OXFORD ECONOMICS

Brazil

Highlights and Key Issues

- National accounts data show a disappointing performance by the Brazilian economy in Q1. GDP rose by just 0.2% on the quarter, with particular weakness in fixed investment. And more recent indicators suggest that growth will remain modest in Q2. We now forecast GDP growth of just 2.2% in 2012, before accelerating to 5.1% in 2013.
- The ongoing crisis in the Eurozone and the weakening global outlook have resulted in a depreciation of the Brazilian real (BRL) since the start of the year. While this should help to boost competitiveness of local exporters, the factors driving the depreciation may undermine any resulting boost to exports.
- The BRL has also been weighed down by falling interest rates. The central bank has cut the Selic rate by 400bp since August 2011, and minutes from the last central bank meeting suggest a further cut is likely.
- High interest rates are commonly seen as a constraint on long-term potential growth in Brazil, and President Rousseff's desire to bring them more in line with other developed nations is justifiable. But an increasing number of other policies favouring domestic producers over foreign firms could in time deter much-needed inflows of foreign investment and could limit long-term potential growth.

Forecast for Brazil

(Annual percentage changes unless specified)

	2011	2012	2013	2014	2015	2016
Domestic Demand	3.7	2.4	5.5	5.2	4.7	4.6
Private Consumption	4.1	3.9	5.2	4.8	4.7	4.4
Fixed Investment	4.7	0.2	9.6	7.8	5.3	5.5
Stockbuilding (% of GDP)	1.5	0.7	0.4	0.5	0.5	0.5
Government Consumption	1.9	3.9	3.7	3.5	4.1	4.2
Exports of Goods and Services	4.5	5.4	9.4	10.6	9.9	9.0
Imports of Goods and Services	9.7	5.4	10.1	10.9	10.3	9.4
GDP	2.7	2.2	5.1	4.8	4.2	4.1
Industrial Production	0.4	-1.6	4.7	5.8	5.3	4.2
Consumer Prices	6.6	5.5	6.0	4.9	4.1	4.1
Government Budget (% of GDP)	-2.6	-1.9	-1.8	-1.8	-1.9	-1.9
Trade Balance ($bn)	29.8	23.0	14.4	12.5	11.5	10.2
Current Account ($bn)	-52.5	-55.0	-61.7	-60.7	-64.1	-66.0
Current Balance (% of GDP)	-2.1	-2.3	-2.3	-2.3	-2.3	-2.3
Short-Term Interest Rates (%)	11.7	8.7	8.8	8.3	7.9	7.9
Exchange Rate (Per US$)	1.67	1.86	1.91	2.07	2.20	2.32

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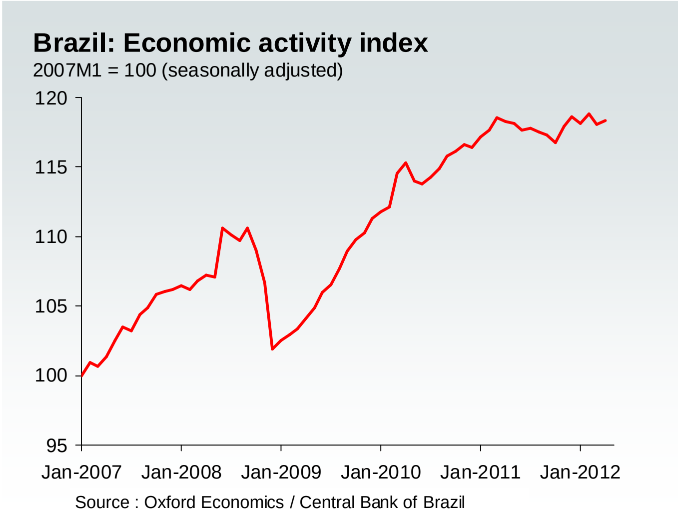
Overview

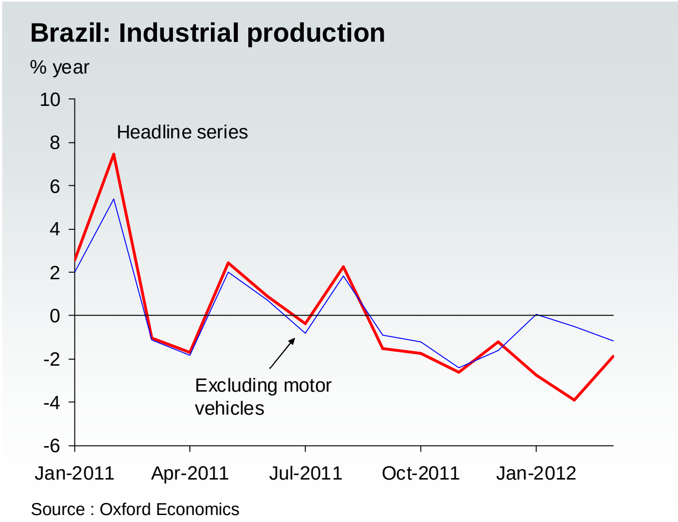
Growth remained weak in Q1…

- GDP grew by just 0.2% on the quarter in Q1 on a seasonally adjusted basis. A sharp 1.8% decline in investment partially offset growth of 1% and 1.5% in private and government consumption respectively, while net trade remained a drag on the economy.
- The weakness in exports and investment highlight the current growth mismatch in Brazil, with weakness in output contrasting with robust domestic demand. This split is also evident within the sectoral patterns of output, with continued resilience in the services sector helping to offset weakness in the manufacturing and agricultural sectors.

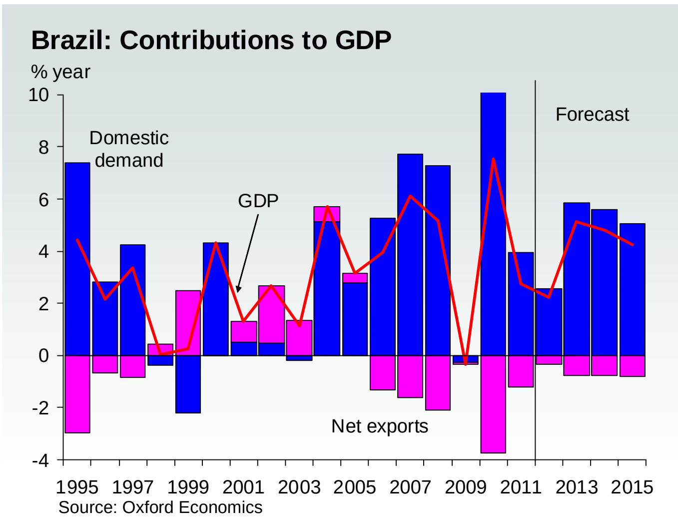


…and a modest Q2 expected

- More recent monthly indicators suggest that growth in Q2 will remain weak, albeit quicker than in Q1. The economic activity index, a seasonally adjusted proxy for GDP, rose by 0.2% on the month in April following a 0.6% contraction in March. But the services sector, which until recently has proved relatively healthy, has shown signs of slowing. The May services PMI fell to 49.7, below the 50 level that separates expansion from contraction and sharply down from 54.4 in April. Meanwhile, the PMI for manufacturing remains lacklustre, with particular weakness in the auto sector. This is partly due to a contraction in credit availability, driven by rising defaults on auto loans. As a result, inventories have built up which will weigh on output in the near-term.



- The competitiveness of producers will have been boosted since Q1 by a depreciation in the Brazilian real (down by about 10% since the start of April). However, the depreciation has been driven primarily by the increased tensions surrounding the Eurozone and concerns about a slowdown in growth in key trading partners, notably China. As a result, the boost to the competitiveness of domestic exporters provided by a weakening of the exchange rate is likely to be offset by weaker foreign demand.
- The weakness in growth has helped to contain CPI inflation, which has slowed from 7.4% in August 2011 to 4.9% in May, bringing it within the central bank's target range of 2.5-6.5%. And the recent decline in the price of commodities, particularly oil, should help to further dampen inflation in the near term.



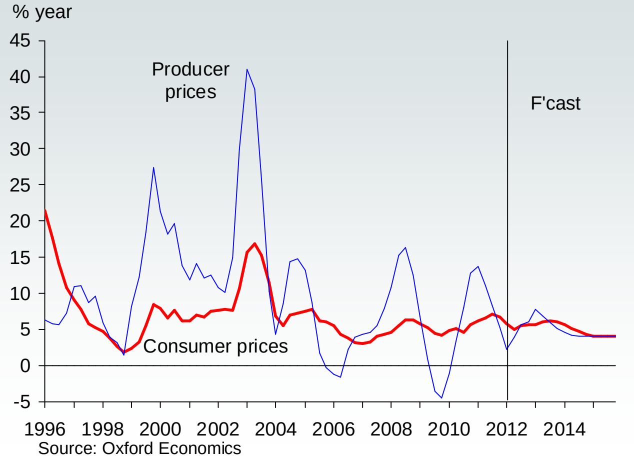
Further rate cut expected…

- The weak growth outlook and a slowdown in CPI inflation have prompted a loosening of monetary policy in recent months. The key Selic rate has now been cut by 400bp since August 2011.
- Lower interest rates should help to raise growth in domestic demand, which is already benefiting from solid growth in real earnings, low unemployment and upbeat confidence. Indeed, retail sales increased by 9% on the year in April. And slowing inflation in recent months, combined with other relatively weak data, is likely to prompt another 50bp cut in the Selic rate in July, to an historic low of 8%. This view is also supported by minutes from the May Copom meeting, which hinted at further monetary loosening.
- However, a tight labour market, the recent depreciation in the exchange rate and the lagged impact of earlier monetary easing are likely to boost core inflation over the next few months. Our forecast is for headline CPI inflation to accelerate in the second half of the year, rising to over 6% in 2013. Meanwhile, the combination of weaker-than-expected Q1 growth, indications of subdued growth in Q2 and revised 2011 data has resulted in a downward revision to our 2012 GDP growth forecast, to 2.2% from 2.6% previously.

…but long-term growth uncertain

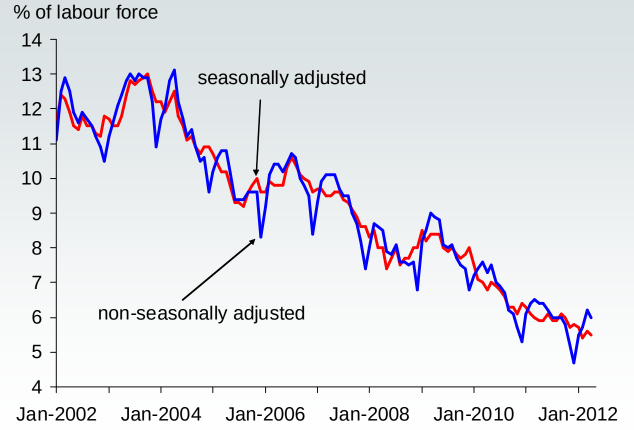
- While a shift towards structurally lower interest rates should help to boost long-term growth, other policies being pursued by the government may hinder long-term growth potential. The head of the state development bank, BNDES, recently commented that the government would always side with Brazilian companies over foreign rivals in corporate takeover bids. While Brazil as a whole is regarded as a relatively investor-friendly country, such intervention by the state may deter foreign investment. Other examples include taxes on capital flows, restrictive land laws and indirect tariffs on certain imports.
- While these policies could support domestic production in the near term, they may begin to deter FDI inflows, reducing the associated boost to expertise and technology within the country. Infrastructure bottlenecks and a complex tax and legal system also contribute to our expectation for GDP growth of just 4% a year over the next decade, lower than most other emerging economies.

Brazil: Consumer and producer prices



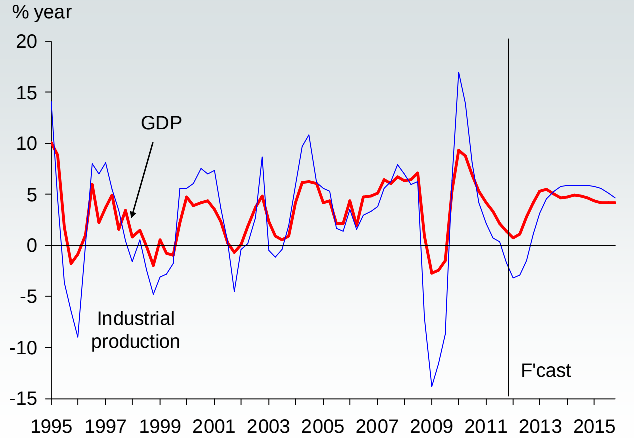
Source: Oxford Economics

Brazil: Unemployment rate



Source : Oxford Economics/IBGE

Brazil: GDP and industrial production



Source: Oxford Economics

Key Indicators: Brazil

Percentage changes on a year earlier unless otherwise stated

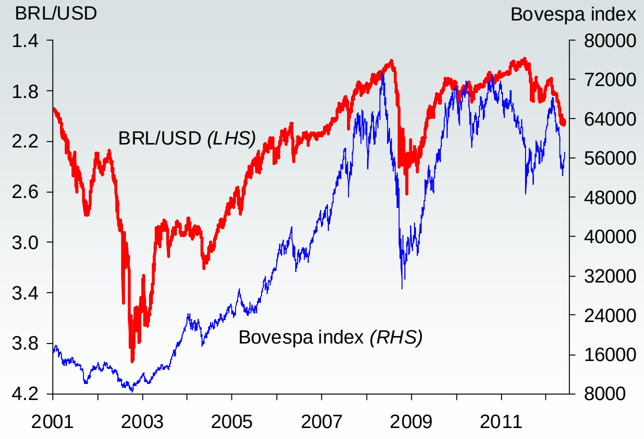
	Industrial prod. (s.a.) % m-o-m	Retail sales (s.a.)	CPI (IPCA)	Wholesale prices % m-o-m	Unemploy-ment %	Public Debt Real bn	Export value in $	Trade balance ($ mn)
May	1.3	7.7	6.6	-0.6	6.4	1,532	31.1	3524
Jun	-1.3	6.8	6.7	-0.2	6.2	1,542	38.6	4430
Jul	0.4	7.9	6.9	-0.1	6.0	1,545	25.9	3138
Aug	-0.1	5.1	7.2	0.8	6.0	1,549	36.0	3889
Sep	-1.9	5.2	7.3	0.9	6.0	1,481	23.6	3073
Oct	-0.3	5.0	7.0	0.5	5.8	1,535	20.5	2358
Nov	-0.3	6.0	6.6	0.3	5.2	1,508	23.1	571
Dec	0.6	6.2	6.5	-0.6	4.7	1,509	5.8	3811
2012								
Jan	-1.7	8.9	6.2	0.0	5.5	1,545	6.1	-1296
Feb	1.3	8.9	5.8	0.0	5.7	1,564	7.7	1714
Mar	-0.5	7.9	5.2	0.6	6.2	1,538	8.4	2019
Apr	-0.2	9.0	5.1	1.3	6.0	1,515	-3.0	881
May	-	-	5.0	0.9	-	-	0.0	2953

Financial Indicators: Brazil

Percentage changes on a year earlier unless otherwise stated

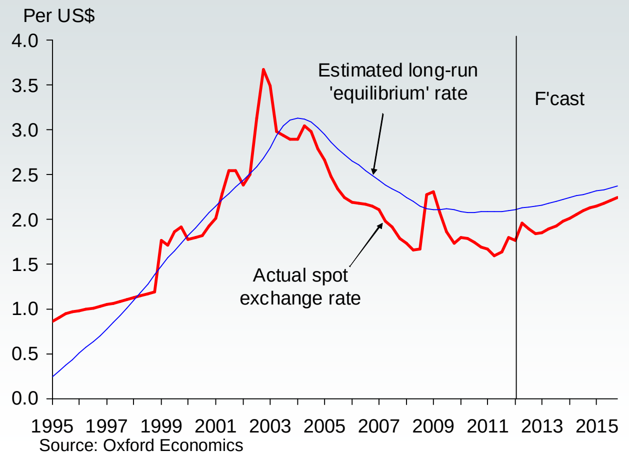
	Selic rate (actual) %	Short-rate 60 days %	Money supply M3	Exchange rate Real/Euro	Exchange rate Real/$ avg.	Primary balance Real mn	Asset price (Bovespa)	Reserves (end-month) $ mn
May	11.92	11.8	19.7	2.315	1.614	-7,506	63,731	333,017
Jun	12.10	11.8	19.7	2.281	1.585	-13,370	62,299	335,775
Jul	12.25	12.3	19.9	2.229	1.563	-13,789	60,432	346,144
Aug	12.42	12.0	19.7	2.290	1.597	-4,561	53,841	353,397
Sep	11.91	11.0	18.6	2.409	1.749	-8,096	55,399	349,708
Oct	11.70	10.3	17.7	2.426	1.770	-13,936	54,669	352,928
Nov	11.40	10.6	18.1	2.422	1.786	-8,204	57,094	352,073
Dec	10.90	10.6	18.8	2.424	1.839	-1,934	57,408	352,012
2012								
Jan	10.70	10.0	20.8	2.304	1.785	-26,016	60,698	355,075
Feb	10.40	9.3	19.7	2.270	1.716	-9,514	65,484	356,330
Mar	9.82	8.9	20.5	2.370	1.795	-10,442	66,613	365,216
Apr	9.35	8.3	21.0	2.438	1.852	-14,240	62,579	374,272
May	8.87	-	-	2.534	1.981	-	57,136	372,409

Brazil: Exchange rate & equity market



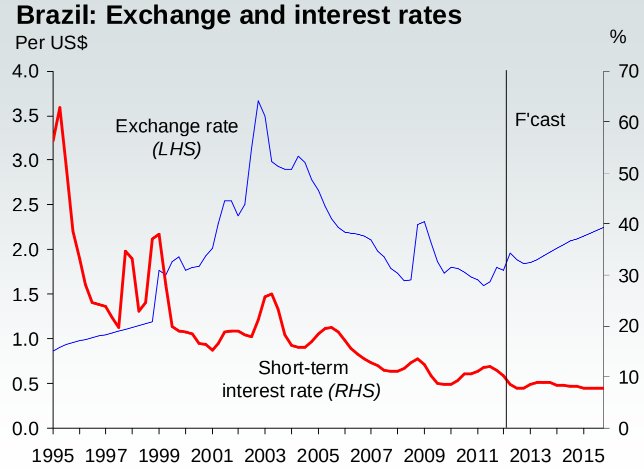
Source: CEIC

Brazil: Exchange rate v. 'equilibrium'



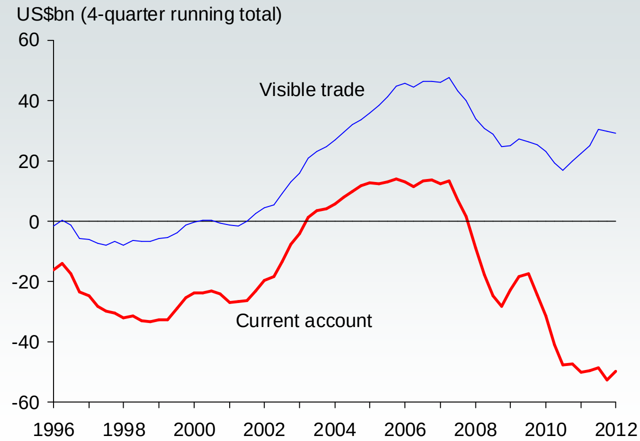
Source: Oxford Economics

Brazil: Exchange and interest rates



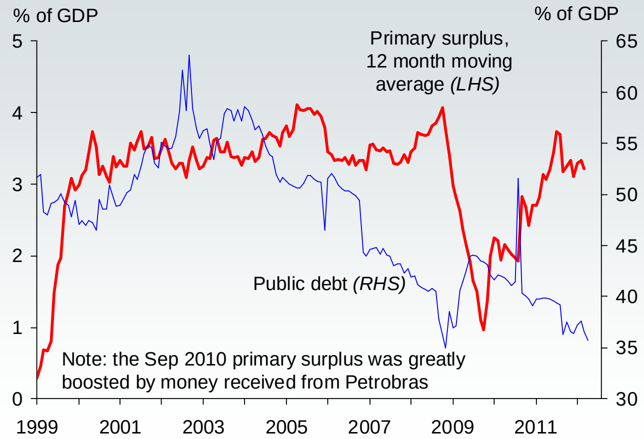
Source: Oxford Economics

Brazil: External balances



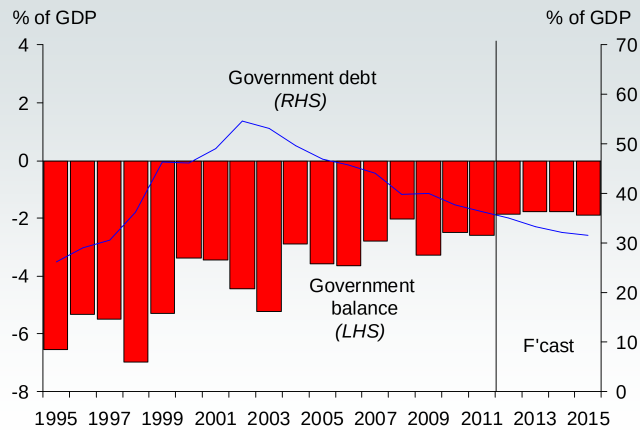
Source: Central Bank of Brazil

Brazil: Fiscal policy & public debt



Source: CEIC

Brazil: Government budget balance and debt



Source: Oxford Economics

BRAZIL	TABLE 1 SUMMARY ITEMS Annual Percentage Changes, Unless Otherwise Specified										
	CONSUMERS EXPENDITURE (C)	TOTAL FINAL EXPENDITURE (TFE)	TOTAL FIXED INVESTMENT (IF)	REAL GDP (GDP)	INDUSTRIAL PRODUCTION (IP)	UNEMPLOY-MENT RATE (%) (UP)	AVERAGE EARNINGS (ER)	WHOLE ECONOMY PRODUCT-IVITY (GDP/ET)	COMPETIT-IVENESS (2008=100) (WCR)	PRODUCER PRICES (PPI)	CONSUMER PRICES (CPI)
YEARS BEGINNING Q1											
2010	6.94	11.12	21.33	7.53	10.56	6.74	9.17	3.91	118.34	5.72	5.04
2011	4.10	3.82	4.71	2.73	0.37	5.98	9.39	0.66	126.29	9.43	6.64
2012	3.85	2.74	0.25	2.22	-1.64	5.82	10.36	0.78	125.54	4.46	5.47
2013	5.21	5.95	9.59	5.10	4.69	5.90	7.69	3.54	122.16	6.38	5.97
2014	4.85	5.85	7.81	4.79	5.84	5.62	7.64	3.29	114.76	4.24	4.91
2015	4.68	5.34	5.28	4.24	5.28	5.71	7.15	3.09	110.56	4.12	4.06
2016	4.39	5.12	5.49	4.11	4.16	5.71	7.04	2.96	106.29	4.12	4.06
2010											
I	8.46	12.92	29.88	9.34	16.95	7.40	5.67	6.03	113.41	-1.09	4.86
II	6.16	12.35	27.16	8.76	13.93	7.27	8.17	4.57	115.87	3.42	5.11
III	5.91	11.25	20.26	6.93	8.15	6.60	10.40	3.48	120.44	8.07	4.60
IV	7.32	8.28	11.12	5.33	4.17	5.70	12.34	1.77	123.63	12.70	5.58
2011											
I	6.01	5.54	8.84	4.24	2.11	6.33	10.75	1.85	127.98	13.75	6.10
II	5.62	5.01	6.19	3.31	0.74	6.33	9.87	0.92	125.97	11.02	6.59
III	2.80	2.73	2.48	2.12	0.37	6.00	9.64	0.14	128.48	8.22	7.14
IV	2.15	2.19	1.99	1.37	-1.73	5.23	7.45	-0.20	122.72	5.21	6.70
2012											
I	2.54	1.61	-2.06	0.75	-3.18	5.80	10.03	-1.07	132.66	2.26	5.77
II	3.15	1.33	-1.78	1.09	-2.92	6.00	11.35	-0.44	118.58	3.93	5.01
III	4.63	3.33	0.71	2.75	-1.52	6.00	9.54	1.70	123.85	5.62	5.54
IV	5.04	4.62	3.92	4.23	1.12	5.50	10.54	2.88	127.08	5.98	5.57
2013											
I	5.37	5.73	8.56	5.26	3.19	6.00	7.82	3.27	129.31	7.77	5.68
II	5.36	6.19	9.85	5.47	4.52	6.10	7.46	3.92	122.09	6.82	6.03
III	5.16	6.06	10.16	5.03	5.26	6.00	7.60	3.55	119.33	5.89	6.14
IV	4.98	5.81	9.71	4.68	5.74	5.50	7.88	3.42	117.91	5.13	6.03
2014											
I	4.85	5.77	9.21	4.72	5.84	5.83	7.92	3.41	119.85	4.52	5.67
II	4.84	5.92	8.41	4.90	5.84	5.80	7.77	3.39	114.12	4.22	5.09
III	4.86	5.95	7.43	4.88	5.84	5.60	7.54	3.22	112.48	4.12	4.65
IV	4.83	5.74	6.42	4.65	5.84	5.25	7.34	3.12	112.61	4.12	4.27
2015											
I	4.80	5.47	5.59	4.43	5.75	5.95	7.22	3.30	114.82	4.12	4.06
II	4.73	5.31	5.11	4.22	5.54	5.90	7.15	3.07	110.11	4.12	4.06
III	4.65	5.33	5.15	4.18	5.17	5.67	7.12	3.01	108.67	4.12	4.06
IV	4.57	5.27	5.28	4.16	4.69	5.34	7.10	3.00	108.62	4.12	4.06
2016											
I	4.49	5.16	5.37	4.15	4.37	5.95	7.08	2.88	110.71	4.12	4.06
II	4.41	5.13	5.46	4.12	4.16	5.90	7.05	2.93	105.85	4.12	4.06
III	4.35	5.14	5.53	4.10	4.06	5.67	7.03	2.99	104.26	4.12	4.06
IV	4.30	5.07	5.58	4.07	4.06	5.34	7.00	3.04	104.33	4.12	4.06

BRAZIL	TABLE 2 SUMMARY ITEMS									
	TRADE BALANCE ($ BN) (BVIS/1000)	CURRENT ACCOUNT ($ BN) (BCUS/1000)	CURRENT ACCOUNT (% OF GDP) (BCUR%)	GOVERNMENT FINANCIAL BALANCE (REAL TRN) (GB/1000)	GOVERNMENT FINANCIAL BALANCE (% OF GDP) (GB*100/GDP!)	SHORT-TERM INTEREST RATE (RSH)	SPREAD OVER US SHORT-TERM RATE (RSH-RSH US)	REAL SHORT-TERM INTEREST RATE (Note 1)	EQUILIBRIUM EXCHANGE RATE PER US DOLLAR (RXEQUIL)	EXCHANGE RATE PER US DOLLAR (RXD)
YEARS BEGINNING Q1										
2010	20.1	-47.3	-2.2	-93.7	-2.5	9.8	9.5	4.8	2.08	1.76
2011	29.8	-52.5	-2.1	-108.0	-2.6	11.7	11.3	5.0	2.09	1.68
2012	23.0	-55.0	-2.3	-83.4	-1.9	8.7	8.2	3.2	2.13	1.86
2013	14.4	-61.7	-2.3	-89.3	-1.8	8.8	8.4	2.9	2.19	1.91
2014	12.5	-60.7	-2.3	-97.1	-1.8	8.3	7.9	3.4	2.27	2.07
2015	11.5	-64.1	-2.3	-113.5	-1.9	7.9	7.2	3.8	2.34	2.20
2016	10.2	-66.0	-2.3	-126.8	-1.9	7.9	6.3	3.8	2.41	2.32
2010										
I	0.9	-11.9	-2.5	-26.3	-3.1	8.7	8.4	3.8	2.09	1.80
II	7.0	-11.9	-2.3	-23.8	-2.6	9.4	8.9	4.3	2.08	1.79
III	4.8	-11.5	-2.1	-14.1	-1.5	10.5	10.2	5.9	2.08	1.75
IV	7.5	-11.9	-2.0	-29.4	-2.9	10.7	10.4	5.1	2.08	1.70
2011										
I	3.1	-14.8	-2.6	-19.7	-2.0	11.2	10.9	5.1	2.09	1.67
II	9.8	-11.3	-1.7	-21.9	-2.1	11.9	11.7	5.3	2.08	1.60
III	10.1	-10.6	-1.7	-31.3	-3.0	12.2	11.9	5.1	2.09	1.64
IV	6.7	-15.8	-2.6	-35.1	-3.2	11.3	10.8	4.6	2.10	1.80
2012										
I	2.4	-12.1	-2.1	-13.0	-1.3	10.3	9.8	4.5	2.11	1.77
II	9.0	-13.5	-2.4	-18.2	-1.6	8.6	8.1	3.6	2.13	1.96
III	7.0	-14.5	-2.4	-23.2	-2.0	7.9	7.4	2.4	2.14	1.89
IV	4.6	-14.9	-2.3	-29.1	-2.4	7.9	7.5	2.3	2.15	1.84
2013										
I	1.9	-15.3	-2.5	-13.2	-1.1	8.7	8.2	3.0	2.16	1.85
II	5.5	-15.4	-2.3	-18.2	-1.4	8.9	8.5	2.9	2.18	1.89
III	4.9	-15.5	-2.3	-27.7	-2.2	8.9	8.5	2.8	2.20	1.93
IV	2.1	-15.5	-2.3	-30.2	-2.2	8.9	8.5	2.9	2.23	1.98
2014										
I	-1.3	-15.1	-2.4	-15.7	-1.2	8.4	8.0	2.7	2.25	2.01
II	7.1	-15.0	-2.2	-19.8	-1.4	8.4	8.0	3.3	2.26	2.06
III	5.4	-15.1	-2.3	-29.7	-2.1	8.2	7.8	3.5	2.28	2.10
IV	1.3	-15.4	-2.2	-31.9	-2.2	8.2	7.7	3.9	2.30	2.13
2015										
I	0.5	-15.9	-2.4	-20.8	-1.5	7.9	7.4	3.8	2.32	2.16
II	5.3	-16.0	-2.3	-23.6	-1.6	7.9	7.2	3.8	2.34	2.19
III	3.9	-16.1	-2.3	-33.4	-2.2	7.9	7.1	3.8	2.35	2.21
IV	1.9	-16.2	-2.3	-35.7	-2.2	7.9	6.9	3.8	2.37	2.24
2016										
I	0.4	-16.3	-2.4	-23.5	-1.6	7.9	6.7	3.8	2.39	2.27
II	4.9	-16.4	-2.3	-26.4	-1.6	7.9	6.5	3.8	2.40	2.30
III	3.6	-16.6	-2.3	-37.2	-2.2	7.9	6.3	3.8	2.41	2.33
IV	1.3	-16.7	-2.3	-39.7	-2.3	7.9	5.9	3.8	2.43	2.36

Note 1 : REAL INTEREST RATE = Nominal interest rate (RSH) - % change in CPI

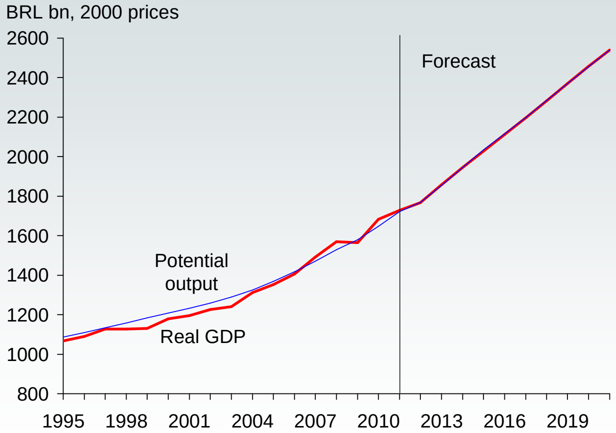
Potential output growth 4.0%pa

- Potential output is projected to rise by 4.0%pa over the next 10 years, a significantly higher rate than in the previous decade. GDP is set to expand by 2.2% in 2012, having grown by 2.7% in 2011 and to be significantly above potential growth at 5.1% in 2013. As a result, the large output gap of 1.21% in 2011 will contract in 2012 to 0.32% and move in 2013 to 0.28%, and it is not forecast to close fully until 2014.

- The main contribution to growth in potential output over the coming decade comes from expanding total factor productivity.

- The 0.7%pt contribution from expanding labour usage reflects the 1.0%pa rise in the working population over the next ten years and an increase in the participation rate which combine to boost the labour supply by 1.1%pa. For the capital stock's contribution of 1.5%pt, the main factor is significantly lower investment growth (at 5.1%pa) than in the previous decade. Finally, total factor productivity growth's significantly higher contribution of 1.7%pt reflects the better contribution to potential growth from factors influencing production other than labour and capital over the coming decade.

Brazil: Real GDP and potential output



Source: Oxford Economics

Potential GDP and Its Components
Average Percentage Growth

	2002-2011	2012-2021
Potential GDP*	3.4	4.0
Employment at NAIRU	2.2	1.1
Capital Stock	2.2	4.3
Total Factor Productivity	1.2	1.7

*ln(Potential GDP)=0.65*ln(Employment at NAIRU) +0.35*ln(Capital Stock)+ln(Total Factor Productivity)

Long-Term Forecast for Brazil
(Average annual percentage change unless otherwise stated)

	2002-2006	2007-2011	2012-2016	2017-2021
GDP	3.3	4.2	4.1	3.8
Consumption	2.9	5.4	4.6	3.8
Investment	2.3	8.9	5.6	4.5
Government Consumption	3.0	3.5	3.9	3.7
Exports of Goods and Services	9.4	2.5	8.8	7.4
Imports of Goods and Services	4.8	13.8	9.2	6.8
Unemployment (%)	11.1	7.6	5.8	5.7
Consumer Prices	8.1	5.2	4.9	4.1
Current Balance (% of GDP)	0.8	-1.5	-2.3	-2.2
Exchange Rate (vs US$)	2.7	1.8	2.1	2.5
General Government Balance (% of GDP)	-4.0	-2.6	-1.8	-2.1
Short-term Interest Rates (%)	18.6	11.2	8.3	7.9
Working Population	1.6	1.3	1.2	0.8
Labour Supply	2.8	1.5	1.3	0.9
Participation Ratio	76.4	77.6	78.1	78.3
Labour Productivity	0.4	1.7	2.7	2.8

Long-Term Forecast for Brazil

Annual percentage changes unless otherwise specified

	2002-2011	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-2021
GDP	3.8	5.2	-0.3	7.5	2.7	2.2	5.1	4.8	4.2	4.1	4.0	3.9	3.9	3.7	3.4	3.9
Consumption	4.2	5.7	4.4	6.9	4.1	3.9	5.2	4.8	4.7	4.4	4.2	4.1	3.9	3.6	3.4	4.2
Investment	5.6	13.6	-6.7	21.3	4.7	0.2	9.6	7.8	5.3	5.5	5.4	5.1	4.6	3.9	3.5	5.1
Government Consumption	3.2	3.2	3.1	4.2	1.9	3.9	3.7	3.5	4.1	4.2	4.0	4.0	3.8	3.5	3.3	3.8
Exports of Goods and Services	5.9	0.5	-9.1	11.5	4.5	5.4	9.4	10.6	9.9	9.0	8.7	8.4	7.6	6.5	5.8	8.1
Imports of Goods and Services	9.2	15.4	-7.6	35.8	9.7	5.4	10.1	10.9	10.3	9.4	8.6	7.9	6.7	5.7	5.2	8.0
Unemployment (%)	9.3	7.9	8.1	6.7	6.0	5.8	5.9	5.6	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7
Consumer Prices	6.6	5.7	4.9	5.0	6.6	5.5	6.0	4.9	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.5
Current Balance (% of GDP)	-0.4	-1.7	-1.5	-2.2	-2.1	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3	-2.2	-2.1	-2.0	-2.2
Exchange Rate (per $)	2.3	1.8	2.0	1.8	1.7	1.9	1.9	2.1	2.2	2.3	2.4	2.5	2.5	2.6	2.6	2.3
General Government Balance (% of GDP)	-3.3	-2.0	-3.3	-2.5	-2.6	-1.9	-1.8	-1.8	-1.9	-1.9	-2.0	-2.0	-2.1	-2.1	-2.2	-2.0
Short-term Interest Rates (%)	14.9	12.4	10.1	9.8	11.7	8.7	8.8	8.3	7.9	7.9	7.9	7.9	7.9	7.9	7.9	8.1
Working Population	1.5	1.3	1.3	1.3	1.3	1.3	1.2	1.2	1.1	1.1	1.0	0.9	0.8	0.7	0.6	1.0
Labour Supply	2.2	1.8	0.9	2.0	1.2	1.3	1.6	1.2	1.2	1.1	0.9	0.9	0.9	0.9	0.8	1.1
Participation Ratio (%)	77.0	77.7	77.4	77.9	77.9	77.9	78.2	78.1	78.2	78.3	78.2	78.2	78.3	78.4	78.5	78.2
Labour productivity	1.1	1.7	-1.1	3.9	0.7	0.8	3.5	3.3	3.1	3.0	3.0	2.9	2.9	2.7	2.6	2.8
Employment	2.7	3.4	0.7	3.5	2.1	1.4	1.5	1.5	1.1	1.1	0.9	0.9	0.9	0.9	0.8	1.1
Output gap (% of potential GDP)	-0.5	2.6	-0.3	1.4	1.2	-0.3	0.3	0.0	-0.2	-0.3	-0.2	-0.1	0.0	0.0	0.0	-0.1

Background

- With a GDP of about US$2.5 trillion in 2011 according to IMF data, and over 195m people, Brazil is now the sixth largest economy in the world and by far the largest in Latin America. In the last 15 years, the country has pursued a strategy of export-led growth and regional integration. The economy is relatively well diversified with a strong manufacturing and agricultural base, and mineral riches. But economic activity is still concentrated in the southeast, particularly in the state of São Paulo, and income inequality remains high.
- During the period 1950-80, the economy grew by an average yearly rate of 7.4%. This was achieved through an inward-looking strategy of industrialisation (ISI) led by the state. However, eventually this model of development generated high inflation, sustained external and fiscal deficits and growing public debt. Already in the 1970s the ISI began to show signs of exhaustion, but trade liberalisation did not begin in earnest until 1990. The recent economic history of the country is dominated by three crises linked to the balance of payments.
- The 1982 debt crisis, and the shrinkage of capital inflows that followed, was a major shock for the Brazilian economy. A period of macroeconomic instability and hyperinflation ensued, prompting a series of unsuccessful stabilisation plans from 1986 to 1994 – the name of the currency was changed four times during the period. Only in 1994 did the Real Plan restore macroeconomic stability to the economy. This plan, devised by Fernando Henrique Cardoso (later to become president during the period 1994-2002), used the nominal exchange rate as an anchor for domestic prices, as in previous stabilisation attempts, but this time it was underpinned by the opening up of the economy to global influences and a reform of public finances.
- The 1997-98 Asian and Russian crises found Brazil with rising public debt and large current account deficits, exposing its economy to swings in investor sentiment and speculative attacks against the BRL (a crawling peg was then in place). At the start of 1999 there were doubts over fiscal sustainability following the rejection by Congress of an IMF adjustment package. This, together with a debt moratorium declared by the state of Minas Gerais, prompted speculative pressures that forced the central bank to float the BRL, causing an immediate depreciation of 30% against the US$. However, the maxi-devaluation did not lead to high inflation and the introduction of inflation targeting in June 1999 helped to support the transition to the new exchange rate regime.
- Again in 2002, the increasing likelihood of a new government led by the left-wing candidate Luiz Ignacio "Lula" da Silva threw the markets into turmoil (exacerbated by weak global financial sentiment). The electoral risk, a fragile public debt structure and perverse debt dynamics, and the increased risk aversion of international capital markets were major sources of instability for the economy at this time. Over 80% of domestic debt was linked to either the Selic interest rate (the key monetary policy instrument) or to the US dollar, meaning that any major decline in the currency would result in a higher burden of interest payments and a rise in the domestic value of the public debt. Moreover the average maturity of the domestic debt was only three years, so vast sums needed to be rolled over every year. As a result, Brazil was walking a tightrope.
- But contrary to excessively pessimistic market expectations, one of the main achievements of President Da Silva's first-term administration was a strengthening of fiscal discipline, needed to honour debt payments and improve investor confidence. The debt structure is now much less exposed to currency fluctuations and its maturity has been lengthened (although about 30% is still linked to the Selic rate). This has improved the debt profile significantly. In 2004 and 2005 Brazil ran primary fiscal surpluses (excluding interest payments) of over 4.25% of GDP per year, and the surpluses were only marginally lower between 3.8% and 4.1% during 2006-08. However, the government's control over the overall nominal deficit is limited by high interest payments, which account for over 5% of GDP (even though they have fallen significantly over the last five years). Despite only implementing a relatively modest fiscal boost in the wake of the global crisis, the primary surplus fell sharply to 2% of GDP in 2009.
- President Lula comfortably won a second term in office in the 2006 elections and promised to boost economic growth and to narrow the gap between rich and poor. But with his left-wing Workers' Party (PT) having lost seats in the highly fragmented 513-member Congress, he had to rely on alliances to push through legislation. Moreover, within the key reform areas of tax, pensions, social security and political structures there was little

appetite to press for far-reaching changes. With the still popular Lula unable to run for a third consecutive term, presidential elections were held in October 2010. Lula's chosen successor, Dilma Rousseff, emerged victorious at the polls and her new administration took power on 1 January 2011. The key economic policy challenge facing the new administration will be whether it can implement medium-term fiscal adjustment. It may prove difficult for Rousseff to emerge from the shadow of her mentor and the impact on the public purse of her election pledge to continue the large-scale social spending policies that have helped lift more than 30m people into the ranks of the middle class over the past five years.

- However, the major efforts of the last decade to secure macroeconomic stability, together with the more modest structural reforms, have created the right conditions for a period of sustained growth. The country is now more integrated into the world economy and, at the same time, it has become more resilient to external shocks. Meanwhile, there has been important progress in the conduct of economic policy, with the passage of legislation to ensure fiscal responsibility, introduce inflation targeting, simplify the tax system and reduce the fiscal burden of the pension system. Other reforms have been enacted to deal with central bank independence and the credit market. The Law of Monetary Responsibility aims to consolidate price stability by extending the operational autonomy of the central bank in the conduct of monetary policy and the control of inflation. Meanwhile, the credit market reform aims to stimulate the expansion of credit in the private sector, reduce intermediation costs and improve investor confidence. This legislation seeks to reduce lending risks for banks – so as to encourage a willingness to reduce the gap between the official Selic rate and the actual interest rates faced by individuals and companies. Prior to the global crisis, bank lending was growing very strongly (despite still high interest rate spreads) and although it has slowed since, it has not stopped altogether as public sector banks have stepped in to supply credit. Against a background of inflation remaining under control and more households looking to own their homes, the demand for and supply of credit is likely to be on a strong uptrend over the next decade from the comparatively low level of 42% of GDP in mid-2009, supporting consumer spending and overall activity.

- Brazil has made significant progress in terms of its integration into the world economy. The openness indicator (the ratio of exports and imports to GDP) has doubled since 1990 (from 14% then to over 28% in 2008). This was partly the result of a deliberate strategy to diversify and open up new markets for Brazilian products in the US and the EU over the last ten years or so, while the expansion of exports to China since 2001 was a response to the rapid growth in Chinese demand for commodities.

- Greater openness to international trade has been accompanied by a more diversified export base (both in terms of products and geography), resulting in a considerable reduction in the country's exposure to external risks. Since 1990, the composition of products has become more varied, including a wide range of products from aircraft to commodities. In 2008 about 46.8% of Brazilian exports were finished manufactures, 13.7% semi-manufactures and 36.9% primary goods (the bulk of which were agricultural products, though iron ore exports accounted for 8.3% of all exports). In 2008 the main markets for Brazilian exports were the EU (a 23.4% share), the US (14%), Argentina (8.9%), the rest of Latin America (17%), China (8.3%) and the rest of Asia (10.6%). However, with the Chinese economy much stronger than any of these other regions in 2009 and 2010, the share of Brazilian exports going there has shot up, averaging 15.2% in 2010, while the share of exports to the EU had declined to 21.4% and that to the US had dropped 4.4% points to a 9.6% share.

- These new fundamentals have underpinned a turnaround in the country's external accounts. In the eight years 2002-09 the current account balance averaged a surplus of 0.1% of GDP, whereas in the previous seven years there was an average deficit of 3.6% of GDP. This, together with investors' increasing confidence in the soundness of the policy framework and in the country's growth potential, prompted a steady appreciation of the exchange rate between mid-2004 and mid-2008, before the eruption of the global crisis prompted a 33% fall in the BRL (at its worst). However, the return of confidence to global markets since March 2009 has led to a major rally, placing the currency in overvalued territory once again. Although this has had relatively little impact on the commodities sector, parts of the country's manufacturing sector are finding it increasingly difficult to maintain market share against foreign competition. Reflecting the growing imbalance between domestic demand and supply, the current account deficit has begun to widen again and was just above 2% of GDP in 2010 and 2011.

Key Facts

Politics

Head of state: President Dilma ROUSSEFF
Head of government: President Dilma ROUSSEFF
Political system: Democracy
Date of next presidential election: October 2014
Date of next legislative election: October 2014
Currency: real (BRL), floating exchange rate

Long-term economic & social development

	1980	1990	2000	2011*
GDP per capita (US$)	1932	3089	3701	12578
Inflation (%)	-	2947.7	7.0	6.6
Population (mn)	121.7	149.7	174.7	196.9
Urban population (% of total)	67.4	74.8	81.2	86.0
Life expectancy (years)	62.5	66.3	70.2	72.4

Source : Oxford Economics & World Bank

Structure of GDP by output

	2009
Agriculture	6.1%
Industry	25.4%
Services	68.5%

Source : World Bank

* 2011 or latest available year

Source : CIA Factbook
Location : Eastern South America, bordering the Atlantic Ocean (CIA Factbook)

Long-term sovereign credit ratings & outlook

	Foreign currency	Local currency
Fitch	BBB (Stable)	BBB (Stable)
Moody's	Baa2 (Positive)	Baa2 (Positive)
S&P	BBB (Stable)	A- (Stable)

Corruption perceptions index 2011

	Score
Developed economies (average)	7.70
Emerging economies (average)	3.44
Brazil	3.77
Western Hemisphere	3.80

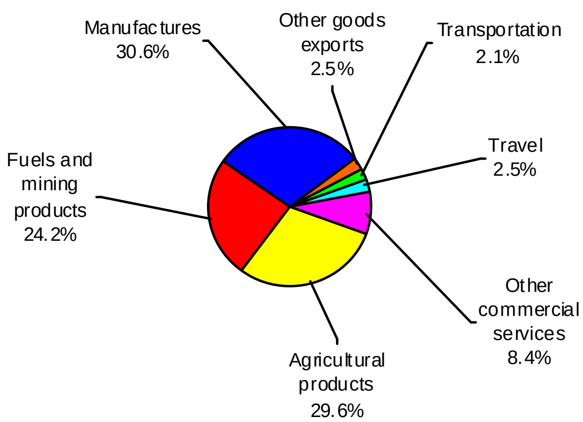
Source: Transparency International
Scoring system 10 = highly clean, 0 = highly corrupt

Structural economic indicators

	1990	1995	2000	2011*
Current account (US$ billion)	-3.8	-18.4	-24.2	-52.5
Trade balance (US$ billion)	10.8	-3.5	-0.7	29.8
FDI (US$ billion)	0.3	3.3	30.5	67.7
Debt service (US$ billion)	8.2	21.6	64.8	50.8
Debt service (% of exports)	22.4	38.5	95.1	20.0
External debt (% of GDP)	25.9	20.9	37.5	11.8
Oil production (000 bpd)	631	695	1269	2105
Oil consumption (000 bpd)	1466	1788	2166	2560

Source : Oxford Economics / World Bank / EIA

Composition of goods & services exports, 2010



Source : WTO

Destination of goods' exports (2010)

European Union (27)	21.8%
China	15.6%
United States	9.8%
Argentina	9.4%
Japan	3.6%

Source : WTO