

Brazil—Real Revival

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Brazil is a headline performer in the quick recovery of some emerging markets from the global economic crisis. Stronger fundamentals already led to a healthy economic performance before the crisis, with growth averaging 4.7% in the last five years and more than 6% through most of 2008. Plunging investment and exports caused a thumping GDP fall in 08Q4 and a further decline in 09Q1. However, with government stimulus and aggressive monetary easing, the two-quarter technical recession ended in 09Q2 when GDP popped up strongly, led by private consumption (*Chart 1*). Recent indicators suggest that Q3 GDP may be as strong as in Q2. Industrial production has risen consistently since January while capacity utilization is now near the average of the last five years (*Chart 2*). Unemployment fell from 9.0% in March to 7.5% in October, helping to sustain healthy retail sales volume growth of above 5% y/y in the last six months.

Inflation continues to ease, falling below the central bank's 4.5% target to 4.2% y/y in October (*Chart 3*). The comparatively modest decline in recent months reflects the resilience of the economy and the country's still-sizeable degree of indexation. However, indexation, along with a strong currency and tighter economic policies, will help keep inflation near its target next year.

The global economic crisis and Brazil's recession slashed exports and imports this year, widening the trade surplus and cutting the current account deficit by about a third. However, imports are now responding to revving domestic demand, rising almost 20% in October on a 3mo/3mo basis while exports rose 3%. Exports will likely continue to lag imports, doubling the current account deficit to 2.4% of GDP in 2010. The deficit is moderate and well financed as FDI inflows so far this year easily exceeded the current account deficit (*Chart 4*). With portfolio inflows also now climbing rapidly, Brazil's large foreign reserves are again on the rise, reaching \$238 bln in November. The strong capital inflows fuelled a sharp rise in the currency, prompting the government to impose a 2% tax on capital inflows in October. The real has stabilized, but the action is likely to have only a short-term impact and raises policy uncertainty for the future. The real may be near its peak as a rising

CHART 1
STEEP, BUT BRIEF, RECESSION

Brazil (% chng)

GDP Growth

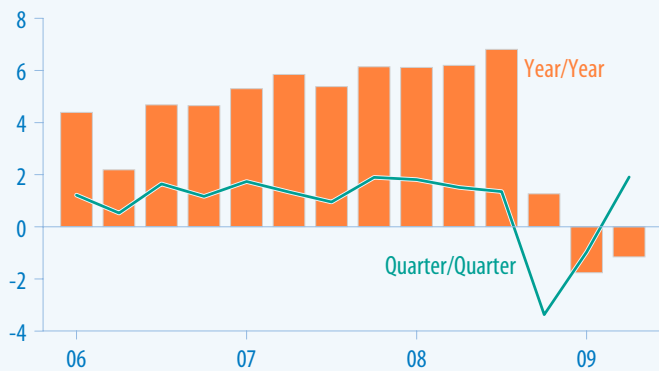


CHART 2
RECOVERY FIRMLY IN PLACE

Brazil

Industrial Production
(2002 = 100)

Capacity Utilization
(percent)

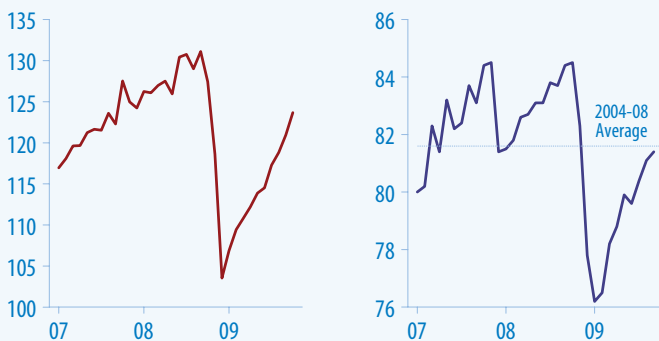


CHART 3
INFLATION REMAINS CONTAINED

Brazil (y/y % chng)

IPCA Inflation

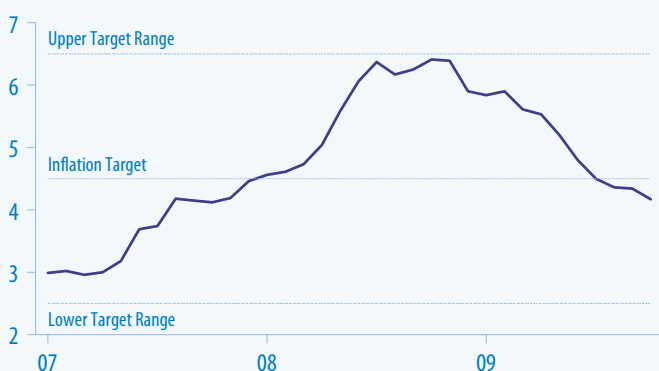


CHART 4
CURRENT ACCOUNT WELL FINANCED

Brazil (US\$ blns : 12-mnth ms)

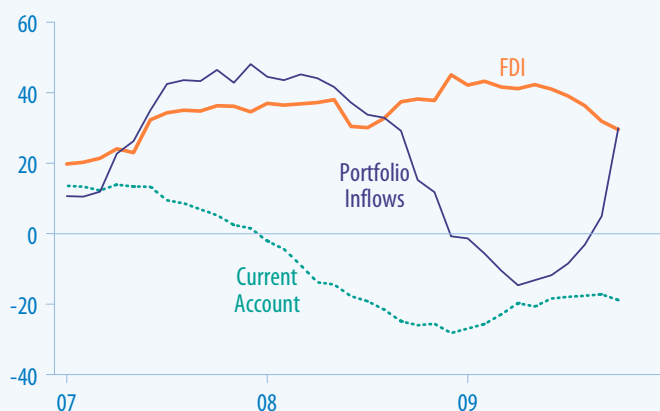


CHART 5
FISCAL SLIPPAGE BECOMING A CONCERN

Brazil (% of GDP)

Public Sector Primary Surplus

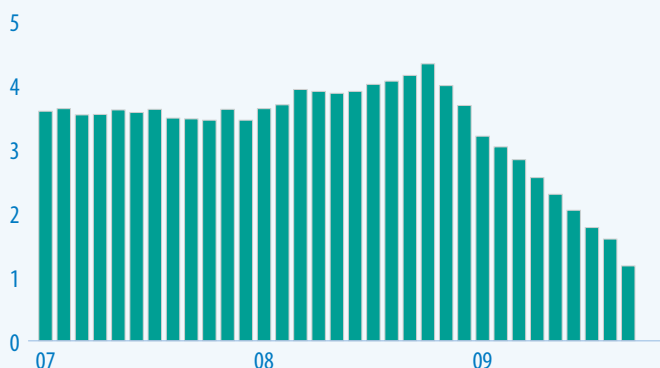


TABLE 1
BRAZIL ECONOMIC INDICATORS

	2007	2008	2009f	2010f
GDP Growth (%)	5.7	5.1	0.2	5.3
IPCA Inflation (% avg)	3.6	5.7	5.0	4.5
IPCA Inflation (% eop)	4.5	5.9	4.3	4.6
Public Sector Balance (% GDP)	-2.8	-2.0	-3.4	-2.6
Public Sector Primary Balance (% GDP)	3.5	3.7	1.1	2.4
Trade Balance (US\$ billions)	40.0	24.8	24.9	9.8
Current Account (US\$ billions)	1.6	-28.2	-18.3	-48.4
% of GDP	0.1	-1.8	-1.2	-2.5
FX Reserves (US\$ billions)	179.4	192.8	240.0	265.0

f = forecast

current account deficit and election-related volatility offset a weakening drift of the US\$.

Fiscal slippage is becoming an area of concern. In recent years Brazil has set and met sizeable public sector primary (non-interest) surplus targets. These surpluses averaged over 3.5% of GDP in the last five years. The target was reduced to 2.5% this year due to the recession and stimulus measures, but even that is proving a challenge as falling tax revenues and buoyant spending lowered the primary surplus to 1.0% of GDP in the 12 months to October (*Chart 5*). The budget allows the target to be reduced to 1.6% by removing some capital spending, but even this is out of reach. Fiscal revenues should improve with the economy next year, but the primary surplus target also moves back to 3.3% and, with tax incentives being recently renewed, there is little to indicate that there will be concerted fiscal tightening as the October 2010 elections loom. The fiscal slippage is not large compared to many other countries, but a large government debt means it needs correction. An expansionary fiscal policy also forces monetary policy to carry an undue share of policy adjustment. Interest rates were aggressively eased this year, with the benchmark Selic rate cut 500 bps to a record low 8.75%. The central bank is in no rush to raise rates given the benign inflation outlook. However, the Selic rate should begin rising early in 2010 and is expected to increase 200 bps to 10.75% by year-end.

With the economy already on a strongly improving trend, GDP growth should rise slightly into positive territory for the year. The effects of fiscal and monetary stimulus will carry into 2010 and help raise GDP growth above 5% before easing somewhat in 2011. Prospects over the longer term will be buoyed by continued infrastructure investments, including those related to the World Cup in 2014, the Rio Olympics in 2016 and offshore oil investments which will soon make Brazil a major oil producer. However, Brazil's outlook will depend on re-establishing fiscal consolidation. The elections will delay this adjustment, but the next government will need to harness the broad consensus in favour of fiscal prudence and push ahead with other reforms to solidify Brazil's medium term prospects.

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