BBVA Research

Brazil

Economic Outlook

February 2011

Economic Analysis

- Economic policies will become more restrictive to moderate a still too robust domestic demand. After growing around 7.5% in 2010, GDP should expand 4.1% in 2011.
- Inflation pressures are mounting due to the dynamism of domestic demand, high commodity prices, increasing labor costs, and inertial price adjustments.
- The Central Bank should remain focused on mitigating inflation pressures even though this could add appreciatory pressures on the exchange rate. Tightening of monetary policy will, therefore, continue. We expect the SELIC to be adjusted by 100bps to 12.25% in the next few months. In addition, the implementation of more macro-prudential measures to moderate and control credit growth should not be viewed with surprise.
- This time, fiscal policy is expected to complement monetary policy's counter-cyclical efforts, but if expenditure cuts fall short of expectations, monetary policy would have to carry the extra burden of the adjustment and the SELIC rate would have to be adjusted upwards by more than 100bps.
- The implementation of a counter-cyclical fiscal policy will help to take some pressure off the exchange rate, but economic authorities will continue intervening in exchange rate markets to prevent the real from strengthening sharply.
- The tightening of the fiscal policy should also open space for a new sovereign debt rating upgrade throughout this year.
- The current account deficit will near 3.0% of GDP this year and 4% in coming years. Although abundant capital inflows should provide more than enough funding, the widening of the current account deficit increases the potential negative impacts that an external shock could have on the country.
- Overall, Brazil's situation is manageable and positive, but there are economic and political risks to be watched.

Index

1. Global outlook: decouplings at play ... 3

2. Economic activity to moderate due to more restrictive economic policies ... 6

3. Mounting inflationary pressures ... 8

4. Fiscal accounts: limited progress in 2010; uncertainties regarding 2011 ... 10

5. External accounts: current account deterioration and abundant capital inflows ... 12

6. Balance of risks ... 13

7. Tables ... 14

Closing date: February 7, 2011

1. Global outlook: decouplings at play

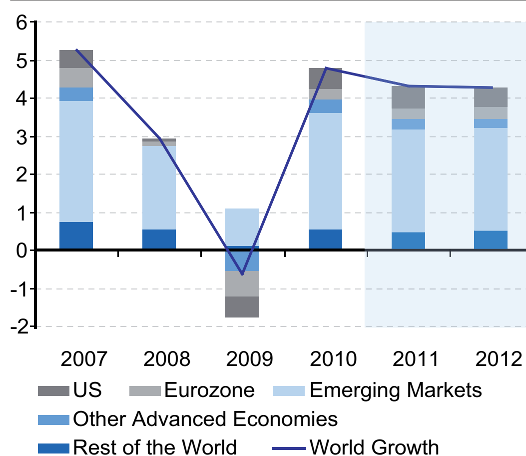
After closing 2010 with a growth rate of 4,8%, the global economy is expected to decelerate slightly to 4,4% both in 2011 and 2012. The global economy has thus ended the year with a stronger growth than anticipated 12 months ago, and in part that is due to advanced economies decelerating less than expected back then. However, the real engine of global dynamism continues to be the emerging world, led by Asia (and China in particular, see Chart 1). This sustains a scenario where decoupling between emerging and developed economies continues unstopped. As we have also highlighted in the past, there is an increasing growth divergence between the US and the EMU, reinforced after the likelihood of a double dip in the US seems to have abated substantially. But growth decoupling is also increasingly evident within Europe, between core countries and those of the periphery, dragged by financial market tensions. In fact, even though financial market tensions in Europe worsened during the last quarter of 2010, economic activity the region as a whole has been able to accelerate, thus showing –at least temporarily– a degree of decoupling also between the financial and the real side.

All these decouplings have three important implications for the outlook. First, the divergence between growth in advanced and emerging economies will continue to promote markedly different macroeconomic policies going forward. Monetary policies will continue to be highly accommodative in the US and Europe, fuelling a search for yield elsewhere (in emerging markets and increasingly in commodities as well). At the same time, signs of overheating are starting to emerge in some countries in Asia and Latin America, pushing authorities to consider tightening policy faster than previously envisioned given incipient inflationary pressures, especially in Asia (Chart 2). The resulting incentives for capital inflows into emerging economies will contribute to increase policy dilemmas in both regions, between tightening policy to ensure a soft landing and preventing sudden and sharp exchange rate appreciations.

Second, the growth divergence between the US and EMU will continue to put downward pressure on the euro and, perhaps more significantly, will keep drawing market attention to the relative difficulty of the EMU to grow out of their high public debt levels. This is one of the elements –together with the different size of their central banks' bond-purchase programs and the turmoil around economic governance in Europe– that explains why markets have not reacted significantly to a further postponement of fiscal consolidation in the US. The difference with market punishment to the European fiscal outlook could not be starker.

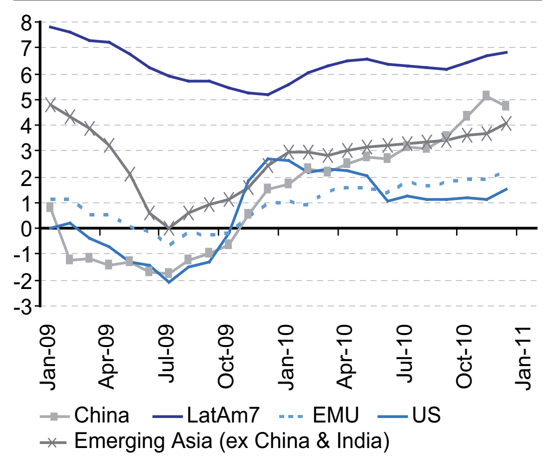
Finally, the increasing decoupling within the EMU will start straining the conduct of a common monetary policy for the region, already torn between an incipient risk of inflation, especially in core countries, and the need to continue supporting financial stability, especially –but not exclusively– in peripheral economies.

Chart 1
Global GDP growth and contributions



Source: BBVA Research

Chart 2
Inflation



Source: BBVA Research and Datastream

As we expected, the US did not fall into a double dip, and the chances of that happening in the future have faded since the summer. Four main factors have contributed to the change in sentiment regarding the outlook for growth in the US. First, better macro outturns at the end of 2010 signaled that household consumption was more resilient than was feared. Second, decisive action by the Federal Reserve, implementing and additional round of asset purchases (QE2) provided support for bond prices in particular, and asset prices in general. Third, reduced uncertainty and increased business confidence is expected to benefit investment. Finally, and perhaps more important, a new fiscal stimulus package,

approved at the end of 2010, will provide a significant boost to economic growth. We have thus adjusted our growth forecast for 2011 by 0,7 percentage points, to 3%.

However, weaknesses have not disappeared. Real estate markets remain feeble and still prone to negative surprises. Household income is still sluggish given that the speed of the recovery will not be sufficient to significantly reduce unemployment rates. On top of it, credit growth and securitization processes remain subdued. While none of this should derail the recovery, it continues to configure a scenario in which an additional negative shock would harm the economy. For now, this outlook of gradual economic recovery with low inflationary pressures on the demand side, will permit monetary policy to remain accommodative for an extended period.

Moreover, the lessons from the sovereign crisis in Europe should not be forgotten. Granted, the new fiscal package at the end of 2010 had the benefit of boosting growth in the short-run, at the time when doubts about a double dip were still in the air. But one should not overestimate the strength and persistence of the factors that have prevented a negative reaction from bond markets to a further delay of fiscal consolidation in the US. Central bank bond purchases and the turmoil in Europe (and thus flight to quality to US bonds) are by nature short-run factors that will disappear in the medium run, and before that happens the US will need to show a clear commitment to fiscal consolidation or risk a sudden spike in long-term interest rates. Rating agencies have already started to signal this risk. There is time, but discussions and plans should start as soon as possible to reduce long term fiscal concerns.

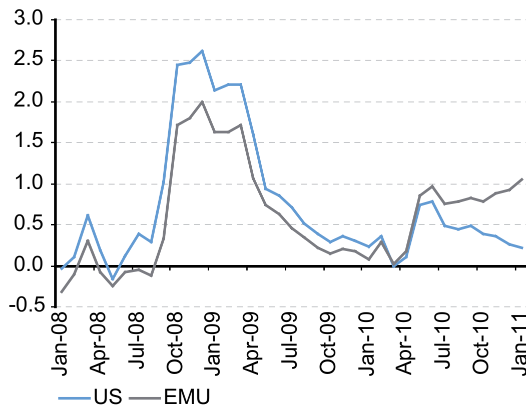
Since October 2010, financial tensions in Europe have surged again (Chart 3), especially in peripheral countries. Concerns about fiscal sustainability and financial sector losses resurfaced again, leading to widening sovereign spreads and funding pressures. However, contrary to the episode in May, financial spillovers to other countries in Europe and outside the EU were more limited.

The increase in financial market tensions was triggered by two events. First, markets were uncertain about the ability of European institutions to deal with sovereign debt crises. Private investors were spooked by the proposal that they would bear losses on possible restructurings after 2013, and the likelihood that haircuts on existing debt would be needed to restore fiscal sustainability. The second trigger was increasing doubts about the credibility of stress tests, given the need to support Irish banks shortly after they were deemed adequately capitalized. These two triggers developed amid the background of concerns about the capacity of some peripheral countries like Portugal and Ireland to fulfill their fiscal deficit targets and doubts about the ability of some European economies to generate enough growth momentum to make their debt burden sustainable.

The fragility of the recovery in financial markets right after the summer highlights that markets are increasingly focusing on sovereign solvency problems in some countries, rather than just liquidity concerns. This stresses the need for a comprehensive solution, both for solving this crisis, as well as establishing a sound crisis prevention and resolution mechanism for the future. For future crisis prevention, fiscal coordination needs to be reinforced, providing for shock absorbers for idiosyncratic shocks in individual countries, but also reinforcing surveillance both in the fiscal front and in the macroeconomic dimension (including preventing the build-up of private sector imbalances). For crisis resolution, a clear and transparent mechanism that defines those who will bear losses needs to be put in place, to avoid excessive market volatility due to uncertainty, but probably at this stage is extremely important to guarantee an adequate transition mechanism.

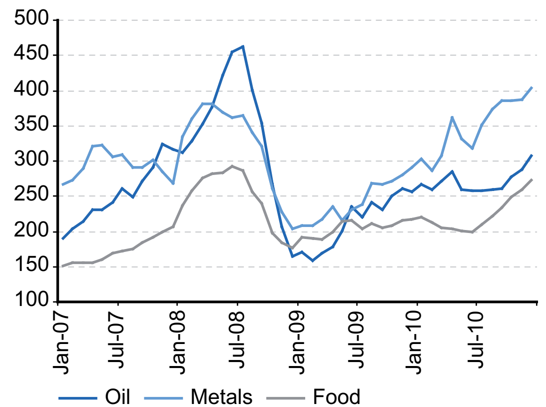
As pointed out above, financial spillovers from this recent episode have been rather limited, including to core countries in Europe. Thus, growth in the EMU as a whole was stronger than anticipated, especially due to very positive outturns in Germany and other core European countries. However, this decoupling between financial tensions in peripheral countries and real economic activity in Europe will not last if a comprehensive governance reform is not agreed soon and countries do not continue pushing economic reforms to reduce fiscal vulnerabilities, restructure the financial system and increase potential growth. What is agreed at the next European Council in March will be key in this respect.

Chart 3
Financial Stress Index



Source: BBVA Research

Chart 4
Commodity Prices (2000=100)



Source: World Bank and BBVA Research

Commodity prices have surged across the board in recent months, reaching all-time highs in the case of some metal prices (Chart 4). This is consistent with what seems to be the beginning of a long-term upward trend in commodity prices driven by surging demand from emerging economies, but there are other short-run factors that have contributed to the recent surge, at least in some commodity classes. For instance, the very fast increase in food prices in the past two months is to a great extent the effect of one-time supply-side factors (weather disturbances), which should wind down during the rest of 2011. Moreover, given ample global liquidity conditions, investors have piled into commodities as an asset class, increasing financial premia across the board.

Going forward, we expect commodity prices in general to level off around current readings. In the case of food prices this will be the result of normalizing crops in 2011. For metals, elevated inventories will start to weigh on prices. Only in the case of oil we expect a tight market to continue pushing prices slightly higher in 2011 but gradually easing afterwards. This easing will be helped by a likely reduction in financial tensions in Europe, which should shift investment flows away from commodities into other assets with more contained risk premia. Nevertheless, risks are tilted to the upside, as strong demand in Asia will continue to support an upward trend in prices in the medium run.

The increase in commodity prices has been responsible, in part, for the increase in inflation observed in emerging economies at the end of 2010 (Chart 2). In particular, the increase in food prices has had a direct and important first-round effect on higher inflation in a number of countries –especially in Asia– with the risk of feeding into overall inflation. However, going forward, the expected leveling of food prices will mean that this factor should become less important in determining headline inflation. Although the risk has also increased in developed countries, it is smaller than in emerging economies, given that food prices have a smaller weight on CPI and ample unused capacity and anchored inflation expectations will help keep inflation pressures in check.

More worrying for emerging economies is the realization that rapid growth and strong capital inflows in Asia and Latin America are starting to generate overheating pressures, through inflation but also evident through rapid credit growth and increasing asset prices. Indeed, we expect Asian economies to continue growing strongly, although in our opinion authorities will be able to steer them to a soft landing and avoid overheating, although that is surely a more pronounced risk than three months ago. Driven by domestic demand and high commodity prices, Latin America is also poised to grow strongly in 2011, converging to potential growth of around 4% in the region. As mentioned before, the biggest challenge for both regions will be to manage the policy dilemmas generated by strong capital inflows. We expect policy to continue tightening in most countries, while at the same time imposing ever more stringent administrative controls to limit those inflows and prudential measures to limit credit growth, especially in Asia.

2. Economic activity to moderate due to more restrictive economic policies

After eight years under the Presidency of Lula, Brazil has been under the government of Dilma Rousseff since January 1st. The economic and political transition went very smoothly. Markets practically didn't react to the power switch as Dilma had beforehand committed to the three macroeconomic pillars that have been in place since the government of Fernando Henrique Cardoso, namely the no-tolerance with inflation policy, the solvency of the public sector, and the flexibility of the exchange rate.

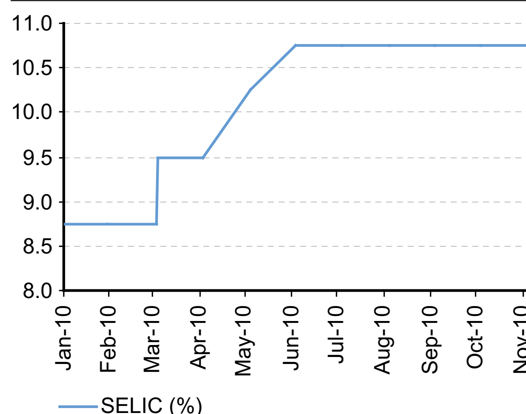
Economic continuity was reinforced by the announcement of Dilma's economic team. The Minister of Economy during the last years of the Lula government, Guido Mantega, will continue in charge of coordinating the country's macroeconomic policies. Alexandre Tombini, Director of the Central Bank from 2005 to 2010, was chosen to replace Henrique Meirelles in command of the monetary authority.

The appointment of Guido Mantega and Alexandre Tombini was accompanied by declarations that, on one hand, the fiscal policy would be made more restrictive from now on, and on the other hand, that the Central Bank would continue to be independent to determine the monetary policy and would not become more tolerant with inflation to accommodate exchange rate pressures.

The latter already received a concrete backing from the recent decision of Alexandre Tombini's Central Bank to raise the SELIC rate by 50bps in January and by announcements of the Central Bank that support the idea of further monetary tightening in the coming months. The former, however, has yet to be seen.

Chart 5

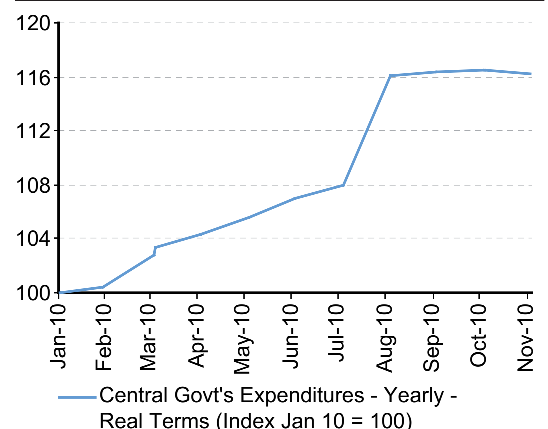
In 2010, the monetary policy played a clear counter-cyclical role...



Source:Central Bank

Chart 6

… while fiscal policy remained strongly expansive



Source: IPEADATA

In our base scenario we assume that the Central Bank will hike the SELIC rate by 100bps more to 12.25% (we expect two 50bps increases in each of the next monetary policy meetings on March 2nd and April 20th). Fiscal measures are expected to be announced so that the public sector can reach the R$ 118bn goal for this year's primary surplus and, therefore, also contribute to avoid overheating the economic activity, differently from what happened in the end of the previous government when the weight of the adjustment was essentially borne by monetary policy (see Charts 5 and 6).

In addition, the economy should also be driven down by macro-prudential measures as those announced last December (increase in banks' reserve and capital requirements). These measures are expected to help credit growth to decline from 20%y/y in 2010 to 15%y/y this year. And although there is a generalized view that the credit expansion in Brazil is based on fundamentals, these measures should also limit credit and more general financial risks [1].

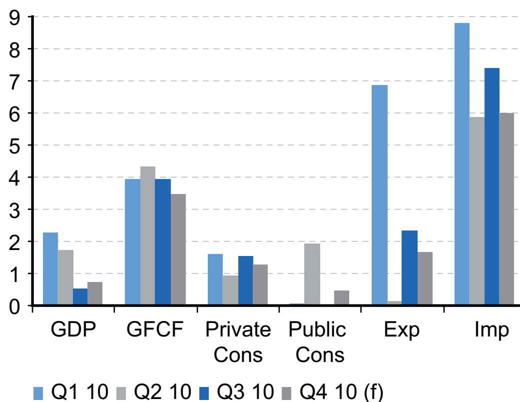
In case fiscal policy refrains from playing a significant countercyclical role, the SELIC rate would then have to be adjusted upwards by more than 100bps. Also, the likelihood of more (and tougher) macro-prudential measures would increase. But at this moment, we do not regard this scenario as the most likely (see Section 4 for more about fiscal policy).

1: Credit as a share of GDP increased from 23% in 2003 to 47% in 2010, but remains low in comparison to other emerging countries (as Chile, where credit reaches currently 71% of GDP), especially in segments as the credit for real estate, which represents only 3% of GDP. In addition, non-performing loans remain limited in spite of the recent credit expansion (3.2% in December of 2010 in comparison to 5.1% on average in 2003).

The need for more restrictive economic policies is clearly evidenced by the still very strong dynamism of domestic demand, by the deterioration of inflation expectations (see Section 3), and by the worsening of external accounts (see Section 5).

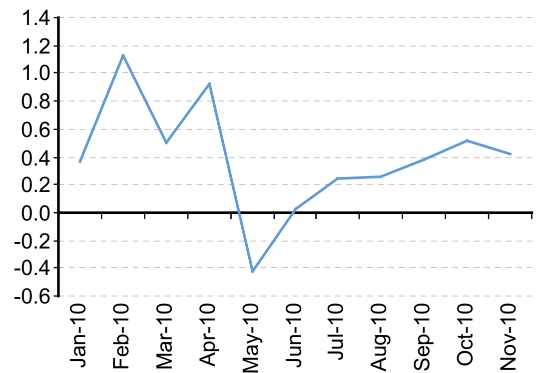
GDP moderated to 0.52%q/q in the third quarter (from 1.76%q/q in the second), but this slowdown was essentially driven by the growth of imports and not by a weakening of the domestic private demand (see Chart 7). On top of that, high frequency indicators, such as the Economic Activity Index of the Central Bank, show that the economy could have accelerated marginally in the fourth quarter.

Chart 7
GDP and demand components: quarterly growth (SA; q/q%)



Source: IBGE; BBVA Research

Chart 8
Monthly Activity Index - IBC-Br (SA; m/m%)

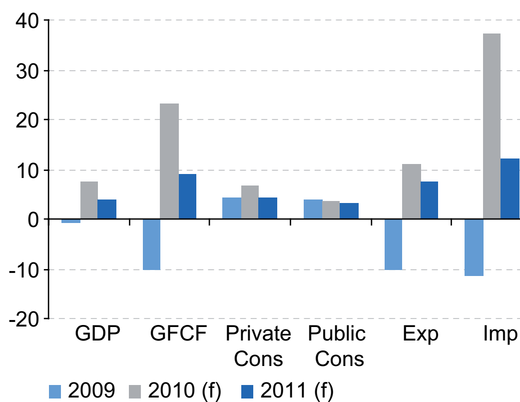


Source: Central Bank

Our estimates point to a GDP growth around 0.8% q/q in the fourth quarter and an overall growth of 7.6% in 2010. The carry-over effect for the next year will be around 1.5%, i.e. if quarterly growth is equal to zero in each one of the four quarters, GDP would grow 1.5% in 2011. But GDP is expected to grow 1%q/q on average in 2011 (in comparison to 1.3% in 2010) and in this case overall growth would be around 4.1% this year (see Chart 9).

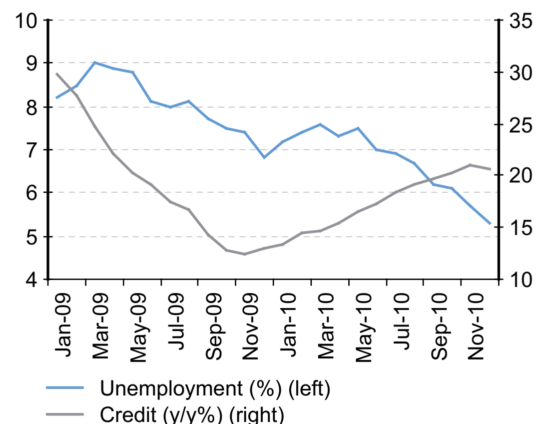
This moderation will be induced by the more restrictive tone of economic policies, which in turn should reduce the dynamism of credit and labor markets, the two main supporters of domestic demand (see Chart 10). Private consumption and investments, however, will continue growing at a fast pace (4.4%y/y and 8.9%y/y respectively) and driving Brazilian economic growth. Import growth will also moderate, but will continue higher than export expansion as domestic demand will remain relatively strong and the exchange rate appreciated (12.1%y/y vs. 7.3%y/y in 2011 in comparison to 37.3%y/y and 11.1%y/y in 2010).

Chart 9
GDP and demand components (y/y%)



Source: IBGE; BBVA Research

Chart 10
Unemployment Rate and Credit Expansion

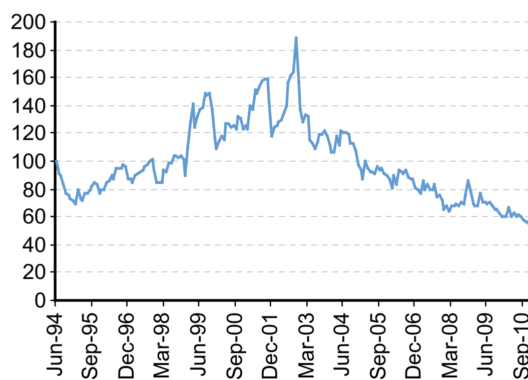


Source:Central Bank

The gap between domestic and external growth – together with high commodity prices - will continue putting pressure on the exchange rate. In any case, the Central Bank should keep the focus primarily on inflation and, at most, secondarily on the exchange rate. In other words, the monetary authority is not expected to be more tolerant with inflation to take some pressures off the exchange rate, but it could, at the margin, rely on macro-prudential measures instead of additional SELIC hikes.

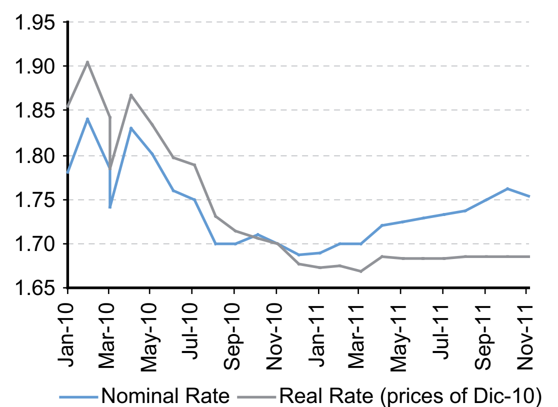
The main instruments to ease the pressure on the real rate are those that have already been used in the last few months: the purchases of dollars (certainly by the Central Bank and possibly also by the Treasury through the Sovereign Wealth Fund), new increases of the IOF tax on capital inflows, and limitations on banks' positions in exchange rate future markets. These measures should help to create a floor for the real and keep the Brazilian currency fluctuating around the 1.70 mark – as has been the case since economic authorities started intervening more heavily in the exchange rate in October of 2010. More precisely, the real is forecasted to average 1.72 in 2011 in comparison to 1.76 in 2010. As recent data suggests, the bias in our forecasts is towards a more appreciated real, especially if commodity prices continue to surprise to the upside.

Chart 11
Real Effective Exchange Rate, corrected by productivity (Index Jul 94 = 100)



Source: BBVA Research

Chart 12
Exchange Rate - R$ per USD



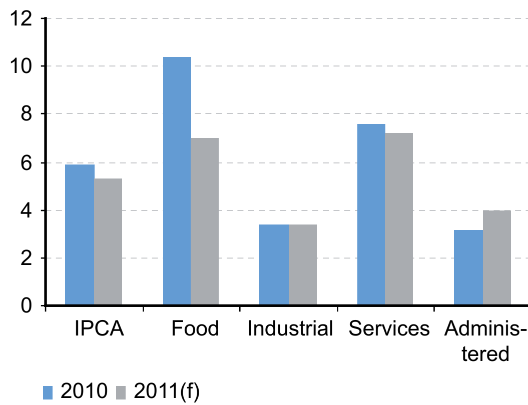
Source: Central Bank; BBVA Research

3. Mounting inflationary pressures

Since the end of 2010, there are increasing concerns regarding inflation in Brazil. Inflation spiked significantly to 5.9%y/y in December from 4.5%y/y in August. Preliminary inflation readings are also surprising on the upside in the beginning of this year.

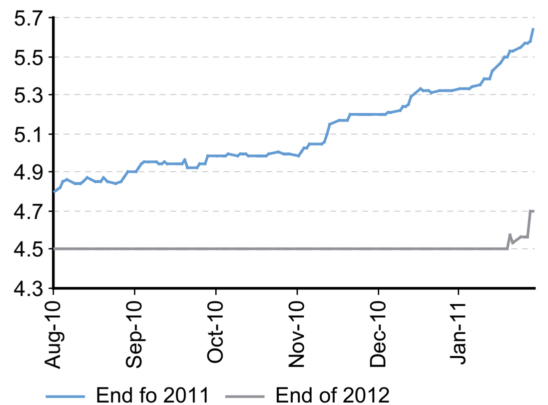
Inflation expectations are also trending up quickly as illustrated by Chart 13 below. For the end of 2011, projections have increased from 4.8%y/y in August to 5.7%y/y in January. For the end of 2012, the market's forecasts started to move up recently and are currently at 4.7%. These figures are broadly in line with our forecasts: 5.3%y/y and 4.6%y/y for the end of 2011 and 2012 respectively.

Chart 13
IPCA by components (%), 2010-11



Source: IBGE; BBVA Research

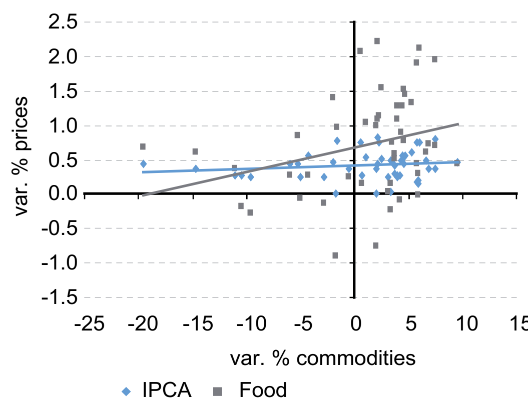
Chart 14
Inflation Forecasts, IPCA (%), Market Expectations



Source: Central Bank

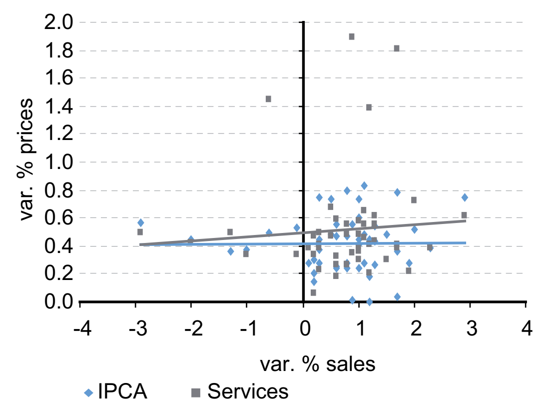
Charts 15 to 18 below show how inflation (and its components) reacted to a different number of factors in the 2007-10 period and help us see how domestic prices will react to a series of factors this year. As expected, inflation was positively correlated to commodity prices, to depreciation of the exchange rate, and to domestic demand (retail sales). Unsurprisingly, the correlation with commodity prices is particularly strong for Food/Beverages prices. In addition, the positive correlation with the exchange rate and domestic demand is especially significant for Industrial and Services prices, respectively. On the other hand, the correlation between inflation and the unemployment rate was clearly negative, suggesting how a tight labor market (lower unemployment) could drive up inflation (especially Industrial inflation).

Chart 15
Commodities vs IPCA and Food Prices (%m/m; 2007-10)



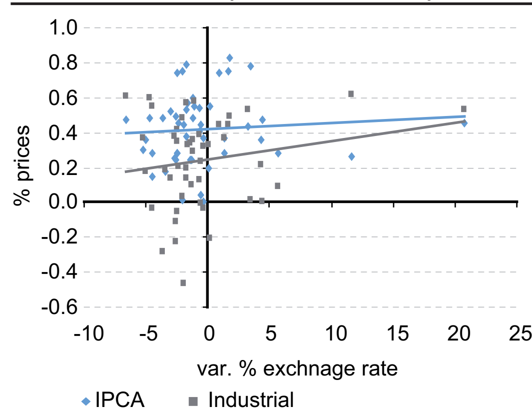
Source: IBGE; BBVA Research

Chart 16
Domestic Demand (Retail Sales) vs. IPCA and Services Prices (%m/m, 2007-10)



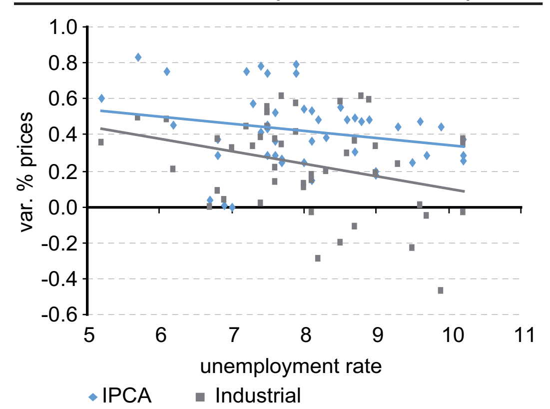
Source: IBGE; BBVA Research

Chart 17
Exchange Rate vs IPCA and Industrial Prices (%m/m; 2007-10)



Source:IBGE; BBVA Research

Chart 18
Labor Costs (Unemployment Rate) vs IPCA and Industrial Prices (%m/m; 2007-10)



Source:IBGE; BBVA Research

We expect Services and Food/Beverages inflation to continue putting pressure on domestic prices this year, driven by a still robust internal demand, by high commodity prices, and by an inertia process driven by price indexation (which is still significant in Brazil, especially in the case of Services inflation). The moderation of the economy should help these components contribute to total inflation less negatively than in 2010, especially if commodity prices do not move up significantly (otherwise, IPCA forecasts for 2011 will have to be adjusted up). Industrial prices should remain lower than 4% this year in spite of a tight labor market. In addition to the moderation of activity, Industrial inflation is expected to be constrained by a strong real and by the strong dynamism of imports. Although inertia will help Administered prices to grow this year more than in 2010, its contribution to total inflation should remain limited.

4. Fiscal accounts: limited progress in 2010; uncertainties regarding 2011

The public sector's primary surplus reached 2.8% of GDP in 2010 and, therefore, did not meet the 3.1% goal for the year. The nominal result, which includes the payment of interests, was equal to -2.6% of GDP.

These figures compare relatively well with 2009 fiscal accounts (+2.0% primary surplus; -3.3% nominal result), but poorly with pre-crisis results (in 2008, +3.3% primary surplus; and -2.0% nominal result).

The limited recovery of fiscal results in 2010 was especially disappointing given the very good performance of revenues, which were supported by the strong dynamism of the domestic demand, which helped to drive central government's tax revenues up by 16% y/y, and by the large amount of extraordinary resources generated last year. The capitalization of Petrobras by itself generated 0.9% of GDP (in net terms), without which, fiscal results would have been worse than 2009's results.

Given 2010's exceptionally high revenues, it was the strong expansion of expenditures that prevented the public sector from meeting the 3.1% primary surplus goal for the year. The central government's primary expenditures grew 22%y/y (15%y/y if we exclude those related to Petrobras' IPO). Regional governments' results were driven down by electoral expenditures and also help to explain the limited recovery of fiscal accounts in 2010. More precisely, regional governments' primary surplus was equal to 0.6% of GDP in 2010 (0.7% in 2009 and 1.0% in 2008) and regional governments' nominal result equal to -1.3% (0.1% in 2009 and -1.2% in 2008).

The net debt of the public sector dropped to 40.4% of GDP in 2010 from 42.8% in 2009 (38.5% in 2008) driven, at a large extent, by the robust GDP expansion.

Table 1
Fiscal Accounts 2010 and 2011

	2010		2011(f)	
	R$ millions	% GDP *	R$ millions	% GDP *
Federal Government				
1) Total Revenue	917,265	25.1	944,116	23.4
1.1) National Treasury - Taxes and Contributions	644,731	17.6	723,095	18.0
1.2) Petrobras Extraordinary Revenues	74,800	2.0	0	0.0
1.3) Treasury's Restitutions and Incentives	-14,234	-0.4	-17,603	-0.4
1.4) Social System's Revenues	211,968	5.8	238,625	5.9
2) Tranfers to Regional Governments	140,678	3.8	152,563	3.8
3) Net Revenues (1-2)	776,587	21.2	791,553	19.7
4) Total Expenditures	839,304	22.9	877,931	21.8
4.1) Primary Expenditures	697,101	19.1	777,600	19.3
4.1.1) Treasury's Expenditures	398,100	10.9	499,535	12.4
4.1.2) Petrobras Extraordinary Expenditures	42,900	1.2	0	0.0
4.1.3) Social System's Expenditures	254,859	7.0	276,500	6.9
4.1.3) Tranfers to Central Bank	1,242	0.0	1,565	0.0
4.2) Expected Budget Cuts to Meet Goal	**-**	**-**	**-65,611**	**-1.6**
4.3) Interest Payments	142,203	3.9	165,942	4.1
5) Primary Result [(3) - (4.1) - (4.2)]	79,486	2.2	79,564	2.0
6) Nominal Result [(3) - (4)]	-62,717	-1.7	-86,378	-2.1
Central Bank				
7) Primary Result	-520	0.0	-782	0.0
8) Nominal Result	17,175	0.5	18,777	0.5
Regional Governments and State Owned Firms				
9) Primary Result	22,973	0.6	39,119	1.0
10) Nominal Result	-47,888	-1.3	-33,251	-0.8
Public Sector				
11) Primary Result [(5) + (7) + (9)]	101,939	2.8	117,900	2.9
12) Nominal Result [(6) + (8) + (10)]	-93,430	-2.6	-100,852	-2.5
11) Primary Result without Budget Cuts [(11) + (4.2)]	101,939	2.8	52,289	1.3
14) Nominal Result without Budget Cuts [(12) + (4.2)]	-93,430	-2.6	-166,463	-4.1

* In this table, 2010 GDP is taken from government's estimatives and not from BBVA's. To calculate 2011 GDP we take 2010 GDP as base and apply our inflation and GDP growth forecasts.
Source: BBVA Research; Treasury of Brazil

For 2011, we expect tax revenues to grow 12.2%y/y and total net revenues of the federal government to expand 12.8%y/y (excluding Petrobras' revenues from 2010 accounts). According to the Proposed Budget for 2011, federal government's primary expenditures will reach R$777.6bn, an 18.9%y/y expansion (not including Petrobras' expenditures). Taking into account our fiscal forecasts for the remainder of the public sector (Central Bank, Regional Governments and State Owned Firms), in this scenario the primary surplus of the public sector would reach only 1.3% of GDP.

However, the government is soon expected to announce budget adjustments and total expenditures cuts. According to our calculations, these should amount to R$65.6bn in order to reach the primary surplus' goal (see Table 1). Given the magnitude of the required cut - and the loose fiscal spending policy of the last few years - , there are increasing concerns about the government's ability to reach this year's target.

We expect the government's budget adjustments to be close enough to R$65.6bn so that fiscal policy could complement monetary policy's countercyclical efforts. If the announced adjustments equal R$65.6bn, the federal government's primary expenditures as a share of GDP will decline to 17.7% from 19.1% in 2010 (17.9% if Petrobras-related expenditures are excluded from 2010 accounts).

The expected moderation in expenditures will be partly offset by an increase in interest payments driven by a higher average SELIC rate (12.0% in 2011 versus 10.0% in 2010). All in all, the nominal deficit of the public sector should decline slightly this year to around 2.5% of GDP.

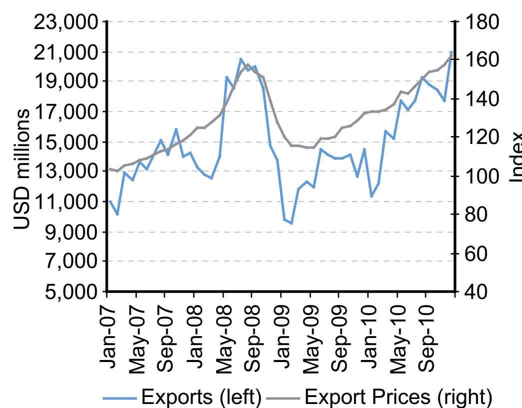
The net debt of the public sector as a share of GDP should continue trending down during coming years due to better fiscal results but especially to a solid GDP growth. We see, however, the (unofficial) goal of reaching 30% by 2014 very ambitious. By the end of 2011 it should, according to our estimations, reach 39.4% and by the end of 2014, 35.5%.

5. External accounts: current account deterioration and abundant capital inflows

The current account deficit reached 2.3% of GDP (USD47.5bn) in 2010, more than the deficit observed in 2009 (1.5%; USD24.3bn), and is expected to continue trending upwards next year. More precisely, we expect this deficit to reach 2.8% of GDP (USD65bn) in 2011 and then gradually converge to 4% in the 2012-15 period.

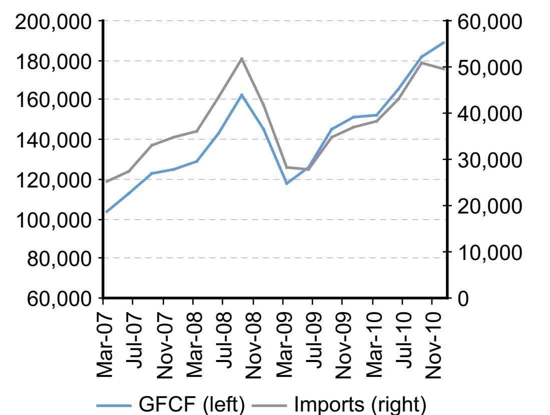
Part of the deterioration of the external accounts is due to the trade balance weakening. In 2010, the trade surplus was equal to USD20bn, 20% less than the previous year. In spite of very positive export prices, export growth in 2010 (32%y/y) was significantly lower than import growth (42%). The stronger expansion of imports is related to the dynamism of domestic demand, especially investment (gross fixed formation of capital) which is growing at record pace, and to the appreciation of the exchange rate. For 2011, we expect import expansion to continue topping export growth and the trade result to shrink to USD9.7bn.

Chart 19
Exports and Export Prices, monthly



Source: IPEADATA

Chart 20
Imports and Gross Fixed Capital Formation (USD millions)



Source: IPEADATA

The deterioration of external accounts is also seen on both income and services accounts (see Table 2 below for precise numbers). Among the main items that contributed – and will continue contributing – to the increase of the deficit in these accounts are travel expenditures (which increased 88%y/y and reached USD10.5bn in 2010) and remittances of profits and dividends (whose net balance amounts to –USD30.4bn, 20% more than in 2009).

The current global optimism towards the Brazilian economy as well as the international abundance of liquidity generated capital inflows into Brazil that more than compensate for the current account deficit in 2010. The surplus in the capital and financial account reached USD100.1bn in 2010. This surplus represented 4.9% of GDP in 2010, higher than in the two previous years (4.4% in 2009 and 1.8% in 2008) but lower than in 2007 (6.5%). FDI inflows outperformed expectations and reached USD 48.5 billion or 2.4% of GDP (by themselves enough to finance the current account deficit), but the main bulk of capital inflows was in the form of portfolio investments, which amounted to USD 64.5 billion (3.2% of GDP). Portfolio investments in equities accounted for 68% of total portfolio investments while investments in fixed income, which were affected by the measures to control capital inflows announced last year, accounted for 32%.

Table 2
Balance of Payments 2009-2011

Balance of Payments (USD millions)	2009	2010	2011(f)
1) Current Account	**-24,320**	**-47,518**	**-65,178**
1.1) Trade Balance	25,347	20,266	9,510
1.1.1) Exports	152,995	201,915	214,771
1.1.2) Imports	127,647	181,649	205,261
1.2) Income and Services Balance	-52,930	-70,630	-80,344
1.2.1) Services	-19,245	-30,573	-34,069
1.2.2) Income	-33,684	-40,057	-46,276
1.3) International Transfers	3,263	2,845	5,656
2) Capital and Financial Account	**70,551**	**100,102**	**92,812**
2.1) Capital Account	1,129	1,119	2,812
2.2) Financial Account	69,423	98,984	90,000
2.2.1) Foreign Direct Investment	36,033	36,962	25,000
2.2.1.1) Abroad	10,084	-11,500	-15,000
2.2.1.2) In Brazil	25,949	48,462	40,000
2.2.2) Portfolio Investment	49,133	64,458	65,000
2.2.3) Derivatives	156	-112	0
2.2.4) Other	-15,900	-2,324	0
3) Errors and Discrepancies	**434**	**-3,484**	**0**
4) Current,Capital and Fin. Accounts (1+2+3)	**46,666**	**49,100**	**27,634**
5) Reserves Variation (- = increase)	**-46,666**	**-49,100**	**-27,634**

Source: BBVA Research; Central Bank

We do not expect Brazil to face problems funding the current account deficits in the coming years. In addition to expected large inflows of capital, the country counts on increasing international reserves, which now amount to USD288.5bn and are expected to continue increasing in the coming years following dollar purchase policies implemented by the Central Bank. However, it is important to note that the widening of the current account deficit increases the potential negative impacts that a deterioration of terms of trade or a crisis of confidence in Brazil could have on the country.

6. Balance of risks

The outlook for the Brazilian economy is positive. The dynamism of domestic demand should continue to sustain a significant expansion in GDP and to reduce both poverty and inequality. Fiscal and external accounts are not expected to generate a solvency problem. This scenario should, in fact, trigger another round of upward revisions of the country's ratings by rating agencies throughout this year. There are, however, some factors that should be watched as they have the power to change the expected dynamics of the Brazilian economy.

Currently the main uncertainty in the domestic scenario is what role fiscal policy will play this year and during the rest of the government of Dilma Rousseff. If fiscal policy does not become countercyclical, then the cost of the adjustment will be carried mainly by monetary policy (but also by macro-prudential measures). This mix of macroeconomic policies is clearly inefficient as it adds unnecessary pressure on the exchange rate, prevents domestic interest rates from closing the gap with international rates, and has clear negatives effects on fiscal accounts (both due to higher expenditures and also to larger interest payments) and on external accounts. Although Brazil's fiscal situation is relatively solid, this could create doubts about its longer-term evolution and reinforce inflationary concerns. Regarding external accounts, this inefficient mix of policies could trigger a faster than forecasted deterioration of the current account, which in turn could feed uncertainties about its funding.

The political scenario should also be monitored, especially the ability of President Dilma and of her party (PT) to control and accommodate the political ambitions of the other main party in the government coalition, the PMDB. A shaky relationship between PT and PMDB could generate some political turmoil with negative impacts on the economy.

Another source of risks is the negative impact of an (unlikely) sharp reversion of commodities' prices. Although the country has developed mechanisms to counterbalance the impact of a drop in commodity prices, this situation would put more pressures on external accounts. According to some simulations, if commodity prices revert back to long-term structural levels, the current account deficit would reach 3.0% already this year and would then converge to 5% - and not 4% - in the 2012-15 period.

7. Tables

Table 3

Macroeconomic Forecasts Quarterly

	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11
GDP (% y/y)	-3.0	-2.8	-1.8	5.0	9.3	9.2	6.8	5.4	4.5	3.8	3.9	4.2
Inflation (% y/y)	5.8	5.2	4.4	4.2	4.9	5.1	4.6	5.6	5.7	5.6	6.3	5.6
Exchange Rate (vs. USD)	2.32	2.08	1.87	1.74	1.80	1.79	1.74	1.70	1.69	1.71	1.73	1.75
Interest Rate (%)	12.62	10.33	8.86	8.75	8.75	9.75	10.75	10.75	11.42	12.25	12.25	12.25

Source: BBVA Research

Table 4

Macroeconomic Forecasts Annual

	2009	2010	2011
GDP (% y/y)	-0.6	7.6	4.1
Inflation (% y/y, average)	4.9	5.0	5.8
Exchange Rate (vs. USD, average)	2.00	1.76	1.72
Interest Rate (%, average)	10.10	10.00	12.00
Private Consumption (% y/y)	4.2	6.5	5.5
Government Consumption (% y/y)	3.9	3.6	3.1
Investment (% y/y)	-10.3	23.2	8.9
Fiscal Balance (% GDP)	-3.4	-2.6	-2.6
Current Account (% GDP)	-1.5	-2.3	-2.9

Source: BBVA Research

DISCLAIMER

This document and the information, opinions, estimates and recommendations expressed herein, have been prepared by Banco Bilbao Vizcaya Argentaria, S.A. (hereinafter called “BBVA”) to provide its customers with general information regarding the date of issue of the report and are subject to changes without prior notice. BBVA is not liable for giving notice of such changes or for updating the contents hereof.

This document and its contents do not constitute an offer, invitation or solicitation to purchase or subscribe to any securities or other instruments, or to undertake or divest investments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

Investors who have access to this document should be aware that the securities, instruments or investments to which it refers may not be appropriate for them due to their specific investment goals, financial positions or risk profiles, as these have not been taken into account to prepare this report. Therefore, investors should make their own investment decisions considering the said circumstances and obtaining such specialized advice as may be necessary. The contents of this document is based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. BBVA accepts no liability of any type for any direct or indirect losses arising from the use of the document or its contents. Investors should note that the past performance of securities or instruments or the historical results of investments do not guarantee future performance.

The market prices of securities or instruments or the results of investments could fluctuate against the interests of investors. Investors should be aware that they could even face a loss of their investment. Transactions in futures, options and securities or high-yield securities can involve high risks and are not appropriate for every investor. Indeed, in the case of some investments, the potential losses may exceed the amount of initial investment and, in such circumstances, investors may be required to pay more money to support those losses. Thus, before undertaking any transaction with these instruments, investors should be aware of their operation, as well as the rights, liabilities and risks implied by the same and the underlying stocks. Investors should also be aware that secondary markets for the said instruments may be limited or even not exist.

BBVA or any of its affiliates, as well as their respective executives and employees, may have a position in any of the securities or instruments referred to, directly or indirectly, in this document, or in any other related thereto; they may trade for their own account or for third-party account in those securities, provide consulting or other services to the issuer of the aforementioned securities or instruments or to companies related thereto or to their shareholders, executives or employees, or may have interests or perform transactions in those securities or instruments or related investments before or after the publication of this report, to the extent permitted by the applicable law.

BBVA or any of its affiliates´ salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, BBVA or any of its affiliates’ proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. No part of this document may be (i) copied, photocopied or duplicated by any other form or means (ii) redistributed or (iii) quoted, without the prior written consent of BBVA. No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

This document is provided in the United Kingdom solely to those persons to whom it may be addressed according to the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 and it is not to be directly or indirectly delivered to or distributed among any other type of persons or entities. In particular, this document is only aimed at and can be delivered to the following persons or entities (i) those outside the United Kingdom (ii) those with expertise regarding investments as mentioned under Section 19(5) of Order 2001, (iii) high net worth entities and any other person or entity under Section 49(1) of Order 2001 to whom the contents hereof can be legally revealed.

The remuneration system concerning the analyst/s author/s of this report is based on multiple criteria, including the revenues obtained by BBVA and, indirectly, the results of BBVA Group in the fiscal year, which, in turn, include the results generated by the investment banking business; nevertheless, they do not receive any remuneration based on revenues from any specific transaction in investment banking.

BBVA and the rest of entities in the BBVA Group which are not members of the New York Stock Exchange or the National Association of Securities Dealers, Inc., are not subject to the rules of disclosure affecting such members.

“BBVA is subject to the BBVA Group Code of Conduct for Security Market Operations which, among other regulations, includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. The BBVA Group Code of Conduct for Security Market Operations is available for reference at the following web site: www.bbva.com / Corporate Governance”.

This report has been produced by the Emerging Markets Unit:

Enestor Dos Santos
enestor.dossantos@grupobbva.com

BBVA Research

Group Chief Economist
Jorge Sicilia

Chief Economists & Chief Strategists:

Regulatory Affairs, Financial and Economic Scenarios:

Financial Scenarios
Sonsoles Castillo
s.castillo@grupobbva.com

Financial Systems
Ana Rubio
arubiog@grupobbva.com

Economic Scenarios
Juan Ruiz
juan.ruiz@grupobbva.com

Regulatory Affairs
María Abascal
maria.abascal@grupobbva.com

Spain and Europe:
Rafael Doménech
r.domenech@grupobbva.com

Spain
Miguel Cardoso
miguel.cardoso@grupobbva.com

Europe
Miguel Jiménez
mjimenezg@grupobbva.com

Emerging Markets:
Alicia García-Herrero
alicia.garcia-herrero@bbva.com.hk

Cross-Country *Emerging Markets* Analysis
Daniel Navia
daniel.navia@grupobbva.com

Pensions
David Tuesta
david.tuesta@grupobbva.com

Asia
Stephen Schwartz
stephen.schwartz@bbva.com.hk

South America
Joaquín Vial
jvial@bbvaprovida.cl

Argentina
Gloria Sorensen
gsorensen@bancofrances.com.ar

Chile
Alejandro Puente
apuente@grupobbva.cl

Colombia
Juana Téllez
juana.tellez@bbva.com.co

Peru
Hugo Perea
hperea@grupobbva.com.pe

Venezuela
Oswaldo López
oswaldo_lopez@provincial.com

Market & Client Strategy:
Antonio Pulido
ant.pulido@grupobbva.com

Equity and Credit
Ana Munera
ana.munera@grupobbva.com

Interest Rates, Currencies and Commodities
Luis Enrique Rodríguez
luisen.rodriguez@grupobbva.com

Asset Management
Henrik Lumholdt
henrik.lumholdt@grupobbva.com

United States and Mexico:

United States
Nathaniel Karp
nathaniel.karp@bbvacompass.com

Mexico
Adolfo Albo
a.albo@bbva.bancomer.com

Macro Analysis Mexico
Julián Cubero
juan.cubero@bbva.bancomer.com

Contact details

BBVA Research Latam
Pedro de Valdivia 100
Providencia
97120 Santiago de Chile
Teléfono: + 56 26791000
E-mail: bbvaresearch@grupobbva.com

This report is also available in Spanish and Chinese