Brazil

In 2006 the Brazilian economy grew by around 2.8% while the inflation rate fell to its lowest level since the exchange-rate crisis of 1999. Between January and October 2006, there was a real year-on-year increase in the wage bill of over 6%, and formal employment in the six main metropolitan areas expanded by 3.5% in net terms over the same period.

One factor contributing to this performance was the favourable external situation, thanks to high prices for the country's export commodities. Despite the rise in imports, the increase in the trade surplus contributed to the appreciation of the Brazilian currency, which in turn kept domestic prices stable and allowed a further reduction of nominal interest rates; this led to an expansion of credit, especially consumer credit. Gross fixed capital formation has grown less rapidly than expected under these conditions, although a 6% growth rate is estimated for 2006 (compared to growth of 1.6% in 2005).

In 2006 economic policy continued to be based on a system of inflation targets, a floating exchange-rate regime and an emphasis on fiscal responsibility. The gradual fall in the inflation rate to a cumulative 3.2% for the year up to October (lower than the initial target of 4.25%) made it possible to reduce the benchmark interest rate (Special System of Clearance and Custody (SELIC)) from an annualized 19.5% in September 2005 to 13.25% in November 2006. Nevertheless, the rate of reduction was less than the drop in inflation, which has kept the real interest rate high (about 10% per annum).

Brazil's currency continued to appreciate for the third consecutive year, with a nominal increase in value of 7.7% since December 2005; this is primarily attributable to the net supply of foreign exchange generated by a growing trade surplus, which will amount to about US$ 44 billion. Some of this foreign currency was purchased to build up international reserves, which posted a record level of over US$ 83 billion in November 2006 (equivalent to a rise of US$ 29 billion over the year).

As for fiscal policy, the expansion of federal public spending in the first 10 months of 2006 (15.6% in nominal terms), and especially the payments made for retirement and other pensions by the National Social Security Institute (INSS) (which increased by 19.1% owing to the advance payment in September of half of the annual bonus), have raised questions as to the viability of maintaining the fiscal target of a primary surplus for the non-financial public sector equivalent to 4.25% of GDP. Federal revenues expanded by 12.8% over the same period. The higher growth in public revenues came from taxes (11.1%), especially on business profits, while there was a lower rate of expansion in social contributions (7%). In 2006, one important source of income for the national treasury was the revenues generated by an increase in dividend payments by State enterprises and banks; in fact, federal banks paid out about 6.7 billion reais in such dividends, equivalent to about 0.3% of GDP.

In October 2006, total net public debt was equivalent to 49.5% of GDP, which was a decline from the 51.5% level of December 2005. In 2006 the Brazilian public sector virtually eliminated its net foreign-exchange liabilities. According to estimates for the period up to October, the public sector's external debt was reduced to US$ 74.6 billion, an achievement which, combined with the high level of international reserves and the fact that the authorities have replaced domestic debt securities indexed to the exchange-rate with other securities (mainly fixed-rate securities in local currency), meant that in October 2006 the Brazilian public sector recorded net foreign-currency assets equivalent to 2.1% of GDP. Net domestic debt amounted to 51.6% of GDP in October 2006.

Growth rates for 2006 are expected to amount to 4% in the industrial sector and 2.5% for both agriculture and services. Different industrial subsectors have led the overall sector's growth during different periods. Over the period from January to September 2006, in relation to the year-earlier period, the best performances were in mining (7%) and civil construction (5.4%). Manufacturing grew by 1.4% over the same period.

Manufacturing subsectors have also performed unevenly. Over the year as a whole, growth in the production of durable consumer goods, driven by the rise in the wage bill and consumer credit, is estimated at over 6%, while production of non-durables and semi-durables will have increased by about 3.5%. Output of capital and intermediate goods is expected to expand by around 5% and 2%, respectively.

Agricultural activity has been handicapped by a financial crisis in the sector caused by the excessive debt levels accumulated over past years. This problem has been aggravated by lower profits due to the real's appreciation and lower international prices for the sector's products compared to previous years. In 2006, for the second consecutive year, agriculture expanded by approximately 2.5%. The area under cultivation for the 2005/2006 harvest was 3.4% smaller than in 2004/2005, but thanks to very favourable weather conditions, there was no fall in output. The results have varied considerably across products: significant reductions in cotton, moderate growth in beans, corn and soya, and a strong expansion in coffee and sugar cane.

A review of activity levels on the demand side shows that the main factor holding back growth was the external sector; despite the continuation of excellent results for the trade balance, import volumes expanded more rapidly (16.8% for the period from January to October 2006, compared to the year-earlier period) than export volumes (4.7% over the same period).

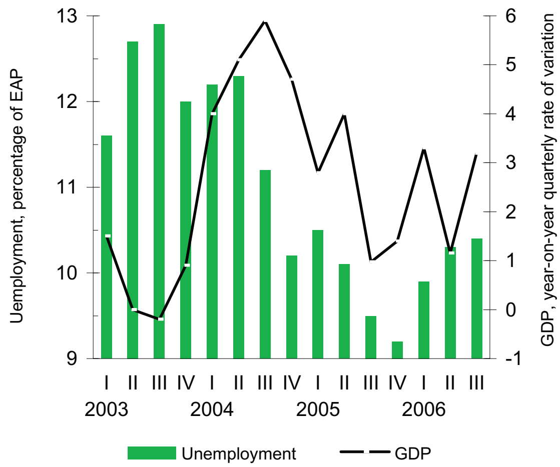
Growth has been driven mainly by household consumption, which is expected to expand by more than 4% over the year, thanks to higher total wages, the continued growth of credit and the impact of the expansion of income transfer programmes. Credit reached a level equivalent to 33% of GDP. Once again, loans repayable by direct payroll deduction have led to increased levels of personal credit, as they had expanded by 44% by October and accounted for 52% of all personal credit. The family grant ("Bolsa Familia") programme already includes over 11 million families that are considered to be the poorest in the country.

Gross fixed capital formation made a positive contribution to GDP growth (estimated at over 20% of GDP at current prices). Nevertheless, there is still resistance to a significant increase in investment, owing to a number of factors. The most important is the combination of high short-term interest rates —which are declining in nominal terms but not to the same extent in real terms— and uncertainty as to the future direction to be taken by monetary policy in response to the potential effects on prices of an exchange-rate devaluation, which could push up the interest rate again. Growth in public investment continues to be subject to the constraints created by rising levels of current expenditure, the need to meet fiscal targets and difficulties in project implementation that act as operational limitations on the formation of joint ventures.

Between January and October 2006 the average unemployment rate in the country's major metropolitan areas was higher than the year-earlier figure (10.2% versus 9.8%). One of the reasons for this appears to be the labour market's very limited capacity to absorb the

Figure 1

BRAZIL: GROSS DOMESTIC PRODUCT AND UNEMPLOYMENT



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures..

larger increase in the economically active population that stemmed primarily from the entry of new job-seekers. Real mean labour income in these cities between January and September was up by 3.2% compared to the corresponding period in 2005.

The balance-of-payments current account posted a cumulative surplus for the period from January to October of US$ 11.7 billion (1.5% of GDP) as the net result of a positive trade balance (US$ 37.9 billion) and a services and income account deficit of US$ 29.8 billion.

Export growth was mainly driven by high prices. Over the first 10 months of 2006 the value of exports grew by 17.3% (4.7% in terms of volume), while imports increased by 25.2% in the same period (16.8% in volume). The fastest-growing export products were semi-manufactures and commodities, as their export value rose by 19.2% and 16.3%, respectively. The performance of exports reflected the impact of the real's appreciation, but the results have varied from one destination market to the next. In real terms, while the real appreciated against the United States dollar by 10.3% over the 12-month period to September, its appreciation against other Latin American currencies amounted to 6.6% for the same period.

The increase in the value of imports for January-October 2006 compared to the corresponding period in 2005 was attributable to the higher level of imports of consumer durables (42.5%) and fuels and lubricants (29.4%). The sharpest increases were in consumer durables (79.8%) and capital goods (26.7%), in terms of import volumes up to September 2006, and in fuel prices (31.8%).

The income account reflected a negative net flow of interest payments amounting to US$ 9.4 billion, which is less than the US$ 11.5 billion recorded for the same period in 2005. Net payments of profits and dividends amounted to a deficit of US$ 12.5 billion, which is much higher than the US$ 9.7 billion deficit for the year-earlier period.

A US$ 9.2 billion net outflow of foreign direct investment (FDI) was registered for the first 10 months of 2006, compared to a net inflow of US$ 10.1 billion for the same period of 2005. This result reflects US$ 22.8 billion in Brazilian investments abroad (much of which corresponded to the acquisition of the Canadian mining company Inco by the Brazilian Companhia Vale do Rio Doce (CVRD) for US$ 13.2 billion) and US$ 12.6 billion (about 1.8% of GDP) in inbound FDI. This means that, for the first time ever, the value of Brazil's outward FDI has exceeded inward FDI. External portfolio investments jumped from US$ 1.8 billion for the period from January to October 2005 to US$ 5.3 billion for the same period of 2006.

In October, the total external debt stood at US$ 174.6 billion (US$ 197.4 billion if inter-firm loans are included), which is higher than the figure for the end of December in 2005 (US$ 169.4 billion) and reflects an increase in external loans to the private sector. Measured as a percentage of the total value of exports, debt servicing was reduced from 55.8% in December 2005 to 49% in October 2006.

Table 1

BRAZIL: MAIN ECONOMIC INDICATORS

	2004	2005	2006 [a]
	Annual growth rates		
Gross domestic product	4.9	2.3	2.8
Consumer prices	7.6	5.7	3.0 [b]
Average real wage [c]	0.7	-0.3	3.4 [d]
Money (M1)	17.4	14.0	14.2 [e]
Real effective exchange rate [f]	-4.8	-18.3	-12.7 [e]
Terms of trade	0.9	1.4	3.2
	Annual average percentages		
Urban unemployment rate	11.5	9.8	10.1 [g]
Central government operating balance/GDP [h]	-1.3	-3.5	-4.0
Nominal deposit rate	8.2	9.4	2.0 [i]
Nominal lending rate	41.1	43.7	40.6 [j]
	Millions of dollars		
Exports of goods and services	109 059	134 403	158 229
Imports of goods and services	80 096	97 801	122 483
Current account	11 679	14 193	13 074
Capital and financial account	-5 073	13 398	11 926
Overall balance	6 607	27 590	25 000

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

[a] Preliminary estimates.
[b] Twelve-month variation to November 2006.
[c] Workers covered by social and labour legislation, private sector.
[d] Estimate based on data from January to September.
[e] Year-on-year average variation, January to October.
[f] A negative rate indicates an appreciation of the currency in real terms.
[g] Estimate based on data for January to October.
[h] Includes the federal government and the central bank.
[i] Average from January to September, annualized.
[j] Average from January to October, annualized.