# BRAZIL

## 1. General trends

The Brazilian economy demonstrated its vibrancy in 2010, staging a rapid recovery from the impact of the international crisis, with 7.5% GDP growth, the highest rate observed since 1986. This expansion was underpinned by the response of the domestic market and the rebound in exports. However, the strength of domestic demand and the higher commodity prices in external markets pushed inflation up to 5.9% in 2010, which the economic authorities viewed as perilously close to the upper limit of the inflation target of 6.5%. In an effort to contain these pressures, the authorities adopted a tough monetary stance (raising interest rates) and strict credit policies (imposing more stringent lending conditions) and have programmed cuts in public expenditure for 2011. These steps, together with the dismantling of measures introduced in 2010 to address the crisis, will also help to mitigate the impact of fiscal policy on economic activity. Thus, lower growth of approximately 4.0% is forecast for 2011.

The new administration of President Dilma Roussef, which took over in January 2011, reaffirmed its commitment to macroeconomic stability and maintaining economic growth. Shortly after taking office, the new federal government, faced with a deterioration in inflation expectations, announced a fiscal package designed to cut back expenditure by almost 50 billion reais. The public-sector primary surplus to April was equivalent to 4.54% of GDP, up from 3.5% in the same period of 2010.

The central bank raised the Special System of Clearance and Custody (SELIC) interest rate from its lower nominal level of 8.75% to 12% in April 2011. This corresponds to a real annual rate of over 6%. The tightening of monetary policy has gone hand in hand with the implementation of macroprudential regulations geared to reinforcing the capitalization of the financial system, containing credit expansion and strengthening entities against the eventuality of further delays in the disbursement of approved loans.

These measures were complemented by a strategy for coping with the rapid rise in the value of the currency as a result of the amount of capital flooding into the country. The purchase of hard currencies on the foreign-exchange market, which swelled international reserves to approximately US$ 330 billion in April 2011, was accompanied by more rigorous measures designed to discourage the inflow of short-term foreign capital, including the imposition of a tax on specific types of financial operations. This tax was set at 2% in October 2009 and reached 6% in October 2010.

The initial results for 2011 point to steady economic growth with a gradual impact on the rate of inflation, aided by a fall in fuel prices due to the continuing currency appreciation. In the first quarter of 2011, GDP grew by 1.3% over the last quarter of 2010 and by 4.2% in relation to the first quarter of 2010, at a time when growth has been slowing as confirmed by industrial production data and overall sales figures for April.

## 2. Economic policy

### (a) Fiscal policy

Public-sector results for 2010 still reflected the use of measures adopted in 2009 to address the crisis and their gradual withdrawal during the course of the year. The public-sector primary surplus was equivalent to 2.78% of GDP, surpassing that of 2.03% of GDP recorded in 2009. This improvement reflects in part the posting of the capitalization operation concluded between the Treasury and Petrobras, which resulted in a net inflow equivalent to 0.87% of GDP. In 2010, federal government tax receipts (excluding those relating to the Petrobras operation) grew by 13.6%, compared with just 3.2% in 2009. Expenditure again increased significantly: by 14.9%, the same rate as in 2009. Payroll costs, social security payments and investment projects were the main factors pushing up expenditure.

In the first few months of 2011, fiscal policy sought to restore the public-sector primary surplus to a level close to the target of 3.0% of GDP. Between January and April, the federal government accrued a primary surplus equivalent to half of its annual target of 82 billion reais. The subnational governments also recorded a surplus, which stood at 16.7 billion reais, a 27.2% increase over the figure for the same period in 2010. The sustained growth has fuelled successive increases in tax collection. Federal tax collections were up by 18.4% in the first four months of the year. Following rate reductions, collections from the tax on industrial goods, which served as a valuable instrument in alleviating the impact of the crisis, picked up by 22.0%. Favourable corporate results, especially those of financial institutions and those relating to commodity exports, contributed to a 16.3% rise in income tax receipts.

On the expenditure side, the new government announced cut-backs of 50 billion reais in the 2011 budget, which in real terms was tantamount to zero growth in the budget. However, the government has maintained social initiatives, such as the Bolsa Familia programme or the new programme for overcoming extreme poverty, and investment projects that are part of its Growth Acceleration Programme, version two. In terms of its main expenditure, the government has postponed hiring new civil servants and launching wage negotiations with existing staff; the Congress passed a law which establishes an increase in the minimum wage, indexed on past inflation and the variation in GDP over the two preceding years. The authorities have sought to raise efficiency with less resources including greater control and a reduction in travel costs and other current expenditure.

The government is also facing higher spending pressures, especially with regard to the infrastructure for the major events scheduled to take place in the country, namely the 2014 Football World Cup and the 2016 Olympic Games. Other investments will also be necessary, in particular for the exploration of new areas of production by Petrobras. For the third year in a row, the Brazilian Development Bank (BNDES) will receive an injection of new capital, this time amounting to 50 billion reais, almost half the amount transferred annually in the previous years. In addition, with the rise in the interest rate, interest payments are expected to increase; payments in January-April 2011 were already 30.9% higher than in the same period of 2010.

### (b) Monetary policy

With the recovery in economic activity in the last three quarters of 2009, the central bank took steps throughout 2010 to eliminate the incentives and special lines of credit which had been put in place in response to the crisis. The support mechanisms provided to Brazilian companies to enable them to reschedule their foreign debts or obtain credit for their exports were dismantled; the legal reserve requirement for banks was adjusted, which meant that liquidity contracted by over 100 billion reais; and essentially from April, the authorities started to raise the basic SELIC interest rate in order to rein in domestic demand. In September, these interest rate rises were halted but were resumed in January 2011. By April, the rate stood at 12%.

In the last few months of 2010, the central bank started to introduce new conditions for granting certain types of credit. For example, the capital requirement ratio was raised from 11% to 16.5% for operations of over 24 months involving natural persons or for 14-to-36-month operations for motor vehicle loans, provided the down payment was not more than 20% of the total cost; to 30% for operations of 37-48 months; and to 40% for operations of over 48 months. In addition, the marginal reserve ratio for sight deposits was increased from 8% to 12% and for long-term deposits from 15% to 20%. These higher legal reserve ratios should reduce liquidity by 61 billion reais. In addition to these measures, various initiatives have been adopted to strengthen control over sales consortia and credit cards

Although credit expanded in the first four months of 2011 by much the same rate as in 2010, it was more expensive with slower growth in the operations of public institutions, which had been largely responsible for the sharp growth in credit during the crisis. Moreover, the central bank has indicated that its objective is to gradually bring the rate of inflation back down to the middle of the target of 4.5% by the end of 2012. The central bank thus hopes to be in a position to support a sustainable level of economic growth, combining price stability with the expansion of production capacity.

Another economic policy challenge in Brazil has been the substantial influx of foreign capital. In 2010, net foreign direct investment (FDI) inflows represented US$ 36.9 billion and net portfolio investments exceeded US$ 64.5 billion. This abundance of foreign exchange placed strong pressure on the exchange rate, which was countered by significant purchases by the central bank. International reserves swelled by over US$ 49 billion, closing the year at US$ 288.575 billion. These strong capital movements continued into 2011. In the first four months, net inflows exceeded US$ 34.5 billion and were absorbed through central bank purchases, bringing international reserves to US$ 328.062 billion. However, the currency continued to appreciate against the United States dollar, gaining more than 10% cumulatively between the end of 2009 and April 2011. With domestic inflation at a higher rate, the real exchange rate continued to deteriorate. According to ECLAC data, in the twelve months to May 2011, the real effective exchange rate fell by 11.2%, compared with the level twelve months earlier.

In order to differentiate between the types of inflows, in October 2010, the authorities once again raised the tax on financial operations by two percentage points, in particular on short-term inflows intended for stock purchases. Following this rise, the rate stood at 6%. In April 2011, the tax was extended to short-term loans of up to two years and the rate set at 6%.

## 3. The main variables

### (a) Economic activity

Brazil’s economic performance in 2010 was remarkable as witness the high growth of 7.5%; the increase in formal employment by 2.1 million new posts; the reduction in the rate of unemployment to its lowest levels: an average of 6.7% in the principal metropolitan regions; and a 4.4% increase in real average income. Investment in civil construction as well as in the purchase of locally produced and imported equipment rallied by 21.8%, boosted by public and private financing with funding from BNDES, which disbursed more than 169 billion reais, or approximately 4.6% of GDP.

In the first quarter of 2011, the Brazilian economy grew by 1.3% in relation to the previous quarter so that the cumulative 12-month growth rate was 4.2%. The quarterly rate was higher than those of the two previous quarters (0.4% and 0.8%). Nevertheless, in comparison with the same period of the previous year, activity has been growing more slowly. This slowdown is concentrated mainly in the processing industry, where the total production level has stabilized in recent months, close to the peaks observed before the 2008 crisis, with 1.6% cumulative growth between January and April, compared with 9.7% in 2010. The pace of growth has varied however from one industry to the next. The production of capital goods grew by 6.2% in the first four months of 2011, compared with the same period in 2010 and the production of consumer durables was up by 2.3%, with automobile production increasing by 1.9%. Intermediate goods and semi-durables expanded by 1.1% and 0.1%, respectively, in the four-month period compared with the same period in 2010.

The growth in the production of capital goods is related to the increase in gross fixed capital formation, which in the first quarter of 2011 grew by 8.8% in relation to the same quarter of 2010. Civil construction recorded an increase of 5.2% over the same period. Agriculture is also expected to post favourable results in 2011, with growth rates of close to 6.5% in 2010. A 6% expansion is projected for this year’s grain harvest and the livestock sector will again perform robustly with the rally in external demand for its products.

Overall consumption, including household and public consumption, was a vital component in the Brazilian economy’s resilience in the face of the crisis. Even with the impact of the economic recession, household consumption has grown steadily since the end of 2003, attaining cumulative growth of 7.0%, a rate unseen since the 1980s. In addition to sound labour-market conditions, credit has played an essential role in sustaining the higher level of purchases. In 2010, credit to private individuals increased by 21.9% and credit for housing soared by over 50.4%. In the first quarter of 2011, household consumer growth slowed down, with a variation of 0.8% compared with the previous quarter, reflecting the impact of the higher inflation on income and the higher cost of credit operations.

### (b) Prices, wages and employment

In the last few months of 2010, Brazil started to feel the repercussions of the rise in international commodity prices. Between August 2010 and April 2011, wholesale agricultural prices shot up by 24.8%. To a lesser degree, wholesale prices for industrial products, which had slumped in 2009 (-4.43%) as a result of the crisis, rose by 10.3% in 2010 in response to the upturn. The extended national consumer price index (IPCA) moved up throughout the year, averaging 5.91% in 2010 compared with 4.31% in 2009. In April 2011, the 12-month variation was 6.51%, exceeding the upper target limit.

However, prices for agricultural crops, especially sugar cane used to produce ethanol, trended sharply downward, declining by 0.6% in April. The wholesale price index was practically flat in May 2011. With the fall in ethanol prices, decreases of up to 10% were observed in the price of gasoline, which contains up to 25% ethanol.

The challenge for the coming months will be to incorporate price rises in the indexation mechanisms that still operate in the Brazilian economy, in particular for rental contracts of over one year and for public utilities.

Future wage negotiations should also be followed closely, as rising prices for agricultural products and services will be an additional pressure in favour of wage increases. Up to April 2011, the trend in wage indicators remained favourable. The wage bill in the main metropolitan areas continued to expand, registering an increase of 5.6% in comparison with April 2010. Real average income rose by 3.2%. In the six main metropolitan areas, the employment rate edged up by 0.6 percentage points during the first five months of the year compared with the same period in 2010, which resulted in a fall in the unemployment rate from 7.4% to 6.4%. In the same period, the number of formal-sector wage-earners increased by 6%.

## (c) The external sector

The abundant international liquidity generated by the measures adopted in the developed countries in order to keep interest rates down or boost the money supply has resulted in strong inflows of foreign exchange into Brazil in the form of direct or portfolio investments and credit inflows. Thanks to this liquidity, there was no difficulty in financing the significant foreign currency expenditure resulting from rising imports or the higher payments for goods and services and repatriation of profits. Consequently, the country had to use more external savings with a widening deficit on the current account. In the first four months of the year, the Brazilian trade balance showed a surplus amounting to US$ 5.032 billion, or 132% more than in same period of 2010. The increase in exports (31.3%) outstripped the rise in imports (27.0%), thanks to commodity sales, which exceeded those of manufactures in 2010 and constituted the leading category of exports from Brazil.

Export performance up to April 2011 was shored up by the windfall prices (up 27.1% over those of the corresponding period in 2010), while export volumes expanded by just 3% over the year-earlier period. In terms of the cumulative rises for January to April 2011, increases were observed for all categories, led by commodities (up 45.5%), while semi-finished goods were up by 21.1% and manufactured goods by 12.4%. In volume terms, semi-finished products climbed by 9.2%, commodities by only 1.1% and manufactures by 3.1%.

During the period January-April, the value of imports increased by 27.0%, while the overall increase (including both prices and volumes) was 12.7%. However, the rate of expansion of Brazilian imports slowed slightly by 4.6 percentage points in volume terms, owing to the increase in prices in particular those of fuels (32.0%), in comparison with the same four-month period in 2010. In the other import categories, cumulative growth rates over the year were lower than those of the 12 months up to April 2011: for example, capital goods (up 28.3% compared with 44.4% in the earlier period), intermediate goods (up 9.6% in contrast with 26.4%) and consumer non-durables (18.4% and 24.5%). Imports of consumer durables maintained a growth rate of 38%, with motor vehicle sales especially buoyant.

The income and services deficit widened in the first four months of 2011 to stand at US$ 24.236 billion (up from US$ 19.771 billion in the same period of 2010). During the same period, owing to falling rates on world markets, the net interest payment amounted to US$ 3.083 billion (compared with US$ 3.743 billion in the same period in 2010). Given the positive results from their subsidiaries and the parent companies' capital requirements, multinationals will repatriate net dividends and profits totalling US$ 10.515 billion (up from US$ 7.931 billion in the same period in 2010).

The current transactions deficit continued to grow in 2011, recording US$ 18.119 billion up to April, compared with a deficit of US$ 16.565 billion in the same period of 2010. However as GDP grew strongly throughout 2010, the deficit, expressed as a percentage of GDP, declined from 2.46% for the first four months of 2010 to 2.39%.

In the first four months of 2011, the surplus on the capital and financial account almost doubled (amounting to US$ 53.418 billion, compared with US$ 27.614 billion in the same period of 2010). This points to the more abundant liquidity position in international financial markets and the incremental rate of return on Brazilian assets. It was mainly foreign direct investment that increased in the first four months as a net inflow of US$ 31.658 billion was recorded, similar to the amount for the entire year 2010, which was US$ 36.919 billion. Portfolio investment declined from a net positive position of US$ 15.274 billion in the first four-month period of 2010 to US$ 12.730 billion in the same period of 2011, bearing in mind the higher cost of short-term operations for the implementation of the higher tax rate now applying, which stands at 6% in some cases.

The total external debt stood at US$ 282.461 billion in April 2011, up from US$ 256.804 billion in December 2010. The widening short-term debt, which at the end of 2009 amounted to US$ 30.973 billion, increased to US$ 57.307 billion in December 2010 and swelled to US$ 64.333 billion in April 2011. Nevertheless, the country's external debt indicators did not show any further deterioration. The debt service to exports ratio fell from 23.0% in December 2010 to 21.2% in April 2011; the debt burden ratio decreased from 6.7% to 6.3%; the total debt/GDP ratio increased from 12.3% to 13.0%; and the international reserves/short-term external debt ratio rose from 371.4% to 386%.