Current Issues

International topics

Deutsche Bank Research

# Brazil 2020

## Economic & political scenarios - update

November 27, 2009

**Brazil is rapidly emerging from the global crisis.** Strong external solvency and liquidity, a solid macro-policy framework, greater fiscal flexibility and a well-capitalised banking sector have allowed the economy to absorb the external shock with relative ease. The economy is already recovering in a sustainable fashion and real GDP growth should reach 4-5% in 2010.

**The "country of the future" turned in quite a respectable economic performance over the past five years,** especially compared to the 10-15 year period leading up to 2003. During 2003-08, real GDP growth averaged 4.7%, almost twice the 2.5% during 1994-2003. Rising investment and increasing exports, flanked by favourable international economic and financial conditions and domestic economic stability, were the key factors behind the improved performance.

**We have revised upwards our 2020 growth projection.** We now expect the economy to grow at an annual average rate of 4.25% over the next decade. In our revised "upside" scenario, Brazil could reach annual growth of 5%. However, unless there is a tangible increase in domestic savings or significant structural reform, such a growth rate will remain elusive.

**The 2010 presidential elections may bring about a slight shift in economic policy.** A PT administration could relax the fiscal policy stance somewhat (or refrain from tightening it), while a PSDB administration would maintain a tight(er) fiscal policy. By contrast, a PT victory would likely leave monetary policy framework unchanged, while a PSDB victory could lead to looser monetary policy and a weaker exchange rate. Neither administration is likely to pursue policies that undermine economic stability.

**The financial sector is set to thrive in the coming years** on the back of lower interest rates, solid economic growth, increasing per capita income and continued financial deepening. A favourable growth outlook, an expanding domestic market and an abundance of strategic commodities will make Brazil an attractive destination for capital flows.

**Brazil's economic and political importance will continue to increase over the next decade.** While the political, economic and financial rise of both China and India may outpace Brazil's, the country's relative position vis-à-vis advanced economies will improve. Its hosting of both the Football World Cup in 2014 and the Olympic Games in 2016 reflects Brazil's promise and aspirations.

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**Brazil among the top-10**

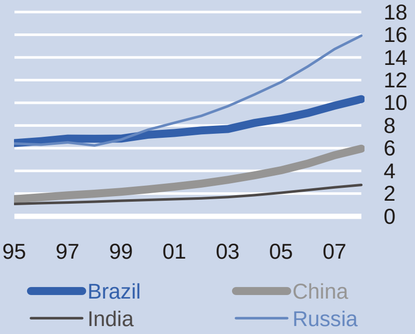
GDP, 2008

| | Current prices, USD bn | Rank | PPP, USD bn | Rank |
|---|---|---|---|---|
| US | 14,441 | 1 | 14,441 | 1 |
| Japan | 4,911 | 2 | 4,356 | 3 |
| China | 4,327 | 3 | 7,926 | 2 |
| Germany | 3,673 | 4 | 2,918 | 5 |
| France | 2,867 | 5 | 2,130 | 8 |
| UK | 2,680 | 6 | 2,228 | 7 |
| Italy | 2,314 | 7 | 1,818 | 10 |
| Russia | 1,677 | 8 | 2,265 | 6 |
| Spain | 1,602 | 9 | 1,395 | 12 |
| **Brazil** | **1,573** | **10** | **1,984** | **9** |

Source: IMF 1

**Ahead of China & India**

GDP per capita (PPP, USD, '000)




Source: IMF 2

**Debt crisis of 80s ended high growth phase**

Real GDP, % change, 10Y avg.


Source: IPEA 3

## Brazil 2020: Moving forward

Brazil is the world's fifth-largest country by population and land mass. It is the world's ninth-largest economy (measured on a PPP basis) and its official FX reserves exceed USD 230 bn, making it the world's seventh-largest holder of official reserve assets (chart 1). Moreover, recent oil and gas finds carry the promise of turning Brazil into an important international energy player[1]. Brazil also sits on the fourth-largest amount of arable land and it is the world's second-largest biofuel producer and the world's largest biofuel exporter.

After nearly two decades of financial instability and disappointing economic growth following the Latin American debt crisis of the early 1980s, Brazil seems to be finally coming into its own, politically and economically. The election of a left-wing president in 2002, amongst other things, attests to the maturity of the political system. Political stability is underpinned by a strong consensus regarding the respect for democratic principles and the desirability of economic stability.

Brazil's much-strengthened financial position is today most visibly reflected in an investment grade rating, while its economic resilience has been demonstrated by its performance during the global crisis, including its early exit from it. It was as recently as 2002 that Brazil came close to falling into a sovereign default. After repaying its debt to the IMF and the Paris Club a few years ago, Brasília's recent purchase of IMF bonds symbolises its much-enhanced financial status. Increasing economic stability and financial prowess have also helped Brazil raise its diplomatic profile, reflected both in its membership of the G20 and the informal BRIC group and in its important role played in international trade negotiations and regional affairs. The hosting of the 2014 World Cup and the 2016 Olympics is a tacit recognition of Brazil's increasing importance and rising fortunes.

Brazil's economic performance has improved markedly since 2003, with real GDP growth averaging almost 5%, or nearly twice the rate registered over the previous decade. However, growth has remained far below that of the other BRICs, especially the "superstars", China and India. On the basis of indicators like per capita income (chart 2) and urbanisation, Brazil is a much more advanced country than China and India. (Brazil is more highly urbanised than the United States, according to UN data.) Therefore, all other things being equal, Brazil should not be expected to grow at Chinese or Indian rates. After all, Brazil experienced its high growth period during 1950-80, which came to an abrupt end in the wake of the Volcker shock of the late 1970s and the debt crisis of the early 1980s (chart 3). Nonetheless, in the past few years, Brazil has moved closer to the kind of growth rate typical of middle-income countries.

## Brazil has weathered the global crisis well

Brazil has weathered the global economic and financial crisis well. The economy is already on the mend and is even forecast to register very modest growth in 2009 and expand 4-5% or more in 2010. The rebound will be more sustainable than in several other emerging and many developed economies, as Brazil has managed to avoid banking-sector problems and both private and sovereign balance sheets remain in good shape (chart 4).

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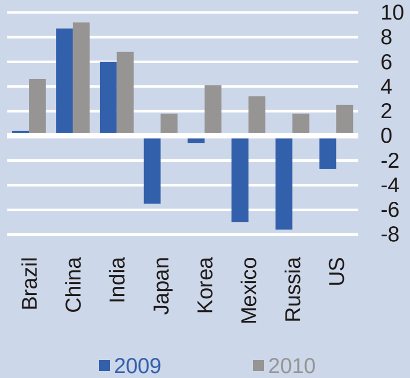
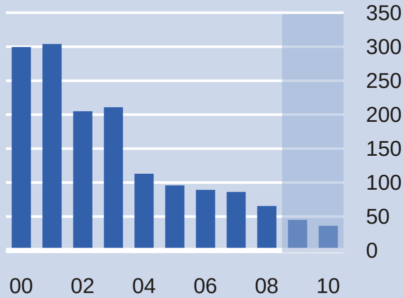
[1] The growth scenarios assume that recent oil and gas finds will not have a major effect on growth before the middle of the next decade.

**Escaping the downturn relatively unscathed**
Real GDP, % annual change




Source: DB Research 4

**Solid external position (1)**
External financing requirements, % of FX reserves




Source: DB Research 5

**Solid external position (2)**
Net external debt*, % of GDP


*Incl. external assets of commercial banks.

Source: BCB 6

Although the external shock was very severe, the economy is recovering quickly and sustainably. Unlike in the past, Brazil was not forced into a pro-cyclical fiscal adjustment. Aggressive interest rate cuts also provided support. Admittedly, in the short run, it was the countercyclical role played by public-sector banks that helped to sustain, albeit modest, domestic credit growth. But as the economy and the banking sector do not suffer from excessive leverage or capital constraints, lower interest rates will eventually fuel higher loan growth among private banks and thus support the economic rebound. The economy's external liquidity position is strong, and capital inflows have recovered strongly in the past few months, further easing private-sector financing conditions. Even if world growth remains subdued in the coming years, Brazil is very well-positioned to return to close to pre-crisis growth levels. In retrospect, the global financial crisis and economic downturn will turn out to have had only a minor effect on Brazil's medium-term growth trajectory. More sluggish global growth will weigh on Brazil's export performance, but the domestic sources of economic growth remain in place.

## Economic stability has been consolidated further

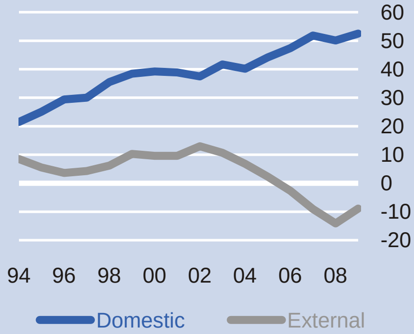
The considerable improvement in economic fundamentals reflected in Brazil's investment grade status allowed the economy not only to absorb the global financial shock and recover quickly from its economic consequences but also to put Brazil on a higher medium-term growth trajectory.

A flexible exchange rate, manageable sectoral foreign-currency (FCY) mismatches and a solid external liquidity position helped Brazil absorb the balance of payments shock without lasting damage (chart 5). The central bank was able to let the currency depreciate without running the risk of causing an outright financial crisis. Both the government's and the banking sector's solid FCY positions meant that, unlike in previous crises, currency depreciation did not threaten public-sector debt sustainability, nor banking-sector stability. Some corporates took hits on their FX derivatives exposure in the wake of the sharp exchange rate adjustment, but this did not have any systemic implications. Similarly, while the temporary lack of access to international capital markets did have a major effect on investment and economic activity, it did not threaten economic or financial stability.

If the external assets of the commercial banks are taken into account, Brazil is a net external creditor to the tune of 2-3% of GDP. This contrasts sharply with a net debtor position of 33% of GDP at end-2002 (chart 6)! The public sector's net external creditor position allowed it to provide liquidity to the capital-account-shocked private sector, thus alleviating somewhat the severe external liquidity squeeze (chart 7). FCY mismatches in the banking sector are very manageable and banks mainly fund themselves locally. In short, neither external liquidity nor solvency is a concern for Brazil.

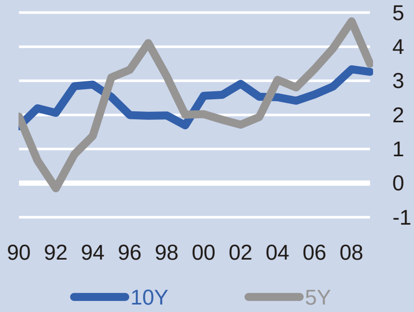
The public sector's FCY position combined with a significant (pre-crisis) primary fiscal surplus prevented concerns about public-sector debt sustainability from emerging in the wake of the sharp currency depreciation. In fact, due to the "long" FCY position, net public-sector debt declined to less than 39% of GDP from 42% between July and November 2008. Public debt, especially on a gross basis, remains relatively high, but fiscal policy is tight enough to ensure a declining debt-to-GDP ratio over the medium term. Even if the government failed to reverse some of the discretionary measures

**Gov't is net FCY creditor**
Net public sector debt, % of GDP



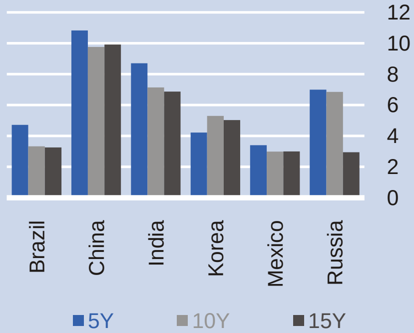

Source: BCB 7

**Moving onto higher growth path**
Real GDP, % change, moving avg.




Source: DB Research 8

**Improved, but lagging**
Real GDP, % avg. change




Source: DB Research 9

taken to counter the economic downturn this year, the primary surplus would be large enough to ensure a further, albeit gradual, decline in the net debt-to-GDP ratio (see below). Unlike in the late 1990s and early 2000s, debt sustainability is not a concern.

Finally, and importantly, a strong commitment to maintain economic stability through disciplined fiscal and monetary policies underpins domestic and foreign investor confidence. Combined with a gradual decline in interest rates, this will help generate higher investment and higher medium-term economic growth, especially if the government manages to increase savings. Public debt will continue to decline and this in turn should lead to lower real interest rates. This should also contribute to higher investment and economic growth through increased confidence and predictability.

## Medium-term growth outlook has improved

Three years on, it is time to revisit our medium-term projections[2] (table 10). In 2003-2008, economic growth averaged 4.7%, up from a mere 2.5% in 1994-2003. The improvement occurred at a time when world economic growth was running at an impressive 4.5%. Thus Brazil's growth looks just about average, and even unfavourable compared to many other emerging markets. However, trend growth has clearly picked up (charts 8 and 9).

It might be argued that simply extrapolating the recent high growth rates is overly optimistic, as Brazil benefitted from ample global liquidity, high commodity prices and strong global growth. However, global liquidity is ample again (for now) and commodity prices are rebounding. While global growth is expected to remain weak-ish over the next few years, Brazil's economic growth will continue to be sustained by solid demand growth supported by, amongst other things, sustained domestic credit growth. The balance of payments will not be a constraint on growth over the next few years. The improvement in underlying fundamentals, and especially the increase in investment spending pre-crisis, is compatible with a baseline trend growth rate of 4.25% (p = 70%). In our upside scenario (p = 20%), which would see a sharp increase in investment over the next decade and/or substantial progress on the structural reform front, none of which is especially likely, real GDP growth could average 5%.

**Economic scenarios 2020**

| **2006** | Scenario 1 | Scenario 2 | Scenario 3 |
|---|---|---|---|
| Probability | 60% | 25% | 15% |
| Avg. real GDP, % | 3.25 | 4.25 | 2.50 |
| **2009 update** | Scenario 1 | Scenario 2 | Scenario 3 |
| Probability | 70% | 20% | 10% |
| Avg. real GDP, % | 4.25 | 5.00 | 3.25 |

Source: DB Research 10

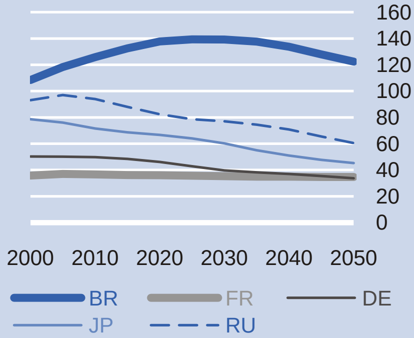
[2] DB Research (2006). Current Issues. Brasil: O país do futuro?

## What has changed in terms of underlying growth drivers

Our basic growth model[3] takes into account four fundamental growth drivers: demography, human capital, openness and investment. Demographic trends and changes in the human capital stock are by their very nature very slow-moving and we have not made any changes to our projections. Generally speaking, the demographic outlook remains relatively favourable in terms of dependency ratios and age structure. Although its demographic structure is maturing, Brazil's profile is in many respects more favourable than China's or Russia's or, naturally, that of most advanced economies (chart 11). As regards the human capital stock, we have left our projections unchanged, too. A programme like *bolsa familia*, which encourages school attendance through cash payments to poor families, may turn out to be more successful than anticipated, but its effects will only be felt over time.

**Fair demographic outlook**

Population, million, aged 15-59

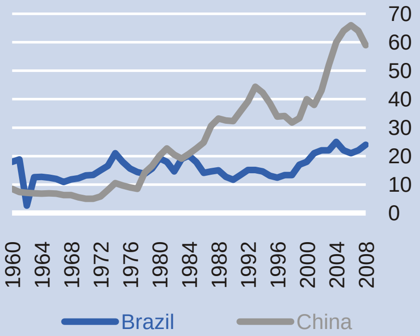



Source: UN 11

While Brazilian exports and trade expanded strongly in the years leading up to the crisis, economic openness measured as a share of GDP has increased more moderately due to rapid USD GDP growth, fuelled to some extent by currency appreciation (chart 12). However, the considerable expansion of trade, combined with an appreciating exchange rate, has allowed a significant surge in foreign imports, including capital goods. Following the 2008 shock, trade openness should continue to increase gradually, helped not least by continued growth in resource-hungry China. We now project economic openness to spread more rapidly than previously projected. Nonetheless, Brazil remains by far the least open economy among the BRICs.

**Weighing on TFP growth**

Merchandise trade, % of GDP

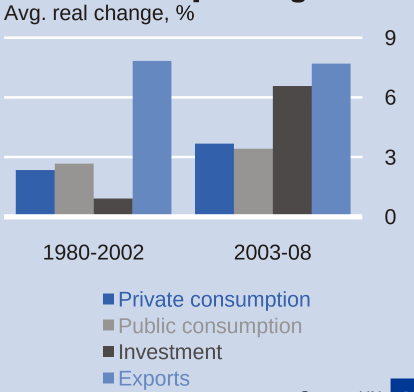



Source: World Bank 12

Last but not least, investment trends have improved, leading us to upgrade our projections. The investment ratio began to pick up pre-crisis. Investment in machinery, equipment etc. measured as a share of GDP reached a multi-decade high (chart 13, 15 and 16). This happened in the context of a solid current account position, meaning the pick-up was sustainable from a balance-of-payments point of view. (Savings increased to 18% of GDP during 2004-08 from an average 15-16% of GDP previously.) Generally, fair domestic demand growth, a functioning banking system (albeit one that charges considerable spreads), lower interest rates and a lower economic risk should support a further increase in domestic private investment. Declining government interest payments should open space to increase government savings and/or investment, limited bureaucratic capacity to implement public investment projects notwithstanding. Necessary infrastructure investment in the run-up to the 2014 World Cup and 2016 Olympics should also help underpin higher public investment. So should oil- and gas-discovery-related investments.

**Tangible improvement in investment spending**

Avg. real change, %




Source: UN 13

## Increasing investment is key to raising growth

Real GDP growth averaged 3.3% over the past 10 and 15 years. Why has growth been so slow, especially compared to other emerging markets? One way to analyse economic growth is to analyse changes in factor inputs (labour, capital) and attribute the residual to "efficiency gains" and/or "technological progress"[4].

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[3] DB Research (2005). Current Issues. Global growth centres 2020.

[4] Growth accounting suffers from well-known shortcomings. It nonetheless is a useful heuristic tool.

### Brazil disappointed on all fronts during 1980-2000

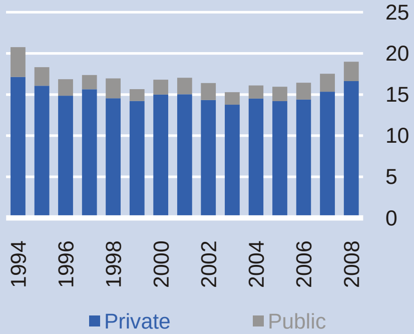
| | Brazil | | | Industrial countries | | | East Asia* | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Contribution of: | | | Contribution of: | | | Contribution of: | |
| | Output per worker | Capital** | TFP | Output per worker | Capital** | TFP | Output per worker | Capital** | TFP |
| 1960-70 | 2.8 | 1.1 | 1.6 | 4.0 | 1.7 | 2.3 | 3.7 | 2.2 | 1.5 |
| 1970-80 | 2.7 | 1.6 | 1.1 | 1.9 | 1.5 | 0.4 | 4.3 | 3.4 | 0.9 |
| 1980-90 | -1.8 | 0.5 | -2.3 | 1.7 | 0.9 | 0.8 | 4.4 | 3.1 | 1.3 |
| 1990-2003 | 0.3 | 0.5 | 0.2 | 1.6 | 1.1 | 0.5 | 3.1 | 2.5 | 0.6 |
| 1960-2003 | 1.0 | 0.9 | 0.1 | 2.2 | 1.2 | 1.0 | 3.8 | 2.8 | 1.0 |

*Excluding China. **Includes physical capital and education.

Sources: Bosworth and Collins (2003), IMF 14

### Rising private investment

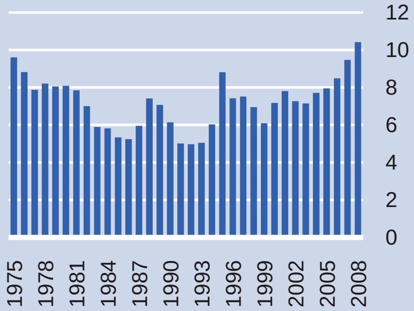
% of GDP




Source: OECD 15

### At multi-year high

Investment in machinery & equipment, % of GDP




Source: OECD 16

During the 1980s and 1990s, Brazil underperformed in terms of both capital accumulation and total factor productivity (TFP) growth, compared with both emerging and developed markets. It is not surprising that China and India experienced greater TFP growth given that technologically they were less advanced than Brazil. But Brazil even underperformed the capital-rich, technologically advanced developed markets, where it should be more difficult to generate TFP gains than in relatively technology-poor Brazil. Not only that, but TFP growth in Brazil was negative during that period! Brazil thus failed to raise the efficiency with which it uses factor inputs and/or failed to incorporate “technological progress” on account of a failure to implement TFP-boosting structural reforms (or even increasing structural impediments) and a very low level of trade openness (limiting capital goods imports and competition).

Structural reforms would have helped lift productivity growth and investment. (Unfortunately, little progress has been made under Lula’s first and second administration. Excluding the public-sector pension reform, there were no important big-ticket reforms.) If the World Bank surveys are to be believed, productivity growth continues to face considerable structural impediments. Brazil fares poorly, especially given its relatively higher per capita income. It seems odd that it should be easier to register property in nominally communist China than in Brazil (table 17).

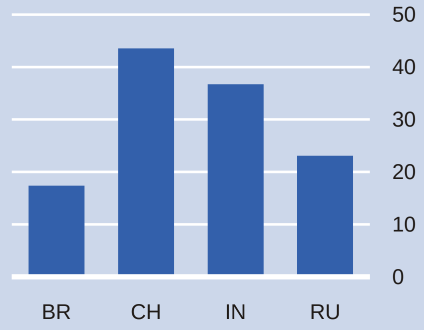
### Lots of room for improvement

Doing Business ranking (1=best, 183=worst)

| | Brazil | China | India | Russia |
|---|---|---|---|---|
| Ease of Doing Business | 129 | 89 | 133 | 120 |
| Starting a business | 126 | 151 | 169 | 106 |
| Dealing with construction permits | 113 | 180 | 175 | 183 |
| Employing workers | 138 | 140 | 104 | 109 |
| Registering property | 120 | 32 | 93 | 45 |
| Getting credit | 87 | 61 | 30 | 87 |
| Protecting investors | 73 | 93 | 41 | 93 |
| Paying taxes | 150 | 130 | 169 | 103 |
| Trading across borders | 100 | 44 | 94 | 162 |
| Enforcing contracts | 100 | 18 | 182 | 19 |
| Closing a business | 131 | 65 | 138 | 92 |
| Unweighted average | **115** | **91** | **121** | **102** |

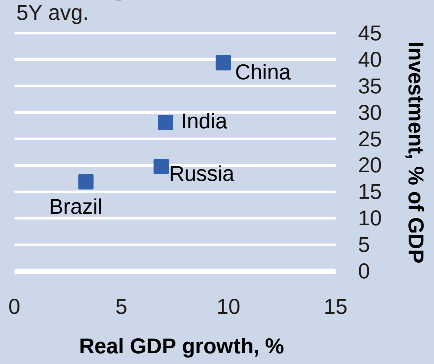
Source: World Bank, Doing Business 2010 17

**Lagging by comparison**
Investment, % of GDP, 2004-08 avg.



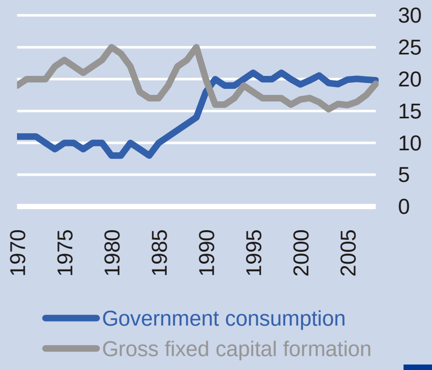

Sources: DB Research, IIF **18**

**As simple as that?**
5Y avg.




Source: DB Research **19**

**Public consumption weighs on investment**
% of GDP




Source: UN **20**

Brazil also underperformed in terms of investment. Investment averaged a mere 17% of GDP over the past 5, 10 and 15 years. This contrasts sharply with many emerging markets in Asia where both savings and investment are much, much larger, not infrequently in the 30-40% of GDP range (chart 18). Brazil is suffering from a low level of both public and private-sector investment. Public-sector investment in many Asian countries amounts to 4-6% of GDP. Due to high levels of public current expenditure, the Brazilian government invested less than 2% of GDP during much of 1995-2005. This is one the reasons why Brazil has fallen behind many Asian countries in terms of the quality of its infrastructure.

Public-sector investment is low due to a very low level of government savings and a limited capacity to run large fiscal deficits. As regards the low level of private-sector investment, the 2003 World Bank ICS points to high taxes and high financing costs, followed by economic and regulatory uncertainty and economic instability, as the main obstacles to higher investment. Since the early 2000s, economic instability and, somewhat less so, high financing costs should have become less of a constraint. This may help explain the observed rise in private-sector investment, which reached 19% of GDP in 2008, over the past few years.

In the "growth diagnostics" framework[5], growth is low if expected social returns are low, which is due to either low returns or their low level of appropriability, or if the cost of financing is high. The standard view[6] attributes low investment to the high cost of financing faced by private-sector investors rather than low returns. The high cost of financing in turn is attributed to the low level of domestic savings, largely attributed to a high level of public-sector consumption and transfers[7]. Public-sector consumption averaged 10% of GDP until the 1980s and then precipitously jumped to 20% of GDP where it has remained since (chart 20). Similarly, social transfers have been growing more gradually and are very large given Brazil's level of development and demographic situation. Another view[8] attributes the low level of investment to the low level of appropriability of private-sector returns (due to heavy and inefficient taxation). Theoretically, it could also be attributed to low social returns (due to human capital or infrastructure constraints).

These views provide fundamentally different explanations of Brazil's low investment and growth levels, but they agree to some extent on the macro solution. The first explanation would advocate lowering public consumption and transfers to increase the savings available to, and lower the costs of financing for, the private sector. The second view would also support a reduction in public consumption and transfers as it would offer scope for lowering taxes (to increase the appropriability of returns) and boost public investment in education and/or infrastructure (to lift social returns). Given the limited scope for fiscal maneouvre, the two views agree that lowering government current expenditure is an important intermediate policy target – whether to increase domestic savings,

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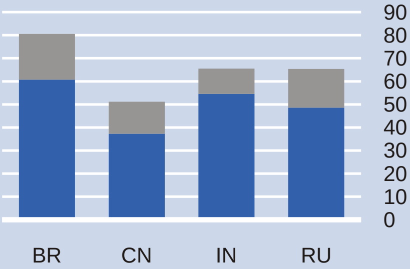
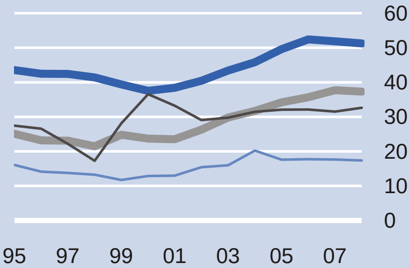
[5] Hausmann et al. Doing Growth Diagnostics in Practice: A 'Mindbook'. CID Working Paper No. 177. 2008.
[6] Hausmann, R. In Search of the Chains that Hold Brazil Back. HKS Working Paper No. 61. 2008.
[7] Transfers (e.g. pensions) encourage private consumption at the expense of savings, while reducing the savings available to the private-sector agents taxed.
[8] Blyde et al. "What is impeding growth in Brazil?". Agosin et al. Growing Pains. Binding Constraints to Productive Investment in Latin America. IADB. 2009.

**Consuming too much**
% of GDP, 2007



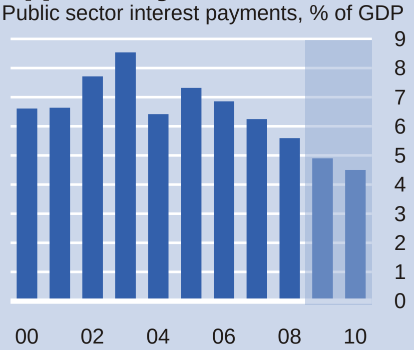

Source: UN 21

**Lagging by comparison**
Domestic savings, % of GDP




Sources: IIF, DB Research 22

**Opportunity**
Public sector interest payments, % of GDP




Source: BCB 23

lower taxes or address the causes of low social returns through public investment.

## What can be done to raise investment?

Raising the investment ratio without raising savings would force Brazil to run larger current account deficits. The balance-of-payments constraint has weakened considerably in recent years and Brazil could afford to run a larger external deficit, which would allow it to raise its investment ratio by 1-2% of GDP given a present current account deficit of 1-2% of GDP. But raising the investment ratio by more would require an increase in domestic savings (chart 22). The best way to do this would be to reduce public-sector current expenditure (as a share of GDP). (In light of the heavy tax burden and the potentially low appropriability of returns, it would not be desirable to raise taxes to boost investment.) Even if the government failed to take advantage of the resulting savings to lift public-sector investment due to bureaucratic obstacles, it could use the increased savings to pay down debt and/or lower taxes, thus helping to put downward pressure on interest rates and/or making private-sector investment more attractive. Ultimately, whether one advocates an increase in public investment, a reduction in public debt or a cut in taxes will depend on the (social) returns of public-sector investment versus the elasticity of private-sector investment to lower financing costs and/or lower taxes. This is ultimately an empirical question. Again, in all cases, increasing public-sector savings is an intermediate policy objective[9].

Compared to other countries, both public-sector consumption and social transfers are large given Brazil's per capita income. There is clearly scope to lower social transfers (as a share of GDP!) without negatively impacting socio-economic and redistributive goals. Raising the quality and efficiency of transfer payments in particular could compensate for a slower increase in spending. The government also has a tremendous opportunity to lift the savings and/or investment rate on the back of what is likely to be a permanent decline in government interest outlays (chart 23). If real interest rates settle at, say, 5% (a level that sounds about right given economic fundamentals), the primary surplus required to stabilise net public debt as a share of GDP would be less than 1% of GDP, assuming 4% real GDP growth. The cyclically adjusted structural balance is currently in the vicinity of 2-3% of GDP. This means that, even without reducing current expenditure as a share of GDP, the government could lift savings. More importantly, the projected decline in public-sector interest payments could allow for an increase in public investment of 1-2% of GDP over the next few years. In fact, the government has already announced a significant increase in investment spending (chart 24), but Brasília continues to struggle with non-financial obstacles (bureaucratic, legal, regulatory etc.) in its attempt to further boost investment under the *programa de aceleração de crescimento* (PAC).

If the government moreover managed to slow current expenditure growth to half the rate of real GDP growth, the resulting public savings would allow Brazil to lift the investment ratio to 25% of GDP or more towards the end of the next decade. Politically, this will be

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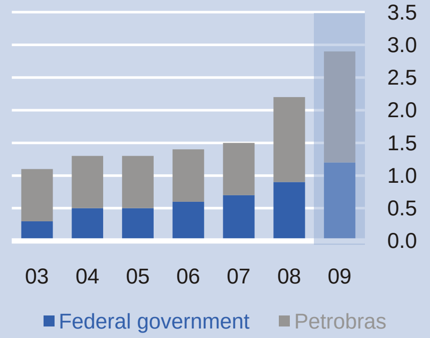
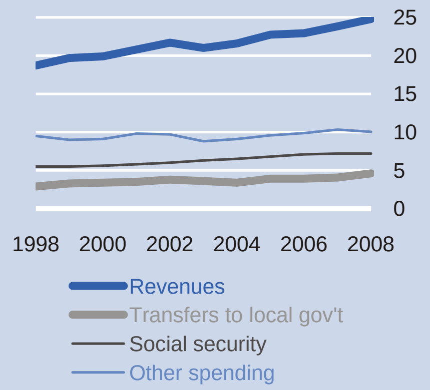
9 As Hausmann succinctly puts it: "A first best solution to Brazil's growth problem would simultaneously lower the level of public consumption and transfers, increase investment in infrastructure and human capital and lower taxes, while reducing the overall deficit to create space for private investment". It is beyond the scope of this comment to analyse which policy would yield the highest return in terms of growth.

**Rising public investment**
Investment, % of GDP



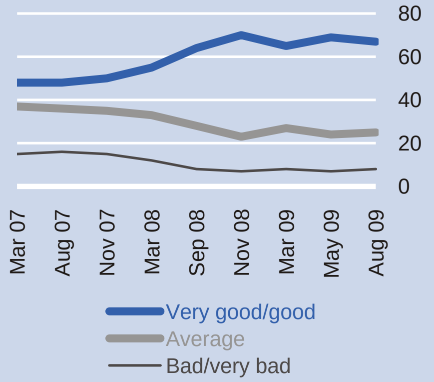

Source: Fazenda 24

**Rising tax burden, rising current expenditure**
Central government, % of GDP




Source: STN 25

**Maintaining economic stability is popular**
Presidential approval ratings, %




Source: Datafolha 26

very difficult to achieve given the political incentives to raise current spending (or the disincentives to try to lower it) and we attribute only a 20% probability to such a scenario. The potential windfall from recent oil and gas finds could further provide a boost to savings and investment, but probably won't have a significant effect on growth before the second half or end of the next decade. How much Brazil will benefit will be highly dependent on how wisely it manages the expected oil windfall and avoids resource-curse-related problems.

In sum, a combination of economic stabilisation, lower financing costs and increasing public-sector savings opens considerable scope to lift the investment ratio. Even if the government fails to slow current expenditure growth to below the level of GDP growth (but manages to keep it at current levels), a moderately greater reliance on external savings combined with declining public-sector interest outlays would allow to lift investment from currently 18-19% to a sustainable 22-23% of GDP, a level by and large not seen since the high-growth mid-1970s. If the government does manage to reduce public current spending (as a share of GDP), an investment ratio of 25-28% would be achievable, arithmetically at least. This could lift potential real GDP growth to 5-6% or more. Finally, higher medium-term economic growth would likely help lift private-sector savings, and thus the potential investment ratio, even further.

## Political outlook and economic reform scenarios

Regardless of the outcome of next October's presidential and congressional elections, the ability of any administration to implement wide-ranging and substantial structural reform will remain constrained[10]. Brazil's political system gives the government a high degree of control over monetary and fiscal policy, revenue ear-marking and expenditure rigidity notwithstanding. But a fragmented congress, not to mention powerful state governors and a restrictive constitution (changes to which require super-majorities), provide plenty of obstacles. Even presidents with a strong popular mandate find it difficult to take on vested interests, "co-opt" or overcome the various "veto players" and build the congressional majorities necessary to implement large-scale reform. On balance, a newly elected PSDB administration would probably be more ambitious in terms of reform than a re-elected PT administration. After all, Lula II has made little to no progress despite very high approval ratings. Moreover, if the economy recovers in a sustained way, the perceived need to press for structural reform will also be limited. It is difficult to be very optimistic about the outlook for structural reform.

Compared to other countries, there are relatively few obstacles to changing the course of monetary and fiscal policy in Brazil. The central bank is not *de jure* independent and the government faces very limited (non-financial) constraints in terms of fiscal policy. However, the political constraints limiting potential changes in monetary and fiscal policy have increased in recent years. Maintaining economic stability and low inflation against a backdrop of fair economic growth has created a considerable consensus with regards to the continuation of the current policy mix, which any president will find it politically risky to disregard completely. What are the likely consequences of next year's presidential elections in terms of economic policy?

[10] DB Research (2006). Current Issues. Brasil: *O* país do *futuro?*

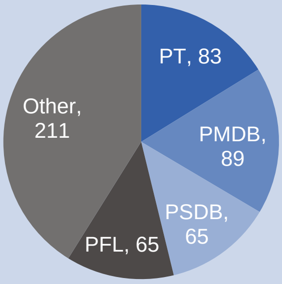
### Voting intentions

| % | Mar-08 | Nov-08 | Mar-09 | May-09 | Aug-09 |
|---|---|---|---|---|---|
| José Serra (PSDB) | 38 | 41 | 41 | 38 | 37 |
| Dilma Rousseff (PT) | 3 | 8 | 11 | 16 | 16 |
| Ciro Gomes (PSB) | 20 | 15 | 16 | 15 | 15 |
| Heloísa Helena (PSOL) | 14 | 14 | 11 | 10 | 12 |
| Void/ null/ nobody | 16 | 12 | 13 | 13 | 12 |
| Don't know | 9 | 9 | 8 | 8 | 7 |

Source: Datafolha 27

### Fragmentation limits reform prospects (1)

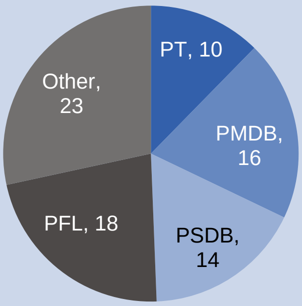
Seats, %, Chamber (2006)




Source: Camera 28

### Fragmentation limits reform prospects (2)

Seats, %, Senate (2006)




Source: Senado 29

***Scenario "Dilma"***

— Dilma Rousseff would broadly maintain current macroeconomic policies, but may favour slightly less "orthodox" fiscal policies. In practice, this may mean a less disciplined (but still stability-oriented) fiscal policy. A substantial shift away from Lula administration policies is unlikely given that the PT has fared well with the current set of policies, allowing it to win the 2006 presidential elections and increase its support in the poorer North and North-East and among the urban middle class.

— On the structural reform side, it is not easy to envision major progress. As long as the economy remains stable and continues to expand at rates close to 4%, there is little incentive to rock the boat and pursue politically controversial structural reforms unpopular with its base (e.g. social security, labour, central bank independence).

***Scenario "Serra"***

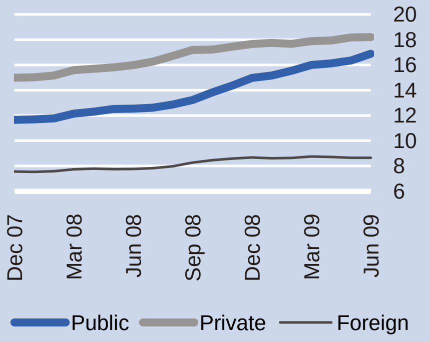
— Jose Serra, the likely PSDB candidate, has a reputation of being a heterodox "developmentalist" and a hands-on manager who seems to favour tight fiscal but less "orthodox" monetary and exchange rate policies (including more aggressive FX intervention to "manage" the currency). Specifically, he seems to favour a weak, undervalued exchange rate intended to boost exports and economic growth.

— On the structural reform front, a PSDB administration would probably be more committed to reforms than the PT. However, a lot would depend on the kind of compromises a PSDB administration would have to strike with the various "veto players" and, above all, a diverse congressional base.

***Scenario "Outsider"***

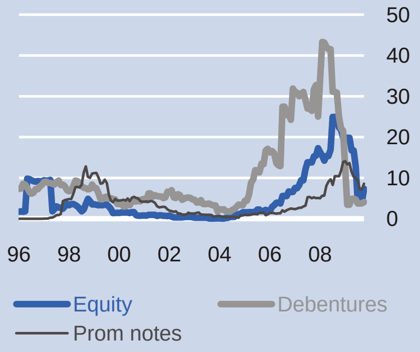
— A number of "outsiders" will be running for president. Opinion polls suggest that Ciro Gomes, should be decide to run, might be doing well, especially when running against Aecio Neves instead of Serra. However, even Ciro with his less orthodox views on economic policy will likely have to run a platform that promises not to rock the economic boat too much, for the electorate is quite content with where the country is going. The middle class, despite continued grumbling about the high tax burden and the poor quality of public services, cherishes economic stability, while the poorer strata of society are benefitting greatly from low inflation, rising real incomes and social welfare programmes like *bolsa familia*. After all, maintaining economic stability is very popular (chart 26). However, if Ciro were to win, this could lead to looser monetary and fiscal policies than under either Dilma or

**Private lending will accelerate**
Credit to private sector by ownership, % of GDP



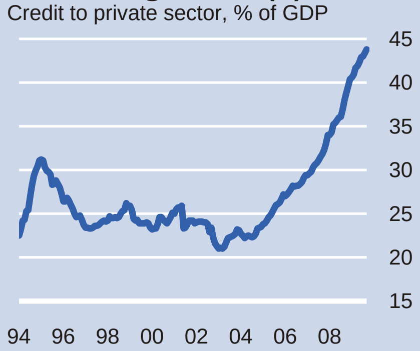

Source: BCB 30

**Domestic capital markets boom pre-crisis**
Issuance in USD bn, 12M rolling




Source: CVM 31

**Increasing credit (1)**
Credit to private sector, % of GDP




Source: CVM 32

Serra and there would likely be little-to-no progress at all on the structural reform front.

What are the implications of these scenarios for economic growth? A less disciplined fiscal policy under a Dilma administration, especially if based on increases in current spending, would benefit medium-term growth less than the tighter fiscal policy likely to be pursued by Serra, especially if the tightening were based on a reduction in public consumption and/or transfers. If, on the other hand, a Dilma administration were to take advantage of declining interest payments to boost (high-return) public investment, this would be good news. It would be even better if it also committed itself to slowing the increase in public current expenditure. This is probably less likely to happen under a Dilma than under a Serra administration. Slowing the growth of public consumption and/or transfers will remain key to boosting investment and growth.

It is not clear that a less "orthodox" monetary policy under Serra would be more beneficial to growth than maintaining the current policy under Dilma. If Serra managed to influence central bank decision-making (a big "if" beyond the appointment of a new central bank president), this could raise longer-term interest rates and might be detrimental to investment. It is not clear that such a policy would make much of a difference over the medium term. There is certainly a debate to be had to what extent a country can manipulate its real exchange rate for the purpose of pursuing export-led growth. Nonetheless, jeopardising the central bank's hard-earned reputation as an inflation fighter could backfire in terms of medium-term growth, while maintaining a "competitive" exchange rate may remain an elusive goal[11].

Finally, a Serra administration would improve the outlook for structural reform somewhat, but probably not to a huge degree. A Serra administration would face political-electoral incentives and political obstacles similar to a PT administration. Initially, a Serra administration may benefit from a greater reform momentum, but whether this will result in big-ticket reforms must remain unclear.

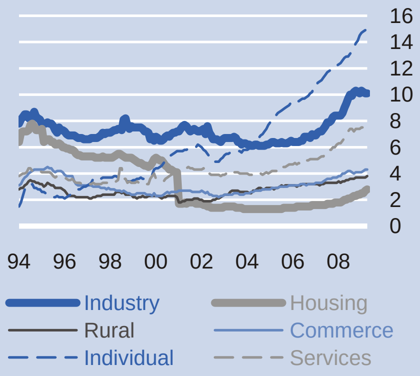
It is early days and it remains to be seen how significantly a Dilma policy would differ from a Serra policy. The consensus in favour of disciplined policies is strong and has strengthened in the wake of the global financial crisis. The next president will have little incentive to bring about a fundamental change in macroeconomic policy. The current policy "works" politically and economically, and close to 4% growth is not be frowned upon. Structural reform will be politically difficult to achieve, regardless of who is president. Reducing the level of public consumption and transfers will be key to future growth, whether via higher public investment, more rapid debt repayments or tax cuts and a "crowding in" of private-sector investment.

## Upbeat financial markets outlook

The outlook is very favourable. A trend towards greater domestic financial market activity was evident in the run-up to the financial crisis (chart 31). Although the crisis put a "sudden stop" to domestic financial activity and capital inflows, the trend towards deeper financial markets will resume, once the proverbial dust has settled. (1) Lower inflation volatility and lower nominal and real interest rates should facilitate financial deepening. (2) Rising GDP per capita

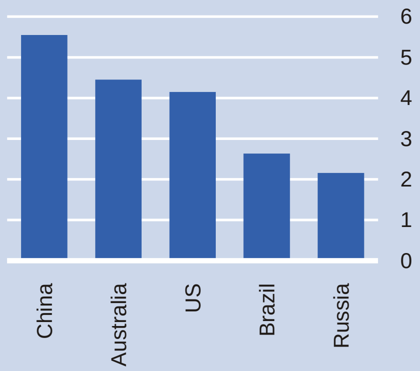
[11] Pastore et al. "Câmbio e crescimento: o que podemos aprender?", in Barros et al. (eds.). Brasil globalizado. Campus Elsevier. 2008.

**Increasing credit (2)**
Credit to private sector , % of GDP



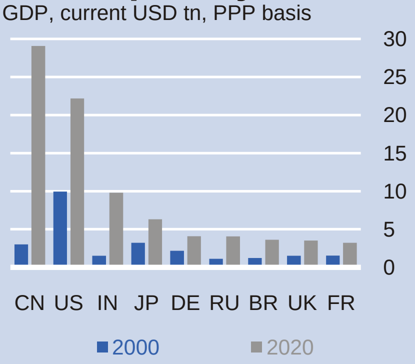

Source: CVM 33

**Major agro-player**
Arable land, million sq km




Source: CIA World Factbook 34

**Seventh place by 2020**
GDP, current USD tn, PPP basis




Sources: IMF, DB Research 35

levels on the back of higher medium-term growth rates should help increase the demand for financial assets, leading to a continued increase in the stock of financial assets measured as a share of GDP. (3) Foreign participation should help foster deeper, more active capital markets, especially given the greater presence of “strategic” as opposed to “opportunistic” foreign investors.

Increased political and economic stability, combined with higher medium-term growth, will attract greater “strategic” capital inflows. Brazil offers investors a sophisticated market infrastructure and good governance while providing foreign investors with relatively easy market access, the recent introduction of a tax on capital inflows notwithstanding. Finally, Brazil will benefit from the relative risk shift favouring emerging markets relative to low-growth, low-yielding and increasingly indebted developed markets, in addition to ample G3 liquidity.

Bank lending grew strongly pre-crisis (chart 32 and 33) and there is every reason to expect that it will continue to grow vigorously with private banks again accounting for an increasing share of loan growth. A structurally lower level of real interest rates, and a decline in inflation and growth volatility should support a further increase in the stock of bank credit. Credit to individuals saw the largest increase in recent years mainly due to *credito consignado*. The mortgage market remains small, but lower interest rates, among other things, should help underpin growth over the next few years. The same will apply to other types of bank lending, especially if the government succeeds in building a more liquid nominal risk-free curve.

Capital markets will continue to deepen, for many of the same reasons that the banking sector will benefit. The domestic fixed income market will expand, possibly helped by increasing foreign participation. So will the local equity market on the back of lower interest rates and an improved medium-term growth outlook. Lower nominal and real interest rates may also lead to a shift of domestic savings into higher-risk and higher-yielding fixed income products and equities, while continued economic growth and lower interest rates will make equity and domestic fixed-income issuance an attractive source of financing for Brazilian companies.

## Economic and political importance will continue to grow

Brazil will do much better during 2010-20 than during the 1980-2000 period. However, Brazil will not match Chinese and Indian growth rates. In our baseline scenario, by around 2020 Brazil will have overtaken both France and the UK to become the world’s seventh-largest economy, reclaiming the position it occupied in 1980. Economic and political stability, combined with an abundance of arable land and strategic commodity and energy resources, will also help raise Brazil’s importance. Recent oil and gas finds will turn Brazil into an increasingly important energy player, while it already accounts for 50% of coarse grain production and 50% of world beef exports[12]. In addition, Brazil occupies promising positions in the Hausmannian product space (e.g. biofuel technology, aerospace).

[12] Barros, G. “Brazil: The Challenges in Becoming an Agricultural Superpower”, in Brainard et al. (eds.). Brazil as an Economic Superpower? Understanding Brazil’s Changing Role in the Global Economy. Washington, DC: Brookings Institution Press. 2009.

However, even if Brazil surprises by implementing key structural reforms, it will still not match Chinese or Indian growth rates. In global economic and political terms, the rise of China and India will be the pivotal event of the 21st century. Neither will Brazil turn into a high-per-capita, high-tech Korea, whose success is due to high levels of investment, trade openness and human capital accumulation. However, economic and political stability will provide the backdrop for Brazil's continued economic growth and its increasing international political importance, especially vis-à-vis the advanced economies (chart 35).

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