



## Brazil's GDP Expected to Rise Moderately in 2012 Amid Strong Fundamentals

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### Executive Summary

Although Brazil's economy is unlikely to rise to the heady heights of 7.5% growth seen in 2010,<sup>1</sup> we still expect healthy year-over-year GDP growth in 2012, with growth rising moderately to 3.5% from 3.0% in 2011.<sup>2</sup> We see current activity as somewhat below Brazil's potential growth; however, a higher figure would also bring with it stronger inflationary pressure, which central bank authorities have been seeking to control.

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### Robust Consumer Spending and Credit

Despite a slowdown in the industrial sector, domestic demand in Brazil remains resilient, boosted by strong household income and credit expansion. We expect consumer spending to remain strong, supported by record low unemployment and the recent rise in the minimum wage, while credit availability might experience some moderation in 2012. However, we do not envision a significant slowdown in credit, given the government's reversal of the increase in capital requirements for banks and its move in December 2011 to cut the financial operations tax (IOF) on consumer loans by 0.5% to 2.5%. Consumer spending should also remain supported by recent tax reductions on home appliances. These were initially scheduled to last until March 2012 but could be extended if the government decides additional stimulus is needed. We believe these loosening measures are the first steps toward further fiscal and monetary stimulus this year, as Brazilian authorities seek to protect the Brazilian economy from potential fall-out from the eurozone crisis and other possible impediments to global growth.



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<sup>1</sup> Brazilian Institute of Geography and Statistics (IBGE).

<sup>2</sup> BNY Mellon ARX estimated projection.

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We expect real income to rise around 4% this year, with the largest increases expected for services, retail and construction sectors.

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### **Record Low Unemployment**

Labor market conditions remain extremely favorable for Brazil, with the unemployment rate having reached record lows last year, below 6%.<sup>3</sup> We expect to see some marginal uptick in the unemployment rate throughout 2012 to a level closer to the non-accelerating inflation rate of unemployment (NAIRU), in response to the slowing of growth that is already underway. Still, we expect employment to remain healthy this year, with further stimulus from the strong nominal increase in the minimum wage in this first quarter. We expect real income to rise around 4% this year, with the largest increases expected for services, retail and construction sectors.

Lending remains resilient, despite the central bank's expectations of a slowdown in growth in 2012. In fact, the central bank has increased its forecast for last year's credit expansion, from 15% to 17%.<sup>4</sup> In our view, the rise and improved distribution of real income create solid fundamentals for expanding credit. The recent rise in consumer debt and delinquency rates have been fueling fears of a possible credit bubble bursting; however, we think high lending rates should play down those concerns. As mentioned, even if there is a moderate slowdown in credit throughout this year, Brazil's government still has a wide arsenal of measures available to offset a potential credit crunch should conditions outside Brazil deteriorate.

### **Range-Bound Inflation**

The last headline inflation reading of 2011 was lower than markets expected, allowing last year's 12-month inflation number to reach 6.5%,<sup>5</sup> within the official target range established by the central bank. This made 2011 the eighth straight year that Brazil's economy fell within the accepted range, contrary to consensus expectations of a reading above the upper band. However, core inflation estimates remain at significantly elevated levels (above 6.5%) as well as service inflation, which ended 2011 at 9%.<sup>6</sup> We believe inflationary pressure from the service sector will persist in 2012, in part due to the strong minimum wage increase (14.0% in nominal terms).<sup>7</sup> Still, in our view there are additional risks of continued food price increases in the short run, due to weather-induced crop damage, although we believe that the overall scenario for this year is still tilted toward moderating commodity prices amid a global economic slowdown. We expect inflation to slow to 5.2% in 2012, aided by the recent restructuring of the weights in Brazil's main inflation index (IPCA).

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<sup>3</sup> Brazilian Institute of Geography and Statistics (IBGE).

<sup>4</sup> Brazilian Central Bank.

<sup>5</sup> IBGE.

<sup>6</sup> *Ibid.*

<sup>7</sup> Brazilian Ministry of Planning.

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Although we believe interest rate easing will extend throughout the first half of 2012, we expect that a jump in inflation could restart the tightening cycle by the end of this year.

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The central bank started the easing cycle at the end of August 2011, with a surprising 50 basis-point drop in the country's benchmark Selic interest rate. Additional cuts toward the end of 2011 dropped the Selic rate to 11.00%. We think the central bank will cut further throughout this year, probably towards something around 9%. It is clear that policymakers are very concerned about the potential adverse effects of foreign financial crises on Brazil's economy, which is already beginning to slow. Although we believe interest rate easing will extend throughout the first half of 2012, we expect that a jump in inflation could restart the tightening cycle by the end of this year.

### **Restrained Fiscal Policy**

With President Dilma Rouseff aiming for lower interest rates, the government has been adopting a restrained fiscal policy. Increased tax collection and atypical flows have boosted revenues, while expenditure cuts have been focused on investment spending. General consensus expects a primary fiscal surplus of 3.2% of GDP to be recorded for 2011<sup>8</sup> although estimates for 2012 are a bit cloudier. We forecast a 2.8% primary surplus this year, falling behind the target due to the need to accelerate investment spending for the soccer World Cup games in 2014 and the Olympics in 2016.

In the past year, foreign direct investment (FDI) inflows have become a huge source of financing for Brazil's current account deficit (CAD), which we expect to continue to widen throughout 2012. In the past 12 months, FDI has amounted to 3.26% of GDP, comfortably covering Brazil's 2.05% current account deficit. However, portfolio inflows have been decelerating in the last months, reflecting in our view the global risk aversion trend and the government's increase of the tax charged on foreign fixed income investments.

After registering a close to US\$ 30 billion surplus in 2011,<sup>9</sup> we expect the trade balance to experience some moderation this year, as slowing global growth exerts downward pressure on commodity prices. We do not believe the current account will remain funded by FDI in 2012, as our estimates consider an acceleration of the deficit from US\$ 55 billion in 2011 to US\$ 65 billion in 2012. In GDP terms, we expect the current account deficit to rise from 2.1% in 2011 to 2.8% this year.

Currency intervention measures adopted by the central bank, along with signs of a further drop in the Selic rate and risk-averse investor sentiment, fostered strong currency depreciation in 2011, with the real dropping from 1.55 to the US dollar in June to near 1.86 by the end of December 2011.<sup>10</sup> However, we believe Brazil's economic fundamentals remain supportive of a strong currency, and we do not envision a further depreciation round of the real in the near term. Our view is that the real should close 2012 at around 1.75.

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<sup>8</sup> Bloomberg.

<sup>9</sup> Ministry of Development, Industry and Commerce (MDIC).

<sup>10</sup> Brazilian Central Bank.

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