financial businesses in certain peripheral economies in the euro area.

The mood in financial markets improved steadily in recent months thanks to three factors: (i) data show that China is not heading for a hard landing, as some analysts had expected; (ii) the US did not fall off the cliff and, in fact, its economy is withstanding uncertainty remarkably well; and (iii) Europe continued to progress towards a the banking union, reinforcing the commitment to preserve the euro.

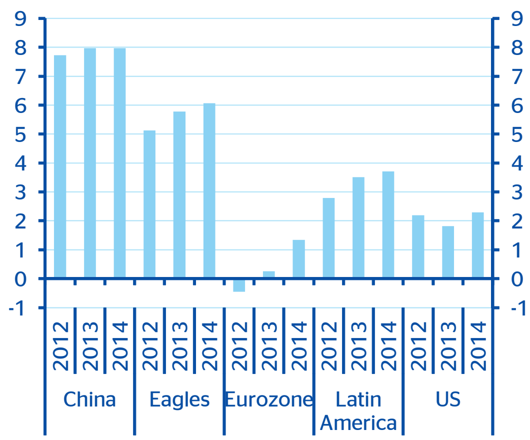
Nonetheless, improvement in market perception does not make up for lack of improvement in fundamentals, and growth will remain weak in developed countries. Therefore, global growth is set to rise from 3.2% in 2012 to 3.6% in 2013 and 4.1% in 2014 - almost the same forecast as three months ago (Chart 1). In 2013, the downward revision of Brazilian growth and the unchanged scenario in the eurozone and the US should be offset by better forecasts for China, Mexico and some Latin American economies (Chart 2).

Chart 1
World GDP growth rate



Source: BBVA Research

Chart 2
GDP growth rate



Source: BBVA Research

The recovery will only continue if the appropriate policies are implemented in the US and the eurozone. The US needs to do more than just soften the impact of imminent tax rises and should dispel any uncertainty surrounding debt repayment and how the burden of fiscal consolidation is to be shared. With respect to the eurozone, progress in governance, especially with respect to the banking union, must continue, both through additional agreements and the effective implementation of the agreements reached on banking supervision and resolution procedures.

Although positive surprises are not out of the question, the uncertainty surrounding the global economic outlook looks set to remain high. Reduced global growth would be the consequence of increased financial tensions and a drop in confidence if doubts reappeared as to the European authorities' commitment to shore up the euro, which have been contained for now both thanks to the ECB's statement last July and the agreements reached between the countries in the eurozone in support of the single currency. If these tensions did emerge, new agreements on financial safeguards would be necessary and the recession in the eurozone would continue throughout 2013. The risk in the US would arise if the contagion arising from the European risk was added to the disagreements regarding fiscal consolidation or the debt ceiling. In that case, and with the support of emerging markets, the global GDP would range from 2.5% to 3% in 2013 and 2014. This risk scenario is less likely and the impact is lower than estimated three months ago. This is thanks to the progress that has been made in implementing policies in the most developed regions, and the resilience demonstrated by the emerging economies.

3. Brazil: slow and fragile recovery underway

GDP is expected to have grown 0.9% in 2012, as the rebound in economic activity was weaker than expected

Brazilian economic activity continued to recover in the second half of the year, but growth in the period was much lower than previously expected.

GDP expanded by 0.6% QoQ in 3Q12, the best performance in more than a year, but still below potential (see Chart 3 below). The analysis by demand components shows that economic recovery is unbalanced and, therefore, fragile as it relies almost solely on consumption. Investment shows no signs of improvement yet; its continued contraction is undermining domestic demand (see Chart 4). Regarding external components, exports per se have not been a source of support to activity. However, the moderation in imports, especially in the last few quarters, implies that the contribution of net exports to domestic growth has been less negative than before (see Chart 5).

The strength private consumption, which so far has been the main driver of recovery in activity, relies fundamentally on the tightness of the labor market. Following positive structural changes in recent years and given the still positive prospects for the Brazilian economy, the unemployment rate remains at historically low levels. In 2012, it averaged 5.5%, below the 6.0% level recorded in 2011 and well below the 9.3% average observed in the 2002-2011 decade. Moreover, real wages grew by 3.2% and thus continue to outpace inflation, which is clearly another source of support to consumption (although also a source of concern in terms of inflation and competitiveness).[1] Finally, the level of informality in the job market continues to decline: it reached 27.2% at the end of 2012 in comparison to 29.0% in 2011 and 39.8% in 2003.

Credit markets continue to support private consumption. Consumers are benefitting from the significant cut in lending rates and the lengthening of loan terms: rates declined from 44% to 35% and terms increased from 402 to 432 days in the last year. However, the support credit markets are providing to private consumption is less important than in the recent past and not as significant as the support provided by the labor market. In 2012, household credit expanded 10.4%, which compares to a 15.2% expansion in 2011. This moderation seems natural -even desirable- given the increase in the household indebtedness, which reached 44% of yearly income at the end of 2012 in comparison to less than 40% just two years ago and half that value at the beginning of 2006.[2]

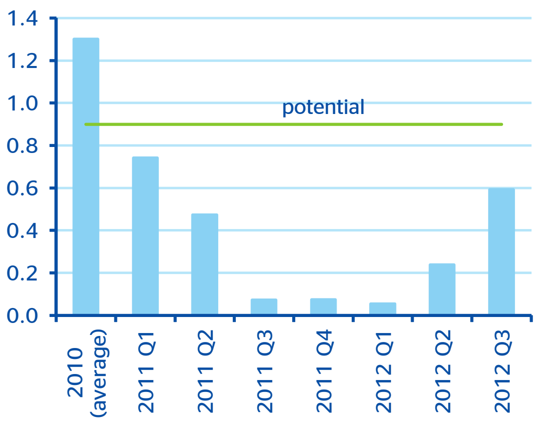
The strength of private and public consumption, together with lower interest rates, a series of tax cuts, credit availability,[3] and a weaker currency, was not enough to drive up investment. In our view, this is due to the abnormally high level of uncertainty surrounding investment decisions. On the one hand, the external environment remains turbulent in spite of the improvement observed

1: Wage growth was, to some extent, impacted by the 15% adjustment in minimum wage adopted at the start of 2012.
2: Non-performing loans (NPL) in the household segment reached 7.9% at the end of 2012, in comparison to 5.7% two years ago.
3: The corporate credit slowdown was less sharp than the moderation observed in household credit in 2012. Credit growth to corporations declined to 13.5% at the end of 2012 from 17.3% at the end of 2011. In addition, NPL in the corporate segment remained practically constant around 4.0% since the end of 2011.

in the last few months; on the other, domestic issues including the excessive intervention of the government in the economy are also a source of concern and uncertainty.

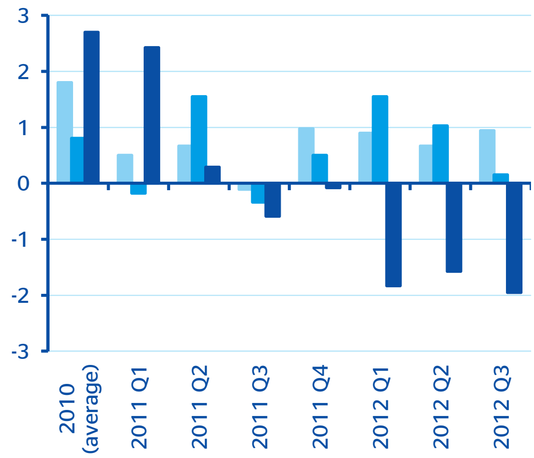
Finally, the reduction in the demand for Brazilian exports due to the situation faced by developed economies, the deceleration in China and India, and the slowdown in Argentina, prevented exports from performing better last year. Nonetheless, the downbeat tone of domestic activity, combined with trade barriers introduced over the year, triggered a correction in imports, which allowed net exports to contribute less negatively to GDP growth.

Chart 3
GDP growth (q/q%)



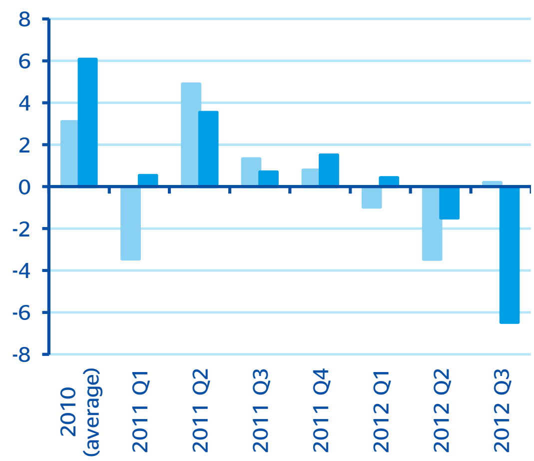
Source: IPEADATA

Chart 4
Consumption and investment growth (q/q%)



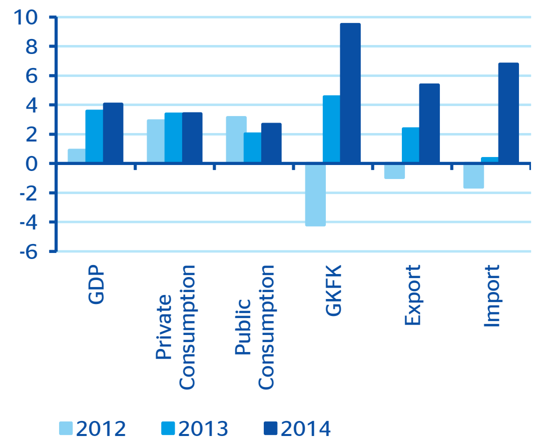
Source: IPEADATA

Chart 5
Export and import growth (q/q%)



Source: IPEADATA

Chart 6
BBVA growth forecasts: GDP and demand components (%)



Source: BBVA Research and IPEADATA

High-frequency indicators suggest that GDP expanded by 0.6% QoQ in the fourth quarter, the same rate recorded in the third quarter. In yearly terms, GDP would have grown only 0.9% in 2012, the worst performance since 2009, when the country was hit by the Lehman Brothers crisis and the economy contracted 0.3%.
Our current estimate for 2012 is lower than what expected just three months ago. We have cut our GDP figure for the year from 1.6% to 0.9% due to a significant downward surprise in the third quarter (observed: 0.6% QoQ; expectations: BBVA 1.4% QoQ, consensus 1.2% QoQ) and prospects of lower than expected growth in the fourth quarter.

Overall, in 2012 domestic activity was characterized not only by a very gradual –much slower than expected- recovery, but also by its fragility, as it relied basically on consumption.

We expect the recovery in activity to gain momentum over the year and GDP to grow 3.6% in 2013

If the economy continued to grow throughout 2013 at the pace observed at the end of 2012 –around 0.6% QoQ- GDP would expand 2.4% this year. However, we see room for economic activity to continue to accelerate gradually in the quarters ahead and GDP to grow 3.6% in 2013.

We expect the strength of private consumption, the openness of infrastructure investment projects to the private sector, lower inventory levels, increasing support from monetary and fiscal policies, credit availability and a slightly less turbulent external environment, to allow investment to recover from the 4.2% contraction in 2012. More precisely, we expect investment to grow 4.6% and be a source of support to domestic demand this year, although not as much as in the recent past (from 2004 to 2011, investment expanded on average 8.7% per year).

The continued robustness of the labor market and a pick-up in household credit, which should coincide with a decline in non-performing loans, are expected to maintain the positive tone of private consumption in 2013. Specifically, we forecast private consumption, which represents around 64% of total GDP, to grow 3.4% in comparison with 3.0% in 2012 (below the figure observed in the recent past: from 2004 to 2011, consumption expanded 5.1% on average).

Even though we expect external demand to be slightly more supportive in 2013 than in 2012, the main driver of the recovery we are anticipating for this year should be domestic demand, which will contribute with 3.4 percentage points out of the 3.6% growth expected for the year. In 2012, we estimate domestic demand to have contributed with 0.7 percentage points out of the 0.9% expected for the period.

In 2014, the consolidation of a more positive growth momentum should sustain GDP close to 4.0% in 2014 (see Chart 6), a year when the country should benefit from the organization of the 2014 FIFA World Cup, continued expansive domestic policies (common in a presidential election year such as 2014) and some improvement in the external environment.

Overall, we are expecting a rebound in investment to drive growth up. Any frustration in this rebound, which could be triggered for example by increased uncertainty due to new bouts of public interventionism in the economy, or by the deterioration of the external environment, would abort the recovery underway. Therefore, even though we remain relatively optimistic on the short-term outlook for the Brazilian economy, we continue to see non-negligible risks (see below a section on external and domestic risks faced by the country).

Inflationary pressures will not recede in 2013

Inflation continued to surprise to the upside and closed 2012 at 5.8%. This puts inflation above the 4.5% target for the third consecutive year, although within the 2.5% - 6.5% official range.

The upward trend in the second half of last year was caused in part by the increase in food prices, which have a weight of around 24% in the IPCA index and closed the year at 9.8% (see Chart 7). However, there are more factors behind the increase in inflation in the second half of 2012. In particular, the tightness of the labor markets has been a source of pressure. As we pointed out before, wages are currently increasing above inflation. Service inflation, which reflects better than other measures the impact of labor market conditions on prices, trended up in the second half of last year and reached 8.7% in December of 2012.

Core measures also support the view that inflationary pressures are widespread and are not only due to higher food prices. The average of the five core measures published by the BCB moved up from around 5.2% at the middle of the year to 5.6% at the end of 2012.

The dynamics of food prices (which are more related to supply issues), the tightness of the labor market (and therefore of service inflation), exchange-rate depreciation, and the high degree of indexation of the Brazilian economy, all help to explain why inflation continued at such high levels even though GDP was running well below potential.

We see no room for moderation in inflation in 2013. Even though food prices could have a more benign performance this year and the minimum wage adjustment will be half of the 15% adjustment adopted in 2012, the tightness of the labor market and the recovery of activity should keep prices under pressure.

Data for the beginning of the year support the view that inflation will continue to be a source of concern this year: in January, the IPCA reached 6.15% YoY, the highest figure in 12 months.

The first weeks of the year also reveal the strategy policymakers will adopt to prevent inflation from running out of control: tax cuts and management of administered prices; combined with the use of instruments other than the SELIC rate, such as the exchange rate.

More precisely, in the middle of January, as inflation concerns continued to rise, the government decided to adopt an earlier and larger than expected cut in electricity tariffs, at within the 18%-32% range, deeper than the previously expected (16%-28%). The tariffs were formally implemented at the end of January, and not in February as anticipated.

Moreover, since the end of 2012 the Central Bank has adjusted its interventions in FX markets to favor an appreciation of the Brazilian Real (BRL) and control inflationary pressures. With the same objective, the government has been unwinding some of the capital control measures implemented previously (see more on this issue on the section about exchange rate below).

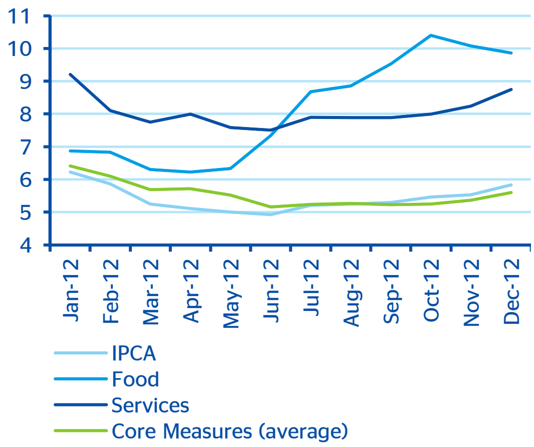
We expect electricity tariff cuts to take some pressure off inflation in February. The postponement of the adjustment in transport tariffs in some cities and states (following a request from federal government) will also bring some relief for inflation in the early part of the year. In addition, other measures such as the eventual reduction in the taxes charged on a series of essential goods (the "cesta básica") and the management of the exchange rate will help to keep inflation within the official range.

According to our estimates, inflation will trend up in the first half of the year to near the 6.5% mark, then decelerate gradually in the second half of the year.[4] We forecast inflation to close this year at 5.6%, slightly less than at the end of 2012. Average inflation in 2013 will move up to 6.1% from 5.4% last year. In 2014, we expect prices to continue under pressure and inflation to average 5.5%, which is increasingly seen as the implicit target of the BCB (see Chart 8).

We do not expect the recovery in domestic demand over 2013 to put severe extra pressure on the labor market and therefore trigger a significant acceleration of service prices this year. In our view, a less significant adjustment in minimum wages this year in comparison to 2012 will work against this. Moreover, we think that the moderation of the economy in 2012, together with what is still a relatively positive outlook for the country in the years ahead, has encouraged labor-hoarding practices, which now would create more room for domestic demand to expand without significantly affecting inflation. Nevertheless, expectations are currently not well anchored and inflation continues to be an important –and increasing- source of risks (see the section about risks to our base-case scenario for the Brazilian economy).

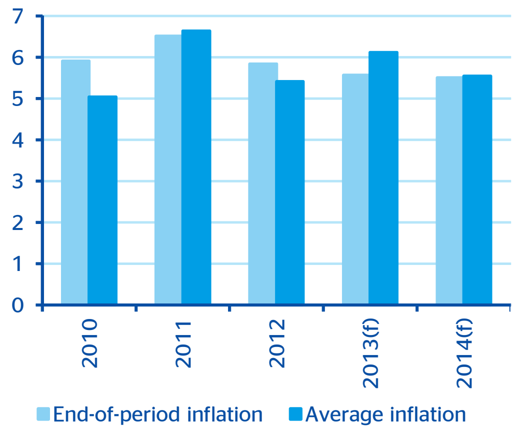
4: Base effects play an important role in the expected path for inflation.

Chart 7
Inflation: headline, core measures (average), food and services (%y/y)



Source: Central Bank of Brazil

Chart 8
Inflation: average and end of period (%)



Source: BBVA Research and Central Bank of Brazil

The BCB maintains monetary conditions stable, trapped between high inflation prints and low growth rates

In its most recent communication, the BCB continued to highlight the complexity of the current external environment. However, its focus has switched to the domestic front. According to the monetary authority, on the one hand, low growth creates downward risks for inflation, while on the other, recent worsening of inflation creates upwards risks. The BCB recognizes that the balance of risks has deteriorated lately, but still sees the stability of monetary conditions for a prolonged period as the best strategy to steer inflation to the 4.5% target.

In our view, the recent BCB communication supports our call for of a stable SELIC at 7.25%, not only in 2013 but also through 2014. As we have been commenting from some time now, we expect increasing inflation pressures to trigger some policy reaction, which could include some tolerance with the appreciation of the currency or even some adjustment of public expenditure in addition to the introduction of more tax cuts, but not a SELIC hike.

An additional round of monetary easing, as expected by some analysts up to a few weeks ago, can be ruled out, at least in the short-term.

An additional worsening of inflation over the first half of this year could make the BCB adopt a more hawkish tone, especially if growth figures do not surprise to the downside, but we continue to see an upward SELIC adjustment unlikely. The expected deceleration of inflation in the second half of the year should then take some pressure off the central bank. In any event, a SELIC cut would continue to be unlikely in the second half of the year, as domestic demand would gain moment by then and inflation would still remain significantly above the 4.5% target.

A new monetary policy, a new fiscal regime[5]

The recent drastic drop in domestic interest rates is one of the most important changes in the Brazilian economy since the end of the hyperinflation era. Among other effects, this is triggering a significant re-shuffling of fiscal policy.

5: This section is based on our Brazil Economic Watch "The macro mix in Brazil: a new fiscal regime, to a new monetary policy".

To put basic numbers into perspective, from 2001 to 2011 public-sector interest payments averaged 6.5% of GDP, of course driven by very high domestic interest rates (real rates averaged 8.5%). Consequently, the country needed to generate significant primary surpluses to keep the total fiscal deficit under control and push public debt-to-GDP down. This fiscal regime worked very well, with the primary surplus averaging 3.2% of GDP in the decade through 2011 and public debt declining from 60.6% in 2002 to 39.1% in 2011.

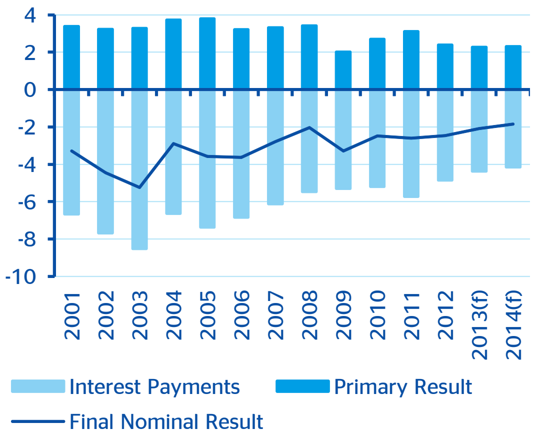
However, the fulfilment of the primary surplus target of approximately 3.1% of GDP had already been relaxed since 2009, with the government increasingly relying on non-recurring revenues (or as many have called it, "creative accounting") to meet the official target. These have included the capitalization of Petrobras, tax debt settlements, atypical dividends, as well as the withdrawal from the National Sovereign Fund. 2012 was not an exception: the government had to rely to on non-recurring revenues to meet the 2.4% "adjusted" fiscal target, which excludes some public investment projects from the full target. In spite of the reduction in the primary surplus, the drop in interest payments to 4.8% allowed the total public deficit to fall slightly to 2.5% and helped the public debt to reach 35.1%.

We expect the government to continue to use the room created by significantly lower interest payments (according to our forecasts, the government's interest burden will continue to decline to close to 4.0% over the next few years) to formally ease its current fiscal target system. In this regard, the government introduced some adjustments in the fiscal target in the 2013 budget bill it sent to Congress. According to this bill, the full primary surplus target will remain around 3.1%, but the government will now be allowed to exclude up to 0.4% of GDP on tax breaks on top of 0.9% of GDP on public investment projects included in the PAC from the target. In practice, the primary surplus target will then be eased to 1.8% of GDP.

This change in the fiscal regime is reasonable, as the Brazilian economy faces a much better environment (lower risk, public and external debt, and interest rates) than when targets were introduced back in 1999. Indeed, it might prove beneficial at times such as the present when the economy is running below potential. In fact, our debt estimates for 2012-2017, which build on our macro forecasts for Brazil, show that even under a significant reduction in the primary surplus target, public debt will continue to fall to levels between 29 and 27% of GDP (see Chart 10).

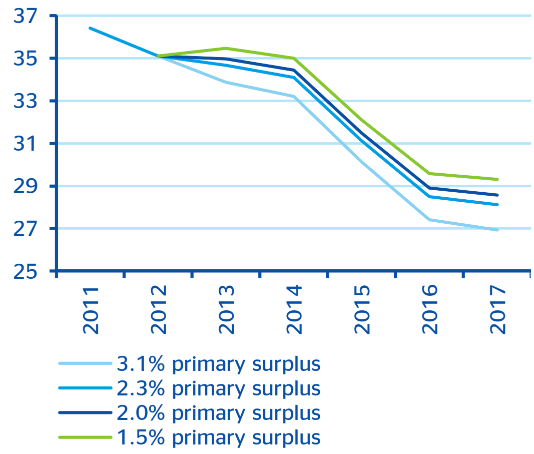
The pressure point from the relaxation of fiscal targets should come in the form of higher inflation and inflation expectations. In addition, it is important that fiscal and monetary authorities continue to coordinate the macro mix, something that did not happen in the last years of the Lula government and which was re-established when Dilma took office in 2011.

Chart 9
Fiscal accounts (% GDP)



Source: BBVA Research and Central Bank of Brazil

Chart 10
Net public debt / GDP (% GDP)
Given assumptions on the primary surplus target



Source: BBVA Research

In our view, the fiscal relaxation should take some pressure off monetary policy, which should be less volatile than in the past. Fiscal policy should be made more expansive when domestic demand weakens (as in 2012 and the beginning of 2013) and less expansive when domestic demand strengthens and inflationary concerns mount. This is what we expect from the middle of this year onwards, when fiscal policy would be tightened to help the BCB avoid having to implement SELIC hikes. In this regard, we consider it likely that the government will end up not using all the room created by easing the fiscal target for this year. In other words, we expect the primary surplus to be around 2.3%, higher than the minimum included in the 2013 budget bill, i.e. 1.8% (see Chart 9).

Even though we regard this fiscal policy fine-tuning as challenging and potentially noisy, we think it will end up contributing to a scenario where inflation does not run out of control, but remains well above the 4.5% inflation target.

The exchange-rate dilemma: support competitiveness or take some pressure off inflation?

Both high inflation and lack of competitiveness are certainly among the main problems currently faced by the Brazilian economy. As the exchange rate impacts both competitiveness and inflation and as Brazilian policymakers raise their interventionism in FX markets (to the point that the current system resembles more a crawling peg regime than a free-floating one), we see this government facing a dilemma: should the exchange rate be used to support competitiveness or to tackle inflation pressures?

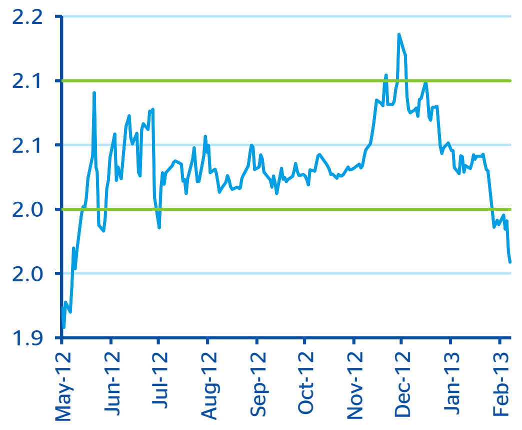
Focusing on competitiveness, the government achieved its goal of weakening the Brazilian Real (BRL) from around 1.8 per dollar in the first four months of 2012 to something within the 2.0 – 2.1 range from May 2012 until very recently. During this period, there was an implicit deal between the Ministry of Finance (which would have backed an even weaker real) and the BCB (which would have backed a stronger real) to keep the BRL within the 2.0 - 2.1 range.

However, recent concerns on inflation triggered the adoption of measures to favor a moderate appreciation of the BRL. More precisely, measures to unwind some of the capital controls introduced previously were announced. The most recent was the reduction from 6% to 0% of the IOF tax on foreign investment in real estate funds. Moreover, the BCB adjusted its interventions in FX markets to indicate clearly that it favors a stronger BRL.

Because of these recent moves, the BRL has been strengthening in the last few weeks and is now below the 2.0 mark, at around 1.96 (the strongest level since May 2012). This appreciation is broadly in line with our view that the government is willing to use tools other than the SELIC to control inflation.

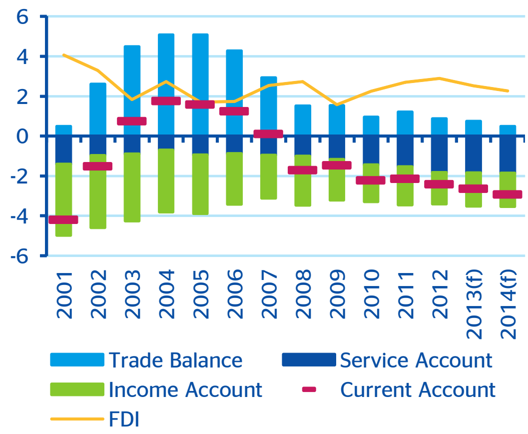
Looking ahead, we expect the BRL to continue to trade around 2.0 throughout 2013 and 2014 (see forecasts tables at the end of this report). Even though we consider it likely to continue slightly below the 2.0 level this year, we regard a stronger appreciation to below 1.85 very unlikely. Although fighting inflation now requires some appreciation of the BRL, the problem of competitiveness will continue to have an important weight on policymakers' decisions.

Chart 11
Exchange rate (BRL/USD)



Source: Central Bank of Brazil

Chart 12
Current-account deficit (% GDP)



Source: BBVA Research

Current account deficit to widen in 2013 and 2014

Driven by the continuous increase in foreign travel expenditure, the service account deficit increased to 1.8% of GDP and, together with a contraction in the trade surplus, determined an additional widening of the current account deficit to 2.4% of GDP in 2012 (see Chart 12). Therefore, the current account continued to trend downwards, in a movement started in 2004 and which is related to the increasing strength of domestic demand and the appreciation of the BRL. The moderation in economic activity and currency depreciation in 2012 actually prevented the current account deficit from worsening more sharply.

Fears of an excessive increase of the current account deficit in the future are limited, because of the recent growth slowdown / currency weakening. In addition, strong foreign direct investment (2.9 % of GDP in 2012) and bulky international reserves (16.7% of GDP) provide insurance against a sharp reversal of capital inflows or a downward correction in Brazil's terms of trade.

We forecast the trade surplus will continue to decline and both service and income accounts will widen more, which would then take the current account deficit to 2.6% this year and to almost 3.0% in 2014 (see Chart 12).

Higher domestic risks offset lower external perils

As noted at the beginning of this report, global turbulence has moderated in the last few months, reducing the chance of an "extreme event" in developed economies. Nonetheless, the degree of uncertainty regarding the global economy continues high.

As we have commented in previous reports, an accident in developed economies would have a non-negligible impact on the Brazilian economy (for more details, see our Q3 2012 Brazil Economic Outlook). Therefore, the reduction in the likelihood of an "extreme event" reinforces our baseline scenario for the Brazilian economy described in the previous sections.

However, there some idiosyncratic factors that could prevent the Brazilian economy from performing as we expect; and in comparison to three months ago, we think these factors are now more significant. In other words, we see now higher domestic risk hovering over the Brazilian economy.

A clear – and increasing – source of risk is inflation. As we noted before, domestic demand could end up having a larger than expected impact on inflation this year. Alternatively, the current strategy to keep inflation under control – i.e. the preference for using tools other than the SELIC to manage inflationary pressures- could prove to be excessively lenient. In any event, the chance of inflation running out of control and forcing the BCB to adjust interest rates up (and the government having to announce tightening measures) should not be downplayed, as it would then have a negative impact on growth, especially painful given the economy would not be running above potential levels.

Another source of domestic risk is the exhaustion of the current growth model based on the expansion of private consumption and credit markets. In our view, this risk is still important, although some measures taken by the government to support the supply side of the economy (infrastructure project concessions to the private sector, tax cuts…) and try to increase competitiveness have helped to ease concerns about this factor.

Another risk relates to the excessive intervention of the government in the economy, which could continue to hold back private investment plans and block economic recovery.

Finally, we continue to see risks (especially in the medium to long term) in excessive public credit expansion (last year public credit grew 27%, in comparison to a 8% growth in private credit, and amounted to 48% of total credit, the highest share in many years).

Even though we remain relatively optimistic about the recovery of the Brazilian economy and the sustainability of growth at around 3.5% in the years ahead, we view with some concern the emergence of idiosyncratic risks that could bring a halt to the development process the country has been experiencing in recent years.

4. Tables

Table 1
Macro Forecasts Yearly

	2011	2012	2013	2014
GDP (% y/y)	2.7	0.9	3.6	4.0
Inflation (% y/y, eop)	6.5	5.8	5.6	5.5
Exchange Rate (vs. USD, eop)	1.87	2.04	1.99	2.04
Interest Rate (%, eop)	11.00	7.25	7.25	7.25
Private Consumption (% y/y)	4.1	2.9	3.4	3.4
Government Consumption (% y/y)	2.0	3.1	2.0	2.7
Investment (% y/y)	4.8	-4.2	4.6	9.5
Fiscal Balance (% GDP)	-2.6	-2.5	-2.1	-1.8
Current Account (% GDP)	-2.1	-2.4	-2.6	-2.9

Source: BBVA Research

Table 2
Macro Forecasts Quarterly

	GDP (% y/y)	Inflation (% y/y)	Exchange Rate (vs. USD)	Interest Rate (%)
Q1 12	0.8	5.3	1.83	9.75
Q2 12	0.5	4.9	2.02	8.50
Q3 12	0.9	5.3	2.03	7.25
Q4 12	1.5	5.8	2.04	7.25
Q1 13	2.5	6.2	1.97	7.25
Q2 13	3.4	6.5	1.95	7.25
Q3 13	4.0	6.0	1.97	7.25
Q4 13	4.4	5.6	1.99	7.25
Q1 14	4.4	5.7	2.00	7.25
Q2 14	4.1	5.5	1.99	7.25
Q3 14	3.9	5.5	2.01	7.25
Q4 14	3.8	5.5	2.04	7.25

Source: BBVA Research

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