Euler Hermes Economic Research

Country Report

Brazil

The World Cup weighed on growth and fuelled inflationary pressures

General Information

GDP	USD2252.664bn (World ranking 7, World Bank 2012)
Population	198.66 million (World ranking 5, World Bank 2012)
Form of state	Federal Republic
Head of government	Dilma ROUSSEFF (PT)
Next elections	October 2014, presidential and legislative

Strengths

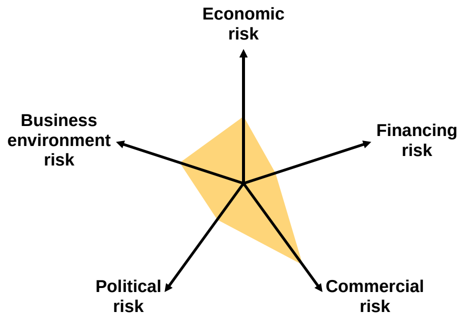
- Overall size of the economy
- Large domestic market and expanding middle class
- Diversified economic base (minerals, agriculture, manufacturing sector)
- Robust foreign direct investment, high level of foreign exchange reserves, moderate external debt
- Durable political system with established effective democratic transfers of power

Weaknesses

- Insufficient domestic investment and infrastructure bottlenecks
- Vulnerable to global commodity demand and prices
- Lack of qualified workforce and high production costs
- Persistent inflation and public spending stresses
- High taxation and bureaucracy undermine competitiveness
- Political and social tensions, persistent insecurity, allegations of corruption and inequalities of income distribution

Country Rating

BB2



Source: Euler Hermes

Trade Structure

By destination / origin (% of total)

Exports		Rank		Imports
China	17%	1	16%	China
United States	12%	2	15%	United States
Argentina	7%	3	7%	Argentina
Germany	5%	4	6%	Germany
Japan	4%	5	5%	Nigeria

By product (% of total)

Exports		Rank		Imports
Iron Ores	14%	1	9%	Refined Petroleum
Other Edible Agri. Products	12%	2	6%	Crude Oil
Crude Oil	9%	3	4%	Fertilizers
Sugar	6%	4	4%	Cars and Cycles
Meat	5%	5	4%	Engines

Source: Chelem, UNCTAD (2012)

Economic Overview

Growth to remain below 1% in 2015

As Euler Hermes expected, the Football World Cup weighed on investment and growth, mainly as a result of fewer working days, while it fuelled inflationary pressures (for further information, see the Economic Insight 2014 World Cup: more inflation than growth for Brazil published in June).

The Brazilian economy slipped in technical recession in Q2 as real GDP contracted by -0.6% q/q (-0.8% y/y) while Q1 figures were revised down to -0.2% q/q (compared with +0.2% initially). Investment drop sharply in Q2 (-5.3% q/q), completing four consecutive quarters of decline, now standing at early 2010 levels. Private consumption increased slightly (+0.1% q/q), but failing to fully offset the decline recorded in Q1 (-0.3% q/q). In line with sluggish domestic demand, imports fell (-2.1% q/q), while exports bounced by +2.8% q/q, but again barely compensating for the fall in Q1 (-3.8% q/q). External demand contributed positively overall to GDP growth (+0.7pps q/q).

For 2014, the carry-over for growth stands at 0.0%. Leading indicators suggest that a recovery in H2 will be gradual. After declining since February, the Index of Economic Activity (a proxy for GDP) and the industrial production grew +1.5% m/m and +0.7% m/m in July respectively, but both remain below the level reached in late-2013. Private consumption remains subdued by persistent inflationary pressures, as real retail sales continued to drop in July (-1% m/m), falling back to same level as a year earlier. Euler Hermes expects the Brazilian economy to stagnate this year (+0.3%) while growth should remain below +1% in 2015 (+0.8%).

Inflationnary pressures to persist

Brazilian inflation continued to edge higher in the top half of the target range (4.5% +/-2pps), at +5.6 % y/y in August. However, a monetary policy tightening is unlikely in the short-term given sluggish growth. The key interest rate (SELIC), at 11% since April, is expected to remain at this level until the end of the year, at least.

Persistent pressures on consumer prices have two main explanations. On the one hand, this is the result of structural weakness of the Brazilian economic model, as the economy has suffered from chronic underinvestment recorded over past years. The investment of Brazil rate stands below 20% of GDP, one of the lowest among the BRICs (China: 47%; India: 34%; Russia: 24%) and below the Latin-American average (Argentina, Chile, Colombia: 24%; Mexico: 22%; Peru: 28%), according to IMF data. When contrasted with the more dynamic private consumption, there is a significant mismatch between internal demand and national supply. For example since 2005 retail sales have grown eight times faster than the industrial production. On the other hand, the sporting mega events hosted by Brazil (Soccer World Cup in 2014 and Olympic Gamer in 2016) have generated additional pressures on prices. Euler Hermes estimates that more than +0.5pp of the annual inflation of 2014 is to be explained by these mega-events. The bullish impact on inflation will remain strong thereafter given the prospects of the Olympics, adding another +0.4pp per year to the inflation rate in 2015-2016. Even if it begins to diminish after the Olympic Games, it may not disappear before 2020 given the inertia of price increases.

All in all, Euler Hermes expects inflation to remain elevated, at +6.2% on average in 2014 and at +5.8% in 2015.

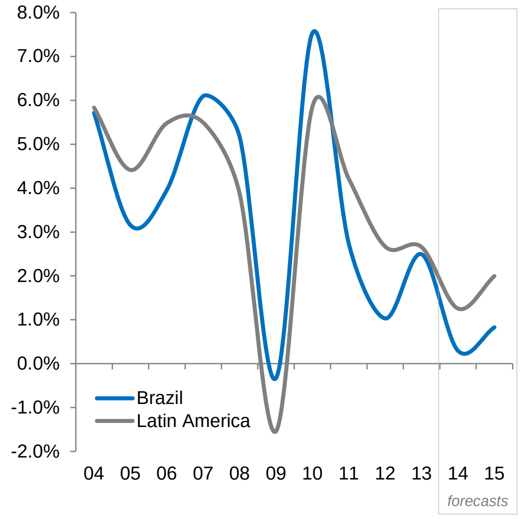
Key economic forecasts

	2012	2013	2014f	2015f
GDP growth (% change)	1.0	2.5	0.3	0.8
Inflation (%, yearly average)	5.4	6.2	6.2	5.8
Fiscal balance* (% of GDP)	-2.8	-3.3	-3.6	-3.0
Public debt* (% of GDP)	68.2	66.3	68.0	68.9
Current account (% of GDP)	-2.4	-3.6	-3.6	-3.2
External debt (% of GDP)	13.9	13.9	14.3	14.2

*Includes Local Government; Nonfinancial Public Corporation; Social Security Funds; State Government

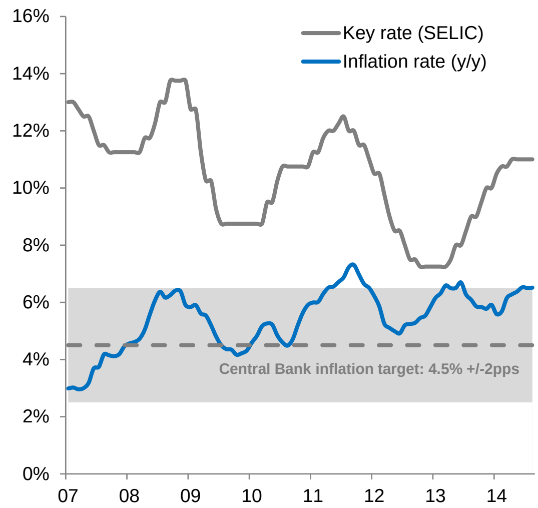
Sources: National sources, IHS, Euler Hermes

GDP growth (%)



Sources: National sources, IHS, Euler Hermes

Inflation rate and Monetary policy rate (%)



Sources: National sources, IHS, Euler Hermes

The current account deficit will remain wide, but external vulnerability is under control

The current account deficit has worsened in recent years (-3.6% of GDP in 2013 vs a surplus of +0.1% of GDP in 2007), mainly due to a decrease in commodity prices coupled with high
er domestic demand and weak competitiveness of the Brazilian industry. Euler Hermes expects it to stagnate at this level in 2014 and to slightly improve in 2015 to -3.2% of GDP, driven by stronger exports performance and domestic demand constraining imports.

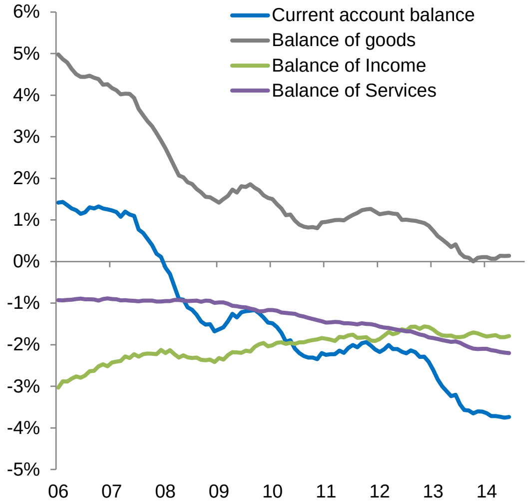
However, external vulnerability is under control. The current account deficit is largely covered by net FDI inflows: +USD64 bn over the last 12 months in August, which represents more than 80% of the current account deficit. The level of foreign exchange reserves is very comfortable at over USD370 bn, covering more than 12 months of goods and services imports. Thanks to this financial cushion, the Central Bank can intervene in the foreign exchange markets to stabilize the BRL without generating financing problems. Indeed, the Central Bank of Brazil announced it will intensify its intervention efforts in the FX markets as the *real* faces strong depreciation pressures ahead of the elections. Encouragingly the external debt is moderate, amounting to about 14% of GDP or 113% of exports of goods and services.

Presidential elections could be a (positive?) turning point for economic policy

General elections will be held in Brazil on 5 October 2014 to elect the President, the National Congress, state governors and state legislatures. In case no candidate in the presidential and gubernatorial elections receives more than 50% of the vote, which seems to be the case given the actual poll results, a second-round runoff will be held on 26 October. Current President Dilma Rousseff is running for re-election.

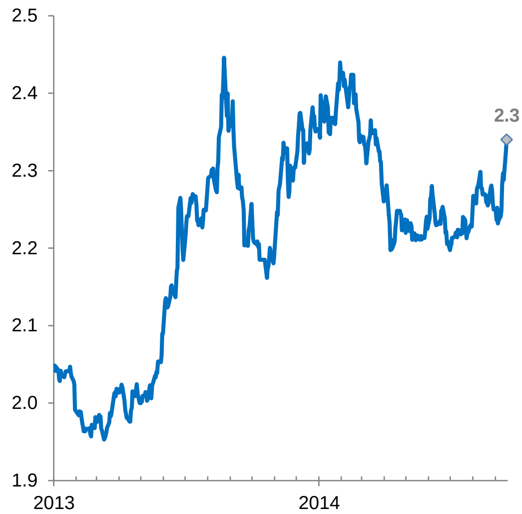
The outcome of the elections will be analyzed closely as it could herald changes in economic policy direction, possibly with more business-friendly programs aiming to boost investment.

Current account balance breakdown (over 12 months, % of GDP)



Sources: National sources, IHS, Euler Hermes

Brazilian real (BRL) per USD



Sources: National sources, IHS, Euler Hermes

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