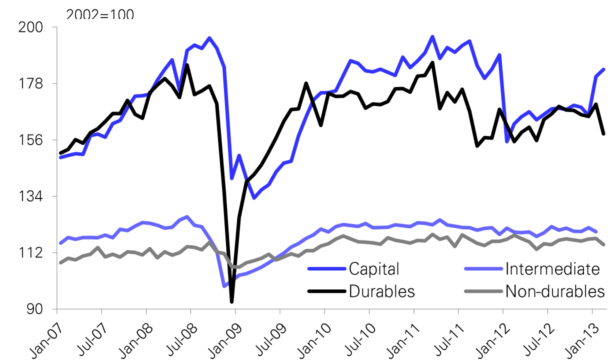
Brazil

Baa2(pos)/BBB/BBB
Moody's/S&P/Fitch

- Economic outlook: While the indicators released so far have been somewhat weaker than expected, they are compatible with a better economic performance this year, especially on the investment front. Given high inflation and the looming monetary tightening, however, our 3.3% GDP growth forecast for 2013 remains at risk.
- Main risks: The *ad hoc* measures to stimulate specific sectors, fight inflation and curb capital flows have increased uncertainty and hurt investment, undermining long-term growth. Strong fiscal expansion and reluctance to tighten monetary policy suggest that inflation remains a high risk.

Brazil: Industrial production



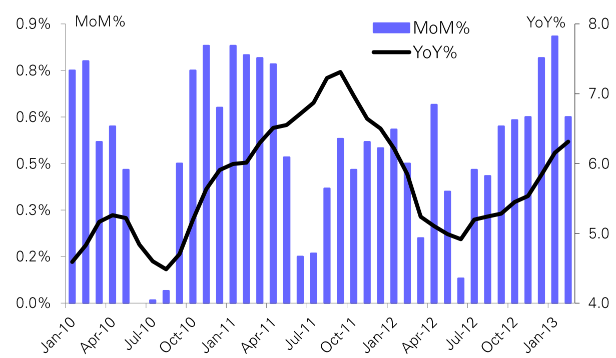
Source: IBGE

Macro view

While the economic indicators released so far this year have been somewhat weaker than expected, they are still consistent with GDP growth slightly above 1.0% QoQ in 1Q13. After posting stronger-than-expected growth of 2.6% MoM in January, industrial production decelerated more than expected and almost erased all the increase by falling 2.5% MoM in February. The vehicles sector, which had been mainly responsible for the increase in January, was also the main culprit in February's strong reversal. Vehicle production fell 9.1% MoM (after climbing 6.2% MoM in January), leading the 6.8% MoM plunge in durable consumer goods (vs. +2.9% MoM in January). Non-durable consumer goods fell 2.1% MoM, as food and beverages fell more than 3% MoM, and medicine production plunged 10.8% MoM. Intermediate goods fell 1.3% MoM, as mining production declined 1.9% MoM. The silver lining was the 1.6% MoM increase in capital goods, despite the 9.2% surge posted in January – which points to a strong recovery in investment, reflecting a number of government incentives (especially the subsidized loans provided by the BNDES development bank). Following February's disappointing performance, we expect industrial production to climb approximately 1.0% MoM in March, led by a strong rebound in the car sector. We believe this would be enough for industrial production to climb a seasonally adjusted 1.0% QoQ in 1Q13 after staying flat in 4Q12. Given that consumption remains relatively strong (mainly due to low unemployment, despite some decline in consumer confidence, probably because of persistently high inflation), and expectations of a strong rebound in agricultural production, we believe the data released so far are consistent with GDP growth slightly above 1.0% QoQ in 1Q13 (our preliminary forecast is 1.2% QoQ).

We continue to forecast GDP growth of 3.3% for 2013. We remain confident that the economy will respond to a myriad of stimuli. On the supply side, we expect a substantial improvement in the agricultural sector, especially due to grain production, which is expected to grow by approximately 13%, led by soybeans. We also expect the industrial sector to benefit from the weaker BRL, lower electricity costs, and lower payroll taxes. Despite some decline in business confidence, we expect services to continue to benefit from low unemployment and strong domestic demand. On the demand side, we believe household consumption will continue to be supported by low unemployment, low interest rates, and improving credit conditions. We expect consumption to grow roughly in tandem with GDP, despite the removal of some tax incentives (although the government backtracked on its decision to fully restore the IPI tax on cars, cancelling the tax increases that were originally scheduled for Apri4l and July). We project that investment will climb 4%, buoyed by low interest rates, cheap official credit, increasing government spending on infrastructure, projects linked to the 2014 World Cup, and concessions in the transportation sector. The rise in BNDES loan applications and the jump in the production of capital goods in 2M13 (led by truck production following a very weak performance in 2012) are encouraging signs that investment is recovering. Nevertheless, risks remain high due to the uncertainty produced by the frequent changes in economic policies, taxes, and regulations. Moreover, the possibility of a hike in interest rates – although probably a relatively short tightening cycle – emerges as another threat to the recovery.

Brazil: IPCA consumer price index



Source: IBGE

High inflation persists, raising the likelihood of monetary tightening ahead. After climbing a hefty 0.86% MoM in January and 0.60% in February, the IPCA consumer price index rose 0.47% in March. Despite the MoM deceleration, 12-month inflation climbed to 6.59% in March, breaching the 6.50% ceiling of the target's tolerance band for the first time since November 2011. Inflation has surpassed 6.50% despite the government's frantic measures to curb price increases, including a 18% reduction in electricity prices in February (which shaved approximately 60bps off the IPCA), a postponement of the adjustment of public transportation prices, and the elimination of federal taxes levied on a basket of 16 essential products in March (with an estimated effect of 40bps, although this seems to be happening more slowly than we expected). Food prices have been under particularly strong pressure and surged 15% in the year to March, reflecting mainly supply disruptions, but probably the strength of demand as well. The role played by domestic demand is evident in the case of service prices (35% of the IPCA), which have continued to rise significantly above the headline, climbing 8.4% YoY in March. Since we still expect food prices to slow due to falling wholesale agricultural prices and expected growth in farm production this year, we are keeping our 2013 IPCA forecast unchanged at 5.4%. However, this forecast assumes no further increase in gasoline prices this year, which is an optimistic assumption considering that domestic prices remain approximately 10% below international prices.

We expect the Central Bank to implement a small cycle of interest rate hikes to fight inflation. The COPOM kept the SELIC overnight rate unchanged at 7.25% in March, but changed its statement to signal higher probability of monetary tightening ahead. Instead of stating that monetary conditions would remain "unchanged for a sufficiently long period" as in the previous meeting, the COPOM linked future decisions to the upcoming data, claiming that "the committee will watch the macro scenario to define the next steps of its monetary policy strategy." In previous occasions, this exact statement was employed two meetings before the CB embarked on a tightening cycle. Moreover, the CB's Inflation Report projected inflation of 5.7% for 2013 and 5.3% for 2014, thus significantly above the 4.5% target for both years. Despite the CB's clear indication that it was getting ready to raise rates, however, President Dilma Rousseff caused great volatility in the market at the end of March when she stated that "she did not believe in policies to fight inflation that reduce economic growth." Speaking beside CB President Alexandre Tombini, Rousseff also stated that "the Finance Minister is the one who talks about inflation," so the comments suggested to market participants that the CB did not have autonomy to raise interest rates. Tombini rushed to tell the press that Rousseff's comments were misunderstood and the government was not lenient with inflation, a remark that was later echoed by the Finance Minister's admission that interest rates could rise to fight inflation. While government officials have indicated that the CB will raise rates if necessary, they have also made it clear that the tightening cycle will be relatively small. According to the Inflation Report, for example, the neutral rate of interest has declined due to structural changes in the economy, and possible deviations from the trend would be "isolated and temporary." We continue to forecast three rate hikes of 25bps, and expect the SELIC rate to finish the year at 8.0%. However, given the enormous anxiety about inflation and the negative repercussion of Rousseff's remarks, we now expect the tightening cycle to begin in April instead of May.

The latest developments have confirmed our expectation of considerable fiscal easing this year. The central government posted a primary fiscal deficit of BRL6.4bn in February, compared to a BRL26.2bn surplus in January, and below our forecast of a BRL4bn surplus. The disappointing result was mainly due to lower-than-expected federal revenues, and larger-than-expected transfers to local governments. Federal revenues decelerated partly due to the several tax cuts implemented by the government to boost economic activity and curb inflation. Despite the very large surplus posted in January, the surplus accumulated in 2M13 totaled BRL19.8bn, falling 24.5% from BRL26.2bn in 2M13. Although revenues rose 7.4%, federal spending jumped 13.9%, led by a 54% jump in unemployment benefits, a 27% increase in current spending, and a 28% in investment. Reflecting the federal government's above-the-line result, the consolidated primary balance posted a BRL3.0bn deficit in February, and the primary surplus accumulated over 12 months declined to 2.16% from 2.46% of GDP. We expect the primary surplus to decline further and reach 1.8% by year-end. President Dilma Rousseff sanctioned a bill allowing the government to deduct up to BRL65.2bn (1.3% of GDP) from its primary surplus target of 3.1% of GDP. The deductions include not only the PAC investment program, but also tax cuts introduced to curb inflation and stimulate economic activity (including, for example, a reduction in payroll taxes that will cost the federal government an estimated BRL16bn in 2013.

We have raised our current account deficit forecast due to the weak trade balance results posted so far this year. The trade balance posted a worse-than-expected USD5.2bn deficit in 1Q13, compared to a USD2.4bn surplus in 1Q12, as imports grew 11.6% and exports fell 3.1%. Although the trade statistics have been distorted by the accounting of approximately USD4.5bn in oil imports that actually took place in 2012, the trade balance that excludes oil trade also shows a gradual deterioration, due to an increase in the demand for imports arising from faster domestic growth, and stagnation of exports due to sluggish global growth, trade barriers in Argentina, and a decline in the demand for oil from the United States. We have lowered our 2013 trade surplus forecast to USD11bn from USD17bn. Consequently, we have also revised our current account deficit forecast to USD70bn (2.9% of GDP) from USD64bn. Instead of a USD6bn balance of payments surplus, we now forecast equilibrium. A crucial assumption is that we expect foreign direct investment (FDI) to total USD65bn and finance most of the current account deficit. For 2014, we now forecast a current account deficit of USD85bn (3.3% of GDP) and a balance of payments deficit of USD7bn. FDI is particularly important because the government reduced the attractiveness for other types of foreign investment (especially portfolio) due to capital controls and aggressive intervention in publicly-traded companies. Although FDI flows have been quite resilient so far, there is a risk that Brazil's disappointing growth rates and rising risk premium due to high inflation and steady deterioration of the fiscal accounts could eventually affect FDI. The bottom line is that the increasing current account deficits will probably lead to tighter financing of the balance of payments, especially if foreign investment falls short of expectations. Although current account deficits should be normal for a country that has low domestic saving and relies on external saving to grow, the deficits will not be sustainable unless foreign investors remain interested in financing it under the tight conditions established by the government. Therefore, although the BRL will probably remain relatively stable in the near future as the Central Bank remains concerned about inflation (and the currency could benefit from monetary easing in Japan), we believe the medium-term outlook for the currency is becoming more uncertain.

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Brazil: Deutsche Bank Forecasts

	2011	2012	2013F	2014F
National Income				
Nominal GDP (USDbn)	2,475	2,252	2,406	2,555
Population (m)	195	197	198	200
GDP per capita (USD)	12,687	11,446	12,123	12,769
Real GDP (YoY%)	2.7	0.9	3.3	4.2
Private consumption	4.1	3.1	3.2	4.2
Government consumption	1.9	3.2	2.0	3.3
Gross capital formation	4.7	-4.0	4.5	7.1
Exports	4.5	0.5	1.5	3.0
Imports	9.7	0.2	4.5	6.0
Prices, Money and Banking				
CPI (YoY%, eop)	6.5	5.8	5.4	5.6
CPI (YoY%, avg)	6.6	5.4	6.1	5.4
Money base (YoY%)	9.3	8.3	9.0	10.0
Broad money (YoY%)	6.2	5.3	6.5	9.0
Fiscal Accounts (% of GDP)				
Consolidated budget	-2.6	-2.5	-2.9	-2.5
Interest payments	-5.7	-4.8	-4.7	-4.0
Primary balance	3.1	2.4	1.8	1.5
External Accounts (USDbn)				
Merchandise exports	256.0	242.6	250.0	265.0
Merchandise imports	226.2	223.1	239.0	262.0
Trade balance	29.8	19.4	11.0	3.0
% of GDP	1.2	0.9	0.5	0.1
Current account balance	-52.5	-54.2	-70.0	-85.0
% of GDP	-2.1	-2.4	-2.9	-3.3
FDI	66.7	65.3	65.0	70.0
FX reserves (USDbn)	352.0	378.6	378.6	371.6
FX rate (eop) BRL/USD	1.88	2.04	2.00	2.10
Debt Indicators (% of GDP)				
Government debt (gross)	54.2	57.8	57.7	57.3
Domestic	51.5	55.3	55.3	55.0
External	2.6	2.5	2.4	2.3
Total external debt	16.3	19.6	19.1	18.8
in USDbn	404.1	440.6	460.6	480.6
Short-term (% of total)	11.6	11.0	11.0	11.0
General (YoY%)				
Industrial production (YoY%)	0.3	-2.7	3.5	3.0
Unemployment (%)	6.0	5.5	5.5	5.3
Financial Markets (EOP)	*Current*	*3M*	*6M*	*12M*
Selic overnight rate	7.25	8.00	8.00	8.00
3-month rate (%)	7.4	8.1	8.1	8.0
BRL/USD	1.97	2.00	2.00	2.05

Source: National statistics and Deutsche Bank Global Markets Research,