British Embassy
Brasilia

BRAZIL ECONOMIC FOCUS: JUNE 2014

Summary

[A Weak Start to the Year]

The World Bank cuts its forecast for Brazil's 2014 growth to 1.5% as the economy stutters and grows 0.2% in Q1. Only agriculture grew strongly. Industrial production, consumer spending, and investment declined. Government spending continued to expand.

[In Focus: The Inflation Challenge]

Brazil could gain competitiveness by reducing inflation, both directly by matching the inflation rate in its competitor countries like China, and indirectly, by allowing for a weaker currency to make exports more competitive. Inflation is coming down in fits and starts. The key is to reduce non-regulated price inflation and allow necessary upwards adjustment in regulated prices. 12 month average inflation is likely to increase over the coming months.

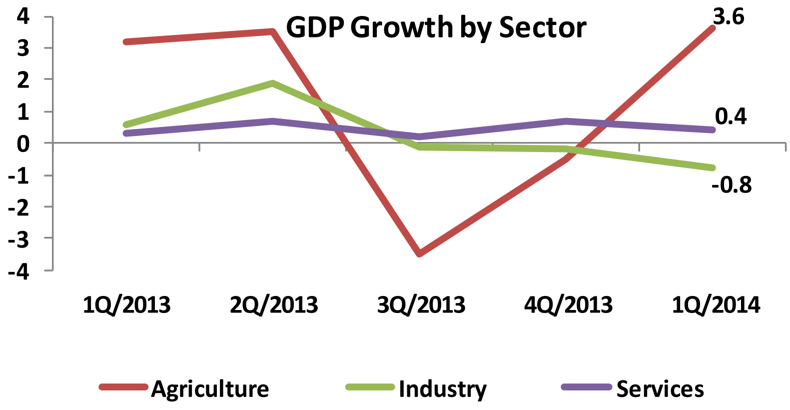
[In Focus: Inflation Control and Capital Consequences]

The Brazilian Central Bank (BCB) has been robust in its use of both the exchange rate and the interest rate to curb inflation. A high inflow of fixed income portfolio investment has resulted and assisted in keeping the Real strong. The BCB will continue its swap programme but probably taper it. Interest rate hikes are on pause. The BCB has a delicate balancing act to play with both policy instruments.

A Weak Start to the Year

1. **The World Bank reduced its forecast for 2014 Brazilian GDP growth to 1.5% after the economy grew by 0.2% in Q1 of 2014.** The biggest drag on this result came from industry, which declined 0.8%. Construction alone fell 2.3%, as World Cup works were completed and public capital projects phase down prior to the elections. Agriculture growth continues to be strong; the sector grew 3.6% in Q1. Services also grew, but decelerated compared to Q1 last year, increasing only 0.4%.

2. **Investment and household consumption also declined in Q1.** Consumption decreased 0.1%, the first negative result since 2011. Investment dropped 2.1%; the investment rate is 17.7% (down from 18.2 last year). Higher interest rates hit have business and consumer confidence. The business confidence index fell by 5.1% between April and May, the fifth fall in a row and the largest since 2008. Consumer confidence also fell 3.3% to the lowest level since December 2009.



3. **Industrial production fell 0.3% in April, reflecting the deceleration in consumption, except for food and drinks, probably boosted by the World Cup.** Consumer durables declined most sharply, by 1.6%. Industrial sales this year grew by a very modest 0.7% compared to sales during the first four months of 2013, and vehicle sales continue to be weak. Jan-May sales in 2014 dropped 3.5% compared to Jan-May sales in 2013. Trucks sales declined even more sharply, by 10.9%, and light vehicles by 5.2%. Both Government and industry are concerned about the lack of demand in the automotive sector because of its high linkage with other sub-supply industries and its importance for employment.

4. **Despite these trends, unemployment remains relatively low and stable.** A national unemployment rate of 7.1% in the first quarter was registered by the new nationwide employment survey of 3500 municipalities. In the same period last year the rate was higher, at 8%. The national rate shows some spare labour force capacity. However, this labour is concentrated in areas that are not the main centres of production (North, North East, Centre West) and is less educated. Unemployment in the five major urban centres remains low at 5%.

5. **Brazil faces the immediate challenge of reducing the level of demand to quell inflationary pressures while avoiding a recession and rising unemployment.** A decline in growth is inevitable as higher inflation and rising interest rates bite into consumer spending. Consumer purchasing power is caught between a rock (higher debt repayments) and a hard place (more expensive shopping basket of goods).

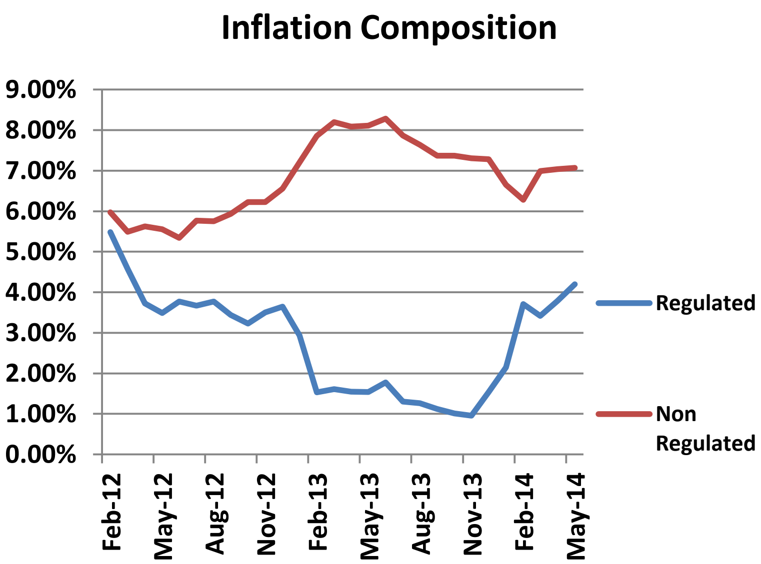
In Focus: The Inflation Challenge

6. **Brazil has much to gain from reducing inflation.** It would help industry avoid losing international price competitiveness, as has been happening for a decade. It would allow the Brazilian Central Bank let the Real weaken without blowing through the 6.5% upper bound inflation target due to the resulting rise in import prices. A weaker Real would further restore some of the lost competitiveness of Brazilian exports and allow the economy to benefit more from international demand and become less dependent on the domestic market. Lower inflation would also sustain medium term domestic demand, which higher inflation is currently eroding.

7. **Inflation pressures are moderating but intermittently.** Inflation in May, at 0.46%, was slightly higher than the market expected, but was significantly lower than April's 0.6% increase. Transport prices fell as airlines offered discounts to fill spare capacity; unlikely to repeat in June. Food price inflation also fell and that trend has continued in early June with food prices falling. Incentives to save on water use in Sao Paulo also helped bring May's housing inflation down.

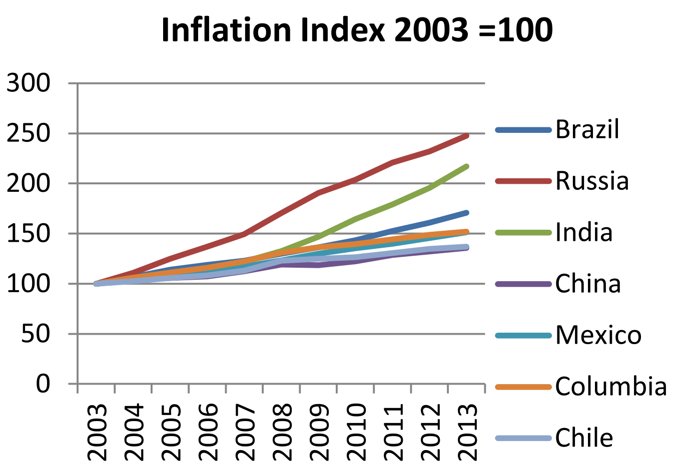
8. **12 month average inflation rose to 6.37%, and is likely to keep rising over coming months towards,- the Central Bank's 6.5% upper target boundary.** Inflation was particularly low last year during June (0.26%), July (0.03%), August (0.24%). Every month of inflation that registers above the corresponding month last year will push the 12 month rate up.

9. **Non-regulated price inflation fell after interest rates began to rise in April 2013 and this gave space for regulated prices to be increased.** An upward blip due to higher food prices broke this trend at the beginning of 2014.



10. **The Government's policy, of limiting increases in regulated prices during 2012 and 2013 has reached a limit.** Electricity prices rose in many States in May; costly thermoelectric generation is boosting low hydroelectric generation due to low reservoir levels. Pressure to increase gasoline prices to improve Petrobras' finances will be more intense after the election. With demand falling, and food prices moderating, such increases may be possible provided Brazil is not too near the 6.5% upper band target.

11. **Brazil has control over inflation and could increase competitiveness by moving to a lower inflation target.** The graph shows the differences in the evolution of consumer prices since 2003. Brazil's cumulative inflation over the past decade was 11-12% more than Columbia or Mexico, and 20-21% more than China or Chile. As a result Brazil has lost ground to Chinese competition both at home and in other parts of Latin America. However, it has not run into problems of inflation control, like Russia (45% higher) and India (27% higher).



In Focus: Inflation Control and Capital Consequences

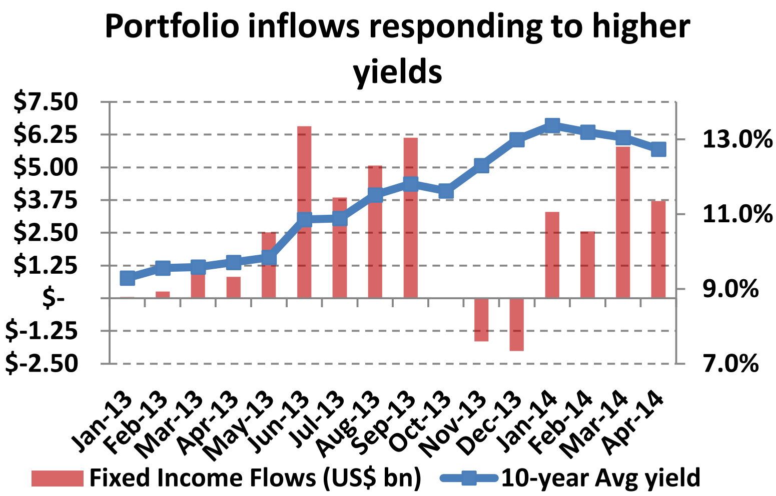
12. **The Brazilian Central Bank (BCB) is deploying the exchange rate and the interest rate to control inflation, but it is not helped by ongoing growth in fiscal spending.** The BCB has been selling swaps that guarantee sufficient Real to buy the same amount of dollars in the future that can be bought today for the Real the BCB receives in payment. Companies which want hedge against a fall in the Real in the future, by selling Real to buy dollars now, buy the swaps instead, as they are sure to be able to buy a guaranteed amount of dollars in the future. This reduces downward pressure on the Real. The BCB seems comfortable with the current level of the Real (R$ 2.30/US$).

13. **The BCB recently announced that they will extend the swap programme beyond the current 30th June deadline but will probably reduce it.** They experimented with not rolling over some swaps in late May but the Real fell in response, and worried about higher import prices, they reversed course. Details on time and size of the extended swap programme will follow later. Although the swaps do not create any direct obligation for the BCB in dollars, the BCB's dollar reserves guarantee that the swaps can be reversed. If the Real depreciates the Bank can draw on the dollar reserves to cover the depreciation loss when reversing the swaps. The BCB has $88bn in swaps outstanding, but $378bn in foreign exchange reserves. As swaps increase so does the amount of foreign exchange reserves covering the risk involved. Note, however, the reserves just cover the depreciation risk involved and not the total amount.

14. **The BCB paused its tightening of monetary policy in May, after nine interest rate rises since March 2013 from 7.25% to 11%.** With consumer spending falling, it does not want to tip the economy into a recession. It also anticipates more feed through from prior rate hikes. It signalled willingness, however, to increase rates further. But political pressure not to do so, prior to the October elections, will be intense.

15. **Given last year's emerging market pessimism, capital inflows are surprisingly strong and support a stronger Real.** Brazil continues to attract foreign capital, both in foreign direct investment FDI (US$ 19bn, same level as in 2013) and portfolio investments (US$ 14.8bn, 39% more than last year). FDI is longer-term directly productive inflows (i.e. purchase of fixed assets and physical capital goods), hence it is less volatile to short term economic fluctuations.

16. **Shorter term fixed income portfolio flows have reacted to government intervention.** Fixed income flows involve investment in bonds that pay a fixed return. Higher interest rates, and the solid Real, enhanced Brazil's attractiveness. 10-year govt bond yields topped 13.5% in February 2014. Fixed income now makes up 94% of total portfolio inflow, up from 24% in 2013. The graph above shows fixed-income portfolio capital inflows increasing with the rise in yield during 2013, except for routine profit taking at year's end. Since then, as expectations of future interest rate rises have receded, the 10 year bond yield has also declined as have fixed income portfolio inflows.



17. **Capital inflows have also been helped by tax changes.** In June 2013, the Finance Ministry removed a 6% IOF financial tax on fixed income investments by foreign investors. While this June, the Ministry also removed the 6% IOF tax on external loans maturing in more than 6 months.

18. **Expectations about the future strength of the Real are moderating as a reduction in the swaps programme is anticipated, and interest rate rises paused.** The effect of both would tend to reduce portfolio capital inflows and weaken the value of the Real. The Real had been expected to rise to R$ 2.45/US$ by the end of 2014, but now market analysts expect it to end the year as it did in 2013 at R$ 2.40/US$.

19. **The Central Bank has a delicate balancing act with both its policy instruments.** It does not want the exchange rate to weaken too much and yet needs to taper its swap programme as the bigger it gets the more difficult, and perhaps costly, it is to unwind. It does not want to cause a recession through rising interest rates, but wants to bring non-regulated price inflation down below 6%. Loosening the fiscal purse strings prior to the election, were it to occur, would make the second balancing act more difficult.

Key Macroeconomic Indicators					
	Jun-13	Sep-13	Dec-13	Mar-14	May-14
Inflation (accum.)	6.7	5.86	5.91	6.15	6.37
Benchmark Interest Rate	8	9.5	10.5	10.75	11
Unemployment 5 major city (%)	6	5.4	4.3	5	-
Trade Balance (US$ bn)	2.3	2.1	2.6	0.1	0.7
Exports (US$ bn)	21.1	21	20.8	17.6	20.7
Imports (US$ bn)	18.8	18.8	18.2	17.5	20
	Q2/2013	Q3/2013	Q4/2013	Q1/2014	Q2/2014
GDP (% var. QoQ)	1.5	-0.5	0.7	0.2	-
Unemployment National (%)	7.4	6.9	6.2	7.1	-