



Highlights of Brazil

2006 - 2007 Edition*

1 Higher growth as the big challenge

In the last 5 years, the developing countries as a whole grew near 7% per year, driven by the exceptional performance of the world economy, while Brazil grew an average of 2.5% only (growth of 2.9% in 2006). This contrast, which in fact has prevailed for three decades, puts the growth problem at the forefront of economic policy. Despite the facts that domestic inflation is near the world average and the country's external indicators are the best in decades, no significant impact on growth has occurred, indicating that deeper structural factors must be responsible for Brazil's slower growth. It is also clear that the attempted reduction of income inequality and poverty through expensive welfare programs, which has been the sole thrust of the Lula administration, will be self-defeating if the economy maintains its mediocre expansion.

It is widely known that the roots of Brazil's structural problems reside in the large size of the public sector (about 40% of GDP against an average of 25% for the emerging market economies) and the backwardness of many of the country's public institutions. A large public sector implies a large tax burden (near 38% of GDP), which impairs the incentives for investment and work effort. In Lula's first term, taxes relative to GDP have grown one percentage point each year. On the other hand, weak institutions mean higher transactions costs and more political and economic uncertainty to the private sector. As a consequence, investment is low (20% of GDP) and overall productivity growth is sluggish (less than 1% per year), producing a potential growth rate of around 3% per year. Reducing the size of government and improving institutions are necessarily long term developments, and although some significant progress has been made in the last decade, the pace of change has been very slow.

From a macroeconomic perspective, 2006 was characterized by falling (but still very high) real interest rates, continuous exchange rate appreciation and falling inflation. Inflation fell steadily, closing the year at 3.1%, well below the target rate of 4.5%, allowing a gradual relaxation of monetary policy and the reduction of the basic interest rate from 18% to 13.25% along the year. The major factor behind the fall in inflation was the steady appreciation of the exchange rate for the fourth year in a row. The country's strong current account position and the inflow of short term capital, induced by the still high interest rate differential, explain the fact.

Although an appreciating exchange rate reduces the rate of inflation in the short term, it can also harm the current account in the medium term. Some signs of this are already visible. In 2006, the volume of exports grew only 3%, while the volume of imports grew 14%. High commodities prices favoring Brazilian exports helped to maintain a large trade surplus and a positive current account (see Table below), but many export and import competing sectors are losing competitiveness in world markets. On the financial side, foreign direct investment has been stagnant around US\$ 15 billion per year, while Brazilian direct investment abroad is rising impressively (US\$ 12 billion in 2006). This reveals that Brazilian companies are going global, but it also means that these companies are transferring part of their production to countries where competitive conditions are more favorable than Brazil's.

The Brazilian foreign debt kept its steady decline in 2006 and for the first time the net foreign public debt (gross public debt minus international reserves) became negative. International reserves ended the year at US\$ 85 billion as the Central Bank kept buying heavily in the foreign exchange market, in the attempt to mitigate the appreciation of the currency. The impressive improvement in the external liquidity and solvency indicators is responsible for the decline in Brazil's sovereign risk, which fell from over 300 basis-points in 2005 to less than 200 basis-points. It is possible that in a few years Brazil will be given the investment grade by the major rating companies.

The steady exchange rate appreciation has also meant a change in the composition of aggregate demand: a weakening net foreign demand (exports minus imports) and a booming domestic demand. Accordingly, a change in the composition of investment toward domestic sectors and away from tradable sectors is occurring. Domestic demand is expanding across the sectors, but especially in consumer durables and residential construction, pushed by a vigorous credit boost and some increase in real incomes.

The 2006 general elections did not produce major changes in the division of political power, despite the wave of scandals and political corruption that marked the last two years. The second term of President Lula (2007-10) is not expected to be much different from the first. The conflicts and contradictions inside the political alliance supporting the government continue, signaling the same difficulties in passing legislation in Congress. No major structural changes should be expected, witnessed by the recent discussion on the social security system: instead of facing the political ordeal of reform, the government opted for an accounting contraption that reduces the apparent deficit of the system. A large fiscal expansion occurred in 2006 at the federal level, triggered by large salary adjustments, a further 13% real increase in the minimum wage, aggravating the social security deficit, and the continuing expansion of the social programs benefiting the poor. Despite the growing fiscal expenditures, the debt to GDP ratio fell 1.5 percentage points to 50% of GDP, helped by the falling interest rate and the increase in tax collection.

2 Perspectives for 2007

The economic trends described above should continue in 2007. An additional reduction of the basic interest rate (perhaps under 8% per year in real terms) is likely, stimulating credit and domestic demand, which will be the driving force of the economy. Current growth forecasts are around 3.5% for 2007. A mild depreciation of the Real should be expected along the year as the trade surplus and the domestic interest rate shrink, but the catching up of the Brazilian currency to its theoretical parity is going to take a few years.

On the front of economic policy, the federal government announced recently a program for stimulating growth, the so-called PAC. The program concentrates on infra-structure expansion (mainly energy, transportation, water and sewage and residential construction) through a combination of government investment, partnerships with the private sector and fiscal incentives to some segments of the economy. The impact of the program, however, is likely to be small, in part due to its limited dimension and lack of confidence still prevailing among potential investors regarding the regulatory framework for public utilities and related infra-structure sectors. The Lula administration made it clear that the government will not abdicate from participation and control over the investments in these areas. The previous regulatory framework, created under the Cardoso administration, and based on autonomous regulatory agencies, has not been maintained by the Lula government, but no clear alternative has yet been defined.

The main risk of the Brazilian economy in the medium term, and the one that can postpone the attainment of the investment grade, is the increase of government spending. Recent proposals for setting ceilings on federal spending were repelled by the Lula administration, which instead is proposing to Congress the inflationary indexation of salaries of public servants and of the minimum wage, plus some real increase depending on the rate of GDP growth. The reintroduction of indexation in the economy by the backdoor is not perceived as a good idea.



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Principal Economic Indicators

	2006 ¹	2005	2004	2003	2002
GDP (US\$ billion, year-average exchange rate)	955	800	602	507	459
Real GDP growth (% per year)	2.9	2.3	4.9	0.5	1.9
Unemployment rate (year average)	10.1	9.8	11.5	12.3	11.7
General price index - IGP-DI (% per year)	3.8	1.2	12.1	7.7	26.4
Consumer price index - IPCA (% per year)	3.1	5.7	7.6	9.3	12.5
Exchange rate at year-end (R\$/US\$)	2.15	2.29	2.72	2.93	3.63
Exchange rate change (% per year)	(6.1)	(15.8)	(7.2)	(19.3)	53.8
Public sector deficit (% of GDP)	3.4	3.3	2.7	5.1	4.6
Public sector debt (% of GDP)	50.0	51.5	51.7	57.2	55.5

(in US\$ Billion)

Merchandise exports	137.5	118.3	96.5	73.1	60.4
Merchandise imports	91.4	73.6	62.8	48.2	47.2
Trade balance	46.1	44.7	33.7	24.8	13.2
Current account balance	14.4	14.3	11.7	4.1	(7.6)
International reserves	85.0	53.8	52.9	49.3	37.8
Foreign direct investment	14.5	15.1	18.1	10.2	16.5
Total foreign debt	160.8	168.9	201.4	214.9	210.7

(1) Some 2006 figures are estimates.

PricewaterhouseCoopers offices in Brazil

São Paulo - SP

Av. Francisco Matarazzo, 1400
05001-903 - São Paulo/SP
Torre Torino - Água Branca
Telephone: (55-11) 3674-2000

Belo Horizonte - MG

Rua dos Inconfidentes, 1190 - 9º
30140-120 - Belo Horizonte/MG
Telephone: (55-31) 3269-1500
Facsimile: (55-31) 3261-6950

Brasília - DF

SHS - Quadra 6 - Conjunto A - Bloco C
Edifício Business Center Tower -
Salas 801 a 811 - Brasília - DF
70322-915 - Caixa Postal 08850
Telephone (55-61) 2196-1800
Facsimile (55-61) 2196-1820

Campinas - SP

Edifício Hannover Tower
Av. José de Souza Campos, 243 10º
13025-320 - Campinas/SP
Telephone: (55-19) 3794-5400
Facsimile (55-19) 3794-5454

Caxias do Sul - RS

Rua Os 18 do Forte, 1256 - Sala 11
95020-471 - Caxias do Sul/RS
Telephone: (55-54) 3202-1466
Facsimile (55-54) 3225-6789

Curitiba - PR

Curitiba Trade Center
Alameda Dr. Carlos de Carvalho, 417 - 10º
80410-180 - Curitiba/PR
Telephone: (55-41) 3883-1600
Facsimile (55-41) 3222-6514

Joinville - SC

Rua Alexandre Döhler, 129 - 6º
Salas 605, 606 e 607
89201-260 - Joinville/SC
Telephone: (55-47) 3422-7848
Facsimile (55-47) 3422-6771

Manaus - AM

Av. Djalma Batista 3.694
Centro Empresarial Art Center
Bl. 01, loja 05
69050-010 - Manaus/AM
Telephone: (55-92) 3236-8873
Facsimile (55-92) 3634-5080

Porto Alegre - RS

Edifício Madison Center
Rua Mostardeiro, 800 8º e 9º
90430-000 - Porto Alegre/RS
Telephone (55-51) 3378-1700
Facsimile (55-51) 3328-1609

Recife - PE

Edifício Empresarial Center
Rua Padre Carapuceiro, 733 - 8º
51020-280 - Recife/PE
Telephone: (55-81) 3465-8688
Facsimile (55-81) 3465-1063

Ribeirão Preto - SP

Rua Rui Barbosa, 1145 - 11º e 12º
14015-120 - Ribeirão Preto/SP
Telephone: (55-16) 2133-6600
Facsimile (55-16) 2133-6685

Rio de Janeiro - RJ

Rua da Candelária, 65 - Centro
20091-020 - Rio de Janeiro/RJ
Telephone: (55-21) 3232-6112
Facsimile (55-21) 2516-6319

Salvador - BA

Edifício Citibank
Rua Miguel Calmon, 555 - 9º
40015-010 - Salvador/BA
Telephone: (55-71) 3319-1900
Facsimile (55-71) 3243-2943

São José dos Campos - SP

Rua Euclides Miragaia, 433
Cjs. 301 e 304
12245-550 - São José dos Campos/SP
Telephone: (55-12) 3913-4505
Facsimile (55-12) 3942-3329

Sorocaba - SP

Edifício Trade Tower
Rua Riachuelo, 460 - 5º
Salas 501, 502, 503 e 504
18035-330 - Sorocaba/SP
Telephone: (55-15) 3231-9001
Facsimile (55-15) 3231-1929

Vitória - ES

Edifício Century Towers - Torre B
Av. Nossa Senhora da Penha, 699
Cjs. 801 e 802
29055-131 - Vitória/ES
Telephone: (55-27) 3200-3139
Facsimile (55-27) 3324-3239

www.pwc.com/br

contato.mkt@br.pwc.com