Deutsche Bank

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# EM Special Publication

# Brazil sails on

## Economics

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The economy grew at an annualized rate of 5.1% in 2Q10. Although GDP decelerated significantly from the unsustainable 11.3% rate posted in 1Q10, growth was faster than expected and prompted us to raise our 2010 GDP forecast to 7.6% from 7.2%. Our forecast assumes growth will further decelerate in 3Q10 due to inventory accumulation and a somewhat smaller fiscal stimulus. Even if there is no additional QoQ growth in 3Q10 and 4Q10 – which is highly unlikely given the economic fundamentals – GDP should still grow 7.0% this year due to the statistical carryover effect.

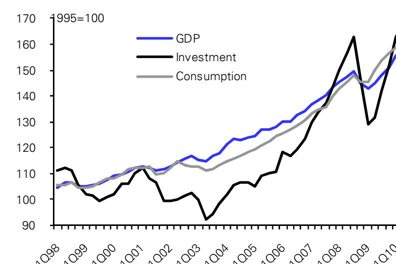
A 2.1% QoQ increase in public consumption was one of the reasons for faster-than-expected growth in 2Q10. Fiscal policy remains expansionary and we believe the government will not be able to meet its fiscal target this year without resorting to the PAC deductions. Moreover, we have not yet seen any strong indication that the government is planning to significantly tighten fiscal policy in 2011. The government reduced next year's consolidated primary surplus target slightly to 3.2% from 3.3% of GDP.

Although the economy has continued to grow above its potential, we do not expect further monetary tightening this year. Consumer price inflation of almost zero in June, July, and August due to food price deflation, and increased uncertainty about the global economic outlook, prompted the Central Bank to interrupt the tightening cycle in September. Moreover, authorities warned that a likely pick-up in inflation in coming months would not be enough for them to resume the tightening cycle, as they believe current interest rates are compatible with sustainable economic growth. Thus, the SELIC overnight rate will likely stay at 10.75% for a long time.

Despite a somewhat better-than-expected trade surplus, the current account deficit continues to increase, reflecting Brazil's need to import external savings to finance growth. However, foreign capital – especially portfolio investment – continues to pour in, attracted to the positive economic outlook and high interest rates, and will most likely be able to finance the balance of payments in 2010 and 2011. Given the resilience of foreign capital flows and the government's decision to go ahead with the capitalization of its oil company, we revised our year-end exchange rate forecast to BRL1.70/USD from BRL1.80/USD.

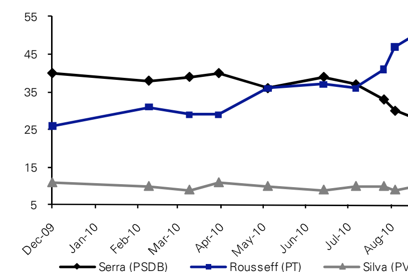
On the political front, the latest polls show that ruling coalition candidate Dilma Rousseff could win the election in the first round scheduled for October 3. We do not expect any major changes in the current economic policy framework and would not be surprised if the next president announced some measures to curb public spending in the long run. Nevertheless, we believe a landslide victory by Rousseff could increase the emphasis on interventionist policies. After all, a strong PT victory in the presidential and congressional elections would be the culmination of a strategy that relied heavily on government intervention to steer the economy during President Lula's second term, especially following the global crisis triggered by Lehman Brothers' bankruptcy.

### GDP




Source: IBGE

### Presidential poll




Source: Datafolha

Deutsche Bank Securities Inc.

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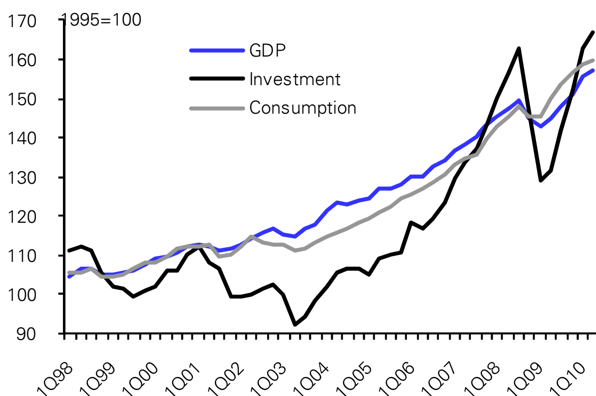
## Economic activity

***GDP grew 1.2% QoQ in 2Q10, down from 2.7% in 1Q10***

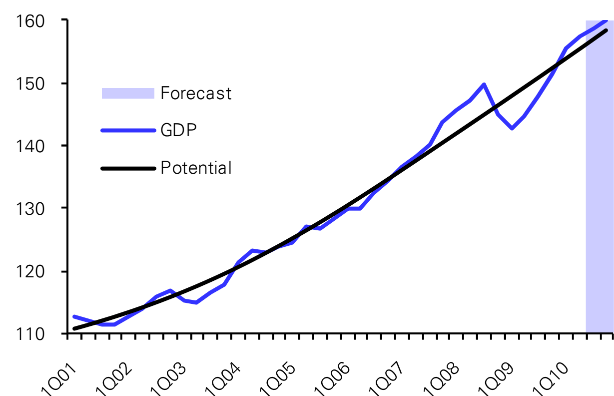
GDP grew a seasonally adjusted 1.2% QoQ in 2Q10, down from 2.7% in 1Q10. The industrial sector grew 1.9% QoQ, the agricultural GDP expanded a hefty 2.1%, and services grew 1.2% QoQ. Although investment slowed from the hefty 7.3% QoQ posted in 1Q10, it still led overall growth with an expansion of 2.4% QoQ. Public consumption came next with higher-than-expected growth of 2.1% QoQ. Private consumption slowed from 1.4% in the previous quarter, but still expanded 0.8% QoQ. In the YoY comparison, industrial GDP grew 13.8% (led by a 16.4% rise in civil construction), agriculture climbed 11.4%, and services increased 5.6% (led by a 12.8% expansion in retail). Still comparing to 2Q09, investment rose significantly by 26.5%, private consumption grew 6.7%, government consumption climbed 5.1%, exports rose 7.3%, and imports increased by an impressive 38.8%.

**Figure 1: GDP**




*Source: IBGE*

**Figure 2: GDP and potential GDP**




*Source: IBGE, Deutsche Bank forecasts*

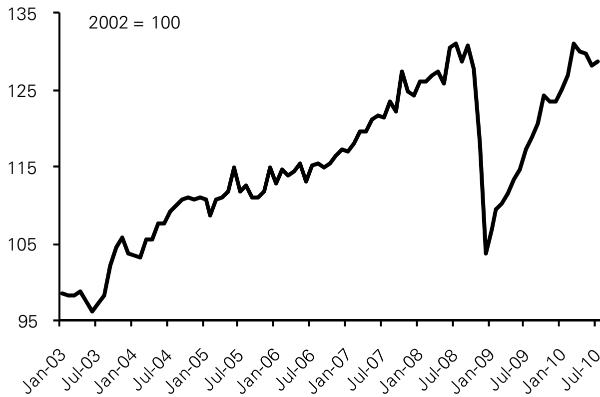
***A slowdown in 2Q10 was inevitable***

As we highlighted in our previous report, some deceleration was inevitable because the 1Q10 expansion was significantly above potential growth. Tax incentives prompted consumers to anticipate purchases in the first quarter, and their withdrawal took a toll on the demand for durable goods (especially automobiles) in 2Q10. Before the IPI tax reduction expired at the end of March, for example, car sales surged 60% MoM in that month. After such a strong increase, it was not surprising that sales fell 21.5% in April and 9.6% in May. The sharp increase in production in 1Q10, followed by a drop in consumption in 2Q10, led to an increase in inventories that helped dampen production in the following months. Moreover, the Football World Cup reduced the number of working days in June (when factories halted production during three days to watch the Brazilian football team play in South Africa), hurting production.

***Industrial production decelerated…***

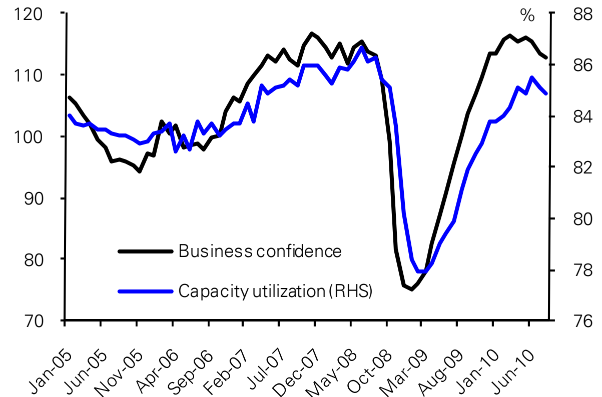
The slowdown was visible in the monthly industrial production survey, which showed 1.3% QoQ growth in 2Q10 following the 3.1% expansion in 1Q10. Industrial production fell in every month of 2Q10, and growth from the previous quarter resulted from the carryover effect. The deceleration was led by durable and non-durable consumer goods, which fell 0.8% QoQ, offsetting a 4.8% rise in capital goods and a 1.2% increase in intermediate goods. The deceleration affected capacity utilization, which receded to 84.9% in August after reaching 85.5% in June, according to an FGV survey.

**Figure 3: Industrial production**




Source: IBGE

**Figure 4: Business confidence and capacity utilization**

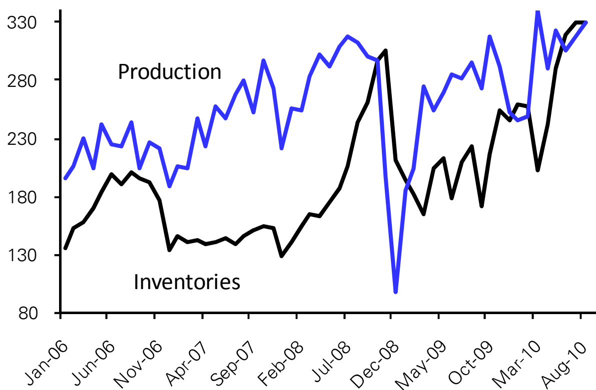



Source: FGV

***...as did retail sales***

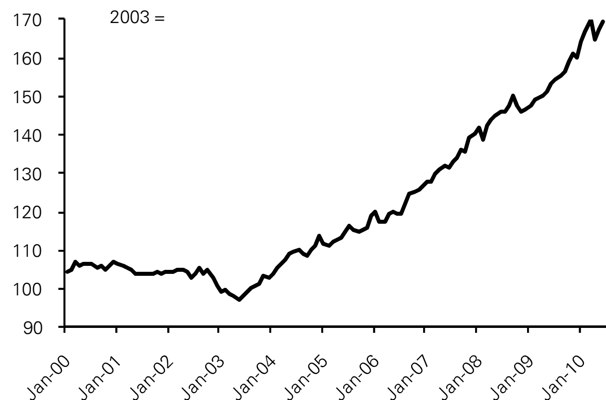
Retail sales decelerated in the second quarter as well. After growing on average 2.1% per month in 1Q10, retail sales, excluding cars and construction materials, were practically unchanged in 2Q10 when compared to the first quarter, as supermarket sales dropped 1.9% and durable goods sales dropped 0.5%. Including cars and construction materials, retail sales dropped 1.9% in 2Q10, as vehicle sales fell a significant 9.3% from the previous quarter.

**Figure 5: Car sales and inventories**




Source: ANFAVEA

**Figure 6: Retail sales**




Source: IBGE

***The slowdown was less intense than expected, and growth remained above potential***

Nevertheless, the 2Q10 slowdown was milder than expected, as we forecast slower GDP growth of 0.6% QoQ. The annualized growth rate of 5.1% remained above the estimated potential growth of 4.5%, and the output gap increased to 1.2% from 1.0% in 1Q10, according to our estimates. On the supply side, the industrial GDP grew faster than expected (+1.9% QoQ, compared to a 1.3% increase in industrial production over the same period). On the demand side, the public sector contribution was stronger than expected (2.1% QoQ, compared with 0.8% QoQ in 1Q10) and the drag from the external sector was somewhat smaller than expected (as imports rose only 4.4% QoQ and exports rose 1.0% QoQ).

***The third quarter will probably be weaker***

We believe growth will likely further decelerate in the current quarter and expect GDP to grow between 0.5% and 1.0% in 3Q10. As the Central Bank pointed out, second-quarter GDP growth was boosted by the statistical carryover caused by strong growth in the first quarter, an effect that will not be repeated in the third quarter. Moreover, we do not expect

public consumption – the only major component of aggregate demand that accelerated in 2Q10 – to maintain the strong growth posted in the last quarter, as legal restrictions imposed by the October elections will probably slow down government spending. Finally, inventory accumulation rose significantly in the second quarter and will probably help tame growth in the next quarter. Note that industrial production had a relatively slow start in 3Q10, as it rose only 0.4% MoM in July. Although production interrupted a series of three consecutive monthly declines, it grew less than our 0.7% forecast, led by a 0.2% drop in the output of capital goods.

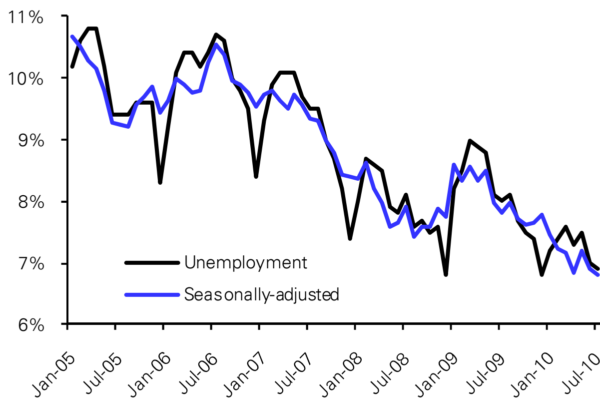
***Even assuming further deceleration, we raised our GDP growth forecasts to 7.6% in 2010 and 4.5% in 2011***

However, in light of the stronger-than-expected 2Q10 GDP growth, we raised our 2010 GDP growth forecast to 7.6% from 7.2%. Even if there is no additional QoQ growth in 3Q10 and 4Q10, GDP should still grow 7.0% this year because of the statistical carryover. We expect fixed investment to grow 21.5% (reaching approximately 19% of GDP in 2010) and private consumption to rise 6.5%. For 2011, we raised our forecast to 4.5% from 4.3%. Although the larger comparison base will make it harder for GDP to grow at the same rate as this year, we expect domestic demand to continue to benefit from low unemployment, credit expansion, and accommodative fiscal policy. Furthermore, we lowered our interest rate forecasts for next year (as we discuss below), so we expect a larger stimulus from monetary policy.

***Fundamentals continue to support domestic growth***

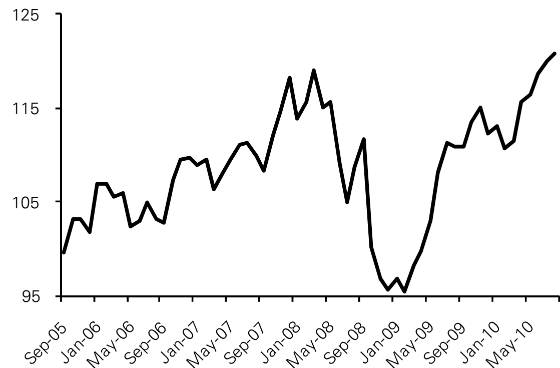
The unemployment rate fell to 6.9% in July from 8.0% a year ago. On a seasonally-adjusted basis, according to our calculations, the unemployment rate fell to 6.8% in July, returning to April's all-time low level. Reflecting strong labor demand, average real earnings climbed 5.1% YoY in July, the steepest increase since January 2009. Reflecting such extraordinary labor market conditions and the sharp drop in inflation in 2Q10, consumer confidence rose for six consecutive months and reached an all-time high in August, due to both satisfaction with current conditions and positive expectations about the future. Not surprisingly, domestic car sales recovered from the slump registered in April and May and grew 15.1% and 3.5% MoM in July and August, respectively.

**Figure 7: Unemployment**




*Source: IBGE*

**Figure 8: Consumer confidence**



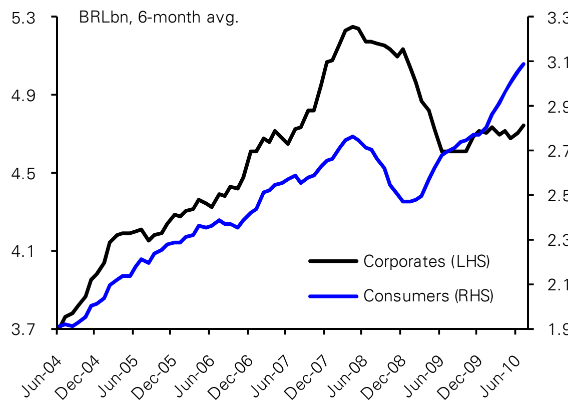

*Source: FGV*

***Credit continues to expand, led by directed loans***

Credit remains buoyant, led by directed loans. Total bank loans climbed 1.2% MoM in July, expanding 18.4% when compared to the same month last year and reaching 45.9% of GDP. Directed loans (especially those provided by the BNDES National Development Bank) continued to lead the expansion and rose 2.3% MoM (and 28.8% YoY), while free market loans climbed 0.7% MoM (and 13.8% YoY). Within the free market, consumer credit grew 1.0% MoM (led by car financing and mortgages), and corporate loans expanded only 0.4% MoM. There was some marginal deceleration, as new consumer loans fell 2.0% MoM and

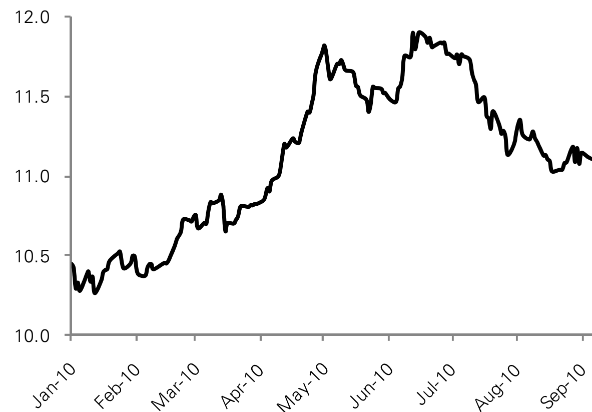
new corporate loans fell 11.5%. Moreover, average interest rates on corporate loans climbed to 28.7% from 27.3% in June, while rates on consumer loans rose slightly to 40.5% from 40.4%. However, non-performing loans remained unchanged at 3.6% in the corporate sector and 6.5% in the consumer sector, which bodes well for further credit expansion. Credit should also benefit from the drop in long-term interest rates caused by the Central Bank's indication that the monetary tightening cycle is over.

**Figure 9: Credit origination (moving average)**




*Source: BCB*

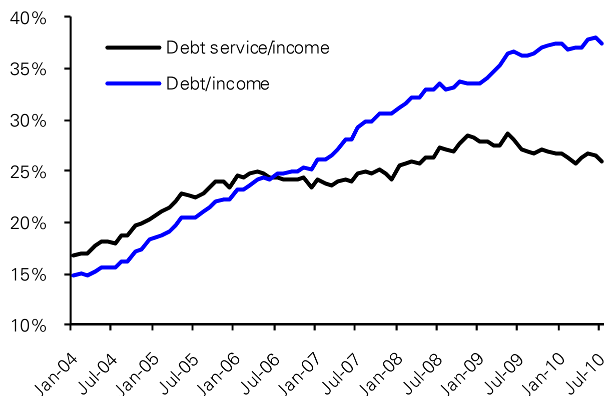
**Figure 10: One-year interest rate (Pre X CDI swap)**




*Source: Bloomberg Finance LP*

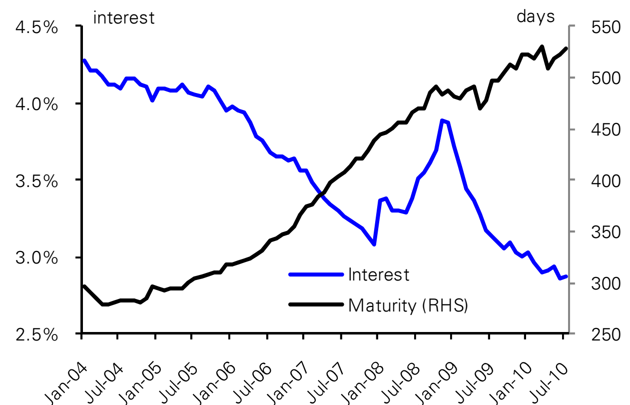
An important question is whether consumer credit has limited upside following several years of strong expansion. Although Brazilian consumers are not highly leveraged (we estimate household debt to be equivalent to approximately 37% of annual income), debt service represents a heavy burden for consumers due to high interest rates and short maturities. We estimate that, on average, consumers devote approximately 25% of their monthly income to service debt, which is likely to be among the highest in the world. However, it is important to stress that this 25% has been roughly stable over the last four years despite the rapid increase in total credit, as Figure 11 shows.

**Figure 11: Debt and debt service over income**




*Source: BCB, Deutsche Bank*

**Figure 12: Average maturity and interest rates**




*Source: BCB*

This can be explained by three main factors: higher labor income, lower interest rates, and longer loan maturities. While the drop in interest rates reflects mainly the monetary policy trend, growing maturities have been led by an increase in the share of payroll-debit loans and

mortgage loans in total credit. Payroll-debit loans are still growing more than 30% YoY, but already account for 32% of total household loans and are therefore bound to decelerate. However, mortgages (which have much longer maturities) are growing more than 40% YoY and still account for less than 2% of household loans, so they have a long way to go. Thus, although the heavy debt service burden suggests that consumer credit will probably decelerate in coming years, further credit penetration cannot be discarded in the near term.

## Inflation and monetary policy

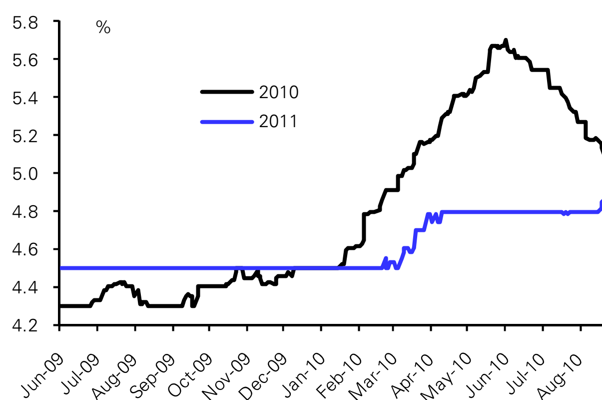
***Headline inflation slowed down significantly due to food price deflation***

After posting surprisingly high numbers in the first five months of the year, inflation decelerated significantly. The IPCA consumer price index was practically flat in June, July, and August. Consequently, the 12-month IPCA declined from 5.26% in April to 4.49% in August, dropping below the 4.5% inflation target for the first time since December 2009.

***Food prices were mainly responsible for the decline in inflation***

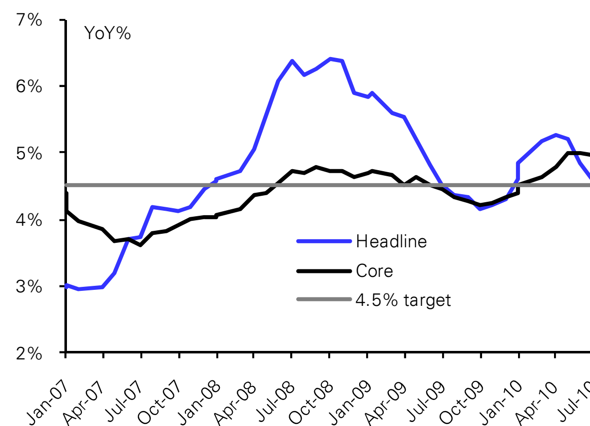
The turnaround in inflation was mainly driven by food prices, which jumped 6.4% in 4M10 (reflecting, to a large extent, excessive rains) before dropping 3.7% between May and August. However, it is important to highlight that core inflation has declined significantly as well. The trimmed core with smoothing of regulated prices, for example, rose 0.25% MoM in July, down from 0.59% in May and the lowest rate since July 2007. Although service price inflation remains at an uncomfortable level (0.41% MoM in August), it decelerated sharply from the first quarter. Thus, while we cannot rule out the hypothesis that core inflation was contaminated by food price deflation, its drop might reflect the economic slowdown observed in 2Q10 as well.

**Figure 13: Expected IPCA (Focus survey)**




Source: BCB

**Figure 14: IPCA headline and core (trimmed tails)**




Source: IBGE

***We lowered our 2010 IPCA forecast to 4.8%***

We expect inflation to pick up in coming months due to seasonal factors and a rebound in food prices that is already showing in wholesale prices. However, since inflation in 2Q10 was lower than we expected, we revised our 2010 IPCA forecast to 4.8% (our forecast was 5.3% in July). The market consensus forecast (as measured by the Central Bank survey of market participants) has declined significantly as well. For 2011, we are keeping our forecast at 5.0% – still above the official inflation target of 4.5% – even though our projection remains vulnerable to fluctuations in commodity prices and there is a risk that a double-dip global recession could lead to lower commodity prices and lower domestic inflation.

***The Central Bank interrupted the tightening cycle***

In response to the slowdown in economic activity and inflation, as well as increased uncertainty about the global economic outlook, the Central Bank Monetary Policy Committee (COPOM) reduced the pace of tightening in July. Instead of hiking the SELIC overnight rate by 75bp as it had done in April and June, the Central Bank raised rates by 50bp to 10.75% and signaled that the tightening cycle was coming to an end. As expected, the COPOM kept interest rates unchanged in September.

***The July COPOM meeting gave rise to controversy***

The COPOM's July decision was controversial, as most market participants expected another 75bp hike. In previous statements, the Central Bank had expressed concerns about the strong pace of domestic demand, declining resource slack, and deteriorating inflation expectations, and at the same time downplayed the importance of a slower global recovery. The Central Bank had stated, several times, that a negative shock to global economic growth would have an ambiguous effect on the local economy and inflation. On the one hand, lower demand for Brazilian exports would help slow the economy and reduce inflation. On the other hand, the resulting exchange rate depreciation could boost inflation.

***The Central Bank seems to be more concerned about external risks***

The minutes of the July meeting put a lot of emphasis on high-frequency data that showed a slowdown in economic activity and inflation (even though this slowdown was led, in our opinion, mainly by transitory factors). Moreover, the Central Bank claimed that the international scenario – especially the slower-than-expected recovery in the U.S. and doubts about China's ability to keep growing at strong rates – imposed a "disinflationary bias" on domestic inflation, without mentioning the possible implications of a weaker exchange rate.

***The Central Bank has highlighted the convergence of rates to international levels***

The dovish tone of the minutes of July's COPOM meeting was reinforced by Central Bank President Henrique Meirelles, who stated publicly that interest rates are on a long-term declining trend and that interest rates will converge to international levels thanks to responsible macroeconomic policies. The Central Bank president also stated that inflation expectations were very close to the target for 2011 and were right at the target for the following years. In light of all these signals, last week's decision to keep the SELIC rate at 10.75% was not a surprise. Also expected was the dovish statement released after the meeting, which stated that the 10.75% SELIC rate was appropriate to make inflation converge to the path even though the Central Bank did not expect the low inflation rates observed in the last months to continue in the near future.

***The Central Bank believes monetary policy has become more efficient***

The minutes of the September meeting maintained the dovish tone. The document stressed that the Central Bank's conditional inflation forecasts for 2011 and 1H12 declined from the previous meeting and were "around the center target." Economic growth decelerated due to domestic and external factors and there were "signs that the economy moved to a trajectory that is more compatible with the long-term equilibrium." Moreover, authorities repeated the conclusions of an analysis published in the June Inflation Report, claiming that due to structural changes in the economy (especially higher credit penetration) and maturity of the inflation targeting policy, monetary policy has become more efficient and the neutral interest rate has declined.

***The SELIC rate will likely stay at 10.75% for a long time***

Our conclusion is that the Central Bank is more concerned about a potentially deflationary external shock than about the risks of excessive domestic demand growth and will be willing to experiment with lower levels of interest rates in the long term. Thus, we now expect the Central Bank to maintain the SELIC rate at 10.75% throughout the end of 2011, even though we expect inflation to exceed the target next year. We believe that, given the looming external risks, the Central Bank would be willing to accept a slower convergence of inflation to the target and might even consider alternative instruments (such as credit restrictions) in case growth fails to decelerate as much as expected. This view seems to be becoming more widespread, as the market consensus forecast for 2011 – as measured by the Central Bank's "Focus" survey of market participants – rose to 4.86% from 4.80% at the end of August, posting the first increase since early April.

## Fiscal policy

***Fiscal policy remains far from optimal***

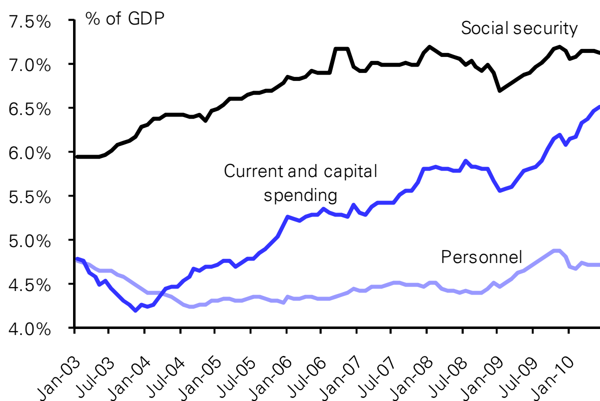
In our opinion, fiscal policy continues to be the Achilles' heel of the Brazilian economy. Although we believe debt sustainability is currently not at risk, strong public spending increases the pressure on monetary policy to stabilize inflation. We would prefer to see a different policy mix, with lower government spending and lower interest rates, so as to reduce the 'crowding out' of the private sector. Moreover, despite the authorities' intense efforts to boost public investment, the federal budget's heavy reliance on mandatory current spending reduces the government's leeway to spend on infrastructure and mitigate important bottlenecks that restrain the country's potential growth.

***The primary surplus remains significantly below the target***

Despite the positive effect of the economic recovery on tax collection, public spending continues to grow rapidly, and the government will probably not be able to meet its fiscal targets without resorting to the PAC deductions this year. In July, the federal government posted another disappointing primary surplus of BRL0.8bn, practically unchanged from BRL0.6bn in June. In the first seven months of the year, the primary surplus totaled BRL25.6bn (1.3% of the period's GDP), compared with BRL20.0bn (1.1% of the period's GDP) in 7M09, and was only 33% of the BRL75.8bn target set for the whole year. Revenues grew 16.4% YoY and expenditures climbed 17.8% YoY in 7M10, led by a 32.9% increase in discretionary spending, including a 67.5% surge in capital spending (which still accounted for only 6.9% of total spending despite the strong growth). As we expected, the BRL10bn budget cut announced by the government earlier this year did not do much to slow down spending.

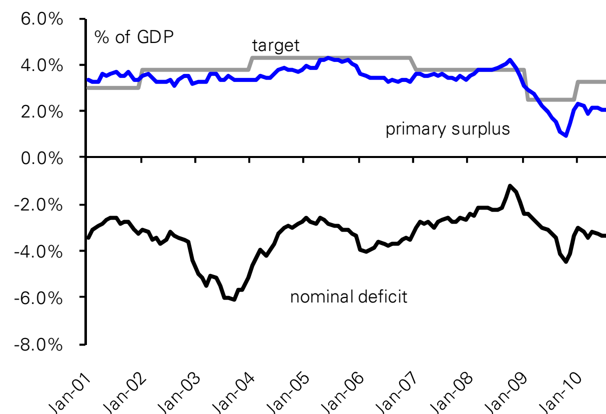
Looking at the consolidated public sector (which includes not only the federal government, but also states, municipalities, and non-financial state-owned enterprises), the primary surplus of BRL42.6bn posted in 7M10 accounted for approximately 40% of the target set for the whole year. In 12 months, the primary surplus reached 2.03% of GDP, still far away from the 3.3% target. The nominal deficit (which includes interest payments on the public debt) reached a high level of 3.3% of GDP in the 12 months to July.

**Figure 15: Federal spending (12 months)**




Source: STN

**Figure 16: PSBR (12 months)**




Source: BCB

***The fiscal targets have become quite flexible***

We forecast a consolidated primary surplus of 2.8% of GDP for 2010, which would fall short of the 3.3% target. However, the government is allowed to deduct up to 1.12% of GDP in PAC and PPI infrastructure investments from the target, effectively reducing it to 2.2% of GDP. Furthermore, the government could resort to some accounting mechanisms to meet the target. In August, for example, the Treasury sold BRL1.4bn in credits from state-owned energy company Eletrobrás to the BNDES, a transaction that it will reinforce the central

government's primary surplus. A similar transaction was implemented at the end of 2009, when the BNDES purchased BRL3.5bn in future Eletrobrás dividends from the Treasury. It is important to mention that the Treasury itself has been capitalizing the BNDES, through huge capital infusions (more than BRL180bn in 2009 and 2010) that are not included in the federal budget. In our opinion, the PAC/PPI deductions and financial transactions between the Treasury and state-owned enterprises reduce transparency and undermine the credibility of the fiscal indicators.

***The 2011 primary target will drop to 3.2% of GDP***

The 2011 federal budget draft that the government submitted to Congress in August reduced next year's primary surplus target to 3.22% of GDP. The target fell from 3.3% of GDP because the Budget Guideline Law (LDO) previously approved by Congress set a fiscal target in nominal terms (BRL125.5bn) instead of a percentage of GDP as it did in previous years. Since the government raised its nominal GDP forecasts (as it revised its real GDP growth forecast for 2010 to 6.5% from 5.5%), the target as a percentage of GDP declined. The government will also be able to deduct from the target PAC investments totaling BRL32bn (0.8% of GDP) plus the amount not deducted in 2010.

***We have not yet seen any indication of a significant fiscal tightening for 2011***

According to the budget draft, both federal revenues and expenditures will rise an estimated 13% in nominal terms next year. We believe the budget overestimates tax revenues, since it optimistically assumes GDP growth of 5.5% for 2011, in contrast with our 4.5% forecast. On the spending side, federal expenditures are currently growing at a rate of approximately 18% YoY, so slowing down to 13% will not be a trivial exercise. The government expects mandatory expenditures (including payroll expenses, welfare, and social security benefits) to climb 10.2%, giving room for discretionary spending (including investments) to rise 23.0%.

**Figure 17: Main Congress proposals that could raise fiscal spending**

| Proposal | Estimated cost |
|---|---|
| Reduction of the DRU mechanisms that reduce the earmarking of federal revenues. | BRL9bn per year |
| Extension of the minimum wage increase to INSS retirees retroactive to 2006. | BRL38bn |
| Indexation of the INSS benefits to the minimum wage. | BRL6bn per year |
| Retroactive correction of INSS benefits according to the minimum wage. | BRL80bn |
| End of social security contribution paid by workers who qualify for retirement | BRL14bn per year |
| Increase of budget earmarking for spending on health care. | BRL20bn per year |
| Pay rise for civil servants in the Judiciary system | BRL7bn per year |
| Creation of 5,365 new jobs at FUNASA | BRL2.4bn per year |
| Creation of new posts for labor judges | BRL3.5bn per year |
| Pay rise for policemen and firemen | BRL30bn per year |

*Source: MCM Consultores, Estado de S.Paulo*

***The minimum wage will probably rise by more than the 5.5% assumed in the budget***

The relatively small increase in mandatory spending is based on the crucial assumption that the minimum wage will increase only 5.5% to BRL538.15 per month in 2011. This adjustment would be much smaller than the 9.7% hike granted this year, and would be just enough to compensate for inflation. However, the minimum wage must be approved by Congress and is subject to changes. Government officials have already stated that they will discuss the new minimum wage with labor unions. Thus, we believe the minimum wage will likely rise by more than the budgeted 5.5%, reducing the leeway for the government to boost discretionary spending unless it decides against raising the effective primary surplus.[1] Furthermore, there are several initiatives in Congress that could lead to a sizeable increase in spending and are not contemplated by the budget (see Figure 17). The bottom line is that we expect the government to resort to the PAC deductions again to meet the fiscal target next year. We forecast a primary fiscal surplus of 2.8% of GDP for 2011, unchanged from 2010.

[1] According to the government, every 1% increase in the minimum wage raises social security and welfare spending by BRL1.5bn per year.

## Balance of payments

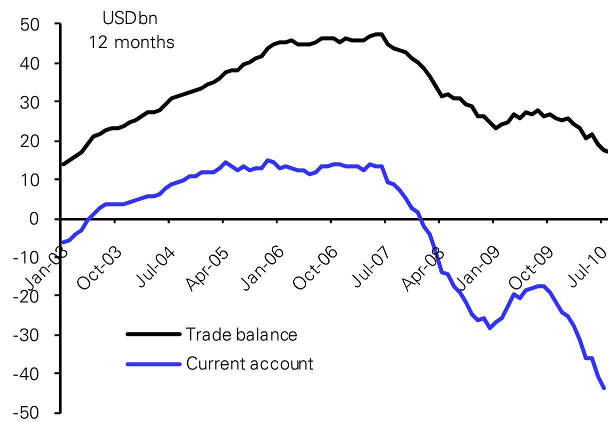
***Both the current account deficit and foreign capital flows are growing***

Despite a somewhat better-than-expected trade surplus, the current account deficit continues to grow, reflecting the strong increase in domestic absorption and the country's need to import external savings to finance growth. However, foreign capital – especially portfolio investment – continues to pour in, attracted to the positive economic outlook and high interest rates, and will most likely be able to finance the entire balance of payments in 2010 and 2011. The main risk, in our opinion, would be a double-dip global recession that could hurt demand for Brazilian exports and commodity prices, while at the same time reduce the appetite for riskier assets.

***The trade balance improved in August***

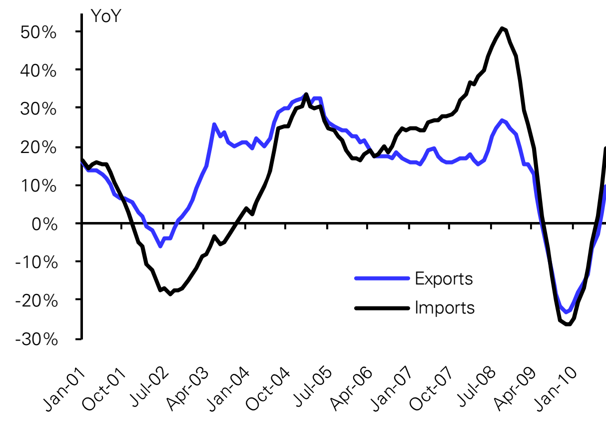
After July's disappointing USD1.3bn surplus, the trade balance posted a net inflow of USD2.4bn in August. The improvement was mainly due to oil exports, which rose 61% MoM. Excluding oil, the trade balance was practically unchanged at USD2.9bn. The trade surplus totaled USD11.7bn in 8M10, compared with USD19.9bn in 8M09, as exports grew 28.0% and imports rose 45.7% YoY. Exports of raw materials climbed 32.5% YoY, led by respective increases of 88% and 80% in oil and iron ore. Exports to Latin America (which account for 24% of total exports) climbed 39.7% YoY. On the import side, durable consumer goods grew 70.1%, fuel increased 64.2%, raw materials rose 43.7%, and capital goods climbed 36.4% YoY. Despite the external risks, we raised our 2010 trade surplus forecast again to USD17bn from USD16bn, mainly due to higher commodity prices.

**Figure 18: Trade and current account balance**




Source: BCB

**Figure 19: Export and import growth**




Source: BCB

***We forecast a current account deficit of USD52bn this year***

The current account deficit totaled USD28.3bn in 7M10, compared to USD8.8bn in 7M09. In 12 months, the deficit reached USD43.8bn (2.2% of GDP), the largest on record. Despite our larger trade surplus forecast, we raised our current account deficit forecast slightly to USD52bn from USD50bn (2.5% of GDP), which would still be roughly twice as large as the USD24.3bn deficit posted in 2009. In addition to a hefty increase in remittances of profits and dividends, we expect larger deficits in other services accounts, such as international travel, freight, insurance, and equipment rental. In July, for example, international travel posted a record-high deficit of USD1.1bn, as Brazilians took advantage of a strong BRL to travel (and spend) abroad.

***The balance of payments continues in surplus***

The balance of payments as a whole has continued to post surpluses despite the large monthly current account deficits, mainly due to strong foreign portfolio inflows. The overall surplus totaled USD18.5bn in 7M10. To finance its current account deficit in 7M10, Brazil relied heavily on foreign portfolio investment of USD22.2bn, including USD12.9bn in equity and USD9.3bn in fixed-income inflows. In addition, Brazil received heavy inflows of short-

term capital (USD20.3bn) and long-term external debt (USD33.5bn, versus USD18.7bn in long-term amortization).

**Figure 20: Balance of payments (USDbn)**

| | 2008 | 2009 | 2010F | 2011F |
|---|---|---|---|---|
| **Uses** | **-50.6** | **-54.4** | **-80.0** | **-92.0** |
| Current account | -28.2 | -24.3 | -52.0 | -62.0 |
| Trade balance | 24.8 | 25.3 | 17.0 | 15.0 |
| Services | -57.3 | -52.9 | -72.5 | -81.5 |
| Interest | -7.2 | -9.1 | -10.0 | -10.5 |
| Profits and dividends | -33.9 | -25.2 | -35.0 | -40.0 |
| International travel | -5.2 | -5.6 | -8.5 | -9.5 |
| Others | -11.0 | -13.1 | -19.0 | -21.5 |
| Transfers | 4.2 | 3.5 | 3.5 | 4.5 |
| Long-term amortization | -22.4 | -30.1 | -28.0 | -30.0 |
| **Sources** | **50.6** | **54.4** | **80.0** | **92.0** |
| Foreign direct investment | 45.1 | 25.9 | 35.0 | 40.0 |
| Portfolio investment | 6.3 | 47.1 | 45.0 | 35.0 |
| Long-term disbursements | 31.6 | 35.8 | 40.0 | 42.0 |
| Brazilian assets abroad | -23.5 | -15.8 | -24.0 | -25.0 |
| Short-term capital, others | -6.9 | 6.9 | 25.0 | 20.0 |
| **Change in reserves** | -26.5 | -32.2 | -41.0 | -20.0 |

*Source: BCB, Deutsche Bank forecasts*

***FDI has been disappointing this year***

Foreign direct investment (FDI) amounted to USD14.7bn in 7M10, but given that Brazilian investment abroad totaled USD8.0bn, the net contribution from direct investment was only USD6.7bn. Although we project USD35bn in FDI for 2010, we believe the risk is tilted to the downside. According to the Central Bank, FDI has been disappointing this year, which could be explained by the aggressive lending provided by the National Development Bank (BNDES), which has allowed multinational companies to fund themselves locally instead of tapping their headquarters abroad.

***We lowered our year-end BRL forecast to BRL1.70/USD***

We lowered our year-end exchange rate forecast to BRL1.70/USD from BRL1.80/USD. We expect a strong flow of foreign portfolio investment to continue to finance the country's growing current account deficit, and we raised our forecast for foreign portfolio investment this year to USD45bn from USD35bn. The government has confirmed that the much-awaited public share offering of a state-controlled oil company will take place this year. The deal – which could reach as much as USD75bn – could not only attract a large amount of foreign capital, but also re-open the IPO market for other local companies.

***The BRL remains vulnerable to fluctuations in commodity prices***

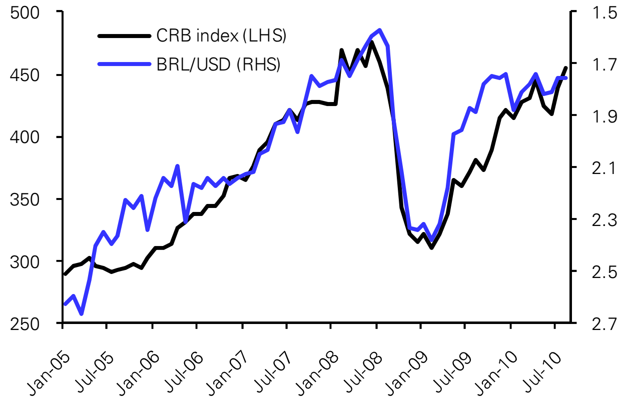
We believe the main risks to our currency forecast are related to the international scenario. The BRL remains sensitive to fluctuations in commodity prices, and any shock that could impair the global economic recovery could be negative for the Brazilian currency. Furthermore, the country's reliance on portfolio investment rather than direct investment to finance the current account deficit renders the balance of payments more vulnerable to external shocks that could impair risk aversion.

***The Central Bank could step up its intervention in the FX market***

On the domestic front, the main risk is probably related to intervention in the FX market, as the government has reiterated its preference against excessive BRL appreciation. The Central Bank has been buying dollars in excess of the net inflows, and Finance Ministry officials have claimed several times that the Sovereign Wealth Fund might eventually purchase dollars in the local market. Moreover, authorities have raised the possibility that the Central Bank could resume its intervention in the futures market through FX swaps. Thus, there is a good chance

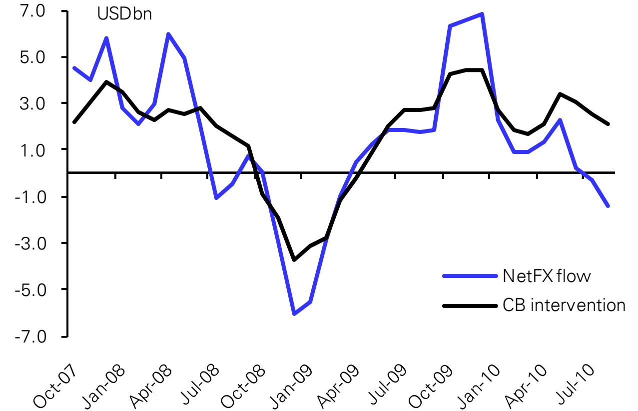
that the government could step up its intervention in the FX market to offset the large dollar inflows that are likely in connection with the stock offerings.

**Figure 21: BRL and commodity prices**




*Source: Bloomberg Finance LP*

**Figure 22: Net FX flow and Central Bank intervention**




*Source: BCB*

## Politics

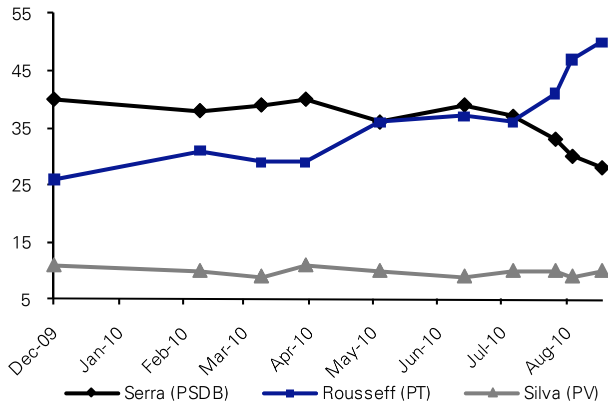
***The latest polls suggest that Rousseff could be elected in the first-round vote***

The latest polls have dealt a major blow to opposition candidate José Serra of the PSDB party. While Serra led the polls until May 2010, President Lula's participation in ruling coalition candidate Dilma Rousseff's campaign and the beginning of the official campaign on radio and TV in early July completely changed the public opinion dynamics. Previous polls had already indicated that many voters were willing to vote for President Lula's candidate, but did not yet know that Rousseff was that candidate. Through the TV campaign, the Workers' Party (PT) was able to clarify this issue, lending President Lula's enormous popularity to its candidate. Consequently, the latest polls indicate that Rousseff could have more votes than all her opponents combined, which would be enough to decide the election in the first-round vote scheduled for October 3 (the second round is scheduled for October 31). So far, the latest reports that PT affiliates have allegedly breached the law to obtain confidential tax information of people related to opposition candidate José Serra (including his daughter) from the Federal Revenue System have not yet had a significant effect on the polls.

***The ruling coalition will likely dominate Congress as well***

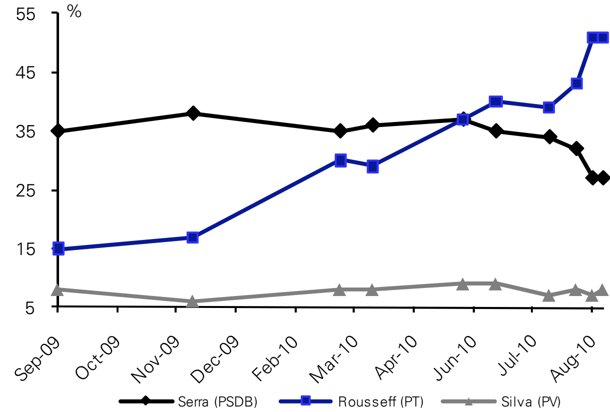
The government coalition is not only poised to obtain a landslide victory in the presidential election, but also to grab a larger share of seats in Congress. The coalition parties will likely consolidate their majority in the Lower House and, more importantly, undermine the leverage that the opposition currently enjoys in the Senate. The opposition currently controls approximately 35% of the Senate, which provides them considerable power to block constitutional amendments. Although the opposition needs 40% of the votes to block a constitutional amendment, it can usually count on a small number of dissenters to defeat the government. In December 2007, for example, the Senate dealt a major blow to the Lula administration when it failed to approve a constitutional amendment that aimed to extend the CPMF tax on financial transactions until 2011. All opposition senators voted against the amendment, and the government was able to muster only 45 votes for the amendment (four votes short of the minimum requirement) as four senators of the ruling coalition dissented.

**Figure 23: Presidential poll (Datafolha)**




Source: Datafolha

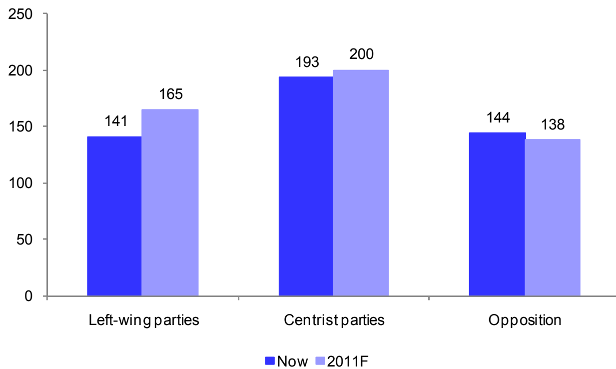
**Figure 24: Presidential poll (Ibope)**




Source: Ibope

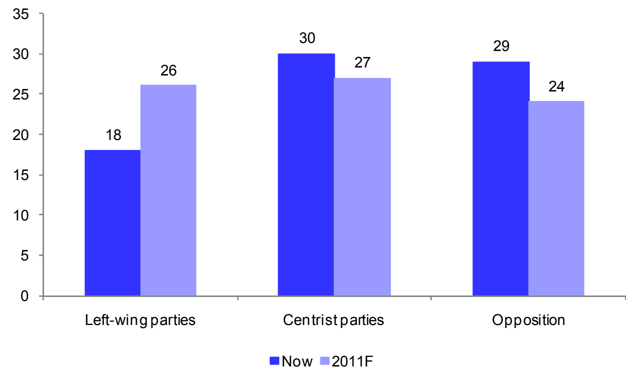
Political consulting firm Eurasia projects the opposition bloc in the Lower House (encompassing the PSDB, DEM, PPS, and PV parties) to drop to 138 seats (27% of the total) from the currently 144 (28% of the total) and from 166 (32% of the total) in the previous election. In the Senate, Eurasia estimates the opposition seats to decline to 24 (30% of the total) from the currently 29 (36% of the total) and from 34 (42% of the total) in the previous election. Opposition party DEM will probably be hit the hardest and lose four seats. Not surprisingly, the Workers' Party (PT) will likely be the main winner and increase its allotment to 15 from nine seats.

**Figure 25: Lower House forecasts (seats)**




Source: Eurasia

**Figure 26: Senate forecasts (seats)**




Source: Eurasia

***Despite the likely outcome of the congressional elections, the outlook for reforms remains uncertain***

Thus, it is likely that the congress that will arise from the October elections will offer more support for the government to pass reforms, especially those that must be implemented through constitutional amendments. However, as long as financial markets are concerned, this could be a mixed blessing. While the government will most likely seek to pass reforms that make it easier to invest in infrastructure – authorities are keen to reduce the power of watchdog agencies that oversee government spending and to streamline environmental licensing approval – the outlook for more controversial reforms remains murky. The obstacles that have stalled the tax reform, for example, are not caused by the size of the government's majority in Congress, but by conflicting positions espoused by the federal government and the different states of the federation. Furthermore, the coalition's increased powers could be used to pass market-unfriendly reforms such as the reinstatement of the CPMF tax on financial transactions.

***Debate about Rousseff's economic policies is heating up***

The possibility of a Rousseff landslide victory has intensified the debate about the orientation of economic policies in the next administration. At the end of August, newspaper *Folha de São Paulo* published an article claiming that, if elected, Rousseff would follow the steps of President Lula, who tightened fiscal and monetary policy immediately after taking office in 2003 to improve market confidence. In response to the article, Rousseff denied that she planned to implement any major fiscal adjustment or reduce the inflation target, if elected. We are tempted to overlook Rousseff's comments due to the proximity of the elections, and instead take solace in her advisor, former Finance Minister Antonio Palocci – who has consistently defended fiscal discipline and might be appointed for her cabinet – and in the speech that she delivered in New York in May, when she stressed the importance of keeping inflation under control.

***The 2002 crisis imposed a strong fiscal adjustment***

However, we remain skeptical about major changes in the basic economic policy framework. The situation that Rousseff is facing today is dramatically different from the crisis that President Lula tackled. The confidence crisis triggered by the election of a left-wing candidate in 2002 put the Brazilian government on the verge of default, amid towering interest rates, massive currency depreciation, and scarce international reserves. Under those circumstances, President Lula had no choice but to implement a strong fiscal adjustment to assure the market that the government was solvent and debt contracts would be honored. Furthermore, the high inflation that arose from the large BRL depreciation provided enormous help for the federal government to curb real spending in 2003.

***The incentives are different today***

Today, public debt sustainability is no longer deemed to be at risk. Interest rates are much lower, the Central Bank owns more than USD260bn in international reserves, Brazil's external debt has an investment-grade rating, and the currency is actually appreciating. The fiscal adjustment defended by many economists – including us – aims to improve macroeconomic efficiency by allowing lower interest rates, private investment crowding-in, and an increase in public investment on infrastructure vis-à-vis consumption. Thus, while we expect some deceleration in spending due to the normal political business cycle and would not be surprised to see the new administration announce some measures to curb spending in the long run, we do not foresee a significant change to the fiscal stance adopted during President Lula's second term, when Antonio Palocci was no longer the Finance Minister.

***Rousseff will probably try to avoid a significant economic slowdown***

As the likely successor of a very popular president, Rousseff will probably try to avoid significant deceleration in economic activity during the first year of her mandate. Therefore, the new president will likely be reluctant to withdraw the fiscal stimulus too fast. Moreover, President Lula's high popularity was not only determined by fast growth and low unemployment, but by significant gains in labor income that were facilitated by a generous minimum wage policy. As we stressed above, although the 2011 budget draft set a minimum wage adjustment of "only" 5.5%, government officials have already stated that it is subject to change and will be negotiated with labor unions after the election. The minimum wage is a crucial determinant of fiscal expenditures. In addition, the sizeable infrastructure requirements imposed by the 2014 Football World Cup and 2016 Olympic Games do not give the government much leeway to curb spending either.

***A landslide victory could reinforce interventionist policies***

We believe a landslide victory by Rousseff could lead the next administration to put more emphasis on interventionist policies. After all, a strong PT victory in the presidential and congressional elections would be the culmination of a strategy that relied heavily on government intervention to steer the economy during President Lula's second term, especially following the global crisis triggered by Lehman Brothers' bankruptcy. The keystones of this strategy are aggressive fiscal spending, strengthening of state-owned enterprises, and industrial policy based on the selection of "national champions" and subsidized loans by the National Development Bank (BNDES).

***José Carlos de Faria, São Paulo, (5511) 21135185***

# Economic Indicators and Forecasts

| | 2006 | 2007 | 2008 | 2009 | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Economic Activity** | | | | | | |
| Real GDP (%YoY) | 4.0 | 6.1 | 5.1 | -0.2 | 7.6 | 4.5 |
| Nominal GDP (BRLbn) | 2,369.5 | 2,661.3 | 3,004.9 | 3,143.0 | 3,546.0 | 3,853.8 |
| Nominal GDP (USDbn) | 1,088.8 | 1,366.5 | 1,636.0 | 1,577.3 | 2,085.9 | 2,141.0 |
| GDP per capita (USD) | 5,867.3 | 7,282.7 | 8,628.2 | 8,237.2 | 10,748.3 | 10,885.4 |
| Industrial production(%YoY) | 2.8 | 6.0 | 3.1 | -7.4 | 12.0 | 4.3 |
| Unemployment Rate (%) | 10.0 | 9.3 | 7.9 | 8.1 | 7.0 | 6.9 |
| **Prices** | | | | | | |
| IPCA (%) | 3.1 | 4.5 | 5.9 | 4.3 | 4.8 | 5.0 |
| IGP-M (%) | 3.8 | 7.7 | 9.8 | -1.7 | 9.1 | 5.4 |
| **Fiscal Accounts** | | | | | | |
| Primary balance (% of GDP) | 3.3 | 3.4 | 3.5 | 2.1 | 2.8 | 2.8 |
| Nominal balance (% of GDP) | -3.5 | -2.8 | -2.0 | -3.3 | -2.2 | -2.0 |
| Net government debt (% of GDP) year end | 45.9 | 42.8 | 37.3 | 42.8 | 39.7 | 38.3 |
| **External Accounts** | | | | | | |
| Merchandise exports (USDbn) | 137.8 | 160.6 | 197.9 | 153.0 | 194.0 | 235.0 |
| Merchandise imports (USDbn) | 91.4 | 120.6 | 173.1 | 127.6 | 177.0 | 220.0 |
| Trade balance (USDbn) | 46.5 | 40.0 | 24.8 | 25.3 | 17.0 | 15.0 |
| Current account balance (USDbn) | 13.6 | 1.6 | -28.2 | -24.3 | -52.0 | -62.0 |
| Current account balance (% of GDP) | 1.3 | 0.1 | -1.7 | -1.5 | -2.5 | -2.9 |
| Foreign direct investment (USDbn, ex-loans) | 15.4 | 26.1 | 30.1 | 19.9 | 25.0 | 32.0 |
| Foreign exchange reserves (USDbn) | 85.8 | 180.3 | 206.8 | 239.1 | 280.1 | 300.1 |
| Reserves (months of next year's imports) | 8.5 | 12.5 | 19.4 | 16.2 | 15.3 | 0.0 |
| **Debt Indicators** | | | | | | |
| Gross external debt (USDbn) | 199.4 | 240.5 | 262.9 | 277.6 | 299.6 | 319.6 |
| Gross external debt (% of GDP) | 18.3 | 17.6 | 16.1 | 17.6 | 14.4 | 14.9 |
| Gross external debt (% of exports) | 144.7 | 149.7 | 132.8 | 181.4 | 154.4 | 136.0 |
| Total debt service (USDbn) | 60.5 | 55.2 | 39.8 | 46.1 | 43.5 | 47.0 |
| Total debt service (% of GDP) | 5.6 | 4.0 | 2.4 | 2.9 | 2.1 | 2.2 |
| **Interest and exchange rates** | | | | | | |
| Overnight interest rate (%, eop) | 13.3 | 11.3 | 13.8 | 8.8 | 10.8 | 10.8 |
| Overnight interest rate (%, average) | 15.1 | 12.0 | 12.5 | 9.9 | 10.0 | 10.8 |
| Exchange rate (BRL/USD, eop) | 2.14 | 1.77 | 2.34 | 1.74 | 1.70 | 1.80 |
| Exchange rate (BRL/USD, average) | 2.18 | 1.95 | 1.83 | 2.00 | 1.77 | 1.75 |

*Source: Deutsche Bank estimates, National Statistics*

# Acronyms

| | |
|---|---|
| BCB | *Banco Central do Brasil* |
| BNDES | *Banco Nacional de Desenvolvimento* |
| CNI | *Confederação Nacional da Indústria* |
| FGV | *Fundação Getúlio Vargas* |
| FIESP | *Federação das Indústrias do Estado de São Paulo* |
| FIPE | *Fundação Instituto de Pesquisas Econômicas da Universidade de São Paulo* |
| IBGE | *Instituto Brasileiro de Geografia e Estatística* |
| SECEX | *Secretaria de Comércio Exterior (Ministério da Indústria e Comércio)* |
| STN | *Secretaria do Tesouro Nacional (Ministério da Fazenda)* |

*Source: Deutsche Bank*

# Appendix 1

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