**Editor:**

**Dimitris Malliaropulos:**
*Economic Research Advisor*
dmalliaropoulos@eurobank.gr

**Written By:**

**Maria Prandeka:**
*Economic Analyst*
mprandeka@eurobank.gr

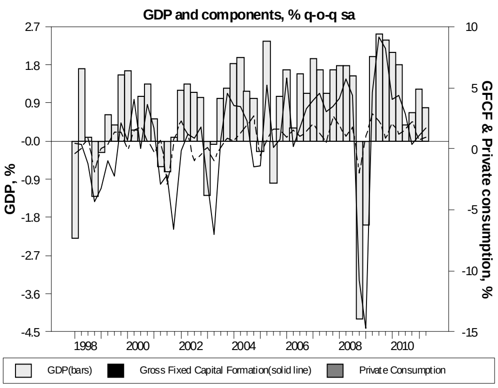
# Brazil: Economy is slowing, but domestic demand remains resilient

- Real GDP growth, albeit slowing, continued to be outpaced by domestic demand growth over the first half of the year.
- Recent economic indicators show clear signs that the economy slowed sharply in Q3 2011, due to the lagged effects from monetary tightening, which are amplified by the global economic uncertainty.
- Despite some temporary positive inflation news, there are significant upside risks in the inflation front.
- Given that there are still significant upside risks for inflation, the central bank is not expected to cut interest rates aggressively, unless the global economic backdrop worsens further, having a stronger hit to Brazil's growth.

## Domestic demand was the key factor driving GDP growth in H1 11

Real GDP growth, albeit slowing, continued to be outpaced by domestic demand growth over the first half of the year. In Q2 2011, real GDP grew 0.8% q-o-q sa, moderating from 1.2% q-o-q sa in Q1 2011 (Figure 1).

**Figure 1**




*Source: Bloomberg*

Growth of domestic demand, however, accelerated in a sequential basis from Q1 2001, with investment and government consumption leading the way up. Private consumption, which makes up about 60 percent of the economy, also strengthened on the back of supportive labor and credit market conditions. As such, the external sector was the major drag of activity, since imports expanded at a large 6.1% q-o-q sa while exports grew at a much more moderate pace of 2.3% q-o-q sa. The negative contribution of external sector was the result of robust domestic demand in combination with weakening external economic environment.

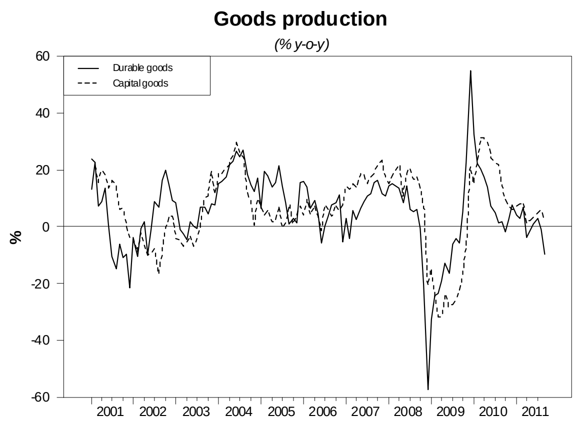
## Increasing signs of a sharp slowdown in the third quarter of 2011

Despite Brazil's resilient performance during the first half of 2011, recent economic indicators show clear signs that the economy slowed sharply in Q3 2011. The indicator of monthly real GDP growth contracted by a faster than expected pace of 0.53% m-o-m sa in August versus an expansion of 0.34% m-o-m sa in July. In addition, in September, industrial production contracted 2.0% m-o-m sa (Figure 2), well below consensus expectations of -1.2%. The IP contraction was widespread across sectors, with a significant decline in capital goods (-5.5% m-o-m sa) and durable goods (-9.0% m-o-m sa) (Figure 3). Meanwhile, manufacturing surveys point to continued contraction in the sector, with the PMI manufacturing index hovering below the 50-point-level that indicates expansion since June 2011. On the demand side, we are beginning to see signs that the increased uncertainty in the global economic backdrop is affecting demand. August retail sales contracted 0.40% m-o-m sa from +1.20% in July and consumer confidence is in a declining trend since its peak in July 2011. Overall, recent negative and weaker than expected data on Brazil's economic activity are clear signs that the lagged effects from monetary tightening, which are amplified by the global economic uncertainty generated mainly by the European sovereign crisis, have started taking effect upon domestic activity. We project real GDP growth to decelerate to 3.5% in 2011, down from 7.5% in 2010, and increase to 3.9% in 2012.

**Figure 2**


*Source: Bloomberg*

**Figure 3**

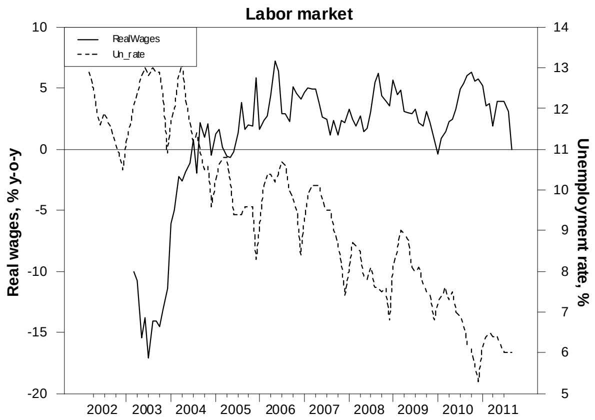



*Source: Bloomberg*

**Robust labor market conditions, but with some signs of moderation**

Brazil's labor market has so far proved very sound and this explains why the deterioration in domestic demand has been concentrated so far mainly in the manufacturing sector. However, September's labor market report pointed to some signs of growth moderation. The unemployment rate stabilized at 6.0% in September for the third consecutive month, compared to an average of 6.7% in 2010 (Figure 4). In addition, annual real wage growth remained flat, after an average growth of 3.7% y-o-y in the year-to-August. Despite these signs of weakness in labor market, unemployment rate is still close to its record low. Moreover, the legally mandated 13.6% minimum wage increase scheduled to the beginning of 2012 is likely to keep real income growth at such pace that will support consumption. Only when this moderation in labor market proves sustained, it would constitute an important downside risk for domestic demand looking forward.

**Figure 4**

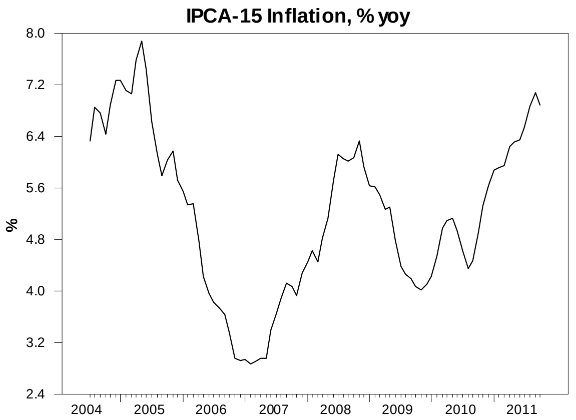



*Source: Bloomberg*

**Despite some temporary positive inflation news, there are significant upside risks**

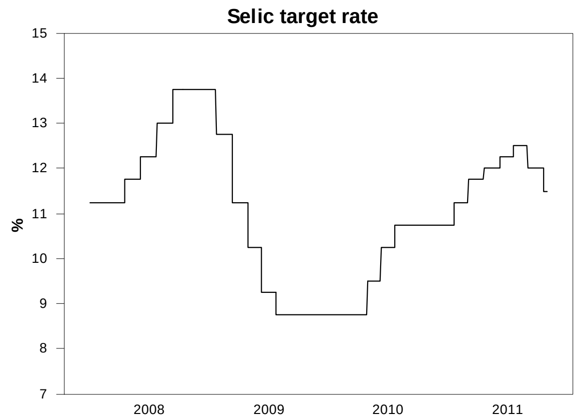
October marked the first month that the headline IPCA-15 inflation declined marginally (to 7.1% y-o-y from 7.3% y-o-y in September) for the first time since the upward trend of inflation began in August 2010 (Figure 5). However, at the moment the underlying trend of inflation is still quite worrisome. The unfavorable global environment along with the stronger than expected deceleration in domestic economic activity should moderate inflationary pressures. However, several factors such as still tight labor market conditions, increasing inflation expectations, strong credit growth and the aforementioned minimum wage increase are likely to bring more upward inflationary pressures, before we see a clear relief on the inflation front.

**Figure 5**




*Source: Bloomberg*

**Figure 6**




*Source: Bloomberg*

**Monetary policy shifted towards easing, despite above-target inflation**

Brazil's central bank cut its key policy rate 50bp to 12%, in an unexpected move on August 31, for the first time since mid-2009 when the tightening cycle began. This surprising interest rate cut came at a time when inflation was running at a six-year high of 6.9% y-o-y (July 2011). Monetary authorities believe that the deterioration in global economic activity will have a disinflationary bias going forward. Moreover, the committee believes that the unfavorable global environment will contribute to intensify the ongoing slowdown in domestic economic activity. Therefore the balance of risks for inflation becomes more favorable. In this context, the committee believes that in order to promptly mitigate the effects of a more restrictive global environment, a moderate adjustment in the level of the policy rate is consistent with inflation converging to the target in 2012. Since then, the central bank cut its key policy rate again 50bp to 11.50% on October 19. We believe that the main challenge for Brazil's monetary authorities hereafter is how to shield the economy from contractionary global shocks, while reducing inflation. Given that, in our view, there are still significant upside risks for inflation, the central bank will proceed with only another 50bp cut in Q4 2011. Risks biased toward further cuts, only if the global economic backdrop worsens, having a stronger hit to Brazil's growth.

## Research Team

**Editor,** Professor **Gikas Hardouvelis**
*Ch ief Economist & Director of Research Eurobank EFG Group*

**Financial Markets Research Division**
**Platon Monokroussos,** *Head of Financial Markets Research Division*
**Paraskevi Petropoulou,** *G10 Markets Analyst*
**Galatia Phoka,** *Emerging Markets Analyst*

**Sales Team**
**Nikos Laios,** *Head of Sales*
**Vassilis Gioulbaxiotis,** *Head of International Sales*
**Yiannis Seimenis, Ioannis Maggel,** *Corporate Sales*
**Stogioglou Achilleas,** *Private Banking Sales*
**Alexandra Papathanasiou,** *Institutional Sales*

**Economic Research & Forecasting Division**
**Dimitris Malliaropulos,** *Economic Research Advisor*
**Tasos Anastasatos,** *Senior Economist*
**Ioannis Gkionis,** *Research Economist*
**Vasilis Zarkos,** *Economic Analyst*
**Stella Kanellopoulou,** *Research Economist*
**Olga Kosma,** *Economic Analyst*
**Maria Prandeka,** *Economic Analyst*
**Theodosios Sampaniotis,** *Senior Economic Analyst*
**Theodoros Stamatiou,** *Research Economist*

Eurobank EFG, 20 Amalias Av & 5 Souri Str, 10557 Athens, tel: +30.210.333 .7365, fax: +30.210.333.7687, contact email: Research@eurobnak.gr