OBSERVATION

TD Economics

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BRAZIL: ENORMOUS ECONOMIC POTENTIAL NEEDS INVESTMENT TO BEAR FRUIT

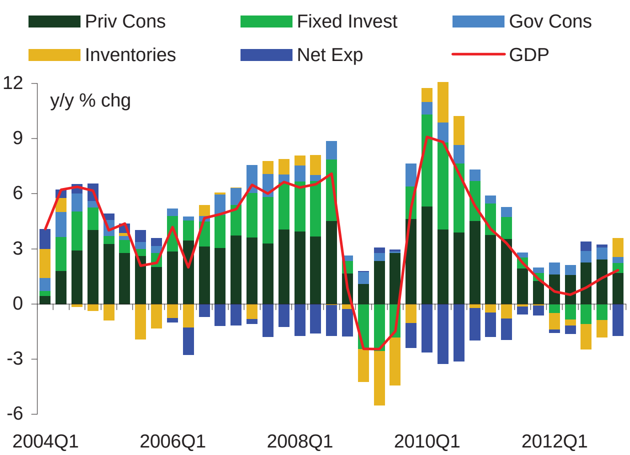
Highlights

- Standard and Poor's recently lowered its outlook for Brazil from stable to negative, citing weak economic growth and an eroding fiscal stance. The heydays of 2004-2010 when annual real GDP growth averaged 4.5% might be a thing of the past. But, Brazil still has plenty of life running through its veins.
- Overall, we foresee the Brazilian economy growing at around 2.5% this year and accelerating further to 3.1% growth in 2014. Private consumption will likely keep rising at a solid pace, as low unemployment supports real wage gains.
- Externally, an acceleration of economic growth in the U.S. and a stabilization of economic activity – albeit at low levels – in Europe should more than offset the hampering effects on Brazilian exports of modestly weaker growth momentum in China and Argentina.
- Returning to economic growth above 4% on a sustained basis would require raising fixed investments as a share of GDP, which are low in Brazil relative to most Emerging Markets.

The boom in commodity prices, an improvement in macroeconomic policy management, and favorable global financial conditions led to robust economic growth in Brazil during the five years that preceded the global financial crisis. The Brazilian economy grew at an average rate of 4.8% during 2004-2008. Following the collapse of Lehman Brothers in late 2008, real GDP growth decelerated sharply, but economic activity bounced back after only two quarters of contraction, and by the end of 2009, Brazil had already surpassed its pre-crisis level of output. In fact, 2010 was a banner year, as the Brazilian economy expanded by an outstanding 7.5% on the back of soaring household consumption and robust fixed investments. But, over the last two years, the performance of Latin America's largest economy has been disappointing, with growth of 2.7% in 2011 and only 0.9% in 2012.

However, 2012 marks the trough in the cycle. The pick-up in momentum that materialized in early 2013 is the beginning of a reacceleration that should drive growth to 3.1% in 2014. In the medium term, if Brazil wants to achieve higher growth rates, it has to invest more to boost its potential output.

BRAZIL CONTRIBUTIONS TO GDP GROWTH



Source: Haver, TD Economics

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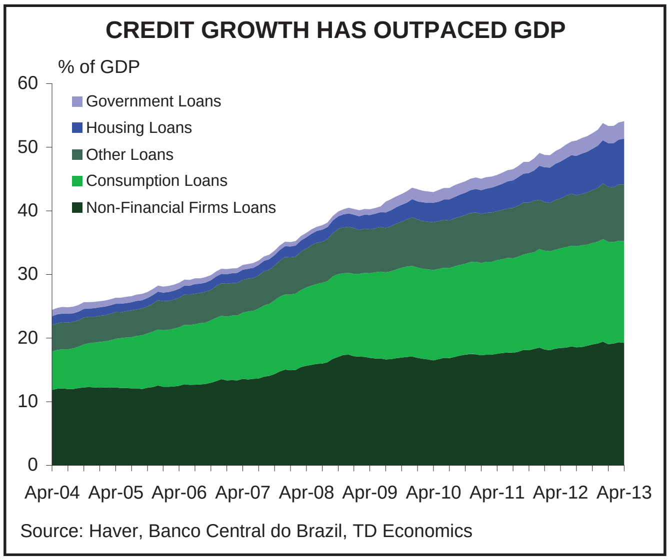
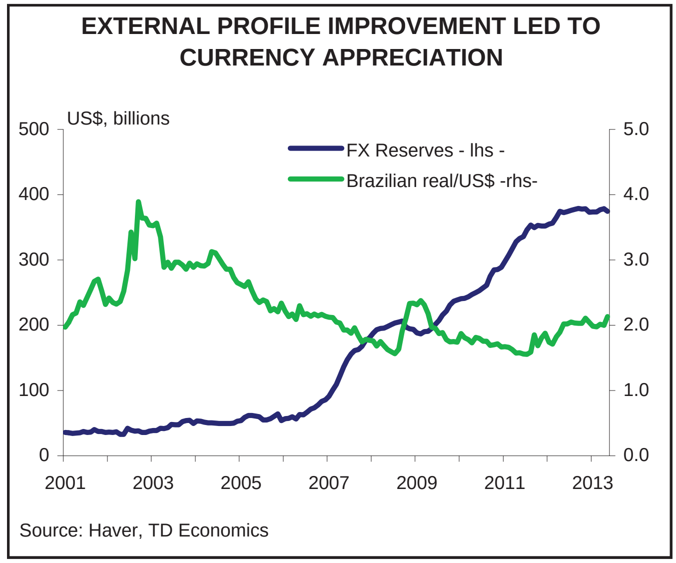
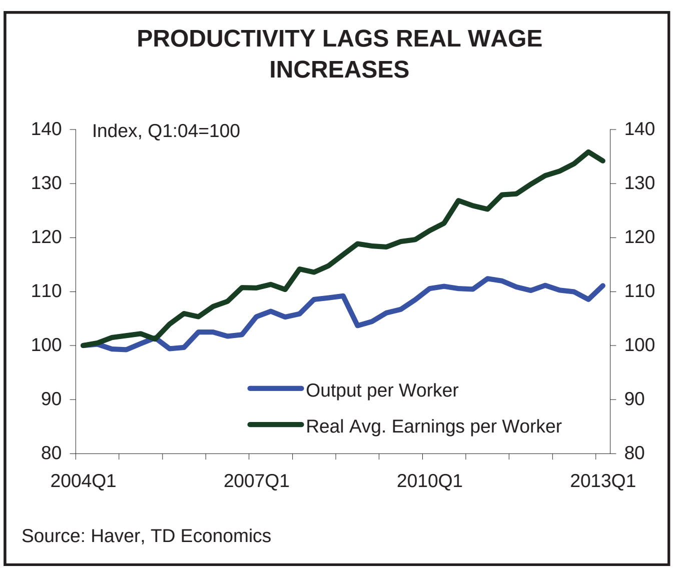




The vibrant past would be difficult to repeat in the short term

In 2002, the Brazilian economy was hit by a crisis of confidence. Argentina's debt default spooked investors under the prospect that Brazil's newly elected leftist president, Luis Inácio Lula da Silva, would follow the same path as its neighbor. Of course, this did not transpire following his inauguration in early 2003. Instead, improving commodity prices and the successful implementation of an inflation targeting regime by the Brazilian central bank, helped Lula's administration stabilize both the economy and fiscal accounts. At the same time, he was able to promote wage increases across the board and revamp social welfare programs. This unleashed pent-up household demand and an ensuing virtuous cycle of job creation and stronger economic growth. In addition, Brazil saw both its fiscal and external profile strengthen with the continued rise in commodity prices. Its sovereign credit rating went from highly speculative in 2002 to investment grade in 2008. This contributed to substantial capital inflows, which, in combination with current account surpluses, led to a sustained accumulation of foreign exchange reserves and an appreciation of the Brazilian real.

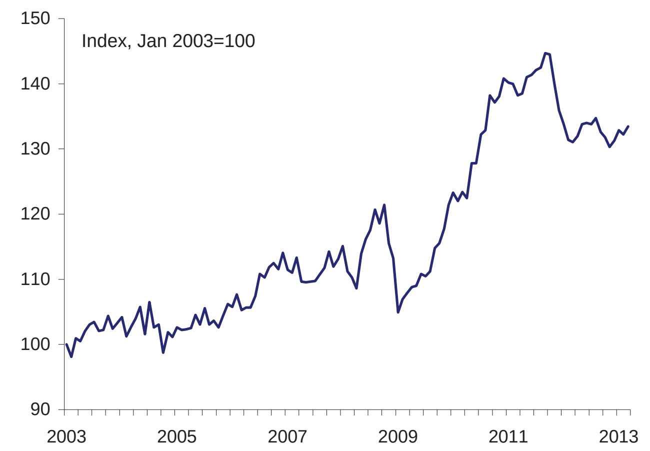


All the above-mentioned factors facilitated a domestic credit boom. As a result, total banking credit as a share of GDP expanded from 24% in early 2004 to 49% at the end of 2011. Lending to households increased from 7% of GDP to 21% of GDP over the same period. Reinforcing these positive growth dynamics, strong capital inflows also fueled strong fixed investments. All in all, real GDP expanded by a massive 40% from 2003 to 2011.

The shine rubs off Brazilian economy in 2012

A number of factors combined in 2012 to yield a sharp deceleration in exports and a decline in fixed investments, causing a marked slowdown in Brazil's economic activity. First, the country faced a deterioration in external conditions, as its main trading partners suffered economic setbacks and its terms of trade declined. Given that 20% of Brazilian exports are destined to Europe, 17% to China, 11% to the U.S., and 8% to neighboring Argentina, the economic deceleration in those markets – and outright recession in Europe – hampered Brazilian export volumes. Global weakness also impacted commodity prices, which led to a 10% decline in Brazil's terms of trade during 2012. As a result, Brazilian exports expanded by only 0.6% in real terms, a

BRAZIL TERMS OF TRADE



Source: Haver, TD Economics

meager performance compared with the previous two years.

Unfortunately, this occurred amidst a tightening domestic labor market that led to unabated wage pressures. And, because labor productivity lagged real wage increases, profit margins rapidly compressed. Real average earnings per worker have climbed by 34% since 2004. Meanwhile, real GDP per worker – an admittedly blunt measure of productivity – climbed by around 10% from 2004 to mid-2010 and has remained flat since then. This has weighed on Brazilian firms, especially in tradable sectors, which must also contend with a loss of competitiveness stemming from an appreciation of the Brazilian real.

As the accompanying chart shows, even after the depreciation observed since its peak in mid-2011, the Brazilian currency is still 36% stronger – in real terms – vis-à-vis the currencies of Brazil's main trading partners, relative to its level in early-2009. The loss of competitiveness of Brazilian products in part explains why imports kept rising in tandem with household consumption last year, even as economic activity was decelerating markedly.

In addition, the incumbent President, Dilma Rousseff, pushed forward with some controversial policy measures, such as compelling electricity producers to lower electricity rates in exchange for renewing their concession contracts; subsidizing some industries to the detriment of others, and fixing prices. This has weighed on business confidence and contributed to a decline in capital inflows, undermining fixed investments.

Lastly, infrastructure bottlenecks, especially those caused by deficient roads and ports, lead to delays in the production and delivery of manufactured goods. After a decade of robust economic expansions, these bottlenecks became severe last year, contributing not only to slowdown the pace of growth, but also adding to inflationary pressures.

As a result of all of these setbacks, Brazilian real GDP growth decelerated to 0.9% in 2012, handicapped by a 4% contraction in fixed investments.

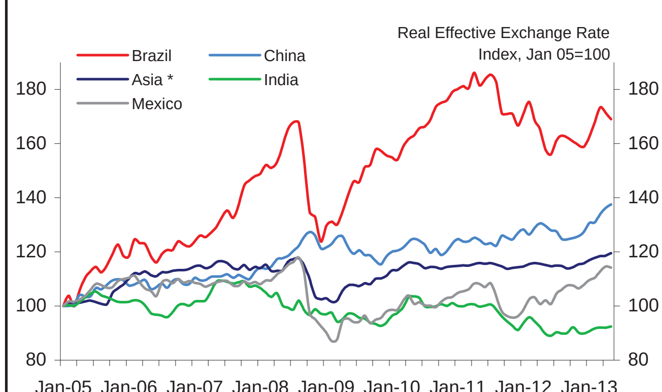
What is in store for the Brazilian economy?

Brazil has definitely proven itself to be a two-speed economy. The question now is which economic speed is the truer characterization of its potential? In our opinion, better days lie ahead for Brazil, but due to a shift in the global economic landscape, economic growth is unlikely to return to the phenomenal pace set during the 2004-2010 period.

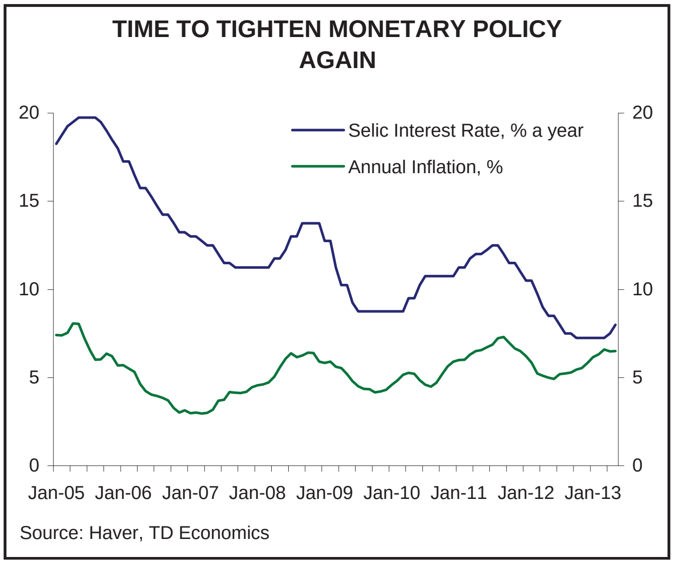
In the short term, the acceleration in economic activity observed during the first quarter is expected to continue throughout the year. Domestic consumption has the underpinnings to move ahead at a solid clip, supported by low unemployment and modest real wage gains. The main question marks for Brazil's economic performance in the short term revolve around the willingness of foreign investors to finance domestic investments and the evolution of demand for Brazilian exports among its main trading partners.

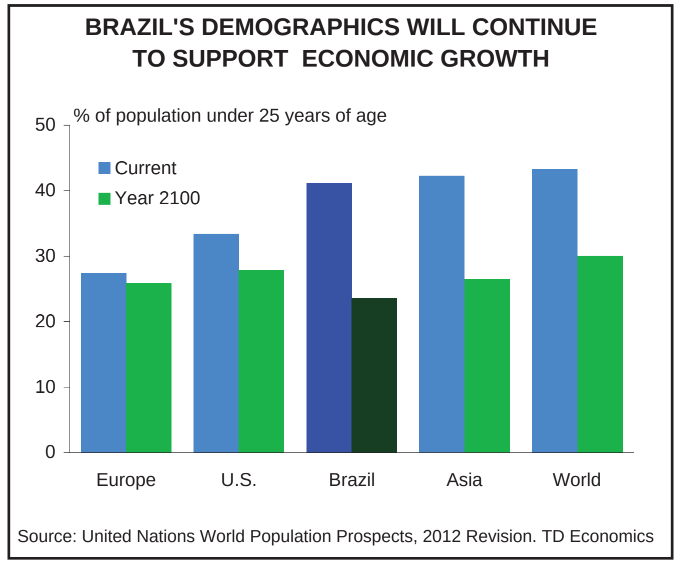
On the first point, the announcement of road, rail, and port concessions worth US$100 billion last year coupled with the recent passage of a bill promoting private investments in port infrastructure should help to boost foreign appetite for domestic investment opportunities – particularly as Brazil prepares to host the 2014 Soccer World Cup and the 2016 Olympic Games. However, the government needs

REAL APPRECIATION HURTS BRAZILIAN COMPETITIVENESS



Source: Bloomberg, TD Economics. Values above 100 represent REER appreciation vis-à-vis January 2005. * includes Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, Thailand, and Taiwan. GDP-weighted.





to follow up by reducing the lengthy bureaucratic approval process if it wants to capitalize on those opportunities.

Regarding the performance of Brazilian exports, stronger economic growth in the U.S. and a stabilization of economic activity in Europe – albeit at low levels – should more than offset the hampering effects of modestly weaker growth momentum in China and Argentina. Therefore, external demand should prove more supportive for Brazilian exports in the coming quarters. But, we have to be realistic in recognizing that the demand environment will not be as strong as the 2004-2008 period, and Brazil's producers will still face a competitive headwind from an elevated real exchange rate given that inflation will hold above 6% in 2013.

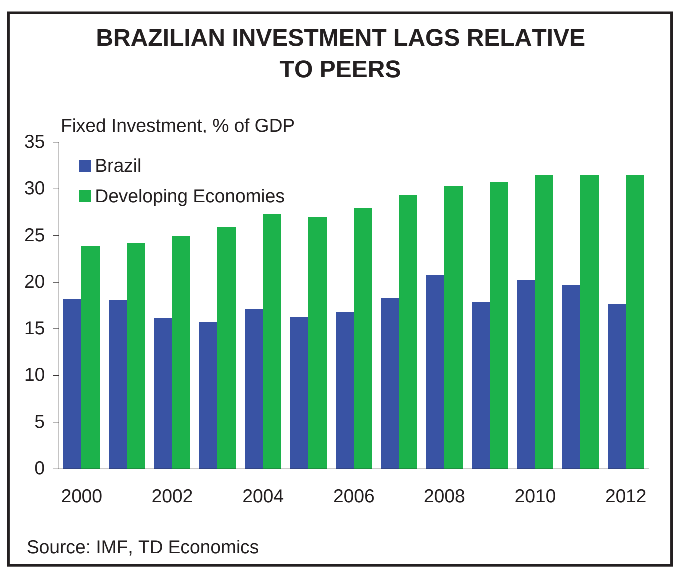
To counteract inflationary pressures, the Brazilian central bank will likely raise its policy rate by an additional 100 basis points this year, taking it to 9.0%.

On the flip side, an acceleration in Brazilian domestic demand combined with the relative strength of the currency should support Brazilian imports, benefiting its main trading partners. For the U.S. in particular, this means that, in the short-to-medium term, Brazil will likely keep increasing its share of total U.S. exports. Already in the past 10 years, U.S. exports to Brazil have tripled, reaching US$ 44 billion in 2012, showing the country to be an attractive growth market for U.S. products.

All in all, we foresee the Brazilian economy growing at around 2.5% this year and accelerating further to 3.1% growth in 2014. Risks to the outlook appear balanced. The Brazilian economy will outperform our projections if the external outlook proves more supportive for its exports and fixed investments, and vice versa.

In the medium term, Brazil has structural characteristics – such as favorable demographics, ample natural resources, and a diversified exports mix – that would allow the economy to grow above 4%. But, it needs to invest more, both in physical and human capital, to boost its potential output to be able to reach that threshold on a sustained basis without overheating.

Indeed, Brazil has one of the lowest fixed investments-to-GDP ratios among developing economies, with a long-term average of 18.3% and 17.6% last year. This is the result of a structurally low domestic saving rate – which leads to a reliance on external savings to fund investments – and a legacy of high inflation and financial instability. Therefore, to increase fixed investments as a share of GDP, Brazil has to continue fostering macroeconomic stability and financial



sector reforms to lengthen the duration of debt contracts and promote the development of longer-term private finance.[1] It would also benefit from reforms to its corporate tax structure that would make capital investments more attractive; and from labor market reforms that would make production costs in Brazil more competitive vis-à-vis other manufacture producers such as Mexico and South East Asian countries.

Final Remarks

Brazil has enormous economic potential to keep raising its income per capita. However, to crystallize that potential, it has to save more so it can raise its stock of both physical and human capital. To achieve this objective, it has to work on structural reforms and continue to promote macroeconomic and financial stability.

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Endnotes:

1 See "Brazil's Capital Market: Current Status and Issues for Further Development, IMF Working Paper 12/224

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