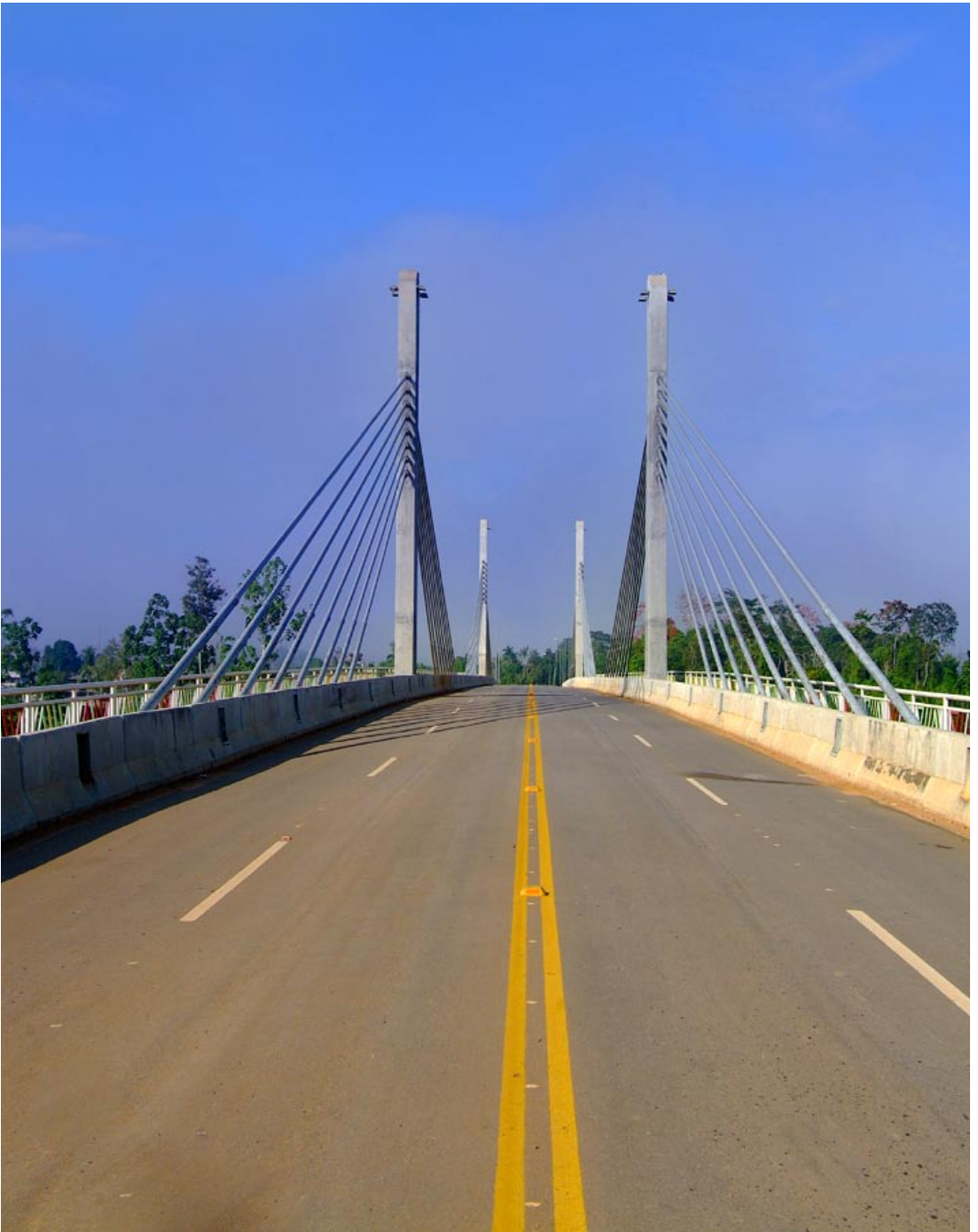


# Highlights of Brazil

## 2008 - 2009 Edition



Pacific Road, Acre - Brazil

# Vigorous Growth Before the Crisis 1

The performance of the Brazilian economy in 2008 is best described by examining before and after the financial crisis that erupted in September. Before the crisis, the economy was growing about 6%, maintaining the trend of the previous year. Domestic demand, in real terms, was growing 9% per year, with private consumption expanding 6%, government spending rising 6% and private investment growing 17%. The boom in the world economy and the vigorous boost in domestic credit were the main engines of this expansion. In April, the Central Bank started a cycle of interest rate hikes to fight the inflationary pressures created by the imbalance between demand and production capacity. At this point, it seemed that annual inflation would exceed the upper limit of the government target (6.5%). In fact, the inflation rate closed the year at 5.9%, largely due to the dampening effects of the crisis.

The gradual increase in domestic interest rates, however, produced little effect on aggregate demand, which held its pace of expansion. A sharp reversal came only in the last quarter of the year, when the international credit markets collapsed and commodity prices plunged. Although Brazilian banks were not involved in the crisis, foreign credit, particularly to the tradable sector, represented about one-fifth of total credit in the economy, and its sudden halt caused a squeeze in banking liquidity, a contraction in domestic credit and an immediate increase in loan rates. At the same time, large Brazilian companies were unable to roll over their foreign debts, shifting their demand for funds toward the domestic financial market and further reducing liquidity there. On the other hand, as a large exporter of commodities (metals and foodstuffs), Brazil endured against a fall in trade with the dramatic plunge in commodity prices starting September, which drove domestic demand even lower.

The effect of the crisis was surprisingly strong and felt quickly in Brazil. GDP dropped about 1% in the last quarter of the year, led by industrial production and influenced by the precipitous fall of activity in the credit-driven sectors (consumer durables, capital goods and construction materials). The production of motor vehicles, for instance, fell to half of its level prior to the crisis in December, as companies adjusted their excess inventories created by the contraction in demand. Industrial production grew 3.6% in 2008, down from the 6.8% maintained until the third quarter – a good measure of the intense impact of the crisis. Nonetheless, the economy grew 5.5% in 2008, although the prospects for the current year seem much less optimistic, as analyzed below. The adjustment made by companies to the drop in demand and the accumulation of excess inventories drove the new job creation rate to zero in the last few months, and in time will increase the rate of unemployment.

The excess domestic demand that prevailed for three quarters of the year spilled over into the trade balance, reducing the trade surplus to US\$ 23 billion in 2008, down from US\$ 40 billion in 2007, with dollar imports growing 46% and dollar exports, 24%. As a result, the current account slumped into a deficit of US\$ 30 billion, the first negative result in six years. The inflow of US\$ 38 billion in foreign direct investments, together with an expressive net inflow of portfolio investments (before the world financial crisis), more than financed the current account deficit, allowing the Central Bank to capture nearly US\$ 200 billion in reserves by the end of the year. As a result, the Brazilian net foreign debt (gross debt minus reserves) remained negligible. The reduction in the country's external vulnerability was recognized in April, when the main rating agencies upgraded Brazil to the investment level.

This favorable situation put downward pressure on the exchange rate, which reached R\$ 1.60 to the dollar in July, the lowest level since 1999. The clear overvaluation of the real did not impact exports as much because of the record high prices of commodities that prevailed until the middle of the year. Since then, the exchange rate has devalued more than 40% in relation to the dollar as portfolio capital has flown out of the country and export revenues have shrunk. However, the usual inflationary impact of the devaluation did not occur, due to the simultaneous fall of commodity prices and weakening of domestic demand.

The reaction of the government to the crisis has been timely and strong, although sometimes arbitrary. Following the pace of most countries, but to a much lesser degree, the Central Bank extended credit to the banking system to protect weaker institutions from the liquidity squeeze and to forestall a major contraction of credit to the private sector. At the same time, the Central Bank interrupted hiking its target interest rate. The government injected capital into the three large federal banks (BB, CEF and BNDES) to improve their credit capabilities, especially to the sectors most affected by the crisis, like the automotive and construction industries. At the same time, Congress approved a new law, allowing federal banks to purchase participation in (or control of) private banks, and the federal banks went out shopping, increasing the already large (one-third) state participation in Brazil's financial system. Large private banks have also bought smaller institutions, and there was a large-scale merger between Banco Itaú and Unibanco, two of the country's largest banks. As a consequence, the bank industry has become more concentrated. By the end of the year, the government had created a "sovereign fund," designed to "transfer" part of last year's primary budget surplus to finance larger fiscal expenditures in 2009, allegedly to offset the effects of the crisis. Critics say that the fund is actually a means to keep up the pace of fiscal expansion of the Lula administration, with an eye to next year's presidential election.

Asset prices in Brazil followed the worldwide downward trend. Real estate prices and common stocks fell sharply after September. The BOVESPA stock index plunged nearly 50% in comparison with its peak in May, reflecting the outflow of capital by foreign institutional investors and the poorer expectations regarding the performance of large companies. In the context of a contracting world economy and of falling oil prices, even the major offshore discoveries by Petrobras (the pre-salt oil deposits) were unable to liven up the stock market. Given the current oil prices, the feasibility of the huge investments required to explore the pre-salt deposits is seen as dubious.

On the political front, the municipal elections held in October have not substantially changed the balance of power among the major Brazilian political parties. In fact, the trends of the last elections have been maintained. If anything, it can be said that the PMDB party was victorious, winning 21.6% of the municipalities, followed by the PSDB (14.2%), the PT (9.9%), the PP (9.9%) and the DEM (9.0%). Taking into account the significant group of the 79 largest municipalities (those with over 200,000 voters), the PMDB won in 17 cities, the PT in 21, the PSDB in 13, and the PP and the DEM in 5 each, the remaining 18 cities being dispersed among a multitude of smaller parties. Looking forward to the 2010 presidential elections, it can be said that the PMDB, which will probably not have a presidential candidate – as per its tradition – improved its bargaining position in the contention between the PT and the PSDB (the two parties that will certainly have strong presidential candidates). From now on, the actions of the political players will be directed at reinforcing their positions for the 2010 general elections. The economic difficulties predicted for the next two years, with the consequential increase in the unemployment rate, may damage the extraordinary prestige enjoyed by President Lula, whose approval rate has risen to an unprecedented 70%, according to recent polls. If Lula loses part of his popular support, it may be more difficult for his party (PT) to name a successor.



The outlook for the Brazilian economy is closely related to the unfolding of the current world crisis. It is recognized today that the crisis will be deep and last long, meaning that the advanced economies and, to a lesser extent, the emerging economies will grow well below their long-term potential for the next three years or so. There are two main mechanisms that will drive the crisis to ultimately affect Brazil: credit and trade channels. The collapse of international credit and the recession in the advanced economies imply that trade finances, bond issues abroad, foreign direct investments and portfolio investments will be greatly reduced in comparison with pre-crisis levels. Secondly, a recessive world economy and the fall of commodity prices mean less export revenues and greater difficulty to finance a current-account deficit.

On the positive side, the deflationary trend in the world economy will help mitigate inflationary pressures at home and counteract the price effect of the exchange rate devaluation. This means that there may be room for a substantial reduction in interest rates over the course of the year, while inflation holds at the target rate of 4.5%. This in turn will help sustain economic activity. Current projections indicate that the economy may grow between 2 and 3 percent in 2009, well below the average of nearly 5 percent recorded in the last four years, but still a positive outcome in relation to the world economy. Nevertheless, the modest economic expansion is insufficient to keep the rate of unemployment constant.

No significant change in fiscal policy or advances in the agenda of institutional reforms should be expected in the remaining two years of the Lula administration, as the presidential elections of 2010 draw nearer. The federal government used the bonanza years, in which real tax revenue increased above GDP growth, to raise current spending (consumption and income transfers), but not public investment. The only investment program launched back in 2007 by the federal government (*Programa de Aceleração do Crescimento – PAC*) was timid, suffered from bad management and conflicting political interests, and has had very limited impact so far. Although private investment boomed in the last few years, public investment, especially in infrastructure, has lagged behind.

# Main Economic Indicators

	2008 <sup>(1)</sup>	2007	2006	2005	2004	2003	2002
GDP (US\$ billion) <sup>(2)</sup>	1584.0	1332.0	1087.0	880.0	664.0	552.0	506.0
Real GDP growth (% per year)	5.5	5.7	3.7	2.9	5.7	1.1	2.7
Unemployment rate (% of labor force)	7.6	9.3	10.0	9.8	9.6	10.9	10.5
General price index - IGP-DI (% per year)	9.4	7.9	3.8	1.2	12.4	7.7	26.4
Consumer price index - IPCA (% per year)	5.9	4.5	3.1	5.7	7.6	9.3	12.5
Exchange rate at year's end (R\$/US\$)	2.45	1.78	2.15	2.29	2.72	2.93	3.63
Exchange rate change (% per year)	37.6	(17.2)	(6.1)	(15.8)	(7.2)	(19.3)	53.8
Public sector deficit (% of GDP)	0.4	2.3	3.0	3.0	2.4	4.6	4.2
Public sector debt (% of GDP)	36.0	42.8	44.9	46.5	47.0	52.3	50.5
<b>(in US\$ billion)</b>							
Goods export	197.9	160.6	137.5	118.3	96.5	73.1	60.4
Goods import	173.2	120.6	91.4	73.6	62.8	48.2	47.2
Trade balance	24.7	40.0	46.1	44.7	33.7	24.9	13.2
Current-account balance	(30.0)	1.7	12.9	14.3	11.7	4.1	-7.6
International reserves	193.8	180.3	85.8	53.8	52.9	49.3	37.8
Foreign direct investment <sup>(3)</sup>	37.9	34.6	18.8	15.1	18.1	10.1	14.1
Total foreign debt	200.2	193.6	172.5	168.9	220.1	235.4	227.7

<sup>(1)</sup> Some 2008 figures are estimates based on the last published data.

<sup>(2)</sup> At the year-average exchange rate. IBGE

<sup>(3)</sup> Including intercompany loans.

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