British Embassy
Brasilia

BRAZIL ECONOMIC FOCUS: JULY 2014

Summary

Summary: 7-1 Stagflation?

As inflation rises and growth falls, government and private sector commentators are revising their score for the economy in 2014. Most private sector estimates envisage a 7-1 (inflation rate – growth rate) rounded score while the Brazilian Central Bank still envisages it will be 6-2. Both industrial and consumer confidence have fallen as credit markets have tightened and industrial production contracts.

In Focus: World Cup – We needn't have worried?

A wonderful World Cup draws to a close, beating expectations. Brazil can be proud of what it achieved off the field. The economic effects however will be mixed. While congestion was eased by days off and cuts in domestic travel, these ate into some of the benefits of additional foreign tourism.

In Focus: Current and Capital Account Conundrums

Brazil's Real is overvalued, supported by Government policies to control inflation. Supporting the currency and increasing interest rates have led to a flood of inward investment in stocks and bonds. This portfolio capital inflow is financing the widening of the current account deficit which would otherwise cause the Real to fall. The risk will come when there is a hint that Government policies will be reversed and portfolio capital will flow out.

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Summary: 7-1 Stagflation[1]?

1. **12 month average inflation, at 6.52% in June, has exceeded the 6.5% target upper limit for the 11th time in the past three and a half years. Private sector forecast growth for 2014 has fallen to 1%.** Like the national football team versus Germany, rounding up to single digits, the economy currently has a 7-1 (inflation-growth) score. The Brazilian Central Bank (BCB) and the World Bank still hope for a score of 6-2, the private sector 6-1.
2. **Encouragingly June inflation fell to 0.4% from 0.46% in May and from 0.67% in April.** Food and beverage prices fell by 0.1%. However disinflation was less than hoped for, principally due to World Cup induced rises in restaurant (22%) and air travel prices (25.3%). 12 month average inflation will very likely rise above 6.6% in July, as almost zero inflation in July 2013 drops out of the average.
3. **Short term, the BCB and private market analysts expect inflation to fall below 6.5% by the end of the year.** The Government hopes that high interest rates and an overvalued Real (see In Focus: Current Account Conundrums below) will make it happen by the October election. Inflation undermines its support**.**
4. **Medium term the BCB's June Quarterly Inflation Report 2014 concedes that inflation will only be brought back towards the 4.5% central target by mid-2016.** It points to three drivers of inflation.
   a. Higher inflation expectations due to the persistence of inflation near the upper target limit.
   b. The tight labour market increasing workers ability to gain higher wages on the basis of higher prices.
   c. The upward adjustment of regulated prices; for example, an 18.7% increase in Sao Paulo electricity prices will hit the consumer price index in July.

Weaker Economic Predictions

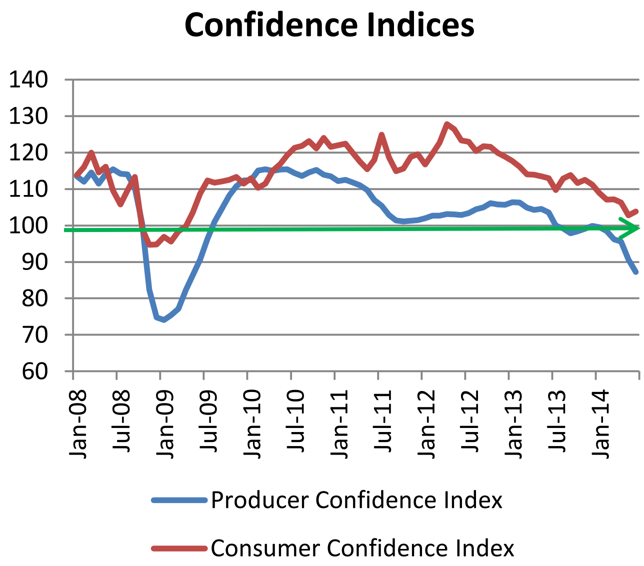
	BCB		**FOCUS BCB (market)**		**World Bank**
	March	**June**	**March**	**July**	**Current**
Inflation	6.20%	6.40%	6.00%	6.48%	6.20%
GDP	2.00%	1.60%	1.70%	1.05%	2.20%
Current Account Deficit	US$80bn	US$87.5bn	US$75bn	US$80bn	n/a

5. **2014 growth estimates have also been revised down to 1% by private market economists.** Three months ago the BCB and the Finance Ministry were both predicting growth at or above 2%. However, high interest rates are dampening the credit that has fuelled consumption while the strong Real is hurting exporters.
6. **Credit markets have tightened sharply.** Banks are worried by a rise in unsecured loan default rates. Since April 2013 they have increased interest rates on less secure credit categories by multiples of the 3.75% increase in the base interest rate – credit cheques +25%, credit cards +39%, car purchase credit +9%. March to May banks also increased their deposits with the Central Bank by R$13bn as extra security. They anticipate a further rise in unsecured loan defaults.

[1] High inflation (7) and low (1) or zero growth.

7. **Households are cutting savings to meet rising interest rates.** Saving scheme deposits fell by 66% in the first half of 2014. C class budgets (4 person household with total annual income £4,100-14,300) are under pressure. They contributed just a third of the increase (7%) in household supplies spending up to April, as against half in 2013. Consumer confidence ticked up in June, perhaps boosted by the World Cup, but the broader two year trend is downwards – see chart below.

8. **May was the third month in a row in which industrial production decreased, -0.6%*.*** It has fallen by 1.6% in 2014 and by 3.2% in the last 12 months. Industry's loss of competitiveness is not just due to relatively high inflation and currency strength. Brazilians are earning more without producing more. Between July 2010 and January 2014, manufacturing productivity grew 1.7% while real hourly wages increased 15%. Even government-affiliated economists agree that increasing productivity is the big challenge.



9. **Industrial confidence has fallen 11% since February.** The graph shows industrial confidence sinking towards levels last seen in 2009, well below the 100 level that indicates neutrality.

10. **Oversupply has hit automotive sector production.** Car production fell 23% in June and was one third lower than in June 2013. Many producers took advantage of the World Cup to give workers holidays and reduce stocks. Car and truck purchases soared in 2012 and 2013 but are falling now. Brazil's number 1 export market for automotives, Argentina, has also slumped.

11. **The Finance Ministry continues to employ a suite of ad hoc measures to assist industry. These have with mixed impacts on the public purse. They:**
    - **a.** Reintroduced a tax credit given up to 3% of the value of exports when the exchange rate is overvalued (Reintegra). Tax receipts will suffer, by an amount as yet uncertain, to compensate for strong the Real.
    - **b.** Made a back tax payment programme (Refis) more attractive to boost the tax take by £4bn. They lowering the initial tax payment due and allowing the use of current tax credits to offset back taxes.
    - **c.** They made the payroll tax cuts for 56 industrial sectors permanent. These diminish the yawning gap between wages and productivity (see para 8 above). The estimated cost is £21bn in over the coming three years.
    - **d.** They extended the reduced manufacturing tax for vehicle to year's end. A recent study estimates that the policy only added 0.02% to GDP and 0.03% to employment between 2010 and 2013. It cost R$2bn.

In Focus: World Cup - We needn't have worried?

12. **Brazil was ready for the World Cup even if it was a last gasp effort.** The degree of success surprised even the optimists. It could not have been delivered successfully without a great deal of

planning. But Brazilian talent for improvisation and charm covered up many last minute gaps. Success raises expectations that the 2016 Rio Olympics, though a more complex event, can be delivered well.

13. **The stadia were impressive overall**.There were no problems with the structure and no accidents. Several of the stadia and their surroundings, however, were not fully finished as planned. Three were finished and partially tested in great haste. But the arenas, built with a focus on sustainability and use of advanced technology, hosted the matches in style, albeit with some incidental problems (e.g. some long queues to get in and to buy refreshments, a couple of internet blackouts, etc.). Concerns about some of the playing surfaces were resolved successfully before the tournament.

14. **Contrary to predictions, airports performed very well.** Just 7% of flights were delayed more than 30 minutes, half the average international level. In Brasilia and in Sao Paulo, public private partnership investment in the key airports, though not yet complete because launched later than planned, still did much to improve the passenger experience.

15. **The World Cup had mixed effects on tourism**. Airline companies did not experience a bonanza. High air fares meant domestic business travel dried up during the Cup. Passenger traffic in the 12 World Cup cities however was 25% higher than typical Carnaval traffic. Three million Brazilians travelled internally. But nationally air travel fell by about 11%.

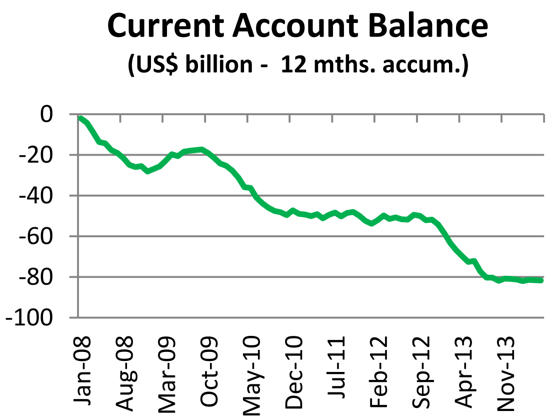
16. **Tourists were, in the majority, delighted by their experience in Brazil.** More than a million tourists arrived in the country, 61% for the first time. The numbers were boosted as the new Latin American middle classes took to the roads and skies to arrive. 83% of tourists surveyed declared that they were completely satisfied with their World Cup experience. 95% want to return. Tourists particularly welcomed the welcome and tourist attractions (98%), gastronomy (93%), night life and tourist information (93%).

17. **Despite the success of the Cup, 12% tourists criticised the high prices of taxis and food in stadia, on beaches and in airports**. The World Cup cities of Recife (0.71%) and Salvador (0.66%) led June price increases. The World Cup has also complicated inflation control this year, particularly in March and June. However World Cup prices should now recede.

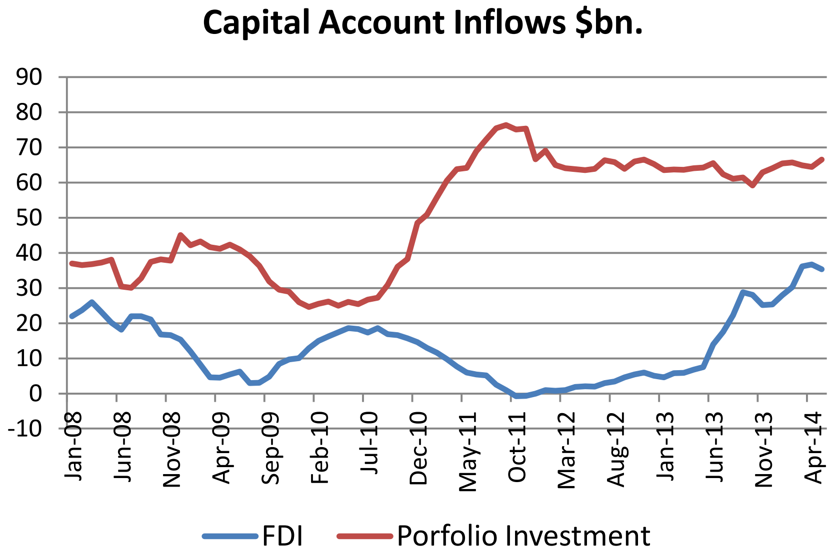
18. **Traffic chaos was mostly avoided by reducing working days which reduced industrial output.** In many host cities the government reduced match day congestion by declaring holidays or discretionary half days. Public transport to the stadia worked well overall. 10% of tourists complained of slow transport in host cities. Fewer working hours during the World Cup show up in reduced energy use which suggests a further decline in industrial production June.

In Focus: Current and Capital Account Conundrums

19. **Brazil's current account deficit reached a historic record of US$ 40bn up till May**. The strong Real boosted services imports and the numbers of Brazilian's travelling abroad, while weakening goods exports. The result for June should be better, due to the World Cup, which kept Brazilians at home and increased receipts from foreign tourists. The Central Bank predicts a deficit of US$ 88bn in 2014.



20. **The Central Bank's strong support for the Real and higher interest rates have attracted more volatile portfolio capital.** This has been financing the widening in the current account deficit. Portfolio capital inflows have now exceeded the levels which in 2008 prompted the Central Bank to increase taxes to deter capital inflows. They are keeping the Real overvalued. Foreign direct investment into productive assets just covered only 63% of the deficit in May. Brazil has been successful in continuing to attract a high level of FDI but requires more given falling domestic savings and the need to invest more in infrastructure.



21. **Brazil's dependence on more volatile capital inflows comes with a risk.** When inflation is under control, the Central Bank will be happier to unwind its programme of swaps and let the Real fall. It will also cut interest rates. Once markets think this is about to happen, and some are already talking about the end of this year, there will likely be a strong outflow of portfolio capital and this could lead to the currency devaluing sharply.

Key Macroeconomic Indicators					
	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14
Inflation (accum.)	6.7	5.86	5.91	6.15	6.52
Benchmark Interest Rate	8	9.5	10.5	10.75	11
Unemployment (%)	6	5.4	4.3	5	-
Trade Balance (US$ bn)	2.3	2.1	2.6	0.1	2.3
Exports (US$ bn)	21.1	21	20.8	17.6	20.4
Imports (US$ bn)	18.8	18.8	18.2	17.5	18.1
	Q2/2013	Q3/2013	Q4/2013	Q1/2014	Q2/2014
GDP (% var. QoQ)	1.5	-0.5	0.7	0.2	-
Unemployment PNAD (%)	7.4	6.9	6.2	7.1	-