



A man talks on mobile in front of a store in Rio de Janeiro August 18, 2011. REUTERS/RICARDO MORAES

BRAZIL'S ECONOMY GOES FROM 'GREAT' TO 'GOOD'

- Brazil's era of 5-7 pct growth rates draws to a close
- Data suggests economy stalled in June, Q3 outlook dark
- Forecasts mounting for 3-4 pct growth in coming years
- Main culprit is Brazilian consumer, who is now indebted

BY BRIAN WINTER AND
STUART GRUDGINGS
BRASILIA/RIO DE JANEIRO, AUG 18

BRAZIL'S LONG BOOM appears to be over.

After several dynamic years that saw it earn a reputation among some Western

investors as "the near China," Brazil now looks to be downshifting into a pattern of economic growth of around 3 percent to 4 percent for the foreseeable future.

While that is still good by the depressed standards of Europe and the United States, it puts Brazil behind most of its true peers -- fellow members in the BRICS group of

large emerging markets and most major economies in Latin America.

The cooler outlook is reflected in Brazil's stock market, one of the world's worst-performing indexes this year. Several companies are scaling back investment plans in the face of disappointing profits. Wall Street economists have been slashing



forecasts for 2011 and years to come.

The main culprit is Brazil's middle-class consumer who powered the expansion of recent years by snapping up cars and TVs at a record pace but now looks to be nearly tapped out. The evidence ranges from the empirical, such as rising default rates, to the anecdotal -- it is astonishing how easy it is to find Brazilians who are in over their heads on debt.

Other restraints include Brazil's poor business climate relative to its peers; left-leaning President Dilma Rousseff's inability to push major reforms to the tax code or other changes to help lift growth; and the global economic crisis, which translates into uncertain prospects for Brazilian commodities such as iron ore in China and elsewhere.

Many Brazilians are proudly optimistic about their country's recent rise to prominence and talk of a less glorious future is still treated like heresy in some circles.

Indeed, Latin America's largest economy still enjoys near-full employment. Even moderate growth may be enough to secure Rousseff's goal of lifting another 16 million people, or nearly a tenth of the population, from poverty by the end of her term in 2014. Certain areas of the economy such as offshore oil and civil construction are likely to keep booming. Factors such as demographics and a relatively low national debt will continue to work in Brazil's favor.

Some welcome slower growth, saying it could help calm high inflation and prevent a more painful collapse later on.

Yet a growing number of corporate leaders, investors and government officials already express nostalgia for the boom years. They will have to scale down their expectations to make way for a more mediocre Brazil.

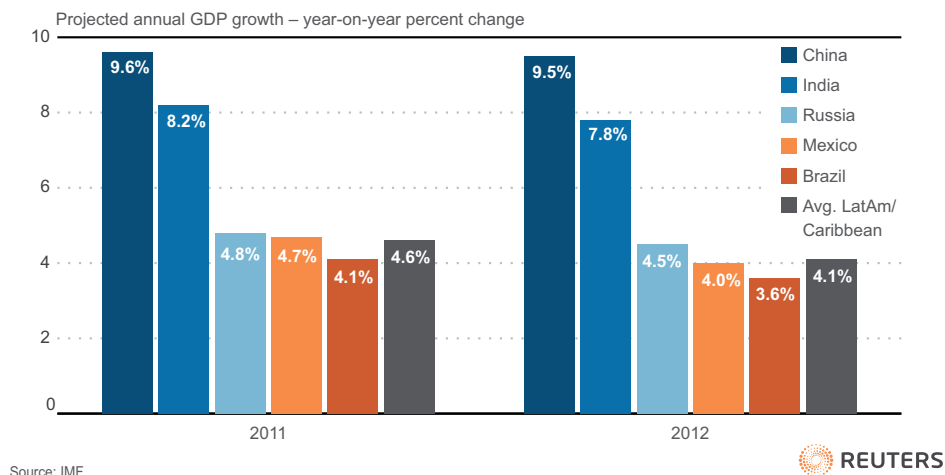
"A slowdown of the economy is a fact," said Claudio Bergamo, chief executive officer of Hypermarcas, the largest Brazilian maker of disposable consumer goods such as beauty care and pharmaceutical products. "It's like a wave that's hitting some people harder than others."

About two-thirds of major companies on the Bovespa stock index failed to meet earnings expectations in the second quarter, according to a Reuters analysis.

Brazil's leading industry group FIESP expects manufacturers to postpone about 17 billion reais (\$10.6 billion) in investments this year, with demand-sensitive sectors such as food and machinery suffering the most. That would put investment by industries about 10

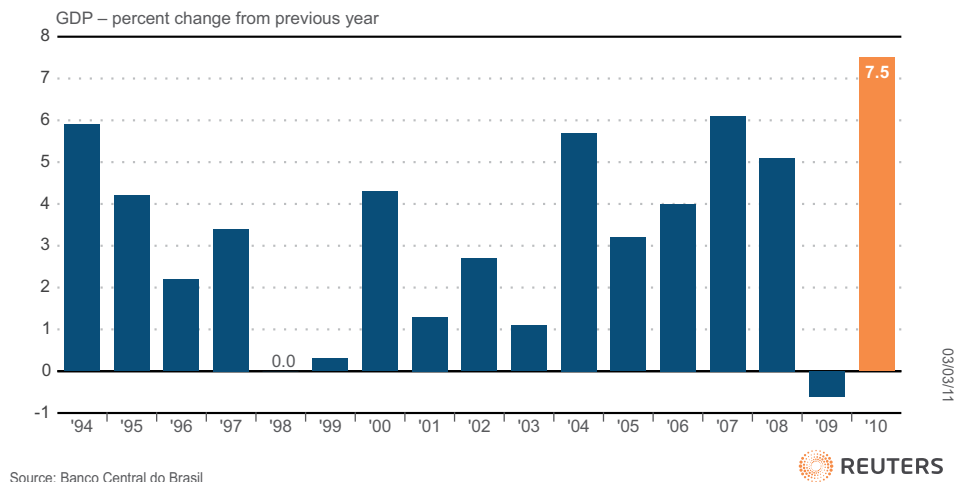
IMF sees Brazil's economy underperforming

Brazil's growth expected to lag its peers.



Brazil GDP

1994, the year Brazil introduced the real, proved to be a turning point in Brazil's economic history.



percent lower than levels seen in 2010, Fiesp said.

"We're hearing a surprising amount of pessimism," said Jose Ricardo Roriz Coelho, head of FIESP's competitiveness and technology department.

Several economists have recently cut their forecasts, including closely watched Gray Newman of Morgan Stanley who on Wednesday cut his outlook for 2012 growth to 3.5 percent from 4.6 percent. Capital Economics now sees growth as low as 2.5 percent by 2013. In the shorter term, Credit Suisse says Brazil's economy could even contract during the third quarter, before resuming a slower expansion toward the end

of the year.

COMING BACK TO EARTH

THAT WOULD BE quite a letdown for a country that enjoyed average annual economic growth of 4.4 percent from 2004 to 2010, even when accounting for the global financial crisis that erupted during that period. Growth peaked at 7.5 percent last year, its fastest pace in 24 years.

Virtually no one expected the pace of 2010 to continue. Hardly anyone foresaw such a heavy hangover from that boom in terms of above-target inflation and one of the world's most overvalued currencies<BRBY><BRL=>. The pain may be felt for years.



Women shop in Rio de Janeiro August 18, 2011. REUTERS/RICARDO MORAES

For example, the central bank has been forced to raise interest rates five times this year to 12.5 percent, giving Brazil one of the world's highest costs of credit. Even though the economy is now slowing, most economists expect inflationary pressures to remain high due to indexation of contracts and workers' expectations handsome salary increases of recent years will continue -- meaning the bank will likely be constrained in how fast it can cut rates.

"We have some local issues here -- high interest rates, a high deficit -- that don't let you grow at the pace" seen last year, said Marco Paulo Costa, vice president of CR2, a bank that lends mostly to small and medium-sized businesses.

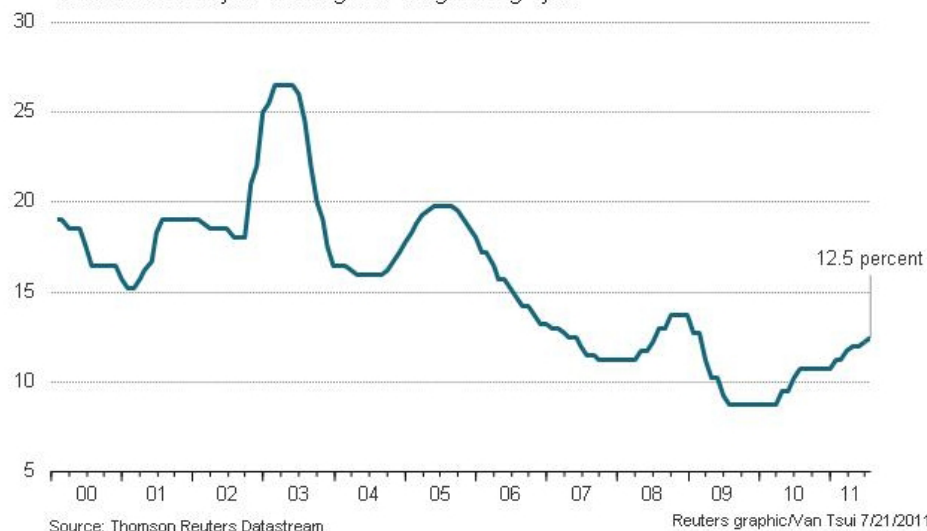
Rising interest rates seem to have been the coup de grace for many Brazilian consumers, especially the so-called "Class C". These lower-middle class consumers earn between \$650 and \$2,800 a month. They quintupled spending on domestic goods from 2002 to 2010 and are the poster children of Brazil's recent boom.

Many of those consumers failed to fully understand what they were getting into. Some recently emerged from poverty and were gaining access to credit for the first time.

Interest rates on consumer debt average more than 45 percent in Brazil and debt

Brazil's benchmark interest rate

Central bank may be nearing end of tightening cycle



payments have ballooned to account for about a quarter of Brazilians' income. That compares with a peak in the United States of less than a fifth before the 2008 financial crisis.

High reserve requirements and other safeguards at Brazilian banks mean there is a reduced risk of a debt bubble exploding the way it did in the United States. But the long spending spree is clearly ending.

"There is no more space to get new (consumer) debt. That will put growth on a slower pace," said Pedro Mariani Lacerda, who manages about \$80 million for Horto, a fund that handles investments and mergers and acquisitions in Rio de Janeiro.

Defaults on personal loans rose 22 percent in the first half of the year, the biggest jump in nine years, according to Serasa Experian, a credit research firm.

In virtually any bakery or bar, especially in working-class neighborhoods, tales of woe are suddenly everywhere.

"I didn't know what I was doing, honestly I didn't," said Reynaldo Ruiz, a carpenter, who bought an \$800 flat-screen TV with a credit card in January but now says he can't afford the payments. Others standing next to him at a juice stand in Brasilia nodded in sympathy, and one woman sipping water from a coconut claimed her nephew had fled the city to escape bill collectors last month.

DISAPPOINTMENT IN GOVERNMENT

BRAZIL'S ECONOMY WAS already running without one of its main engines as industries struggled with the strong exchange rate and high logistical costs kept production flat for the better part of the last two years.

The apparent slowdown in household spending -- which accounts for more than 60 percent of Brazil's economy, compared to 36 percent in China -- is diminishing the strength of another big engine, with a toll on corporate bottom lines.

Many industrial leaders have been disappointed by President Rousseff's inability to reduce Brazil's tax load, which is among the world's highest. Rousseff has ruled out a major fiscal reform that could open up more money for investment, which is low by emerging-world standards.

Prospects for reforms to help improve growth are dimming rapidly as Rousseff faces a rebellion by allies in Congress who are upset by her efforts to control costs and uproot corruption in ministries.

Meanwhile, the government's prized infrastructure program, which includes projects related to the 2014 World Cup and 2016 Olympics, has struggled to execute construction in recent months, leaving long lines on the country's highways and at ports.

"Brazil's industry has lost the ability that it should have to compete," said Humberto Barbato, president of The Brazilian Electrical and Electronics Association. "Brazil is full of costs and we are competing against countries that don't have these costs."

Disappointment over the economic outlook has contributed to a sell-off in Brazil's stock market <.BVSP> as investors see more attractive returns elsewhere in Latin America.

Among the region's top seven economies, only Venezuela will grow more slowly than Brazil this year, according to the International Monetary Fund's latest forecasts. In 2012, Brazil will likely come in last place in the region, with growth of just 3.6 percent,



People observe appliances at a store in Rio de Janeiro August 18, 2011. REUTERS/RICARDO MORAES

according to the IMF.

Many say they have already started to change strategies.

Torgny Krook of Nordea, a Scandinavian bank, was part of a delegation of European investors that traveled to Brazil to meet with government officials and company executives in March, "when there was still a euphoria ... and it seemed to some people like you could gain almost any exposure to Brazil" and reap dividends from growth, he said.

Now, another delegation of executives is due to return in September, he said, with narrower objectives. "We're still very excited about offshore oil...some of the optimism in other sectors has gone away," Krook said.

Some business leaders say they are comfortable with the new outlook and it

could be a blessing. They point to distortions caused by the boom years and remain confident Brazil will remain a good bet with growth and interest rates at zero or low single-digits in Europe and the United States.

Others wonder why Brazil should be content with relative mediocrity after tasting so much success.

"Three percent growth is not a disaster, but Brazil could do much better," said Neil Shearing, an economist for Capital Economics. "It's going to disappoint a lot of people."

(Additional reporting by Guillermo Parra-Bernal and Vivian Pereira;
Editing by Andrew Hay)

EMERGING POWERHOUSES CAN'T SAVE THE WORLD

BY ALAN WHEATLEY

LONDON, AUG 18

EMERGING MARKETS WILL not save the world if the West slides back into recession. In an interconnected global economy, decoupling is a beguiling myth.

As fears mount that the developed world is shifting from slow growth to no growth, emerging markets seem to many economists better placed to weather the storm than they were during the great financial crisis of 2008/2009.

That is not universally true. India is hamstrung by high government debt and inflation. Turkey's yawning current account deficit leaves it vulnerable to an outflow of capital. Brazil is slowing under the weight of lower spending by middle-class consumers hit by rising interest rates.

The resilience displayed by the likes of China and Indonesia is evidence of a secular shift in the global economy from North to South, from West to East, rather than a substitute for zero or negative growth in the West.

Morgan Stanley estimates emerging markets will generate 80 percent of global gross domestic product growth in 2011-2012.

For Bill Belchere, global economist at Mirae Asset Securities in Hong Kong, Asia is finally reaping the benefits of policies to nurture home-grown demand. With incomes across much of the continent now rising faster in the countryside than in towns, millions of peasant farmers are suddenly able to afford a motorbike and a mobile phone and perhaps set up their own small businesses.

"What we're seeing is new poles of domestic growth in the larger economies. No one is totally insulated in a globalised economy, but the dynamic that is developing here is under-appreciated outside Asia," Belchere said.

Rob Subbaraman, chief Asian economist at Nomura in Hong Kong, said the region would run into headwinds from slower exports to the United States, Europe and Japan. But he too pointed to Asia's reduced reliance on external demand. In China, for example, net exports subtracted from GDP growth in the first half of the year.

The size of China's economy will be close to \$7 trillion this year, up from \$4.5 trillion



An investor is reflected in a screen showing stock information at a brokerage house in Shenyang, Liaoning province August 10, 2011. **REUTERS/STRINGER**

as recently as 2008, so this is a shift that matters. "China's own demand has quickly become an important driver of growth in the rest of Asia; it is no longer just an assembly hub for the region," Subbaraman said.

EYES ON CHINA, ASIA

FITCH ON TUESDAY CITED the increased importance of Asia as one reason why the economic outlook in sub-Saharan Africa is brighter than it has been in many decades; as trade with Asia remained buoyant, Africa was less exposed than in the past to what happens in advanced countries, the ratings agency said.

Still, China would not be unscathed if the rich world fell into recession, and reduced demand for its exports would have a knock-on effect on commodity prices and producers. This was the main factor behind a cut in Morgan Stanley's projection of 2012 GDP growth in Latin America, announced on Thursday, to 3.6 percent from 4.6 percent.

"We are wondering what's going to happen with China right now," said Pedro Mariani Lacerda, the head of Horto, a financial consultancy and investment fund in Rio de Janeiro, said of Brazil's economic prospects.

A clear worry is that while the economic fundamentals look better in many emerging economies than they did in 2008, policy makers generally have less leeway. India is especially constrained: the general government deficit has more than doubled

since 2007 and wholesale inflation exceeds 9 percent.

The government and central bank, which has raised interest rates 11 times since March 2010, are still forecasting growth of at least 8 percent in the financial year that began in April. The Australian bank Westpac said in a report that the arithmetic for sustaining such a brisk clip has become "more than a little daunting".

China has more scope to ease if need be despite its own inflation headaches and worries about bad debts in the banking system. Cutting banks' required reserves, now at an eye-popping 21.5 percent, is a ready option, but the government, which is targeting a budget deficit of 2 percent of GDP this year, could also ramp up spending.

"There is now less policy room to respond to a significant deterioration in domestic or external demand than in 2008, but adequate measures are still available," according to Stephen Green, head of China research at Standard Chartered Bank in Shanghai.

NO MAGIC CURE

ALL WELL AND GOOD, but if China were to relax policy, the main beneficiaries are likely to be commodity producers, not rich industrial economies, Capital Economics reckons. The London consultancy calculates that China's huge stimulus in 2008 reduced its merchandise trade surpluses with the United States and Europe by just \$19 billion and \$26 billion respectively between 2007 and 2009 - equivalent to 0.1 percent of their GDP.

For rapid growth in emerging markets to help the developed world, imports from China and oil-producing countries would have to rise sharply, reducing their external surpluses. But in fact, the emerging world's current account surplus is likely to increase in 2011 and remain high, said Neil Shearing, an analyst at Capital Economics.

"In other words, far from helping the developed world out of its rut, emerging economies are becoming an increasing drag on demand in the rest of the world," he said in a note.

(Additional reporting by Stuart Grudgings in Rio de Janeiro; editing by Andrew Hay)

BRIGHT AND TROUBLED SPOTS IN BRAZIL'S ECONOMY

FACTBOX

BRAZIL'S ECONOMY IS returning to more sober growth after years of strong performance that has made it a favorite among foreign investors and earned it comparisons with fast-growing developing giants China and India.

Some sectors are still on course for robust growth and should continue to reward investors, while others seem likely to disappoint. Following are a selection of the promising and the not-so-promising parts of Latin America's largest economy.

BRIGHT SPOTS

* **Oil.** Likely to be among the fastest-growing sectors for years to come as Brazil's Petrobras and foreign firms prepare to tap an offshore area believed to hold more than 50 billion barrels of oil, enough to supply all U.S. consumption for more than seven years. The sector is likely to benefit from high global oil prices, strong domestic demand for energy and Brazil's relative stability compared to other big oil producers, such as Middle Eastern countries.

* **The car industry.** Brazil has become one of the world's hottest auto markets, prompting global automakers to pour money into the country to meet strong local demand for new cars and as a base for exports. Sales jumped 10 percent to a record in the first half of the year, despite rising interest rates and the dampening effect on exports of a strong currency. Brazil is a crucial market for the world's biggest automakers, including Italy's Fiat SpA, Germany's Volkswagen AG and U.S.-based General Motors Co and Ford Motor Co. Asian automakers from Japan, South Korea and now China are also boosting their presence here.

* **Agriculture.** Farming remains a critical long-term strength of one of the world's breadbaskets. The tropical country boasts more spare farmland and more water than any other and is the world's largest exporter of beef, sugar, coffee, and orange juice among other farm products.



People observe appliances at a store in Rio de Janeiro August 18, 2011. REUTERS/RICARDO MORAES

Brazil's sugar crop, for example, is set to grow by 17 percent, or roughly 100 million tonnes over the next three years, analysts say. Although rising production costs have eaten into the competitive advantage of Brazil's sugar, there are few other countries where output can be expanded significantly.

PROBLEM AREAS

* **Consumer spending.** Rampant spending by Brazil's rising consumer class has been central to the economy's success story in recent years but there are signs the party is ending. Consumer spending, which makes up about 60 percent of the economy, has been heavily fueled by expensive credit card and other debt that analysts say appears to be reaching its limit as the central bank has hiked interest rates to 12.5 percent this year. Defaults on personal loans rose 22 percent in the first half of the year, the biggest jump in nine years.

* **Manufacturing.** While there are some bright spots, such as the car industry, many Brazilian factories are struggling with an overvalued currency, imports from China and signs of a broader economic slowdown

at home and abroad. Manufacturing output has been mostly flat for more than a year despite a robust economic expansion, stoking fears of "deindustrialization." Nearly half of the country's exporters have lost market share in the past year, according to a poll released this week by the CNI industry group. Industry's woes prompted the government this month to grant more than \$25 billion in new financing and tax breaks to the sector in the hope of reviving growth.

* **Steel.** Mills in Brazil are grappling with global steel overcapacity, weak prices, a strong currency and a domestic output glut that makes it harder to export excess production. A 50 percent currency rally since the start of 2009 has drawn cheap steel into the country like a magnet, forcing local mills to slash prices to retain market share. Mills' profit margins are evaporating as soaring global coal and iron ore prices are also putting Brazil's status as a low-cost steel producer in jeopardy.

(Reporting by Stuart Grudgings;
editing by Andrew Hay)

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