BBVA

Brazil Watch

Economic Research Department

Second semester 2009

Domestic demand will drive strong economic growth in the coming quarters

Expansive fiscal policy will push for both a tightening of monetary policy and an appreciation of the exchange rate

Current account deficits will widen significantly as the country will grow above its potential

A new regulatory framework for the Brazilian oil sector

Contents

Closing date: November 27th, 2009

Editorial 2

International environment 3

Macroeconomic environment 5

Box 1: A synthetic activity indicator for the Brazilian economy 12

Box 2: A new regulatory framework for the oil sector 13

Statistics and forecasts 14

This report was coordinated by:

Joaquín Vial jvial@bbvaprovida.cl

This report was prepared by:

Enestor Dos Santos enestor.dossantos@grupobbva.com
Ignacio Gonzalez-Panizo ignacio.gonzalez-panizo@grupobbva.com

Editorial

The Brazilian economy is currently expanding around 8% in yearly terms, a "Chinese pace" as recently commented the President Lula. This growth tops previous forecasts mainly because private consumption and to a lesser extent external demand are providing more support than initially expected.

The solid economic recovery underway in Brazil supports the view expressed in the editorials of our previous "Brazil Watch" that the country would leave the crisis stronger. The same view seems to be shared by international markets which are increasingly directing resources into Brazil.

There are some concerns related to potential "bubbles" caused by an excess of optimism about the country, reflected in higher values both for the real and prices in the Sao Paulo Stock Exchange. As a reaction to these concerns, the government has recently introduced a tax on the inflows of foreign capital into fixed and flexible income markets. In addition, it has already signaled that more capital controls could be coming in the near future, if deemed necessary.

A better way to address the appreciation of the currency would be through a fiscal adjustment. This would put less pressure over domestic demand, interest rates and, consequently, over the exchange rate.

However, public expenditures are currently increasing at around 11% in real terms and focused on non-investment items. And this expansion will continue practically unchanged next year. The fiscal policy will therefore create incentives for the Central Bank to promote a tightening in monetary policy, with negative impacts on the exchange rate. In other words, the country is on track to follow an inadequate mix of macroeconomic policies (fiscal expansion and monetary tightening) instead of adopting a mix of policies that would be more helpful to preserve competitiveness (fiscal tightening and less tight monetary policy).

In October of 2010, presidential elections will be held. Although the risks associated to the election of Lula's successor are much lower than in previous presidential elections, they will likely create some volatility. This will be especially true if the main candidates refrain to commit themselves to the maintenance of the economic pillars adopted in the last years (inflation target, flexible exchange rates and fiscal responsibility).

Brazil is set to grow around 4.5% - 5.0% in the coming years. This growth will be driven by a dynamic expansion of domestic demand, which will be based on the expansion of credit, the incorporation of millions of people into the consumption markets and further advances in labor markets. Moreover, in the longer-term, the country will benefit from the recent oil findings and associated investment booms.

The words of caution with respect to the mix of macroeconomic policies and with next year's elections should, therefore, not mask our optimism with respect to the country. However, the current optimism with respect to the country should, on the other hand, not mask the uncertainties, problems and reforms that the country still has to address.

International environment

Global economic prospects improve...

Since the middle of the year the world economy has begun to give clearer signs of recovery. The sensation of free fall prevalent at the end of 2008 and the start of this year has given way to relative stability and, in some cases, moderate growth.

The change in the trend has been favored by the exceptional stimulus measures adopted in most economies. The measures have been implemented both on the monetary front (substantial reductions in the intervention rates, massive injections of liquidity and unconventional operations with assets), and the fiscal front (fiscal stimuli that have boosted sectors such as the automobile industry, and have helped temporarily to sustain the income and spending of private agents).

... although latent risks of a downturn in the short term continue, above all in the most advanced economies

Nevertheless, the fundamentals of the world economy continue to be fragile and the risks of a downturn are therefore present in the short term. The main risk is a possible premature withdrawal of the stimulus packages, above all in the most advanced economies, and uncertainty over whether private-sector spending can replace public spending as the main driving force of recovery. In developed countries, growth during the expansive phase was boosted by domestic demand, supported by the increase in disposable income and also very high private debt. This will not recur in this new phase of the cycle. The labor market figures will also not contribute to a swift emergence from the crisis, since the rate of destruction of employment continues to be very high in many economies.

For all these reasons, the biggest challenge facing economic policy at the present time is the timely and well-planned withdrawal of the public, fiscal and monetary support programs.

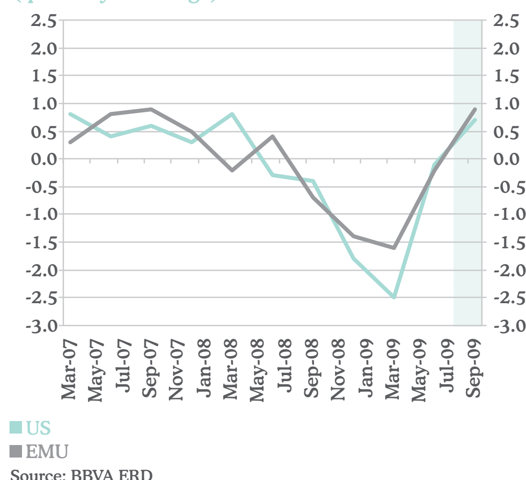
In this situation, the most probable scenario would point to a maintenance of low official rates for an extended period, as it does not appear likely that there will be a significant upturn in inflation, given the high productive capacity available. However, the maintenance of the stimuli over time could also have detrimental consequences, since they distort the incentives to take decisions on adjusting balance sheets; and they also question the sustainability of the public accounts in many economies.

It therefore appears probable that central banks will gradually try out possible alternatives to bring their liquidity policies back to normal when the time comes. The evidence of recent weeks shows the importance of communication on the part of the monetary authorities during this phase. They have to separate what is said about the design of the exit strategies from the moment of their application, which should be delayed until the economy gives signs of self-sustained recovery.

Although the financial tensions have steadily reduced since their maximum levels after the Lehman collapse, the current situation is far from being fully satisfactory. In fact, the levels of tension in the markets are still a long way from pre-crisis levels. The biggest progress so far has been in the interbank markets. The 3-month OIS spreads in the U.S. and the EMU are currently at 18-month lows, despite the fact that these markets still depend on injections of liquidity by central banks.

U.S. and EMU: GDP growth

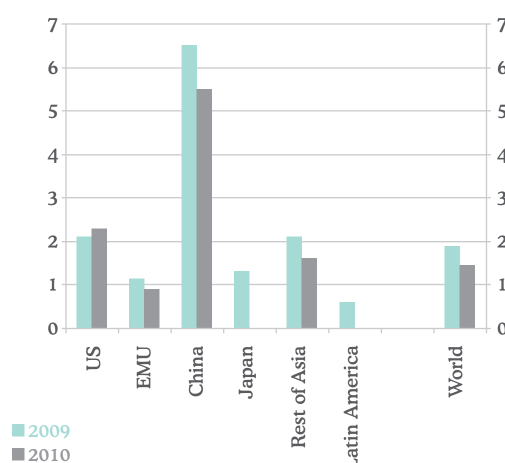
(quarterly % change)



Source: BBVA ERD

Fiscal and budget programs: relative size

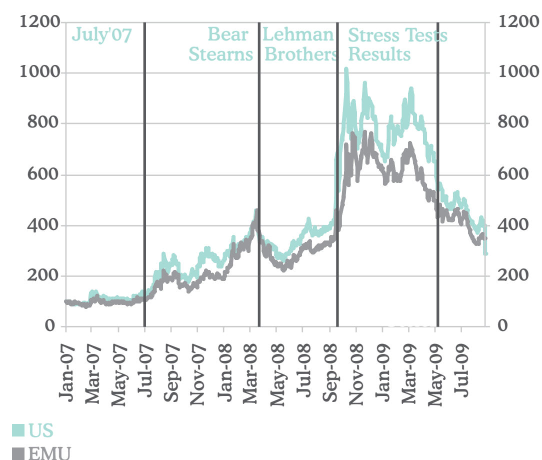
(% GDP)



Source: BBVA ERD

Indicator of Financial Tension

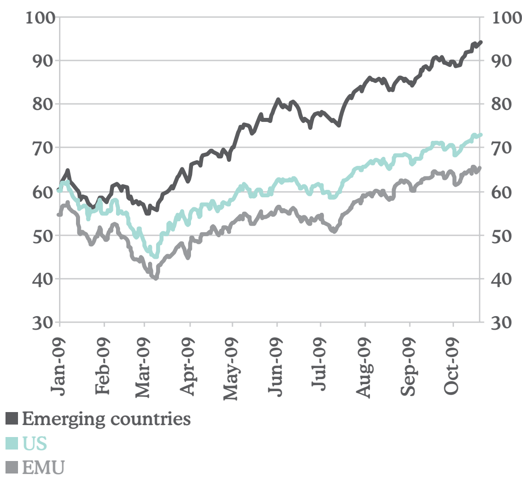
(100=January 07)



Source: BBVA Research Department
The first standardized principal component of the OIS spread series, implicit U.S. stock market volatility, bank and corporate CDS

Equity markets

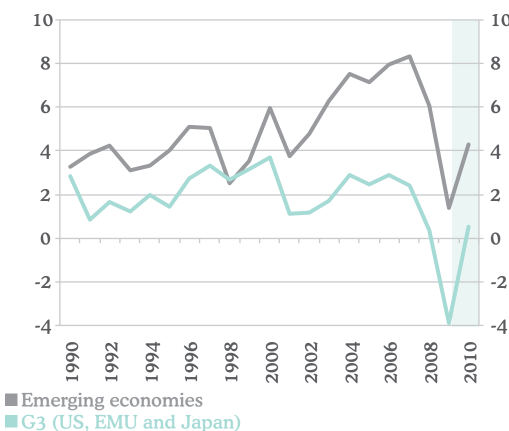
(July 2007=100)



Source: Bloomberg and MSCI

Emerging economies and G3: GDP growth

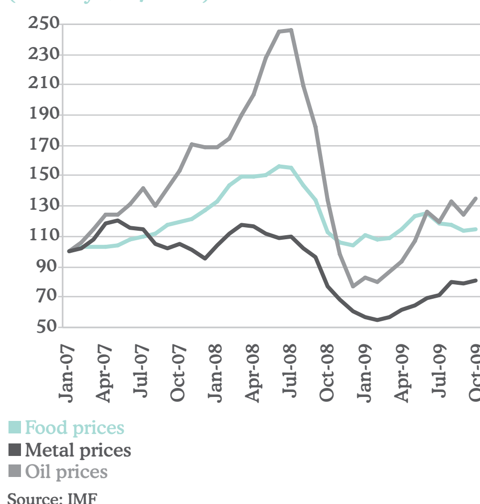
(year-on-year change)



Source: BBVA ERD

Commodity Prices

(January 2007=100)



Source: IMF

The reduction in risk premiums has been extraordinarily swift over recent months. U.S. bank CDS[1] reached their minimum levels since the start of the crisis, and European CDS were at their lowest level for nearly a year before stabilizing. Caution appears to have taken hold in most markets (including equity), in a scenario in which a historically high level of risk aversion still predominates.

Emerging economies, the new motor of global growth

Economic recovery is very uneven. In general terms, emerging economies are on a more solid path to recovery than developed ones. This can be explained by a number of factors that set these economies apart and have made it easier for most of them (with the exception of Emerging Europe countries) to cope with more expensive funding markets and the contraction in activity and employment. Specifically, these factors include: their lower exposure to the financial crisis, above all in its initial stage; the success of the fiscal and monetary stimulus packages implemented after the start of the crisis; the growth in commodity prices in recent months; the modest recovery in world trade after its collapse at the end of 2008; and, perhaps most important for stable long-term growth, the earlier efforts made in many of the countries to promote and practice a policy of macroeconomic stability.

Among developed economies, the U.S. appears to be in a better position than Europe. In particular, the fiscal stimulus in the U.S. will have a relatively greater impact on growth over the coming years. In 2010 it is expected to have an impact of 3 percentage points (pp), compared with 1.5 pp in Europe. The most probable scenario for the U.S. economy is moderate growth, as there is no certainty that once the public stimulus ends, the private sector will recover its high level of sustained growth. In addition, questions such as unemployment or the public accounts are still sources of obvious concern.

In Europe, the fiscal stimulus will be comparatively lower in 2010, and vary among the different countries. The recovery in economic activity will also be delayed by the greater rigidity in the European labor market.

The signs of recovery in activity are already clear in emerging countries, although with some notable variations. China, for example, has already returned to high growth rates, partly as a result of an extremely rapid increase in credit and other stimulus measures. In Latin America, most countries are already showing signs of positive growth in the third quarter. However, there is more risk in the situation of emerging European economies, which are weaker in macroeconomic and financial terms.

Commodity prices recover in this more positive context

Strong demand, above all from China, and the prospects of a recovery in developed countries in 2010 have greatly supported commodities, which began to recover together with the equity markets. In recent months, the fall in risk aversion and the weakness of the dollar have attracted financial investment to these markets and supported a recovery in prices. This has eased the pressure on public funding felt in some emerging economies at the start of the year, and given additional support to the appreciation of the currencies of those countries that are rich in natural resources.

The price prospects for 2010 will depend on synchronizing the recovery of industrial production in developed countries with the normalization of the demand from China. As we expect that Chinese demand will return to normal before the recovery in industrial production, we estimate that the fundamentals point to a moderate correction in commodity prices in the coming months, followed by new rises as the recovery in global demand begins to manifest the restrictions on extending supply capacity in the coming years.

[1] Credit Default Swap or agreement to cover the risk of non-payment of a financial security.

Macroeconomic environment

Domestic demand will drive strong economic growth in the coming quarters

After a sudden and large fall in the last quarter of 2008, the Brazilian economy recovered faster and stronger than expected in the first half of the year, especially in the second quarter when GDP expanded by 1.9% q-o-q. This recovery was driven by the dynamism of private consumption and by an adjustment in net external demand[1].

The same factors that contributed to the good performance of private consumption in the first half of the year will continue to play an important role in the coming quarters. First, the expansion of credit provided by public banks will continue in place for the remainder of 2009 and also in 2010. Credit expansion will actually receive from now on increasing support from the private sector (see section below).

Second, although tax incentives to the purchase of durable goods (especially automobiles and home appliances) will be gradually withdrawn, they will continue strengthening private consumption in the coming quarters. In addition, as showed below, public expenditures kept rising fast during the crises and will continue doing so in the coming quarters (especially in the first semester of 2010, right before presidential elections).

Third, the moderation of the inflation had (and will continue to have) a direct positive impact on real wages. Moreover, it has allowed the Central Bank to cut interest rates to historical lows. Due to the lagged impact on economic activity of lower interest rates, its maximum impact will be observed in the coming quarters.

Finally, private consumption benefited and will continue to benefit from advances in the labor market. Starting on February, the economy started to create jobs at an increasing pace. By October the total number of net jobs created was around 60% higher than the number of jobs destroyed during the worst of crisis (from November to January). Only in the month of October, 0.23 million jobs were created, a figure very close to pre-crisis record levels[2].

The relative strength of the labor market is related to two structural changes that took place in the last years, namely a reduction in the equilibrium unemployment rate and a decline in informality rates. According to our calculations, the equilibrium unemployment rate of the Brazilian economy receded from around 10% in the 2002-2005 period to around 8.5% in 2009. Informality rates, on the other hand, declined from around 30% to 25% in the same periods[3]. Both the equilibrium unemployment rate and the informality rates will continue to trend downwards and, therefore, will continue to support private consumption.

Besides the support from private consumption, domestic demand will receive increasing support from the investment component in the

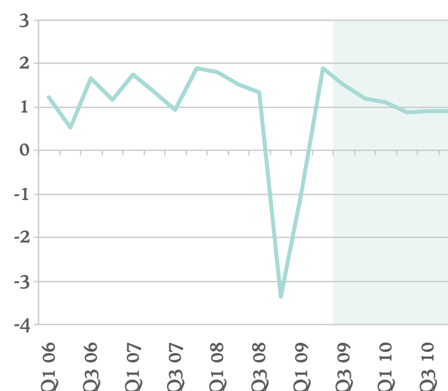
[1] The Brazilian GDP dropped 3.37% q-o-q in Q4 08 and 0.97% q-o-q in Q1 09. In Q2 09 the GDP expanded by 1.91% q-o-q (-1.16% y-o-y) due to a 2.09%q-o-q growth in private consumption, a stability in public consumption and total investments (0.03% q-o-q and -0.06% q-o-q respectively), a 14.13% q-o-q expansion in exports and a 1.54% q-o-q growth in imports.

[2] 0.79 million jobs were destroyed from November of 2008 to January of 2009. From February to October 1.27 million net jobs were created. The positive performance of the job creation amid the world crisis helps to understand why the unemployment rate was much more resilient to the crisis than previously anticipated. It peaked at 9% in March and eased continually from then on. As it is depicted in the graph beside, unemployment rates are currently close to all-times lows. The positive performance of the job creation amid the world crisis helps to understand why the unemployment rate was much more resilient to the crisis than previously anticipated. It peaked at 9% in March and eased continually from then on.

[3] BBVA's calculations based on data from IBGE.

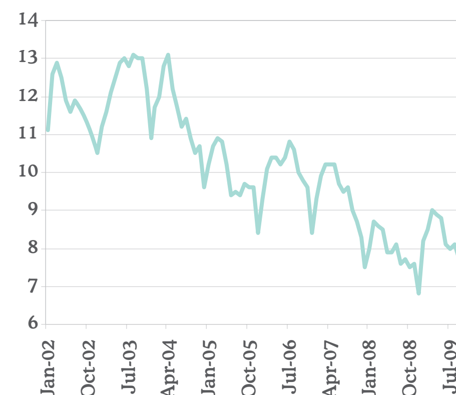
GDP

(q-o-q %)



Source: Bloomberg, BBVA

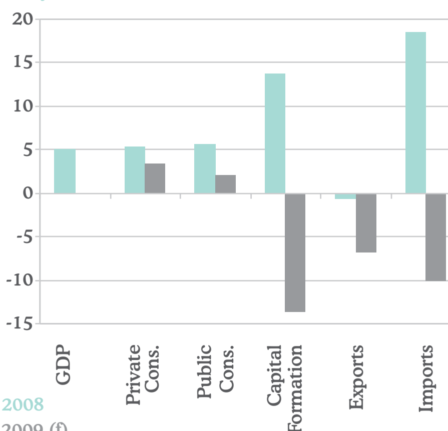
Unemployment Rate (%)



Source: Bloomberg, BBVA

GDP Components

(yearly %)



Source: Bloomberg, BBVA

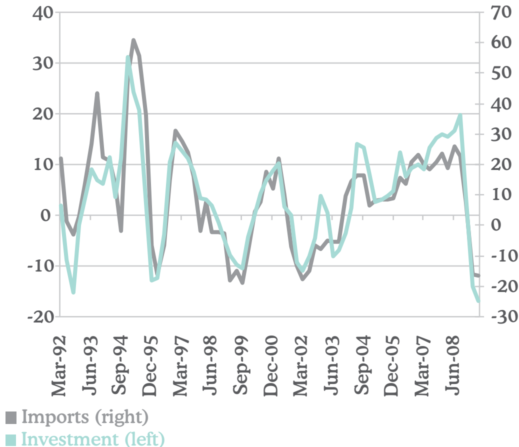
Domestic and External Demand Contributions to the GDP

(y-o-y %)

Source: Bloomberg, BBVA

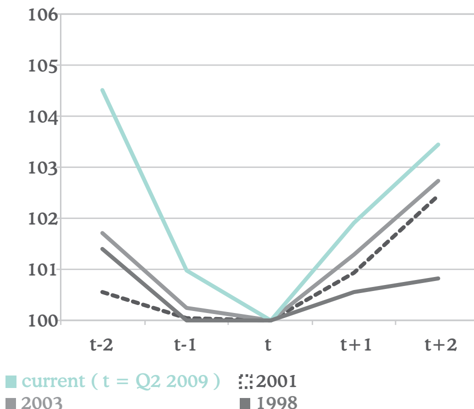
Investments and Imports

(y-o-y %)



Source: National Accounts, IBGE

GDP Performance During Different Recessions (Index SA)



Source: IBGE, BBVA

remainder of this year and in 2010. Investments were much more affected than private consumption by global uncertainties due to its relatively higher dependence on external markets conditions and due to initially high inventory levels. Although the data for the second quarter shows that investments stopped their decline, they were at that point still much lower than before the crisis. The strong rebound of private consumption associated to better perspectives regarding the world scenario will, from the third quarter on, stimulate the recovery of investment levels and add to Brazilian growth perspectives.

Overall, taking into account all these factors, domestic demand should remain practically constant in 2009 with respect to 2008 and should expand by more than 6% in the coming years.

On the other hand the contribution to the GDP of the external demand will provide less support to GDP growth in the coming periods than in the last quarters as showed in graph beside.

More precisely, the contribution of external demand to GDP growth should soon become negative as it was before the crisis (and as should be expected in a country that grows more than its potential). The country will need, therefore, to rely on external savings to finance its growth.

In the fist half of 2009, the adjustment in external demand was a consequence of a sharp contraction of imports from the rest of the world (mainly due to the moderation in the domestic demand growth). Despite the large fall, exports found some support in a solid Chinese demand for commodities (in fact China replaced the USA as Brazil's main trade partner in the first half of this year). Finally, the exchange rate remained relatively depreciated during the first part of the year and this was another driver of the external demand correction. From now on, however, this mechanism will be reversed. Both a higher dynamism of Brazilian domestic demand and the appreciation of the currency will fuel a higher expansion of imports than of the exports. One feature of the recovery of imports will be its correlation with investments. Higher investment needs will have an important role in the expansion of the country's imports (see section below for a detailed analysis of external accounts).

All in all, Brazil should grow around 1.5% in the last two quarters of this year to close with an overall annual GDP growth rate close to 0%[4]. Although this compares poorly with previous' years figures, it is certainly a good result compared to the current performance of most other countries and also in comparison with Brazil's previous experiences during global turbulences (see graph beside). Although the presidential election will generate some volatility, economic growth will be around 4.5% - 5% in 2010 and in the next years.

Benign inflation trend to be reverted soon

Since October of 2008, inflation has been in a benign trajectory due to the moderation of domestic demand growth and a fall in commodity prices from historically high levels. The IPCA, which was rising at 6.4% 12 months ago, have come below the 4.5% target recently and should close the year at 4.2%.

In the first half of 2010 some inflation pressures should emerge from the closing of the output gap and by some recovery in commodity prices. An appreciated exchange rate will have a moderating influence on prices, but will not prevent the IPCA to rise near 4.5% before the middle of the year and to close the year slightly above the target.

[4] The 0.0% forecast for 2009's growth incorporates a 1.5%q-o-q growth in the third quarter and slightly less in the fourth quarter. Recent activity indicators suggest that observed growth could be higher than these numbers (see Box 1) and therefore there is an upward bias in the 0.0% growth for 2009.

A more inflationary scenario, however, would emerge if the expansion of commodity prices is higher than we expect in 2010 or if the impact of a strong fiscal expansion is not offset by an adequate tightening of the monetary policy.

Fiscal policy will remain expansive but debt sustainability will not be an issue in the short term

Public revenues have been very reactive to economic activity performance, even more than many analysts had expected. Revenues rose largely in the pre-crisis period and have been declining sharply since the beginning of the year as depicted in the graph beside.

In contrast to the cyclicality of revenues, public expenditures have been much less sensitive to the cycle. More precisely, public expenditures have remained largely expansionary even after the beginning of the crisis (total expenditures in the nine first months of 2009 are 11% higher than in the same period last year in real terms; expenditures related to public wages rose 13% in the same period, also in real terms). This expansion reflects more the inability of the government to control its expenditures than its ability to implement a countercyclical fiscal stimulus.

In practice, the recently observed expansion of public expenditures helped to ameliorate the impacts of the crisis, even though the only countercyclical measures explicitly and intentionally taken by the government was the tax incentive to the purchase of durable goods (especially automobiles and home appliances)[5]. In addition, the government ordered public banks to expand their loans to provide support to the economy[6 7]. These actions were very effective to speed up the recovery process.

The government has revised downwards this year's primary surplus goal to 1.6% (from 3.5% last year), but in spite of this reduction it's not clear whether they will be able to meet this reduced goal by the end of the year (the primary surplus accumulated in the last 12-months was 1.2% in September). If not, it will probably use part of the Sovereign Wealth Fund created last year (amounting to 0.5% of GDP).

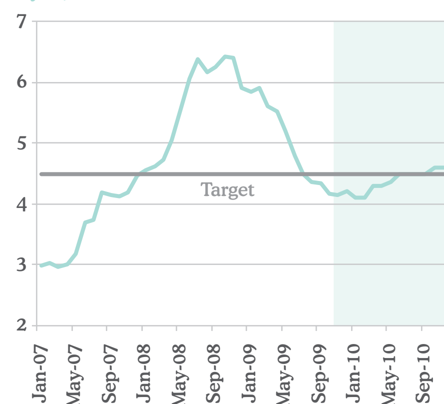
Assuming the government is able to reach the 1.6% goal by the end of the year and given that last year's primary surplus was around 3.7% of GDP, the overall drop in the primary surplus in 2009 will amount to more than 2bps. According to our calculations, half of this deterioration is due to expansive – permanent - expenditures, around 30% of it is due to lower revenues and around 20% due to temporary tax incentives.

As a consequence of a lower primary surplus and despite lower interest payments (due to lower interest rate levels) the nominal deficit should close the year around -3.5% (-2% in December of 2008).

Although the tax incentives are already being gradually withdrawn, to be eliminated at the beginning of 2010, and although public revenues will recover strongly next year, the continuation of the strong expansion of non-investment expenditures, which is the currently the main driver of the deterioration of public accounts, will cause problems. More precisely, public expenditures will contribute probably more than needed to the expansion of domestic demand and therefore to the upward adjustment in interest rates. As a consequence, they will create extra appreciation pressures over the exchange rate and will increase the cost of servicing public debt. It also will generate a crowding-out of the private sector.

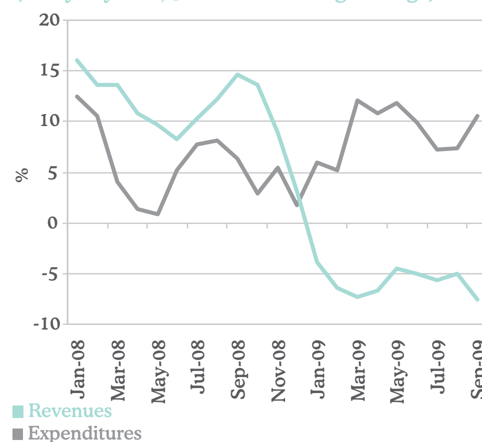
[5] Tax incentives amount to around 0.6% of the GDP.
[6] Public banks results are not included in central government accounts. The expansion of public loans can be labeled as “quasi-fiscal” instead of purely “fiscal”.
[7] Differently from tax cuts and public loans, public expenditures are not easily reversible.

Inflation - IPCA
(yearly %)



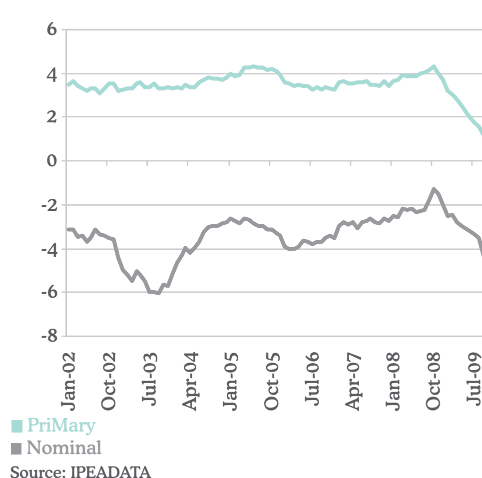
Source: IBGE, BBVA

Central Government's Revenues and Expenditures
(real y-o-y rate, 3-months moving average)



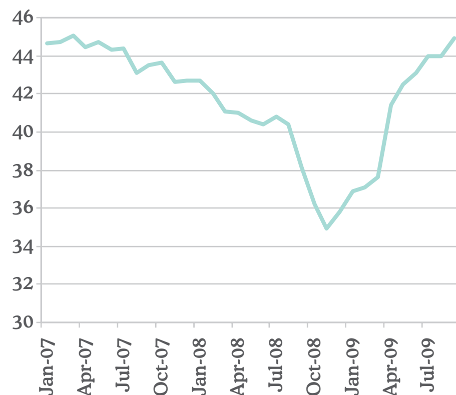
Source: IPEA, BBVA

Nominal and Primary Fiscal Results
(% GDP, accumulated in 12 months)



Source: IPEADATA

Net Public Debt
(% GDP)

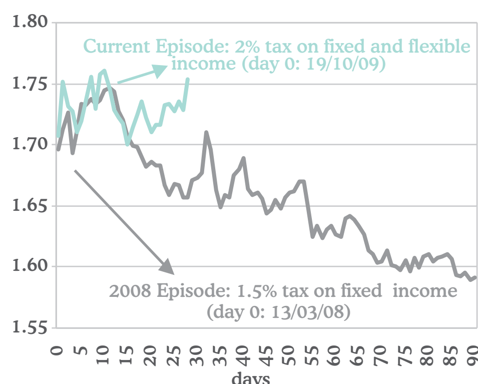


Source: Bloomberg

Exchange Rate
(Real / USD)

Source: Bloomberg

Exchange Rate Performance After the Introduction of a IOF Tax
(two episodes: March of 2008; October 2009)



Source: Bloomberg

The sustainability of public debt, however, should not be an issue, at least not in the short term, because the gains observed in the last years provide some room for temporary fiscal expansions and because the profile of the Brazilian debt is now much better than it was in the past. In addition, over the medium term, especially after elections are left behind, we expect the government to make some fiscal adjustments.

Net public debt should close the year around 45% of GDP (the highest level since the beginning of 2006) but should start to recede again from 2010 on[8].

The tax on foreign capital inflows signals concerns with the appreciation and suggests more controls could come

As a consequence of the strong recovery process that has been underway in Brazil and of an excessive liquidity around the world, the country has been receiving very large inflows of foreign capital and the real has been appreciating. The Brazilian Real is currently around 1.7 per dollar. This is the strongest value observed since September of 2008 and represents a 37% appreciation since the beginning of the year.

The real effective exchange rate is currently around 6% below the five-year average. According to our econometric models, the current exchange rate could be up to 17% over-appreciated in comparison to its long-term equilibrium level[9].

Another consequence of the dollar inflows into the country has been the 76% expansion in the Sao Paulo Stock Exchange[10].

Both the appreciation of the Real and the expansion of the BOVESPA have been generating concerns within the government about the formation of asset bubbles and about a negative impact (of the appreciated Real) over national industries The Central Bank started buying dollars in May to moderate the exchange rate fluctuations, but as the appreciation trend continued, the government implemented a 2% tax on the entrance of foreign capital into fixed and flexible income markets[11].

The direct impact of the implementation of this tax is not expected to be significant because the drivers of this appreciation (basically strong recovery perspectives) will remain in place and because, in the presence of relatively sophisticated financial markets, international investors should be able to find alternatives to invest in the country without the payment of the tax (there is already anecdotic evidence showing that investors are managing to avoid this taxation). Although the direct impact of the implementation of the tax should not be significant (a 1.5% tax on the inflows of foreign capital into fixed income markets was introduced in March of 2008 with a very limited impact; this tax was removed later in 2008), it helps to consolidate the view that the government will implicitly create a floor to the exchange rate. Some recent declarations by public authorities reinforce this view. The government will likely adopt more measures in the near future to avoid the exchange rate to go below the 1.70 mark. All this creates a bias in the exchange rate and could end up having an impact (more significant than the direct impact of the tax).

[8] An important variable to explain the recent fluctuations in the public debt is the exchange rate. As the public sector is currently an external creditor (due to its large international reserves), a currency depreciation helps to reduce the debt. On the other hand, a currency appreciation (as the one observed in the last moths) has a negative impact on the debt.

[9] Calculations regarding the real effective exchange rate are based on IPEA data. Our econometric model is based on a PPP model adjusted to incorporate productivity differentials.

[10] In the same period, the stock exchanges expansion was of 103% in Peru, 99% in Argentina, 49% in Colombia and 33% in Chile.

[11] Dollar purchases by the Central Bank, from May to October, amounted to USD 21 billions. International reserves are at USD 235 billions according to the most recent data (as of November, 16th) and should be increasing in the coming periods.

The best measure to avoid the exchange rate to appreciate would probably be a tighter fiscal policy (which would create less pressures over domestic demand and therefore over the Real), but this is not a likely scenario in the short term.

The Real should close the year around 1.70 and the appreciation trend should gain force in 2010 due to the growth differential with respect to most of other economies and an increasing interest rate differential after the Central Bank start raising interest rates in the first half of the year in advance to the Fed and the ECB.

Overall, the exchange rate should be in the 1.60 – 1.70 range in 2010. An upward risk to these forecasts is the behavior of the dollar in international markets. A recovery of the North-American currency (caused by an economic recovery in US, for example) could create a stronger than expected depreciation pressure over the Real.

Current account deficits will widen significantly as the country will grow over its potential

Since the beginning of the crisis until very recently, the current account deficit of the Brazilian economy went through some correction as the domestic demand growth moderated sharply. More precisely, the yearly deficit declined from USD 28 billions at the end of 2008 to USD 18 billions in October of 2009. From now on, however, the current account deficit will start to widen fast following the domestic demand expansion.

By the end of 2009 the current account deficit should be around USD 20 billion and should reach USD 45 billion by the end of 2010. These figures represent around 1.2% and 2.2% of GDP respectively.

The trade balance surplus, which should close 2009 around USD 26 billion, should deteriorate significantly by the end of the next year. According to our projections, the trade surplus will be around USD 10 billion in 2010 as imports will grow much faster than exports[12]. As commented in a previous section, the dynamism of imports will be driven by a strong Real and by the growth of domestic demand. An especially important driver of imports will be investment performance, which should grow around 15% next year (a graph displayed above depicts the strong correlation between imports and investments).

The balance of services should also deteriorate over the remainder of 2009 and especially in 2010, as a consequence of the appreciation of the Real. We estimate a deficit of USD 46 billion in 2009 to climb to USD 55 billion in 2010.

Higher than expected current account deficits in 2009 and 2010 would not come as a big surprise as the domestic demand expansion could be stronger than expected and given the high sensitivity of the current account results to this variable. Anyway, current account deficits should continue widening in the coming years and could easily average more than 3% of the GDP from 2011 on.

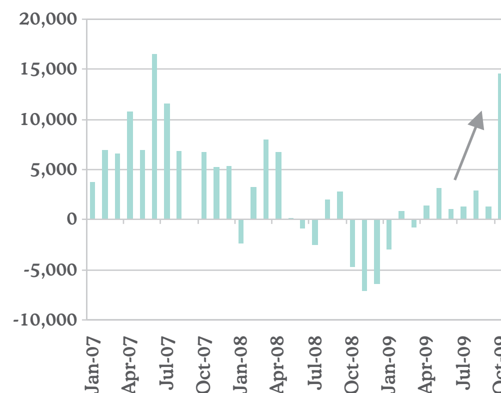
It is very likely that the country continues to attract foreign capital to fund these deficits. More importantly, foreign direct investment (FDI) flows should continue robust. More precisely, in 2009 FDI flows should amount to USD 28 billion, more than the USD 25 billion observed in 2008. And in 2010 they could reach more than USD 35 billion.

Current account deficits are, therefore, expected to be financed by capital inflows. In addition, the Central Bank owns very large - and rising -

[12] More explicitly, imports could grow around 30% in 2010 while exports growth should be around 15%.

Net Dollar Inflows Into Brazil

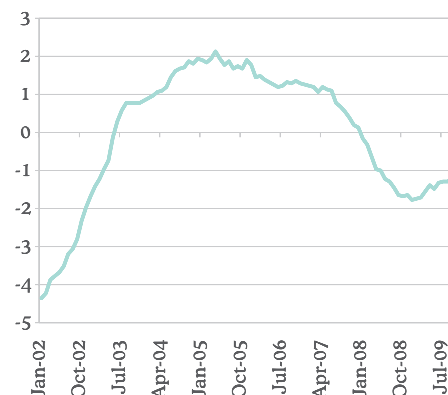
(USD millions)



Source: Central Bank of Brazil

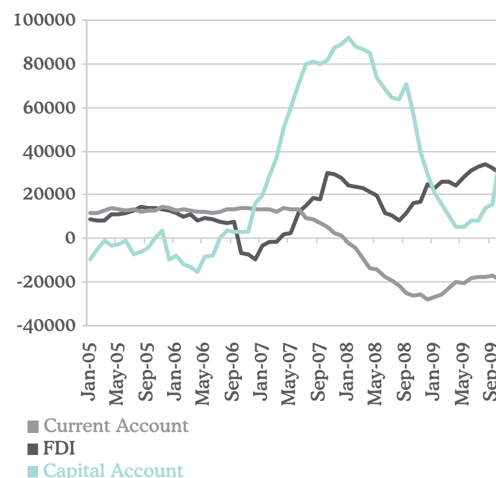
Current Account

(% GDP)



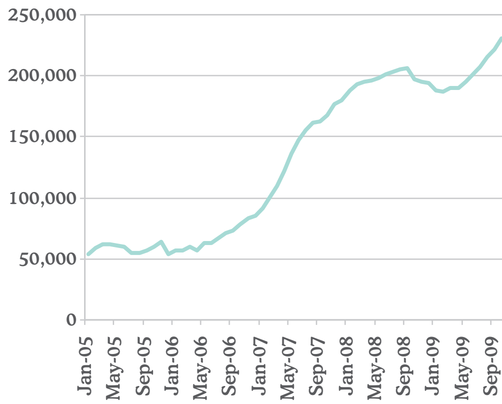
Source: Central Bank of Brazil

Current Account, Capital Account and FDI (USD millions, accumulated in 12 months)



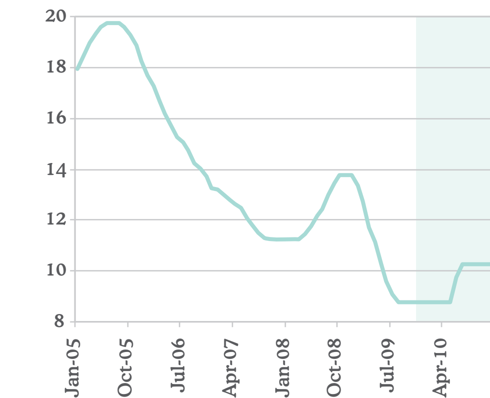
Source: Central Bank of Brazil

International Reserves
(USD millions)



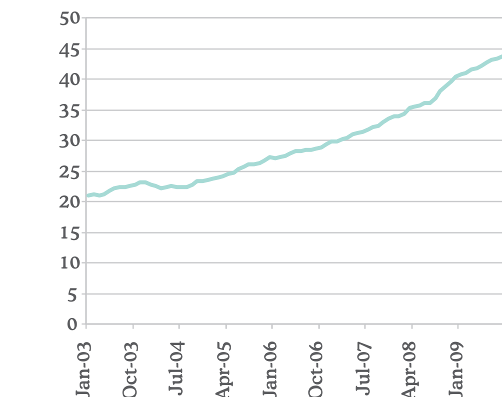
Source: Central Bank of Brazil

SELIC
(yearly %)



Source: Bloomberg

Total Credit to Private Sector
(% GDP)



Source: Centarl Bank of Brazil

international reserves (around USD 235 billion). However, a sudden stop in foreign inflows, driven by the change in the mood of international markets for instance (due to political uncertainties during an election year, for example), could hurt the country. In this scenario of large current account deficits and scarcity of foreign capital, the Real could go through a sharp depreciation with a negative impact over markets in Brazil and in the region. Despite these concerns, at this moment we attach a low probability to a sharp depreciation scenario.

SELIC will be adjusted upwards but will remain below pre-crisis levels

Although there are many uncertainties regarding the monetary exit timing, a solid economic growth should force Central Bank to adjust the SELIC from 8.75% to 10.25% as both inflation and expected inflation move up in the first half of next year. The SELIC should, therefore, remain constant at 8.75% for the remainder of 2009 and in the first quarter of 2010 because “such level of basic interest rate is consistent with a benign inflation scenario … and to the non-inflationary recovery of economic activity” in the words of the Central Bank’s Monetary Policy Committee.

The uncertainties regarding the next exit strategy to be implemented by the Central Bank go beyond those regarding inflation behavior. They include the (limited but non-negative) risk that political factors play a role during an electoral year. The political factors include presidential elections to be held in October as well as the uncertainties regarding the exit at the beginning of 2010 of the president of the Central Bank, Henrique Meirelles. In addition to political factors, the current appreciation of the Real could create a dilemma for the members of the Monetary Policy Committee as an upward adjustment of the SELIC would contribute to generate more pressures over the exchange rate.

The importance of both political factors and exchange rate concerns should remain limited and secondary for the Central Bank’s decisions.

However, if inflation pressures remain more controlled than expected, these factors should contribute for a decision to keep interest rates unchanged until the end of 2010. This scenario, however, seems at the moment less likely than the one in which rates are adjusted to 10.25% in the first half of next year.

Public banks’ credit expansion to be followed soon by private banks

Total credit to the private sector in Brazil reached a new all-time level, 44.1% of GDP in October. One year ago, right before the country was hit by international turbulences, total credit to the private sector was around 38% of GDP.

This strong expansion, simultaneous to the worst economic crisis in many decades, is due to two main reasons. The first is the moderation of GDP growth. This moderation makes an expansion of credit relative to GDP “easier”. The second and more important reason is the countercyclical expansion of public credit.

As there was no significant room to implement a strong countercyclical fiscal policy though a program of public expenditures, the federal government asked public banks to accelerate credit during the crisis. The share of public credit in total credit increased to 38% in October from 33% one year ago.

Public credit is currently growing at 32% y-o-y, much higher than the current private pace, which is around 5%. This is in sharp contrast with the pre-crisis situation when private credit growth was higher than public credit growth. Overall, credit growth is now around 15%, less than half the pace it displayed before the crisis.

Public credit expansion raised concerns about public banks' risks. Despite the initial soundness of the banking system, both a worse than expected deterioration of economic conditions and a large increase in non-performing loans (NPL) could have created problems for public banks. Economic activity has, however, recovered earlier and strongly than expected. NPL remained below previous crisis levels and are already showing signs of moderation (NPL were at 4.4% in September, much higher than the 2.8% level recorded in September of 2008 but much lower than the 10% rate observed in 2000, for example). By supporting the economic recovery, public banks secured a larger share of the credit market and are now in a better position to compete in a market that is expected to grow significantly during the coming years[13].

Credit expansion will be driven by strong economic growth, lower interest rates and by higher competition among banks. It will initially concentrate on consumer and real estate sectors but will soon reach other segments[14].

In another front, the IBOVESPA rose 76% in the year, reflecting the optimism towards the Brazilian economy. Although this expansion has been fueled by large liquidity in international markets, it is supported by the fast recovery in economic growth already underway in Brazil.

The country-risk, measured by the EMBI+, is currently around 215 bps, almost 50% below the level observed at the beginning of the year.

All in all, the country will continue growing in the coming years, but the optimism with Brazil should not hide the need to address its problems

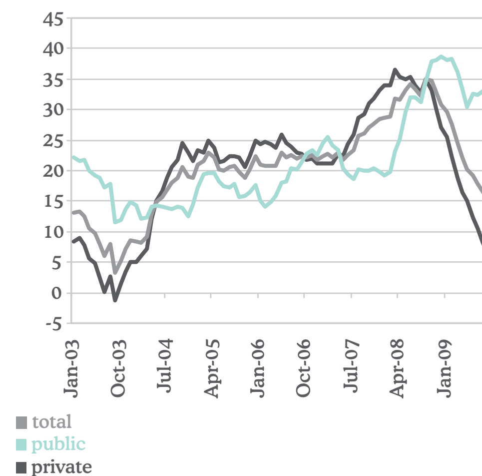
The optimism with respect to Brazil should be taken as an opportunity for the country to consolidate the macroeconomic advances observed in the last years. In particular, the adjustment of fiscal accounts should continue to be an important priority.

All in all, the country will grow around 4.5% - 5% in the coming years in our baseline scenario. On one hand, it seems highly unlikely that growth could average less than 4% in the next three years. But, on the other, the lack of some structural reforms will likely continue limiting the potential growth of the country. Addressing some structural problems such as the distortions caused by the tax system, its low level, of investment in infra-structure and its low human capital levels could grant the country a yearly growth around 6%.

[13] Since September of 2008 till October, public banks' NPL increased from 1.9% to 2.6% while for the private national system NPL rose from 3.3% to 5.6%.

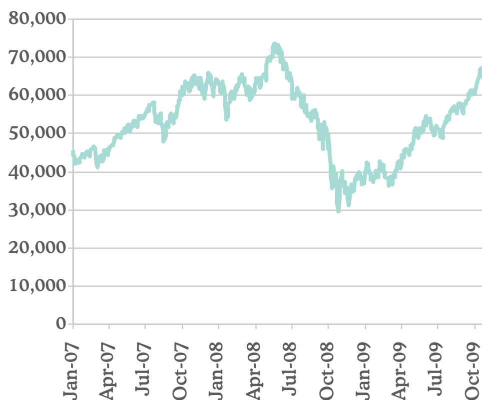
[14] The dynamism of real estate loans is already very high (42% in yearly terms). Some structural changes implemented in the last years, the improved macro scenario and the very low levels of departure should all contribute for the expansion of the sector in the coming years.

Credit to Private Sector - Growth
(y-o-y %)



Source: Central Bank of Brazil

IBOVESPA



Source: Bloomberg

EMBI +

Source: Bloomberg

Box 1: A Synthetic Activity Indicator for the Brazilian Economy

Based on monthly indicators we developed a quarterly Synthetic Activity Indicator (SAI) for Brazil. This indicator summarizes the information provided by high-frequency indicators and can be used to forecast GDP changes in the short-term (basically one or two quarters in advance).

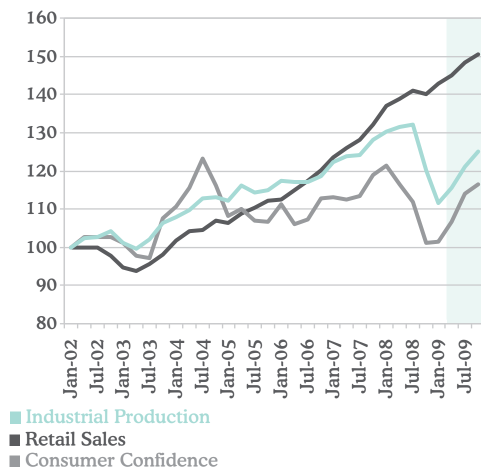
From a large list of monthly leading indicators (including industrial production, exports, retail sales, capacity utilization, employment, industry confidence, consumer confidence, car sales and the unemployment rate) we use an econometric model to identify the most important variables to forecast Brazilian GDP. Using data from 2000 on, we found that the most important variables to be included in a SAI for Brazil are retail sales, consumer confidence and industrial production (which turned out to be the most important variable in our econometric exercise). Using these three variables, as well as a lagged GDP variable (which captures part of the inertia in GDP evolution), one can mimic around 90% of recent GDP fluctuations. We found evidence that other early indicators do not significantly contribute to improve SAI's forecasting power.

For the first two quarters of 2009, for example, our SAI would have suggested a -1.1% q-o-q and 1.7% q-o-q variations in GDP which turned out to be -1.0 and 1.9% in the first and second quarters respectively.

Using already observed data on industrial production, retail sales and consumer confidence our SAI indicates a 2.1% q-o-q GDP growth for the third quarter of the year.

Leading Indicators Incoporated in the SAI

(Index Jan 2002 = 100, SA)

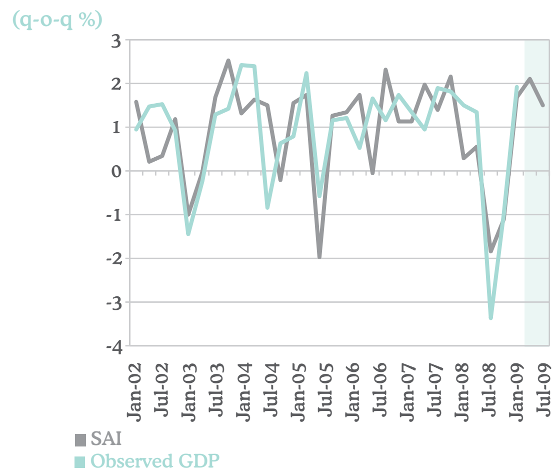


Source: Bloomberg, FGV, BBVA

As can be seen in the graph above, industrial production, retail sales and consumer confidence should all continue expanding in the fourth quarter of 2009 according to our forecasts. More precisely, these indicators should grow around 3.4%, 1.4% and 2.1% in quarterly terms in the last quarter of the year. Based on these increases our SAI suggests that GDP should grow 1.5% q-o-q in the fourth quarter of 2009.

Observed GDP and SAI

(q-o-q %)



Source: Bloomberg, BBVA

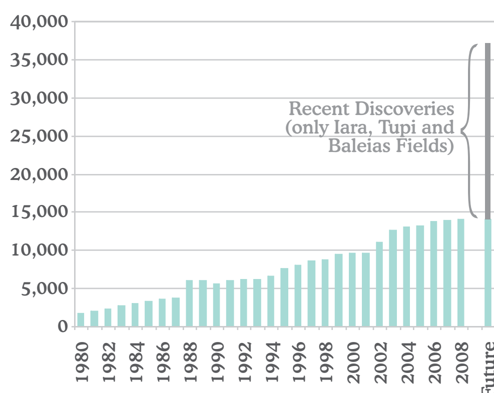
Our SAI model, therefore, suggests that the Brazilian GDP should grow around 2.1% and 1.5% in quarterly terms in the third and fourth quarters respectively. These numbers are slightly higher than our current forecasts for GDP expansion (1.5% and 1.2%). They, hence, suggest a downward bias in our current GDP forecasts for the country, i.e. Brazil could close the year with a yearly GDP growth higher than 0.0%.

Box 2: A new regulatory framework for the Brazilian oil sector

The Brazilian government presented on August 31st a new regulatory framework for the exploration for oil reserves in the pre-salt area (the area amounts to 149.000 km2 off the Brazilian coast; it is called “pre-salt” because the oil is held beneath deep waters, around 3.000 meters of sand and rock, and a layer of salt. It is estimated that it could potentially hold reserves of up to 150 billion barrels, ten times the amount of oil reserves attributed to Brazil prior to 2008)

Brazilian Oil Reserves

(millions of barrels)



Source: Petrobras, Brazilian Government

The project proposes a shift from the currently used concession-production system to a sharing-production system. In a sharing system the government and the oil company share the ownership of the field and of the oil extracted (Saudi Arabia, Russia and Mexico, for example, have adopted this system in at least part of their fields). In a concession system the government concedes the ownership of the field and the oil to a company in exchange of royalties (this is the system adopted in USA, Canada and Norway, for example). Although the advantages of the sharing system over the concession system are not clear, the government argues that it is the best system to adopt for the pre-salt layer because exploration risks (the uncertainty about the existence of oil) are now considered to be small. The change will not apply to regions already under concession (amounting to 28% of the area).

The government also proposes the creation of a social fund to manage the resources generated in the pre-salt. The fund, which will be directed by a board composed by representatives from both the public and private sector, will be used to reduce poverty and to invest in education and R&D. Following the Norwegian example, the resources of the fund will be managed with independence from budgetary resources.

Another proposal is the creation of a public company (Petrosal) to oversee the production-sharing agreements between the government and oil companies. This would be a 100% state owned company (unlike Petrobras) having a seat on each operating committee of all consortia and with a veto right on development decisions.

The last main proposal is to increase the capital of Petrobras, with the aim to increase the government participation in the company (currently around 32% of the company’s equities) and to help the company to obtain the financial resources needed to be the main operator in the pre-salt area (Petrobras will be guaranteed at least a 30% participation in all remaining blocks; it already has the largest stake if not majority of concessions granted thus far in the area). The initial reaction of investors was negative but the mood apparently changed since then and the company recovered the initial losses in the Sao Paulo Stock Exchange.

The government is likely to announce a specific industrial policy to stimulate national production of the inputs required for oil exploration. The government is also expected to announce measures to guarantee that the country become an exporter of oil-derived products instead of oil.

The government has forwarded the project to Congress which will now discuss, amend and vote it.

Overall, the project presented by the government aims to retain within the country a significant part of the resources generated at the pre-salt region. Although a higher participation of the public sector could lead to lower foreign capital inflows, the entrance of investments from abroad will be both welcomed and needed to the development of the fields as the country does not have neither enough financial resources nor the technology to develop the oil from the pre-salt.

The success of the new model will depend on the ability of the government to attract sufficient foreign capital participation as well as to isolate both the social fund and the Petrosal from rent-seekers.

5. Statistic and forecasts

International Context

Commodities (end of period)	2008	2009	2010		2008	2009	2010
Brent (USD/barrel)	45.6	60.6	68.3	**Soybean (USD/t.)**	343	368	339
Copper (USD/t)	3070	5732	3969	**Corn (USD/t.)**	144	130	136
				Wheat (USD/t.)	216	168	160

	Real GDP (%)				Inflation (%, end of period)*			
	2007	2008	2009	2010	2007	2008	2009	2010
USA	2.1	0.4	-2.5	1.5	2.9	3.8	-0.7	1.1
EU	2.7	0.6	-3.8	0.2	2.1	3.3	0.3	0.8
Japan	2.3	-0.7	-5.3	1.1	0.5	1.0	-1.5	-0.3
China	13.0	9.0	8.3	9.3	4.8	5.9	-1.1	1.2
Latin America								
Argentina	8.7	5.7	-2.5	2.6	8.5	7.2	7.5	10.0
Brazil	5.7	5.1	0.0	4.7	4.5	5.9	4.2	4.6
Chile	4.7	3.2	-1.2	4.1	7.8	7.1	-0.7	2.5
Colombia	7.5	2.4	0.1	2.4	5.7	7.7	2.4	3.8
Mexico	3.3	1.4	-7.2	3.1	3.8	6.5	4.0	5.2
Peru	8.9	9.8	1.1	4.3	3.9	6.7	0.6	2.1
Venezuela	8.4	4.9	-2.1	-0.5	18.7	31.3	29.3	35.1
LATAM [1]	5.7	4.0	-2.6	3.5	5.8	8.1	5.6	7.1
LATAM Ex-Mexico	6.7	4.9	-0.6	3.6	6.7	8.6	6.0	7.7

* USA and EU Inflation: Period average

[1] Average of 7 mentioned countries

	Public Sector Balance (% GDP)				Current Account Balance (% GDP)			
	2007	2008	2009	2010	2007	2008	2009	2010
USA	-1.2	-3.2	-9.9	-9.5	-5.2	-4.9	-2.6	-2.0
EU	-0.6	-2.0	-6.6	-7.2	0.1	-1.1	-0.8	-0.3
Japan	-0.4	-0.5	-0.9	-1.0	-4.9	3.2	2.1	2.1
China	0.7	-0.4	-3.8	-4.4	11.0	9.8	5.3	4.7
Latin America								
Argentina [2]	1.1	1.4	-2.0	-0.4	2.9	2.2	2.8	2.5
Brazil	-2.8	-2.0	-3.5	-2.6	0.1	-1.8	-1.0	-2.2
Chile [2]	9.9	4.9	-3.9	-1.9	4.4	-2.0	2.7	1.9
Colombia	-2.7	-2.3	-4.2	-4.5	-2.8	-2.8	-2.4	-1.6
Mexico	-1.1	-2.1	-3.0	-3.7	-0.8	-1.4	-1.0	-1.5
Peru	3.1	2.1	-1.8	-1.1	1.1	-3.3	-1.3	-2.0
Venezuela [2]	4.5	-0.2	-4.6	-6.3	9.0	13.1	1.4	2.5
LATAM [1]	-0.6	-1.1	-3.2	-3.0	0.8	-0.4	-0.4	-1.0
LATAM Ex-Mexico	-0.1	-0.5	-3.4	-2.7	1.4	-0.1	-0.1	-0.6

[1] Average of 7 mentioned countries; [2] Central Government

	Exchange Rate (vs $, end of period)				Official Rate (%, end of period)			
	2007	2008	2009	2010	2007	2008	2009	2010
USA					4.30	0.50	0.10	0.10
EU ($/€)	1.5	1.3	1.4	1.3	4.00	2.50	1.00	1.00
Japan (yenes/$)	113.0	96.1	98.0	100.9				
China (cny/$)	7.6	7.0	6.8	6.8	7.47	5.31	5.31	6.12
Latin America								
Argentina	3.1	3.4	3.9	4.3	13.52	19.08	13.50	14.03
Brazil	1.8	2.3	1.70	1.62	11.25	13.75	8.75	10.25
Chile	499	649	560	564	6.00	8.25	0.50	3.00
Colombia	2015	2244	2020	2070	9.50	9.50	3.50	4.25
Mexico	10.9	13.0	13.2	12.7	7.50	8.25	4.50	4.50
Peru	2.98	3.11	2.90	2.95	5.00	6.50	1.25	2.00
Venezuela	2.2	2.2	2.2	2.2	11.40	16.20	15.20	13.80

Argentina

	2007	2008	2009f	2010f
GDP (%)	8.7	5.7	-2.5	2.6
Consumer Prices (%, end of year)	8.5	7.2	7.5	10.0
Trade Balance ($bn)	11.1	12.6	16.6	16.4
Current Account ($bn)	7.4	7.1	9.6	9.3
% GDP	2.9	2.2	2.8	2.5
Reserves ($bn. end of year)	46.2	46.4	48.4	56.9
Exchange Rate (end of year vs US$)	3.14	3.42	3.85	4.30
Fiscal Balance (% GDP) [1]	1.1	1.4	-2.0	-0.4
Interest Rate (end of year) [2]	13.52	19.08	13.50	14.03

[1] **Argentina**: Central Government. Excluding privatization receipts.

[2] **Argentina**: 30-d deposits interest rate in pesos; **Brazil**: SELIC Rate

Brazil

	2007	2008	2009f	2010f
GDP (%)	5.7	5.1	0.0	4.7
Consumer Prices (%, end of year)	4.5	5.9	4.2	4.6
Trade Balance ($bn)	71.2	4.8	26.0	10.0
Current Account ($bn)	1.5	-28.2	-16.0	-45.0
% GDP	0.1	-1.8	-1.0	-2.2
Reserves ($bn. end of year)	180.3	193.8	245.0	280.0
Exchange Rate (end of year vs US$)	1.78	2.31	1.70	1.62
Fiscal Balance (% GDP) [1]	-2.8	-2.0	-3.5	-2.6
Interest Rate (end of year) [2]	11.25	13.75	8.75	10.25

Chile

	2007	2008	2009f	2010f
GDP (%)	4.7	3.2	-1.2	4.1
Consumer Prices (%, end of year)	7.8	7.1	-0.7	2.5
Trade Balance ($bn)	23.6	8.8	10.1	10.8
Current Account ($bn)	7.2	-3.4	4.3	3.2
% GDP	4.4	-2.0	2.7	1.9
Reserves ($bn. end of year)	16.9	23.2	26.5	26.0
Exchange Rate (end of year vs US$)	500	649	560	564
Fiscal Balance (% GDP) [1]	9.9	4.9	-3.9	-1.9
Interest Rate (end of year) [2]	6.00	8.25	0.50	3.00

[1] **Chile, Colombia**: Central Government

[2] **Chile**: Official Interest Rate (since August 2001 in nominal terms)

Colombia

	2007	2008	2009f	2010f
GDP (%)	7.5	2.4	0.1	2.4
Consumer Prices (%, end of year)	5.7	7.7	2.4	3.8
Trade Balance ($bn)	-0.7	0.8	0.4	-0.3
Current Account ($bn)	-5.8	-6.9	-5.5	-4.1
% GDP	-2.8	-2.8	-2.4	-1.6
Reserves ($bn. end of year)	21.0	24.0	26.0	27.0
Exchange Rate (end of year vs US$)	2015	2244	2020	2070
Fiscal Balance (% GDP) [1]	-2.7	-2.3	-4.2	-4.5
Interest Rate (end of year) [2]	9.50	9.50	3.50	4.25

Mexico

	2007	2008	2009f	2010f
GDP (%)	3.3	1.4	-7.2	3.1
Consumer Prices (%, end of year)	3.8	6.5	4.0	5.2
Trade Balance ($bn)	-10.1	-17.3	-8.4	-14.6
Current Account ($bn)	-2.1	-4.0	-2.3	-3.8
% GDP	-0.8	-1.4	-1.0	-1.5
Reserves ($bn. end of year)	78.0	85.4	—	—
Exchange Rate (end of year vs US$)	10.9	13.0	13.2	12.7
Fiscal Balance (% GDP) [1]	-1.1	-2.1	-3.0	-3.7
Interest Rate (end of year) [2]	7.50	8.25	4.50	4.50

[2] **Mexico**: 28-d Cetes; **Peru**: Interbank Interest in soles

Peru

	2007	2008	2009f	2010f
GDP (%)	8.9	9.8	1.1	4.3
Consumer Prices (%, end of year)	3.9	6.7	0.6	2.1
Trade Balance ($bn)	8.3	3.1	3.9	3.0
Current Account ($bn)	1.2	-4.2	-1.7	-2.8
% GDP	1.1	-3.3	-1.3	-2.0
Reserves ($bn. end of year)	27.7	31.2	0.0	0.0
Exchange Rate (end of year vs US$)	2.98	3.11	2.90	2.95
Fiscal Balance (% GDP) [1]	3.1	2.1	-1.8	-1.1
Interest Rate (end of year) [2]	5.00	6.50	1.25	2.00

Uruguay

	2007	2008	2009f	2010f
GDP (%)	7.6	8.9	1.1	4.5
Consumer Prices (%, end of year)	8.5	9.2	6.0	6.2
Trade Balance ($bn)	-1.1	-3.0	-1.8	-1.9
Current Account ($bn)	-0.1	-1.1	-0.2	-0.2
% GDP	-0.3	-3.4	-0.4	-0.5
Reserves ($bn. end of year)	1.7	1.9	3.0	3.0
Exchange Rate (end of year vs US$)	21.6	24.1	20.5	21.0
Fiscal Balance (% GDP) [1]	0.0	-1.3	-2.5	-2.3
Interest Rate (end of year) [2]	7.25	7.75	8.00	8.00

[1] **Venezuela:** Central Government; **Uruguay**: Public sector global balance (incluyes state-owned enterprises, intendencias and BPS)

[2] **Uruguay**: BCU Interest Rate; **Venezuela**: 90-d deposits Interest Rate

[3] **Venezuela**: including FIEM; **Uruguay**: Reserve assets without compensation from public and financial sectors.

Venezuela

	2007	2008	2009f	2010f
GDP (%)	8.4	4.9	-2.1	-0.5
Consumer Prices (%, end of year)	18.7	31.3	29.3	35.1
Trade Balance ($bn)	23.7	45.4	14.4	19.1
Current Account ($bn)	20.0	39.2	5.2	11.7
% GDP	9.0	13.1	1.4	2.5
Reserves ($bn. end of year)	34.3	43.1	29.7	29.7
Exchange Rate (end of year vs US$)	2.2	2.2	2.2	2.2
Fiscal Balance (% GDP) [1]	4.5	-0.2	-4.6	-6.3
Interest Rate (end of year) [2]	11.40	16.20	15.20	13.80

BBVA

For more information please contact:

Servicios Generales Difusión BBVA   Gran Vía 1 planta 2   48001 Bilbao   P 34 944 876 231   F 34 944 876 417   www.bbva.es

Economic Research Department:

Chief Economist:
José Luis Escrivá

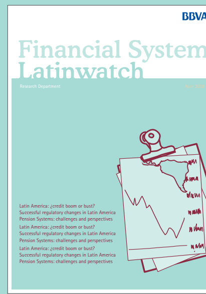
Chief Economist for Units:
Spain and Europe: Rafael Doménech - r.domenech@grupobbva.com
Spain: Miguel Cardoso - miguel.cardoso@grupobbva.com
Europe: Miguel Jiménez - mjimenezg@grupobbva.com

United States and Mexico: Jorge Sicilia - j.sicilia@bbva.bancomer.com
United States: Nathaniel Karp - nathaniel.karp@compassbank.com
Mexico: Adolfo Albo - a.albo@bbva.bancomer.com
Macroeconomic Analysis Mexico: Julián Cubero - juan.cubero@bbva.bancomer.com

Economic and Financial Scenarios: Mayte Ledo - teresa.ledo@grupobbva.com
Sectorial Analysis: Ana Rubio - arubiog@grupobbva.com
Financial Scenarios: Daniel Navia - daniel.navia@grupobbva.com
Quantitative Analysis: Giovanni di Placido - giovanni.diplacido@grupobbva.com
Global Trends: David Tuesta - david.tuesta@grupobbva.com

Emerging Markets: Alicia García-Herrero - alicia.garcia-herrero@bbva.com.hk
Transversal Analysis: Sonsoles Castillo - s.castillo@grupobbva.com
South America: Joaquín Vial - jvial@bbvaprovida.cl
Argentina: Gloria Sorensen - gsorensen@bancofrances.com.ar
Chile: Alejandro Puente - apuente@bbva.cl
Colombia: Juana Téllez - juana.tellez@bbva.com.co
Peru: Hugo Perea - hperea@grupobbva.com.pe
Venezuela: Oswaldo López - oswaldo_lopez@provincial.com
Asia: Ya Lan Liu - yalan@bbva.com.hk

other publications



This document was prepared by Banco Bilbao Vizcaya Argentaria's (BBVA) Research Department on behalf of itself and its affiliated companies (each a BBVA Group Company) for distribution in the United States and the rest of the world and is provided for information purposes only. The information, opinions, estimates and forecasts contained herein refer to that specific date and are subject to changes without notice due to market fluctuations.
The information, opinions, estimates and forecasts contained in this document have been gathered or obtained from public sources believed to be correct by the Company concerning their accuracy, completeness, and/or correctness.
This document is not an offer to sell or a solicitation to acquire or dispose of an interest in securities.