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TABLE: MACROECONOMIC DATA AND FORECASTS

	2004	2005	2006	2007	2008e	2009f	2010f	2011f	2012f	2013f
Population, mn [3]	181.80	184.20	186.80	189.40	192.00	194.70	197.40	199.30	202.50	204.10
Nominal GDP, US\$bn [4]	664.08	882.71	1,073.07	1,314.17	1,562.33	1,227.25	1,314.77	1,706.82	2,160.00	2,466.23
Nominal GDP, BRLbn [4]	1,941.5	2,147.2	2,332.9	2,558.8	2,869.3	3,045.4	3,254.1	3,541.7	3,855.6	4,192.6
GDP per capita, US\$ [5]	3,653	4,793	5,746	6,939	8,136	6,303	6,659	8,566	10,667	12,083
Real GDP growth, % change y-o-y [5]	5.7	3.2	3.7	5.4	5.7	0.8	2.6	4.4	4.5	4.1
Industrial production index, % y-o-y, eop [3]	7.2	3.4	2.0	6.5	4.5	4.0	3.9	4.0	4.1	3.9
Unemployment, % of labour force, eop [3]	9.6	8.3	8.4	7.4	7.8	8.6	8.3	7.9	8.0	8.1
Budget balance, BRLbn [1, 6]	-47.1	-63.6	-69.9	-57.9	-42.0	-64.0	-58.6	-56.7	-52.0	-46.1
Budget balance, % of GDP [5]	-2.4	-3.0	-3.0	-2.3	-1.5	-2.1	-1.8	-1.6	-1.4	-1.1
Consumer prices, % y-o-y, eop [3]	7.6	5.7	3.1	4.5	5.9	3.8	4.5	4.3	4.3	4.4
Consumer prices, % y-o-y, ave [5]	6.6	6.9	4.2	3.6	5.7	5.2	4.6	4.2	4.5	4.3
Exchange rate BRL/US\$, eop [5]	2.65	2.34	2.13	1.78	2.31	2.65	2.30	1.85	1.72	1.68
Exchange rate BRL/US\$, ave [5]	2.92	2.43	2.17	1.95	1.84	2.48	2.48	2.08	1.78	1.70
Exchange rate BRL/EUR, eop [5]	3.60	2.77	2.82	2.60	3.24	3.37	3.10	2.55	2.22	2.10
Central Bank policy rate, % [6]	17.75	18.00	13.25	11.25	13.75	11.25	10.50	11.50	11.50	10.50
Exports, US\$bn [6]	96.48	118.31	137.81	160.65	197.94	212.00	225.00	240.00	270.00	305.00
Imports, US\$bn [2, 6]	62.83	73.61	91.35	120.62	173.10	197.00	218.00	230.00	255.00	280.00
Trade balance, US\$bn [6]	33.64	44.70	46.46	40.03	24.84	15.00	7.00	10.00	15.00	25.00
Balance of goods and services, US\$bn [7]	28.96	36.39	36.82	26.67	9.39	-1.00	-9.45	-7.05	-2.10	7.75
Current account, US\$bn [6]	11.68	13.98	13.64	1.46	-27.26	-41.44	-31.90	-24.80	-14.35	-6.65
Current account, % of GDP [5]	1.76	1.58	1.27	0.11	-1.74	-3.38	-2.43	-1.45	-0.66	-0.27
Foreign reserves ex gold, US\$bn [6]	52.94	53.80	85.84	180.33	193.78	182.00	190.00	205.00	220.00	227.00
Import cover, months g&s [5]	10.1	8.8	11.3	17.9	13.4	11.1	10.5	10.7	10.3	9.7
Total external debt, US\$bn [6]	201.37	169.45	172.46	195.33	187.00	180.00	172.00	168.00	162.00	160.00
Total external debt, % of GDP [5]	30.32	19.20	16.07	14.86	11.97	14.67	13.08	9.84	7.50	6.49

Notes: e BMI estimates. f BMI forecasts. 1 General Government Budget; 2 Keep an eye on which data series is denominated in a negative figure, and which is positive; Sources: 3 IBGE; 4 IBGE; IMF; 5 BMI Calculation; 6 BCB; 7 BCB/BMI Calculation.

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Executive Summary

Brazil's Fundamentals Put To The Test In 2009

- The fundamentals underpinning Brazil's economic successes of the past five years, and its growing role as a regional leader in Latin America will be tested in 2009. Up until now, the Brazilian authorities have moved quickly to address existing imbalances in an effort to contain the effects of the global recession on Brazil. In the *Q209 Brazil Business Forecast Report*, we examine areas of the economy which will come under particular strain in 2009, and which will require political reforms in order to alleviate the risk of a prolonged economic downturn. At the outset of 2009, we believe that policy-makers are gearing up for a succession of rapid and aggressive measures to ease tighter credit conditions and restore domestic demand. The successful implementation of such measures, such as our projections for 250bps of interest rate cuts to 11.25% this year, will determine how severe the current economic slowdown will be.
- An opinion poll conducted by Instituto Sensus in December showed that opposition candidate José Serra from the Partido da Social Democracia Brasileira (PSDB) remains the frontrunner for the 2010 presidential election with 46.5% of votes. While President Luiz Inácio Lula da Silva continues to see approval ratings hit record highs (80.3% in December), his popularity has not been passed onto his chief of staff Dilma Rousseff, who is the official candidate for the ruling Partido dos Trabalhadores (PT), garnering only 10.4%. Ahead of Rousseff is Heloísa Helena with 12.5%, from the Partido Socialismo e Liberdade (PSOL), a Trotskyist offshoot from the PT, founded in 2004 by a group of PT dissidents, led by Helena.
- As the Brazilian economy moves into the new year, it seems to us that the much-praised resilience of the consumer sector has been left behind in 2008. Although signs of a decelerating economy had already started to surface during the last two months of the year, our outlook for 2009 has turned markedly more bearish in January, as a series of negative economic indicators started to appear. Industrial output numbers are showing worrying signs of a prolonged contraction, and sales figures, too, are pointing to retrenching domestic demand. This comes against the backdrop of the global economic recession and the ongoing financial crisis, leading to yet another bout of weakness for global stocks. Such a backdrop will hardly soothe the ongoing decline in confidence levels (both consumer and economic), suggesting to us that borrowing appetite in Brazil this year will be kept to a minimum.
- In our proprietary business environment ratings, Brazil scores 4.7 (out of 100) in the 'hiring cost' subcategory of the labour force rating, the lowest score in all of Latin America. To be sure, Brazil ranks 152nd in this category, out of a total 158 countries in our business environment ratings. At 41.6, Brazil's labour market 'rigidity' score is well below the regional average of 52.6, with the country's overall labour force rating standing at 49.6 (below Latin America's average score of 53.8). It is hardly surprising, therefore, that estimates of Brazil's informal labour market are as high as 50% of the economically active population.

chapter 1 Political Outlook

SWOT Analysis

Strengths

- Lula's administration remains committed to market-friendly policies and the president's popularity remains at record highs.
- Though the corruption scandals during Lula's first term were major blows to Lula's first administration, the response indicates that Brazilian democratic institutions have achieved a reasonable degree of accountability.

Weaknesses

- Should Lula fail to keep his newly built coalition together, the potential for political deadlocks in congress would increase.
- Although the PT has long considered itself a major opponent of corruption, the party has lost much of its legitimacy in this respect over the past few years.

Opportunities

- The new 'barrier' electoral law, which restricts federal campaign financing for smaller parties, may help improve Brazil's highly fragmented party environment by fostering coalition building.
- Brazil's growing political influence in the region may pave the way for the country to assume the role of regional leader, pioneering closer integration among Latin American countries.

Threats

- The leftist members of the PT may stir up trouble for Lula as they feel he has assigned too many cabinet posts to the PMDB party. There are growing signs that PMDB may not seek to back PT during the 2010 election, further undermining the ruling party's chances for re-election after Lula.
- The PT failed to secure enough state capitals during the October 2008 local elections to ensure a PT victory in the 2010 presidential race.

BMI Political Risk Ratings

The Brazilian government is contemplating to reintroduce import tariffs on hot and cold rolled coil products in 2009, a tax levy of 12%, in an effort to protect the local steel industry. Demand for steel has taken a hit while demand for imports, despite coming down, remains high. The state of Minas Gerais, Brazil's economic powerhouse, would benefit most from the proposed measures, although we note that this could pave the way for international confrontations over trade protectionism. Nevertheless, given the current macroeconomic climate, we believe that other Latin American governments will likely prioritise their local constituencies over trade liberalisation efforts, especially with elections on the horizon.

	S-T Political	Rank	Trend
Chile	79.6	1	=
Uruguay	74.8	2	=
Barbados	74.4	3	=
Mexico	72.3	4	=
Trinidad & Tobago	72.1	5	=
Brazil	70.8	6	=
Colombia	70.6	7	=
Dominican Republic	70.4	8	=
Panama	68.8	9	=
Guatemala	68.5	10	=
Peru	67.9	11	=
Honduras	62.3	12	-
El Salvador	61.3	13	-
Jamaica	60.8	14	-
Venezuela	58.5	15	-
Guyana	57.9	16	=
Argentina	55.8	17	-
Ecuador	54.6	18	=
Nicaragua	51.7	19	=
Paraguay	50.8	20	-
Bolivia	49.8	21	+
Regional average 61.5	Global average 63.2	Emerging Markets average 60.5	

	L-T Political	Rank	Trend
Barbados	78.3	1	=
Chile	78.2	2	=
Uruguay	69.4	3	=
Jamaica	68.1	4	=
Mexico	67.1	5	+
Trinidad & Tobago	63.3	6	-
Panama	62.5	7	-
Argentina	61.9	8	=
Peru	61.0	9	=
Colombia	60.8	10	=
Brazil	60.5	11	=
Dominican Republic	57.9	12	=
Paraguay	57.4	13	=
Honduras	57.3	14	=
Venezuela	55.7	15	-
El Salvador	53.5	16	=
Guyana	51.8	17	=
Ecuador	51.0	18	=
Guatemala	43.8	19	=
Nicaragua	41.7	20	-
Bolivia	39.3	21	=
Regional average 61.5	Global average 63.2	Emerging Markets average 60.5	

Regional Politics

Regional Summit: The End Of The Monroe Doctrine?

Following the two-day Latin American and Caribbean Summit on Integration and Development in the Brazilian state of Bahia in December, observers are likely to focus their attention on the vacuum left by the absence of outgoing US President George W. Bush during the meeting of 33 regional heads of state. The summit was the first of its kind, and sought to reinforce existing regional initiatives of closer integration and sustainable development. Talks during December 16 and 17 encompassed the current financial crisis, energy cooperation, food security and climate change. Although there is little evidence that the US sought to attend the summit, the absence of a US delegation could mark a turning point in Latin America's foreign relations.

Since US President James Monroe (fifth president of the US) in 1823 declared that European powers are not to intervene in the affairs of Latin American nations – a move that became known as the 'Monroe Doctrine' – Latin America was considered a sphere of US influence, with little or no outside involvement. Although we acknowledge that countries such as China, Russia and to some extent the EU are growing in prominence, we do not believe that US influence in the region is declining commensurately.

However, issues, such as the 'war on terror' and military operations in Afghanistan and Iraq, have seen the Bush administration backtrack on previous diplomatic commitments to the region. Moreover, the issue of nuclear proliferation in Iran, the global financial crisis, and a severe consumer-led recession in the US ensure that Latin American affairs will likely continue to take a back seat for the time being. We currently see a handful of factors, which help explain the absence of the US from the summit

The attendance of President Bush at the summit would hardly serve any purpose, other than to highlight that a summit of this magnitude cannot be held without the presence of a US administration, especially with a lame-duck president who had only a few weeks left in office.

Indeed, we believe that the summit gives the host, President Luiz Inácio Lula da Silva, an opportunity to show that Brazil is a regional power to be reckoned with, fully capable of discussing regional integration without US guidance on the matter. As Latin America's largest economy, Brazil has gradually been promoting an image of a regional great power.

As far as several Latin American leaders are concerned, the summit provides a good opportunity to send a clear message to President Obama, to rethink his stance on US foreign policy in the region, and his reluctance to sign a free trade agreement (FTA) with Colombia without prior commitments from the Andean nation to address violence and corruption.

To be sure, China and Russia have been making diplomatic overtures to Latin American leaders, demonstrating a growing interest in the region as a whole. China has recently signed up to the Inter-American Development Bank (IDB), with a US\$350mn loan for small businesses, and extended a credit line to Brazil's **Petrobras**, worth US\$10bn. During a state visit by Chinese President Hu Jintao, Peru signed an FTA with China. Meanwhile,

BMI VIEW

Although the absence of US President George W. Bush from the Latin American and Caribbean Summit on Integration and Development is a significant shift in the region's foreign policy, we refrain from overstating any symbolism to the development. We expect the US to maintain a vital diplomatic and economic role in Latin America, but acknowledge that the region's northern neighbour may have to compete with other outside powers going forward.

US Sphere Of Influence At Risk Latin America



Source: BMI

Russia has been conducting joint naval exercises with Venezuela in November, and has agreed to supply military equipment to Venezuelan President Hugo Chávez. In light of high conditionality for US commitment to FTAs and financial aid in the region, Latin American countries may now be spoilt for choice, with Russia and China seemingly demanding little in return.

US Here To Stay

It would be too early, however, to write off traditional US influence in Latin America on the basis of a regional summit, which in our view will yield little directional change in

TABLE: POLITICAL OVERVIEW

System of Government	Parliamentary Democracy, Universal Suffrage: 513-Seat Chamber of Deputies (four year term). Executive Power rests with President.
Head of State	President (Luiz Inácio Lula da Silva), One Four Year Term
Head of Government	President Luiz Inácio Lula da Silva
Last Election	Parliamentary – October 1, 2006 Presidential – October 29, 2006
Composition Of Current Government	Coalition comprising Partido dos Trabalhadores, Partido Comunista do Brasil, Partido Republicano Brasileiro, Partido Socialista Brasileiro, Partido do Movimento Democrático Brasileiro, Partido Liberal, Partido Progressista, and Partido da Mobilização Nacional
Key Figures	Vice President – José Alencar Gomes da Silva (Partido Republicano Brasileiro), Chief of Staff – Dilma Rousseff (Partido dos Trabalhadores), Defence Minister – Nelson Azevedo Jobim (Partido do Movimento Democrático Brasileiro), Finance Minister – Guido Mantega (Partido dos Trabalhadores)
Main Political Parties (number of seats in parliament)	<p>Partido dos Trabalhadores (83 seats): Left-wing social-democratic party founded in 1980 by a group of intellectuals and workers at the Colégio Sion in São Paulo. The Party was led by the current president Luiz Inácio Lula da Silva since its formation until 1994. The party is currently led by Ricardo Berzoini.</p> <p>Partido do Movimento Democrático Brasileiro (89): a centrist party, succeeding its predecessor the Brazilian Democratic Movement in 1981. The party is largely made up of liberals and former guerrillas of the MR-8 group. The party is currently led by Michel Temer.</p> <p>Partido da Social Democracia Brasileira (65): one of the largest and most prominent Brazilian parties, and is the party of former President Fernando Henrique Cardoso. The social-democratic party is associated with the Third Way movement in Brazilian politics. The party was founded in 1988 and is currently led by Tasso Jereissati.</p> <p>Democratas (Partido da Frente Liberal) (65): Considered to be the main centre-right party in Brazil, and is the party of the former military regime which ruled Brazil between 1964 and 1985. The party was founded in 1985 as the Liberal Front, after splitting from the Democratic Social Party. The party's leader is Rodrigo Maia.</p> <p>Partido Progressista (42): This centre-right party was founded in 1995 as the Brazilian Progressive Party and is regarded conservative. The party changed its name to Progressive Party in 2003. It is currently led by Nélio Dias.</p> <p>Other parties represented in parliament include: Partido da República, Partido Socialista Brasileiro, Partido Democrático Trabalhista, Partido Trabalhista Brasileiro, Partido Popular Socialista, Partido Verde, Partido Comunista do Brasil, and Partido Social Cristão.</p>
Next Election	Parliamentary – 2010 Presidential – 2010
Key Relations/ Treaties	Brazil is member of Mercosur , which includes Argentina, Paraguay and Uruguay. Associate members of the economic bloc include Chile, Ecuador, Peru, Bolivia and Colombia. Brazil has increasingly strong ties with the EU.
BMI Short-Term Political Risk Rating	61.7
BMI Structural Political Risk Rating	62.6

Source: BMI

policy on sustainable development and integration. The US continues to play a vital role in the fight on terror and drug trafficking in the region, with aid to Colombia totalling some US\$700mn per year. Indeed, support for Colombia's war on the left-wing guerrilla group Fuerzas Armadas Revolucionarias de Colombia (FARC), which are engaged in narco-trafficking, has proven highly successful recently. With gang violence and drug trafficking on the rise, we expect the US to remain committed to regional security initiatives, as outlined in Obama's 'A New Partnership For The Americas' policy blueprint. What is more, Latin American trade continues to be heavily biased towards the US market, and remittance flows from migrant workers living in the US are still a vital source of income in many Latin American economies.

Risks To Outlook

We note that the severity of the US recession is posing significant risks to a sustained commitment to Latin America and could accelerate a shift towards diversified political and economic links. In part, FTAs will be a much harder sell at home for President-elect Obama, and financial aid to Latin America will likely come with a high conditionality price tag going forward. At the same time, we believe that a growing chorus of left-wing nationalist leaders in Bolivia, Venezuela, and Ecuador, which chose not to pay its coupon on its US\$ Global 2012 bond, will likely welcome the symbolism of the summit and the US's absence. Rising anti-US rhetoric and defiance of global creditors could see a growing number of multilateral financial institutions and key economic partners turn their backs on Latin American economies, at a time when mineral resource wealth no longer guarantees economic stability. Finally, with the issue of resource wealth playing a key role in national sentiment, especially in Brazil, the reactivation of the US Fourth Fleet, after 58 years since its decommissioning to patrol the Caribbean could provoke further negative sentiment towards the US.

chapter 2 Economic Outlook

SWOT Analysis

Strengths

- The government's commitment to primary fiscal surpluses has instilled confidence in the economy.
- Confidence in the central bank and its response to shifting economic dynamics will help to keep long-term investors anchored.

Weaknesses

- Brazil's deteriorating current account dynamics will increasingly cast a shadow on the fundamentals driving the *real*. This could lead to eroding confidence in the currency by investors at a time when the macroeconomic outlook deteriorates.
- The Brazilian economy is highly reliant on strong consumer spending levels, which have been driven by a credit boom. Tighter credit and liquidity conditions amid the global financial crisis are starting to show signs of consumer retrenchment, casting growing uncertainty over the economy.

Opportunities

- The two consecutive investment grade upgrades for Brazil will unlock significant capital inflows from a broader scope of foreign investors over the coming years. Combined with a competitive regional political outlook, this could stimulate large-scale infrastructure development projects across the country.
- Relative price stability, combined with responsible fiscal management and a hefty build up of reserves, should help cushion the economy from the financial crisis and global recession.

Threats

- The largest threat to Brazil's economy is the rapidly deteriorating global macroeconomic picture, and declining demand for the country's commodities. With the economy already set to see a sharp slowdown in growth, there is a prevailing threat that the economic slump could be more prolonged in case of a long recovery period in G7 economies.
- The inability of Lula's government to implement successful economic reforms, such as an overhaul of the tax system, is a key threat to Brazil's economy. Failure to make progress on this front would impede the modernisation and competitiveness of the Brazilian economy.

BMI Economic Risk Ratings

International reserves continued to fall in December, dropping to US\$193.8bn, from a record US\$206.5bn back in September. The 6.2% drop in reserves in the final quarter of 2008 reflects efforts by the **Banco Central do Brasil** to support the ailing Brazilian real, and provide large-scale liquidity injections into the financial system. We expect foreign reserves to continue to decline in the months ahead, as the *real* will likely come under further pressure during the course of the year, and export growth continues to drop.

	S-T Economy	Rank	Trend
Trinidad & Tobago	83.3	1	-
Bolivia	81.0	2	+
Peru	71.9	3	-
Guatemala	69.6	4	-
Mexico	63.5	5	-
Brazil	61.7	6	-
El Salvador	57.3	7	-
Chile	56.9	8	-
Paraguay	55.6	9	+
Colombia	53.5	10	-
Panama	52.9	11	-
Barbados	52.7	12	+
Uruguay	52.3	13	-
Venezuela	50.8	14	-
Argentina	46.9	15	-
Ecuador	46.7	16	-
Jamaica	44.8	17	-
Honduras	44.0	18	-
Dominican Republic	41.7	19	-
Guyana	37.3	20	-
Nicaragua	27.3	21	-
Regional average 61.5	Global average 63.2	Emerging Markets average 60.5	

	L-T Economy	Rank	Trend
Mexico	70.9	1	+
Trinidad & Tobago	68.4	2	-
Peru	68.0	3	-
Chile	66.3	4	-
Argentina	63.7	5	-
Colombia	63.0	6	-
Guatemala	62.8	7	-
Brazil	62.6	8	-
El Salvador	54.7	9	+
Panama	53.7	10	+
Uruguay	52.8	11	-
Venezuela	52.0	12	-
Paraguay	51.8	13	+
Ecuador	51.0	14	-
Barbados	49.1	15	-
Dominican Republic	45.7	16	-
Guyana	45.2	17	-
Jamaica	42.9	18	-
Honduras	40.8	19	-
Nicaragua	39.1	20	-
Regional average 61.5	Global average 63.2	Emerging Markets average 60.5	

Economic Activity

The End Of The Five-Year Boom

As the Brazilian economy moves into the new year, it seems to us that the much-praised resilience of the consumer sector has been left behind in 2008. Although signs of a decelerating economy had already started to surface during the last two months of the year, our outlook for 2009 has turned markedly more bearish in January, as a series of negative economic indicators started to appear. Industrial output numbers are showing worrying signs of a prolonged contraction, and sales figures, too, are pointing to retrenching domestic demand. This comes against the backdrop of the global economic recession and the ongoing financial crisis, leading to yet another bout of weakness for global stocks. Such a backdrop will hardly soothe the ongoing decline in confidence levels (both consumer and economic), suggesting to us that borrowing appetite in Brazil this year, will be kept to a minimum.

Disappearing investor risk appetite and the drying up of global liquidity will have severe implications for fixed investment and capital flows in and out of Brazil in 2009, at a time when there is little incentive to expand output capacity for key industries. Indeed, we see growing indications that global trade has collapsed, which has recently prompted our Asia desk to revise down China's real GDP growth forecast for 2009 to 5.6% (down from 6.8%) – far lower than consensus.

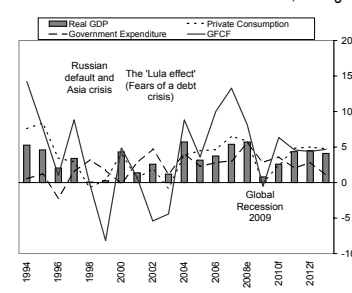
These combined factors have prompted us to slash our economic growth forecast for Brazil this year to 0.8% (from a previous projection of 2.3%), significantly lower than market consensus of 2.0%. We currently see private consumption and gross fixed capital formation – the major drivers of growth during the past five years – contracting by 0.01% and 0.52% respectively. Running this through our contributions to real GDP growth model, our revised forecast implies that government expenditure and stock building will be the only net positive contributors to real GDP growth this year. Putting it into context, our revised forecast suggests that the Brazilian economy is braced for its biggest economic slowdown since the Russian default and the Asia financial crisis of 1998, when real GDP growth fell to 0.1%. In this light, we believe that the administration of President Luiz Inácio Lula da Silva will be facing its toughest challenge on the economic front since coming to power in 2003, when markets initially responded poorly to the news of the former leftist trade union leader being elected as president, causing ripple effects through stock and bond markets.

BMI VIEW

It is becoming clearer to us that impact of the global recession and financial crisis will have a more severe impact on the Brazilian economy in 2009 than previously anticipated. We have revised down our real GDP growth forecast for this year to a below consensus 0.8% (from 2.3%), and expect gross fixed capital formation and private consumption to have negative contributions to economic growth in 2009.

Boom Years Over

Brazil – Real GDP Growth Forecast, % chg



Source: IBGE, BMI

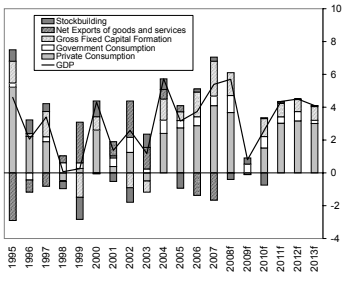
TABLE: ECONOMIC ACTIVITY

	2004	2005	2006	2007	2008e	2009f	2010f	2011f	2012f	2013f
Nominal GDP, BRLbn [1]	1,941.5	2,147.2	2,332.9	2,558.8	2,869.3	3,045.4	3,254.1	3,541.7	3,855.6	4,192.6
Nominal GDP, US\$bn [1]	664.08	882.71	1,073.07	1,314.17	1,562.33	1,227.25	1,314.77	1,706.82	2,160.00	2,466.23
Real GDP growth, % change y-o-y [2]	5.7	3.2	3.7	5.4	5.7	0.8	2.6	4.4	4.5	4.1
GDP per capita, US\$ [2]	3,653	4,793	5,746	6,939	8,136	6,303	6,659	8,566	10,667	12,083
Population, mn [3]	181.80	184.20	186.80	189.40	192.00	194.70	197.40	199.30	202.50	204.10
Industrial production index, % y-o-y, ave [3]	8.1	3.5	2.9	5.9	4.8	2.1	3.6	5.2	4.7	4.3
Unemployment, % of labour force, eop [3]	9.6	8.3	8.4	7.4	7.8	8.6	8.3	7.9	8.0	8.1

Notes: e BMI estimates. f BMI forecasts. Sources: 1 IBGE, IMF. 2 BMI Calculation; 3 IBGE.

Consumer Out Of The Picture In 2009

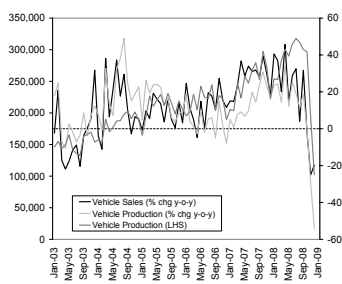
Brazil – Percentage Point Contributions To GDP Growth, % chg



Source: IBGE, BMI

Little To Cheer About

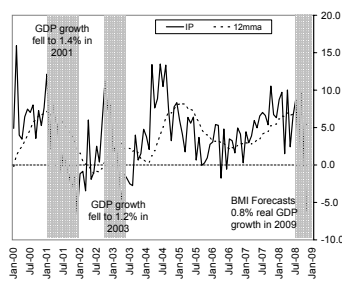
Brazil – Vehicle Sales & Production (Incl. Units), % chg y-o-y



Source: Anfavea, BMI

Hard Landing Ahead

Brazil – Industrial Production Growth, % chg y-o-y



Source: IBGE, BMI

So Where Is Demand?

Latest data show that industrial production took a decisive turn for the worse back in November, when output contracted by a staggering 11.5% month-on-month, marking a fall of 6.2% year-on-year (y-o-y) that month. This was the largest year-on-year drop in industrial output in Brazil since December 2001. Looking at the accompanying chart, previous periods of sharply contracting industrial output numbers, have coincided with a significant slowdown of the real economy. Several months of negative industrial production growth in 2001, culminating in a contraction of 6.4% y-o-y by year-end, saw Brazilian economic growth slow to 1.4%, from 4.3% a year earlier. Similarly, in 2003, real GDP growth slowed to 1.2%, from 2.6% previously, after industrial production growth reached a nadir of -4.8% y-o-y.

Although one month of negative industrial output growth in itself is not necessarily a sign of weak real GDP growth for the whole of 2009, we are particularly concerned by the magnitude of the sudden reversal in industrial production growth in November. This could suggest that further contraction in industrial output will occur in the months ahead, raising uncertainty over Brazil’s economic outlook. This concern underpins our revised real GDP growth forecast of 0.8% for Brazil this year.

Moreover, a key barometer of Brazilian economic activity, in our view, has traditionally been the auto industry. Here too, the alarm bells are ringing. Vehicle output during December collapsed to 102,053 units, from 193,062 units a month earlier, marking a whopping 54.1% y-o-y contraction in output numbers. December vehicle sales data are hardly any more reassuring, when sales growth remained firmly negative, despite a minor bounce from -25.0% y-o-y growth in November. We believe that sentiment in the Brazilian autos sector is reflective of overall consumer sentiment. A survey by the Fundação Getulio Vargas institute saw consumer confidence below 100 in November and December for the first time since the survey was introduced in 2005. Notwithstanding economic stimuli and liquidity injections into the financial system, we believe that room for a recovery of vehicle production and sales figures will remain limited throughout 2009.

All Down To PAC?

Bearing in mind that the Lula administration is heading towards a general election in 2010, in which the popular president will be constitutionally barred from participating, and with the opposition gaining in popularity, the government’s management of the current economic turmoil will be crucial to its re-election chances. It is hardly surprising, therefore, that President Lula recently announced plans to boost his Growth Acceleration Programme, known as PAC, during the first quarter of 2009. Lula reassured Brazilians that no existing projects are set to suffer as a result of deteriorating macroeconomic conditions, and that in fact the government intends to introduce new projects. Towards the end of 2008, Lula’s government raised PAC investments to BRL636bn, from an initial BRL504bn through to the end of 2010.

Infrastructure development projects will be supportive of economic growth over the coming years, when we expect a moderate recovery in real GDP growth to 2.6% in 2010 and 4.4% in 2011. However, we see little scope for higher public spending levels to boost economic

activity sufficiently to prevent a drop in growth to 0.8% in 2009. What is more, we caution that the country's fiscal position may start to look increasingly precarious. Despite an estimated primary surplus of 4.2% of GDP in 2008, we see this declining to just 2.8% of GDP in 2009. We are particularly concerned about the nominal fiscal position (after interest payments), where we see the estimated nominal deficit of 1.5% of GDP widening to 2.1% this year. This may stifle the country's prospects for a quick recovery in 2010, as a larger deficit will restrict room for creating more favourable tax conditions. Our view is in large part underpinned by the prospective decline in government revenues this year.

Risks To Outlook

At present, the main risks to our outlook, in our view, lies in our gross fixed capital formation growth forecast of -0.52%, which in the context of previous downturns in the Brazilian economy may seem overly optimistic. In particular, given tight credit conditions and highly risk averse investors, the real negative growth figure in 2009 could be much higher. This could potentially pave the way for substantially lower economic growth this year, putting the prospects of a recession on the horizon. That said, we believe that the Brazil of today is a different place from even 2003. To give just one example, prudent economic management saw the country achieve investment grade status in early 2008. With regards to upside risks to our forecast, a better-than-expected growth outturn in China may slightly improve the overall picture for Brazil. We see little scope for this to play out, however.

Labour Market

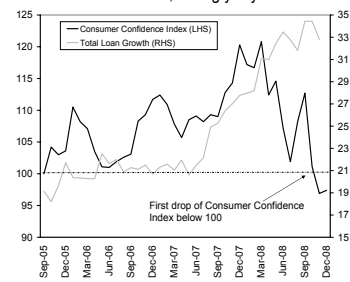
Inflexible Labour Laws Boost Unemployment

Weakening order numbers and falling production levels in Brazil have seen companies cut their workforces and place employees on forced leave. Mining giant **Vale** laid off some 1,300 workers in December and forced 5,500 employees to take a leave of absence. Similar occurrences have been seen across other sectors, such as Brazil's car industry, which saw output levels fall by 54.1% y-o-y in December. We expect a substantial loosening of the labour market in Brazil, and are revising up our unemployment rate forecast for 2009 to 8.5% (from 8.0% previously). This would imply that some one million people will likely lose their jobs across many sectors of the Brazilian economy in 2009, assuming that the country's economically active population measures almost 100mn people. Although we are not forecasting a recession at this stage, we believe that the impact of a sharp slowdown in economic activity on employment will be amplified by the lack of flexibility in Brazil's highly regulated labour market.

Brazil has a very costly and rigid labour market, with one of the highest hiring costs in the world. Brazilian labour laws require employers to make monthly contributions to a Length of Service Guarantee Fund (FGTS), which is basically a severance pay fund, into which employers deposit some 8% of the worker's total income. Access to this fund remains restricted, unless an employee becomes a first-time home buyer, falls ill, or is fired. In addition, labour legislation states that if an employee is made redundant without a just cause, the employer is liable to paying out compensation equivalent to 40% of total FGTS deposits accumulated over the person's working life. Not surprisingly, therefore, there is

Confidence Is Low

Brazil – Consumer Confidence Index & Loan Growth, % chg y-o-y

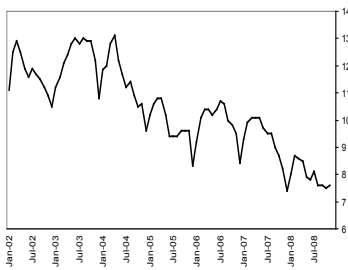


Source: BCB, FGV, BMI

BMI VIEW

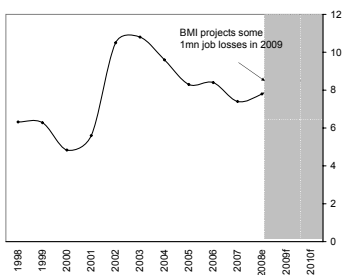
As the sharp economic slowdown takes hold in Brazil, the country's rigid and inflexible labour market is set to exaggerate the effect of slower economic growth on unemployment rates. We believe that President Luiz Inácio Lula da Silva will remain reluctant to consider labour market reforms, which, in our view, may further undermine the ruling Partido dos Trabalhadores re-election efforts in 2010.

Bottomed Out
Brazil – Unemployment Rate, %



Source: IBGE, BMI

Labour Market To Loosen Up
Brazil – End-Year Unemployment Rate, %



Source: IBGE, BMI

BMI VIEW

We are forecasting a 3.4% of GDP current account deficit in Brazil this year, and expect the country to continue posting shortfalls through to 2016. We note that risks of a larger deficit could be mounting as the effects of a global recession will start to make their impact felt on local export growth. We also caution that the current account deficit may be increasingly more difficult to cover this year, as foreign direct investment comes off the boil.

reluctance among employers to keep older and higher-paid employees on the workforce. Moreover, formal workers in Brazil are entitled to 30 days of paid vacations, or will receive 13 months of annual wages instead, adding yet more hiring costs for employers.

Informal Sector Set To Mushroom

In our proprietary business environment ratings, Brazil scores 4.7 (out of 100) in the 'hiring cost' subcategory of the labour force rating, the lowest score in all of Latin America. To be sure, Brazil ranks 152nd in this category, out of a total 158 countries in our business environment ratings. At 41.6, Brazil's labour market 'rigidity' score is well below the regional average of 52.6, with the country's overall labour force rating standing at 49.6 (below Latin America's average score of 53.8). It is hardly surprising, therefore, that estimates of Brazil's informal labour market are as high as 50% of the economically active population. With employers set to feel yet more pressure to let people go, we believe that over the course of the year more employers will resort to hiring informal labour, which is not under the protection of Brazilian labour laws, thus not requiring any social security contributions, severance payments, or paid holidays.

We see a range of problems facing President Luiz Inácio Lula da Silva's administration in case of a mushrooming informal labour market. First of all, the political implications of a rapidly rising unemployment rate will hardly aid the ruling Partido dos Trabalhadores (PT)'s re-election hopes in 2010, which are already looking highly uncertain. Secondly, the fiscal position is also likely to deteriorate as more people move into the informal sector, to a greater extent than under a more flexible labour regime, in our view.

Following on from this point, there may be mounting pressure on President Lula to push through labour market reforms over the coming year. This is a highly sensitive issue for the president, who as leader of Brazil's workers' party and former trade union leader, has remained loyal to unionists and refused to consider deregulating Brazil's labour market. At present, we do not envision extensive reforms of Brazil's labour laws (still based on 1943 reforms) under the current administration. Although such reforms would likely be seen as unpopular by the country's enormous public sector, we note that the disproportionate increase in unemployment rates going forward may further tip the balance in the opposition Partido da Social Democracia Brasileira (PSDB)'s favour come 2010, in our view.

Balance of Payments

Deeper C/A Deficit Widening In 2009

We have revised our outlook on Brazil's current account in 2009, and now expect the deficit to reach US\$41.4bn (up from a previous forecast for US\$37.8bn), equivalent to a projected 3.4% of GDP. We also believe that the deficit will peak this year, before gradually narrowing over the following years, although we do not envision a move back into surplus until 2016 at the earliest. We expect Brazil's income balance deficit to widen to US\$45.0bn this year, from an estimated US\$39.4bn in 2008, and to remain above the US\$30.0bn deficit mark throughout a 10-year forecast period. Combined with our view that Brazil's trade surplus will not return to 2007 levels before 2016, we believe that the country's current

account will remain in deficit over the next seven years. Latest data published by the **Banco Central do Brasil** (BCB) show that Brazil's year-to-date current account balance posted a deficit of US\$25.8bn in November 2008, and we now estimate a full-year shortfall of US\$27.3bn, or 1.7% of estimated GDP.

More Narrowing Of The Trade Surplus

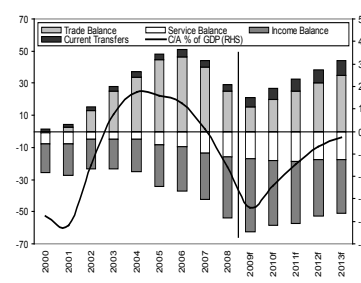
The full-year trade surplus for 2008 slightly overshoot our initial forecast of US\$22.0bn, coming in at US\$24.8bn, which marks a 38.0% annual decline last year. Merchandise exports remained robust in 2008, reflecting Brazil's well-diversified export sector and relatively low reliance on the US economy, which has already been in recession for a year. Export growth rose to 23.2% in 2008, up from 16.6% a year earlier, which saw total exports rise to US\$197.9bn. Import growth, meanwhile, surged by 43.5% (from 32.0% in 2007), to US\$173.1bn, as a stronger currency (during the early stages of the year) and a more affluent Brazilian household lifted demand for imports. In addition, soaring global commodity prices sharply increased the value of Brazilian imports, adding further pressure on the trade surplus. Since the *real* sold off sharply in September and October, however, monthly import growth has receded, dropping into single digits during the last two months of 2008, from 40.4% y-o-y in October.

Looking ahead, we expect the pace at which Brazil's trade surplus has been narrowing to pick up as the global recession comes into full swing. We are currently forecasting a slow-down in export growth to just 7.1% in 2009, which despite a concomitant winding down of import growth to 13.8% this year, will see the trade surplus drop to US\$15.0bn. Perhaps the only silver lining for Brazil's trade balance is our outlook on more currency weakness this year – we forecast an average exchange rate of BRL2.4815/US\$ in 2009. This should help to keep the competitiveness of Brazilian exports in place, even amid declining global demand. In addition, we believe that a broader range of export commodities, counter to many regional peers, which are heavily dependent on a narrow group of exports, should help to ensure a trade surplus over the coming years.

More Pressure From The Income Balance

The global financial crisis and deteriorating macroeconomic outlook has also taken its toll on Brazil's income balance, which accumulated a US\$36.7bn deficit between January and November 2008, a 42% year-on-year widening as profit repatriation and dividend pay-

Sharp Deficit Widening This Year
Brazil – Current Account Balance, US\$bn

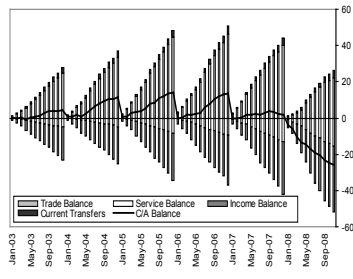


Source: BMI

TABLE: BALANCE OF PAYMENTS										
	2004	2005	2006	2007	2008e	2009f	2010f	2011f	2012f	2013f
Exports, US\$bn [2]	96.48	118.31	137.81	160.65	197.94	212.00	225.00	240.00	270.00	305.00
Imports, US\$bn [1,2]	-62.83	-73.61	-91.35	-120.62	173.10	197.00	218.00	230.00	255.00	280.00
Trade balance, US\$bn [2]	33.64	44.70	46.46	40.03	24.84	15.00	7.00	10.00	15.00	25.00
Current account, US\$bn [2]	11.68	13.98	13.64	1.46	-27.26	-41.44	-31.90	-24.80	-14.35	-6.65
Current account, % of GDP [3]	1.76	1.58	1.27	0.11	-1.74	-3.38	-2.43	-1.45	-0.66	-0.27
Foreign reserves ex gold, US\$bn [2]	52.94	53.80	85.84	180.33	193.78	182.00	190.00	205.00	220.00	227.00
Import cover, months g&s [3]	10.1	8.8	11.3	17.9	13.4	11.1	10.5	10.7	10.3	9.7

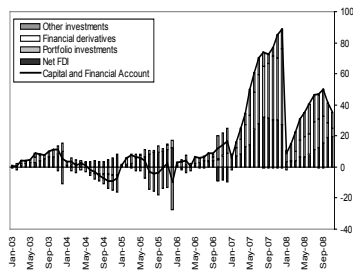
Notes: e BMI estimates. f BMI forecasts. 1 Keep an eye on which data series is denominated in a negative figure, and which is positive; Sources: 2 BCB. 3 BMI Calculation.

Trade Surplus Almost Halved In 2008
Brazil – Y/d C/A Balance, US\$bn



Source: BCB, BMI

Fewer Investments In The Pipeline
Brazil – Year-to-date Capital & Financial Account Balance, US\$bn



Source: BCB, BMI

BMI VIEW

Government revenue streams are set to come under pressure as the economy is bound to suffer a very hard landing in 2009. We believe that this casts growing uncertainty over Brazil's fiscal position going forward, and we caution that the country's nominal balance is set to push deeper into the red.

ments soared. The poor performance of the São Paulo bourse (**Bovespa**) in 2008, along with heightened risk aversion among foreign investors, saw overseas holding companies pull out their profits and cover loss-making positions elsewhere in the world. We therefore believe that an income balance shortfall of US\$39.4bn is on the cards for 2008 as a whole. Going forward, we expect to see a similar trend throughout 2009, though we note that the majority of profits will have been repatriated in 2008. As such, we expect the income balance deficit to widen by 14.2% to US\$45.0bn this year.

Although the current transfers component of the current account is relatively minor, we note that inflows into the current transfers balance, such as remittances from abroad, will be severely affected by the ongoing global recession. Recent legislation permitting relatives to send money in Brazilian *real*, in an effort to reduce the costs of converting foreign currency for recipients, may offer only limited relief. We are forecasting the current transfers balance to post a surplus of US\$5.8bn in 2009, though note that risks are weighted to the downside.

Deficit Becoming Harder To Cover

For the time being, we stick to our long-held view that there are no imminent risks of the capital and financial account no longer covering the forecast current account shortfall. That is not to say, however, that risks do not exist. Net capital and financial account flows contracted by 57.8% year-on-year in the first 11 months of 2008, down from a surge of 489.9% during the same period a year earlier. The year-to-date net capital and financial account balance reached US\$35.9bn in November, comfortably covering the US\$27.3bn current account shortfall estimated for 2008.

However, given the poor outlook on investment and financial markets in Brazil in 2009, we note that there is a risk that, should the ongoing trend in declining investment flows continue, a current account shortfall of US\$41.4bn may be increasingly difficult to cover. Failure to do so would add significant downside pressure on the local currency and require the central bank to step into action. Moreover, this would present further risks to a deteriorating global trade climate and potentially more protectionist policies going forward.

Fiscal Policy

Tighter Room For Public Spending

Brazil's nominal budget swung into a BRL8.92bn deficit in November from a surplus of BRL5.22bn in October, as federal government tax revenues deteriorated. According to data released by Brazil's national treasury, total revenues in November fell to BRL55.06bn, from BRL65.53bn in the previous month. Year-to-date revenues of BRL645.57bn, though, still mark a 17.3% y-o-y increase, reflecting the impressive performance of the Brazilian economy during most of 2008, in line with our projections for real GDP growth of 5.7%. That said, we caution that given our bearish medium-term outlook on the Brazilian economy (we forecast economic growth of 0.8% and 2.6% in 2009 and 2010, respectively), government revenue streams will likely come under increasing pressure as contributions from financial services, the export sector and overall income tax revenues will be subdued by a rapidly

deteriorating global macroeconomic picture. We are currently forecasting a nominal fiscal deficit of 2.10% of GDP in 2009, from an estimated 1.46% of GDP deficit in 2008.

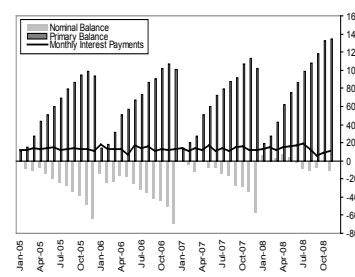
Key factors impacting the federal government's revenue structure in 2008 included the elimination of the lucrative CPMF financial transactions tax at the start of the year, replaced by the IOF tax. Moreover, in light of record high energy prices and rising inflation during H108, the government lowered the quota on gasoline and diesel fuels. In 2009, all emphasis will likely be placed on President Luiz Inácio Lula da Silva's widely publicised Growth Acceleration Programme (PAC), which envisions a considerable increase in public (and private) spending. We believe that measures may involve efforts to ease the tax burden on households and businesses going forward, in an effort to kick start the economy. While Brazil continues to boast an impressive 4.3% of GDP primary fiscal surplus in the 12-month period ending in November (the fiscal balance before interest payments), we caution that the nominal balance may start to push ever deeper into the red, as revenues will moderate and tight credit conditions may adversely impact Brazil's debt refinancing costs (i.e. higher interest payments).

The Risk Of Costlier Debt

Brazil's rolling total public debt rose to BRL1,384.87bn in November, a 3.3% y-o-y increase – a relatively small increase compared to the same period a year earlier, when public debt climbed by 8.8% y-o-y. Local public debt continued to make up the bulk of the government's liabilities. Recently, the widespread move into more secure asset classes, such as government debt, has boded well for sovereign local debt in Brazil, with the yield on Brazil's local 10-Year bond compressing from 16.95% to 12.56% in December alone. However, we note that as global deleveraging is set to continue in 2009, weighing on EM currencies, the attractiveness of holding local government debt in Brazil may start to erode for foreign investors, due to the heightened exchange rate risk (the Brazilian *real* lost 32.5% against the US dollar since the start of 2008). While not our core scenario at this point, a sharp increase in public debt servicing costs over the coming months could push Brazil's nominal fiscal balance ever deeper into the red, increasing uncertainty over public finances, especially ahead of presidential elections in 2010, and severely restrict the President Lula's ability to use counter-cyclical fiscal policy to cushion the economic slowdown looming over Brazil.

More Red Ahead

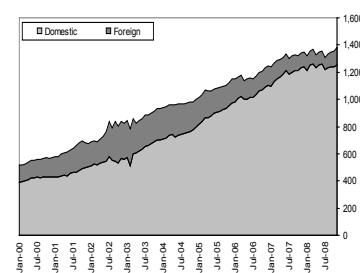
Brazil – YTD Fiscal Balance & Monthly Interest Payments, BRLbn



Source: BCB, BMI

More Expensive To Refinance?

Brazil – Public Debt, BRLbn



Source: National Treasury, BMI

TABLE: FISCAL POLICY

	2004	2005	2006	2007	2008e	2009f	2010f	2011f	2012f	2013f
Fiscal revenue, BRLbn [1,4]	418.4	487.0	541.7	617.5	722.5	781.8	875.6	963.2	1,059.5	1,165.4
Fiscal expenditure, BRLbn [2,4]	370.2	435.6	493.4	560.7	644.9	753.2	843.6	936.4	1,030.0	1,153.6
Budget balance, BRLbn [3,4]	-47.1	-63.6	-69.9	-57.9	-42.0	-64.0	-58.6	-56.7	-52.0	-46.1
Budget balance, % of GDP [5]	-2.4	-3.0	-3.0	-2.3	-1.5	-2.1	-1.8	-1.6	-1.4	-1.1

Notes: e BMI estimates. f BMI forecasts. 1 Central Government Revenues; 2 Central Government Expenditure; 3 General Government Budget; Sources: 4 BCB. 5 BMI Calculation.

BMI VIEW

As inflation slows, we see increasing room for Brazil's central bank to begin its front-loaded monetary easing cycle, starting with a likely 100bps interest rate cut in January to 12.75%. Indeed, we believe that emphasis in addressing slowing economic growth will be placed on monetary easing, which could see interest rates fall to at least 11.25% in 2009.

Monetary Policy

Conditions Ripe For Aggressive Easing

Inflation in Brazil is now firmly in retreat, underpinning our view that the start of an aggressive front-loaded monetary easing cycle is imminent. We are now pencilling in a total of 250 basis points (bps) of interest rate cuts by the **Banco Central do Brasil (BCB)** to 11.25% in 2009, set to start with a 100bps cut at the time of writing. Declining consumption levels, along with falling commodity prices, are contributing to lower inflation, raising concerns of a sharp slowdown in economic growth. Indeed, for some time now we have been highlighting that concerns about the real economy will take centre stage among monetary policymakers. In the January edition of our **Latin America Monitor** on Brazil, we suggested that room for an extensive fiscal stimulus package would be limited, as government revenues would start to dry up. Not surprisingly, therefore, we still expect increased emphasis to be placed on monetary mechanisms and quantitative easing in Brazil, to cushion the effects of a more hostile external macroeconomic environment.

Green Light For Meirelles

The IPCA headline inflation index slowed to 5.9% year-on-year (y-o-y) in December, from a three-year high of 6.4% y-o-y in November in line with our 6.0% end-2008 inflation target, as consumer goods price growth started to come off the boil. We believe that consumer price inflation will remain on a downward trajectory for most of 2009, and we are currently forecasting 3.8% year-end inflation. Although our bearish outlook on the economy (we project 0.8% real GDP growth in 2009) could presage a sharper drop in headline inflation over the coming months, we note that global deleveraging and heightened risk aversion will continue to weigh on the Brazilian *real*, keeping imported inflation risks buoyed.

That being said, the extent of the fall in global commodity prices has kept inflationary pressures resulting from the weaker exchange rate in check for the time being. Brazil's broadest inflation measure, the IGP-M – a monthly index tracking consumer, wholesale and construction material prices – dropped more than expected in December, contracting by 0.13% month-on-month, and falling back into single digits on a year-on-year basis for the first time since April 2008. As the accompanying chart illustrates, the drop in Brazil's broad inflation measure is in line with the falling Reuters-Jefferies commodity index. Given our bearish medium-term outlook on most commodities, which supports our pro-

TABLE: MONETARY POLICY

	2004	2005	2006	2007	2008e	2009f	2010f	2011f	2012f	2013f
Real Lending Rate, %, eop [1,2]	-7.60	-5.70	-3.10	-4.50	-5.90	-3.80	-4.50	-4.30	-4.30	-4.40
Consumer prices, % y-o-y, eop [3]	7.6	5.7	3.1	4.5	5.9	3.8	4.5	4.3	4.3	4.4
Central Bank Policy Rate, % [2]	17.75	18.00	13.25	11.25	13.75	11.25	10.50	11.50	11.50	10.50
Consumer prices, % y-o-y, ave [4]	6.6	6.9	4.2	3.6	5.7	5.2	4.6	4.2	4.5	4.3
Exchange rate BRL/US\$, eop [4]	2.65	2.34	2.13	1.78	2.31	2.65	2.30	1.85	1.72	1.68
Exchange rate BRL/US\$, ave [4]	2.92	2.43	2.17	1.95	1.84	2.48	2.48	2.08	1.78	1.70
Exchange rate BRL/EUR, eop [4]	3.60	2.77	2.82	2.60	3.24	3.37	3.10	2.55	2.22	2.10

Notes: e BMI estimates. f BMI forecasts. 1. Real rate strips out the effects of inflation; Sources: 2 BCB/BMI Calculation. 3 IBGE; 4 BMI Calculation; 5 BCB.

jections for a global recession in 2009 (under the IMF's definition of below 3.0% global economic growth), we see little scope for a reversal of this trend any time soon. As such, BCB President Henrique Meirelles will have ample room to direct monetary policy towards addressing Brazil's economic growth outlook.

Risks To Outlook

We see two main risks to our current outlook on monetary policy in Brazil. The first deviation from our baseline scenario is that lower interest rates will fail to trickle through to the wider economy, as lenders remain cautious, and already highly leveraged households will struggle to take on new loans in light of falling income levels. In the near term, this could prompt more aggressive rate cuts by the BCB in 2009, adding significant downside risks to our end-2009 Selic rate forecast of 11.25%. Looking further into the medium to long term, though, we warn that severe inflationary risks may be brewing as a result of unrestrained liquidity injections. This scenario is similar to our view that the US economy may be facing a W-shaped recession, which means that as the Brazilian economy begins to recover as a result of monetary easing and fiscal stimuli, interest rates are hiked aggressively to pre-empt a sharp spike in inflation, putting the brakes back on economic growth.

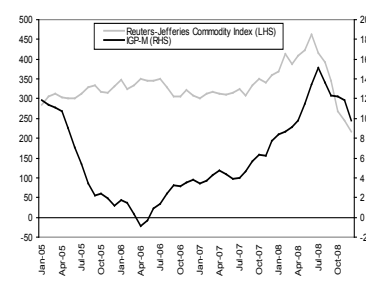
Exchange Rate Policy

Stifled By Deteriorating Growth Outlook

Since our last currency forecast on November 27, we have grown considerably more bearish the Brazilian *real*, marking down our end-2009 and end-2010 targets from BRL1.7800/US\$ and BRL1.6900/US\$, to BRL2.6500/US\$ and BRL2.3000/US\$, respectively. While we believe that most of the key determinants outlined in late November are still in play, our view has shifted in favour of overriding downside forces on the real over the next 24 months (and 2009 in particular). We previously suggested that credible policy responses by Brazil's finance ministry and the central bank would help to anchor investor confidence, supporting the *real* over the medium term. In addition, we pointed to the country's well-diversified export base and wide range of commodity groups, which we believed would help the country weather ongoing demand destruction in G7 countries better than its peers.

Racing To The Bottom

Brazil – IGP-M Inflation (% chg y-o-y) & Reuters-Jefferies Commodity Index



Source: FGV, BMI

BMI VIEW

We see a growing number of factors, which will likely keep the Brazilian real subdued for most of 2009. Indeed, we see scope for another leg of sharp depreciation for the currency as global financial conditions keep investors at bay. Moreover, a deteriorating balance of payments outlook, with rising risks of insufficient capital and financial inflows threatening to affect net foreign reserves and further weigh on the real.

TABLE: EXCHANGE RATE POLICY

	2004	2005	2006	2007	2008e	2009f	2010f	2011f	2012f	2013f
Real Lending Rate, %, eop [1,2]	-7.60	-5.70	-3.10	-4.50	-5.90	-3.80	-4.50	-4.30	-4.30	-4.40
Consumer prices, % y-o-y, eop [3]	7.6	5.7	3.1	4.5	5.9	3.8	4.5	4.3	4.3	4.4
Consumer prices, % y-o-y, ave [4]	6.6	6.9	4.2	3.6	5.7	5.2	4.6	4.2	4.5	4.3
Exchange rate BRL/US\$, eop [4]	2.65	2.34	2.13	1.78	2.31	2.65	2.30	1.85	1.72	1.68
Exchange rate BRL/US\$, ave [4]	2.92	2.43	2.17	1.95	1.84	2.48	2.48	2.08	1.78	1.70
Exchange rate BRL/EUR, eop [4]	3.60	2.77	2.82	2.60	3.24	3.37	3.10	2.55	2.22	2.10
Exchange rate BRL/EUR, ave [4]	3.62	3.18	2.79	2.71	2.92	3.30	3.24	2.83	2.39	2.16
Foreign reserves ex gold, US\$bn [5]	52.94	53.80	85.84	180.33	193.78	182.00	190.00	205.00	220.00	227.00
Import cover, months g&s [4]	10.1	8.8	11.3	17.9	13.4	11.1	10.5	10.7	10.3	9.7

Notes: e BMI estimates. f BMI forecasts. 1 Real rate strips out the effects of inflation; Sources: 2 BCB/BMI Calculation. 3 IBGE; 4 BMI Calculation; 5 BCB.

However, our economic outlook for Brazil has changed somewhat since the start of the year. To begin with, a number of recent macroeconomic data releases have prompted us to revise down our economic growth projections for Brazil in 2009. We are now forecasting real GDP growth of 0.8% this year, from our previous forecast of 2.3%, with private consumption and gross fixed capital formation set to contract (by -0.01% and -0.52%, respectively). Given that the real has traditionally been buoyed by the country's impressive growth story and a booming commodity export sector over the past five years, our call for a severe global recession hardly augurs well for the currency. Partly as a result of our downward revision to economic growth, we now see the current account deficit widening to 3.4% of GDP this year (previously forecast to 2.8% of GDP), from an estimated 1.7% of GDP shortfall in 2008. In addition, we believe that uncertainty regarding steady capital and financial account inflows is on the rise as a result of the deteriorating global economic climate. As markets begin to price in these imbalances, there is bound to be further currency weakness going forward.

Moreover, we remain medium-term bearish financial markets in general, believing that markets are still not pricing in the full extent of the economic downturn and deleveraging, which we see continuing throughout this year. Indeed, our global outlook remains below consensus, and as such we see substantial room for more capital outflows from Brazil in 2009, putting yet more downside pressure on the *real*. Finally, we have revised our monetary policy outlook, currently forecasting a total of 250bps of interest rate cuts in 2009 to 11.25%, starting with a 100bps cut next week, with the declining interest rate differential significantly reducing the one silver lining the currency offers to foreign investors.

Risks To Outlook

The main upside risk to our current outlook on the *real* stems from the potential that investors may seek a relative value play in the region. Although the *real* was the poorest performing currency in Latin America in 2008 (down 31%), the unit could begin to outperform other regional players, such as Mexico, where the economic downturn is set to be deeper and more prolonged as a result of greater exposure to the US economy. This could provide some support for the *real*. Although not our baseline view, the **Banco Central do Brasil** could choose to decisively step in to support the currency, as Brazilian businesses struggle to roll over an estimated total of US\$62bn in foreign debt due this year. External debt servicing costs have skyrocketed since the *real*'s sharp decline in H208. The central bank has already announced a US\$20bn lending facility to help thousands of companies struggling to refinance their external debt, and a more interventionist approach cannot be ruled out at this stage.

The Brazilian Economy To 2018

From BRIC To Economic Powerhouse By 2018

Notwithstanding the economic headwinds currently afflicting the Brazilian economy, we remain long-term bulls on Brazil and continue to see the emergence of a wider middle class as key to the economic success of the country over the next decade. Despite our forecast for 0.8% economic growth in 2009, we are still projecting an average real GDP growth rate of 3.4% for Brazil through to 2018. Our view is in large part underpinned by our belief that credible monetary and fiscal policies will help to keep long-term investor interest in vital sectors of the economy anchored. Much will depend on the long-term implications of the ongoing global recession, the length of the global slowdown, and the changes this will have on the global trade map.

Several developments over the coming years will play a vital role in the economic landscape of Brazil going forward. We see growing prospects for the opposition Partido da Social Democracia Brasileira (PSDB) to make a successful bid for the presidency in 2010, when incumbent President Luiz Inácio Lula da Silva is constitutionally forced to step down. A more centrist social-democrat administration could give rise to a series of crucial reforms in the country – should these not be achieved before the election, which currently is not our core scenario – addressing the country's inflexible and rigid labour market laws, and a highly complex and inefficient taxation system. Indeed, we believe that difficult economic conditions will likely push existing economic imbalances to the fore, previously masked by record high commodity prices and an export boom. Placing such issues as high on the political agenda for a new administration in 2011 will be fundamental in paving the way for Brazil's transition to a regional (perhaps even global) economic powerhouse.

The Rise Of The Consumer

Over the next decade, Brazil's consumer will play a vital role in turning the economy into a robust and stable economy in Latin America. We expect GDP per capita to more

BMI VIEW

Vast natural resources, the emergence of an enormous consumer segment, and a prudent policy mix will keep investor interest in Brazil elevated over the coming 10 years. We believe that a greater proportion of Brazil's poorer classes will increasingly participate in the economy amid more sophisticated micro-financing schemes and infrastructure upgrades. This should help to spread economic development beyond Brazil's main metropolitan areas.

TABLE: LONG-TERM MACROECONOMIC FORECASTS

	2011f	2012f	2013f	2014f	2015f	2016f	2017f	2018f
Nominal GDP, US\$bn [1]	1,706.82	2,160.00	2,466.23	2,698.93	2,901.65	3,190.91	3,541.50	3,869.13
Real GDP growth, % change y-o-y [2]	4.3	4.5	4.1	3.7	3.5	3.5	3.5	3.1
Population, mn [3]	199.30	202.50	204.10	205.60	206.20	206.80	207.90	208.10
GDP per capita, US\$ [2]	8,566	10,667	12,083	13,127	14,072	15,430	17,035	18,593
Consumer prices, % y-o-y, ave [2]	4.2	4.5	4.3	4.7	5.0	4.8	4.6	4.5
Current account, % of GDP [2]	-1.45	-0.66	-0.27	-0.40	-0.14	0.13	0.29	0.38
Exchange rate BRL/US\$, ave [2]	2.08	1.78	1.70	1.69	1.70	1.68	1.65	1.63

Notes: f BMI forecasts. Sources: 1. IBGE, IMF. 2. BMI Calculation; 3. IBGE.

than double between 2008 and 2018, to US\$18,593. We see massive wealth creation in Brazil over the coming decade, with higher income levels and rising demand over the next 10 years likely to take Brazil's growth story outside the main metropolitan areas to smaller towns across the country. At a time of falling retail sales in the US and eurozone, big retailers will be looking to exploit new lucrative markets. We expect Brazil's shifting socio-economic dynamics to attract FDI over the long term. This will unlock significant infrastructure development projects in Brazil's more remote areas, and in turn further stimulate regional economic development. Indeed, the government's ambitious Growth Acceleration Programme (PAC), which has received additional political impetus in light of the sharp economic slowdown, may pave the way for elaborate investment projects to upgrade Brazil's physical infrastructure.

Poverty reduction and higher purchasing power will help to boost consumer demand beyond 2013. We believe that alleviating poverty will remain high on voters' and the government's agenda for some time to come. Although Brazil has undergone extraordinary progress in lifting people out of poverty in recent years (income for the poorest 10% grew by 9% per year between 2001 and 2006 according to the World Bank), social disparities remain among the highest in the world. Not only will addressing this problem determine the nature of Brazil's future polity, but a reduction in poverty levels will underpin solid growth prospects and a dynamic consumer sector. We believe that gang crimes and violence in many poorer urban areas will remain a key concern for some time to come, given that the government can exercise only very little authority over Brazil's gang-dominated shantytowns. However, prospects of benefiting from increasingly sophisticated microcredit schemes in poorer areas should considerably lift the purchasing power of many of Brazil's poorer citizens, ensuring a bigger participation in the local economy.

That said, a rise in inequality cannot be ruled out over the next 10 years, particularly as higher income households stand to gain more from Brazil's robust economy. A further deterioration in income distribution and social disparities could undermine Brazil's social stability score in our ratings and increase political risk going forward. Not only could this jeopardise Brazil's growth prospects, but a potential uptick in social unrest could give rise to less market-friendly political forces and see a return to excessive government intervention. For the time being, however, this is not our core scenario for Brazil.

BMI's long-term macroeconomic forecasts are based on a variety of quantitative and qualitative factors. Our 10-year forecasts assume in most cases that growth eventually converges to a long-term trend, with economic potential being determined by factors such as capital investment, demographics and productivity growth. Because quantitative frameworks often fail to capture key dynamics behind long-term growth determinants, our forecasts also reflect analysts' in-depth knowledge of subjective factors such as institutional strength and political stability. We assess trends in the composition of the economy on a GDP by expenditure basis in order to determine the degree to which private and government consumption, fixed investment and the export sector will drive growth in the future. Taken together, these factors feed into our projections for exchange rates, external account balances and interest rates.

chapter 4 Special Report

In this special report, we examine key risks for 2009 for three of the world's major economies – China, the US and the eurozone. For China, we explore the possibility of political upheaval as economic growth slows. For the US, we examine the potential for a 'double-dip' recession if monetary conditions lurch from easing to tightening. And for the eurozone, where banks are heavily leveraged and exposed to emerging markets, there is every danger of major financial sector turmoil. While it should be borne in mind that these scenarios do not necessarily outline **BMI**'s core views, they represent very serious risks to our global outlook.

China

A Seismic Upheaval In 2009?

With China's economic growth in 2009 forecast to drop below the 8.0% threshold considered necessary to create enough jobs to keep society stable, the global recession will pose a severe test for China's leaders. China is very much an anomaly in that it is the only major economy that is not a democracy. Instead, the ruling Chinese Communist Party (CCP) derives its legitimacy from its economic achievements, such as lifting hundreds of millions out of poverty over the past generation, and catapulting China to great economic power status. But all this comes with a price, namely a high degree of social inequality and corruption, and severe environmental degradation. Chinese citizens have largely refrained from greater calls for democracy and have overlooked the CCP's shortcomings in return for economic growth. However, if growth slows sharply, then there is the potential for domestic political tensions to rise. Provided the CCP handles the situation carefully, this need not create any unmanageable calls for systemic change. However, if they misstep, this could prompt an entire reassessment of the country's political structure.

The year 2009 will also respectively mark the 20th, 50th and 60th anniversaries of the 'Tiananmen Square incident' (June), the Tibet uprising (March) and the revolution (October) that brought the CCP to power, which are dates that carry symbolic importance and are times for reflection.

What Type Of Unrest Might We See?

The main difficulties in anticipating scenarios for political unrest in China are determining whether this will be organised or spontaneous, and whether it will be directed at regional authorities or the central government. The nature of the unrest will in turn determine the policy responses and the political outcome.

What seems likely, however, is that the trigger for unrest would be ongoing layoffs by Chinese companies as a result of weaker external demand. Initially, protestors would de-

BMI VIEW

One of the biggest – and least discussed – 'wild cards' that could rear its head in 2009 is dramatic political upheaval in China. Although this is not our core scenario, such events could conceivably lead to the collapse of the ruling Chinese Communist Party (CCP), ushering in a new era of uncertainty. We outline scenarios as to how this could play out.

mand greater job security and compensation, and a better social safety net. However, such demonstrations could subsequently become occasions to express grievances on broader issues such as corruption and the environment. Before long, tens or even hundreds of thousands of people could take to the streets, not necessarily in Beijing, but in other urban centres, posing a severe challenge for the security forces.

The most dangerous scenario would be organised unrest targeting the central government. This would shift the focus firmly on Beijing, the centre of power. Mass riots in the capital would surely prompt a harsh crackdown, though not necessarily a bloody one as in Tiananmen Square. Under such circumstances, tear gas and water cannons would be the main weapons, and dissidents would be arrested. Such protests would shake China's reputation for stability – a key factor that underpins its growth and appeal to foreign investors.

Another dangerous scenario would be organised unrest targeting a provincial government. Were protestors to take control of administrative offices in 'Province X', Beijing would also be compelled to take dramatic action, lest it appear that it could not control the entire country. In those circumstances, we could see a Chinese version of the 'Kwangju incident'. The latter happened in South Korea in 1980, when opposition forces seized control of the southwestern Korean city. The military regime then sent in special forces to retake the city, killing more than 200 people in the process.

A third scenario could see disorganised unrest target the central government. Sporadic unrest could perhaps be easier to quash, but more difficult to 'negotiate' with, since it would be leaderless. A fourth scenario, disorganised unrest against a provincial government, would probably be the easiest to contain, most probably through a localised state of emergency.

Known Unknowns

There are several 'known unknowns' that could cloud the outcome of events. These are:

- The number of people involved in any demonstrations or protests. Would it be hundreds of thousands, or even millions?
- Whether protests would be limited to 'bread and butter' concerns, or broader issues such as democracy.
- Whether protests would occur across China (including Tibet and Xinjiang), or be limited to key cities.
- Whether the disaffected would protest peacefully, or resort to violence (e.g. attacking government offices, businesses, etc).
- Whether protests would prove sustainable or peter out after a few days or weeks.
- Whether the demonstrators would have widespread public support or whether they would be

seen as a further disruption to economic activity.

- Whether the demonstrators would find sympathy with progressive elements in the CCP.
- The willingness of the government to use deadly force to end demonstrations and restore order.
- Whether the political system can withstand a deadly crackdown.

Who Or What Would Replace The CCP?

Assuming that the central government were sufficiently jolted by protests, to the extent that the CCP's grip started weakening, the next complicating factor would be China's lack of opposition parties (even token ones) waiting in the wings to form the next government. In addition, there are no civic movements such as Poland's solidarity, nor prominent dissidents such as Nelson Mandela, Aung Sang Suu Kyi of Myanmar, or Kim Dae-jung of South Korea. Thus, there would be a risk of a political vacuum if the CCP started weakening.

We see two possible exit strategies from any putative unrest. Firstly, under intense pressure, reformists within the CCP could officially challenge the government, potentially setting up the 'shell' of a new political party. In the absence of an opposition party, liberal factions of the CCP could seize the initiative and seek to co-opt the demands of the protesters into their agenda. Under such a scenario, party leaders could outline a timetable for democratisation, starting with local and municipal elections, then provincial elections, and finally nationwide general elections several years thereafter. The CCP could then break up into parties to contest those polls. China would then undergo a managed transition to democracy.

Secondly, the CCP could dither in its response to nationwide protests, allowing them to continue unchecked. With the CCP unable to decide between a harsh crackdown or caving in to protestors' demands, the military may decide that it is the only institution that can maintain stability, and stage a coup. However, there are two further paths leading from this scenario. Firstly, the military could go for 'hard authoritarianism', thus maintaining dictatorship for the indefinite future, and reversing the economic liberalisation of recent years. Secondly, the military could do the opposite and set a timetable for democratisation, with key generals acting as mediators between CCP officials and new opposition leaders to ensure a smooth transition to democracy.

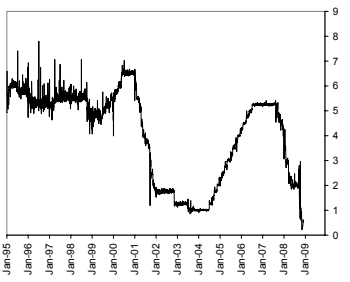
While the above scenarios are highly speculative, we note that economic dislocation often serves a trigger for a political shift or upheaval. South Korea saw its ruling group voted out in 1997, while Indonesia and Russia both saw internal regime change in 1998. Indonesia subsequently saw a new political order emerge, while Russia saw a return to more authoritarian rule. Meanwhile, Argentina saw four presidents in quick succession after its 2001 default. While a sharp slowdown in China would be somewhat different from a financial meltdown, we feel that the scope for political unrest remains one of the biggest wild cards of 2009 and beyond.

United States

A Potential Double-Dip Recession

- The Federal Reserve has reached the lower nominal bound of interest rates, and thus the end of conventional monetary policy. As Chairman Ben Bernanke's playbook suggests, the next step is to fill the Fed's balance sheet with non-traditional assets.
- Deflation/disinflation for both prices and assets remains our core scenario, and there is no obvious end in sight. We recognise the danger of inflation down the road, however, should monetary policy finally gain traction.
- This could cause a 'double-dip' recession, as the Fed would be forced to tighten as inflation returns. We are watching several key indicators, including gold prices and bond yields, for clues as to whether inflation is returning. This scenario is at least a year off, however.
- Although Bernanke has a playbook on how to (try to) avoid deflation, there is no playbook on what to do once it has been avoided and quantitative easing needs to be reversed. The uncertainty over governmental and monetary policy, combined with a potential lurch from inflation to deflation back to inflation makes for an extremely uncertain investment climate. As such, we believe stocks will continue to head lower.

At The Zero Nominal Bound
US – Effective Fed Funds Rate (%)



Source: Federal Reserve

The dramatic decision by the Fed in December 2008 to cut interest rates to a target range of 0.00-0.25% will not make a great deal of difference in reflating the US economy, in our view. The effective Fed funds rate (the rate at which banks actually pay for overnight reserve lending) was trading close to zero prior to the dramatic rate cut, anyhow.

The whole point of lowering interest rates is to lower the opportunity cost of borrowing, and increase the relative attractiveness of higher-yielding assets. Why save when you get no, or tiny, returns on your cash? The answer is: when deflation and deleveraging take grip. A 0% yield on cash suddenly looks very attractive when you are staring depreciating real-world assets in the face, like stocks, real estate... just about everything, really. The definition of inflation, at its very basic level, is that a dollar tomorrow is worth less than a dollar today. And the definition of deflation is that a dollar tomorrow is worth more than a dollar today. If the latter is true, why not hold on to your dollars until tomorrow?

This also hurts the central bank's ability to shape monetary policy. Usually, if the Fed wants to tighten monetary policy, it reduces the amount of money circulating in the economy by selling government bonds in exchange for that money. If it wants to loosen policy, it does the opposite, buying government securities, keeping them on its balance sheet, and putting cash in the hands of the sellers. But what happens when both cash and the securities are yielding zero? In this case, they become equivalent instruments, and open market operations are meaningless. More importantly, borrowers don't want to borrow, and lenders don't want to lend. These phenomena are what is referred to as the 'liquidity trap', and it stymied the Japanese authorities in the 1990s (with no end in sight).

Monetary Policy Is Going Japanese

Speaking of Japan, enter quantitative easing. The Federal Reserve is a monopolist of sorts, in that it is basically like every other bank except for its legal ability to print money at will. As a monopolist of quantity (and with the price of the money it is lending at bargain-basement levels), it is pushing as much cash as possible into the hands of banks, hoping that they will then take the money and distribute it throughout the economy in the form of loans. By borrowing heaps of money at zero cost, and by lending it at a positive non-zero rate, banks should be able to recapitalise themselves and emerge from the credit crunch morass.

The degree of easing has been astonishing in its speed and scale. The monetary base rose from US\$908bn to US\$1.13trn between September and October 2008 alone. The base increased by 36.7% y-o-y in November, by far the biggest increase on record.

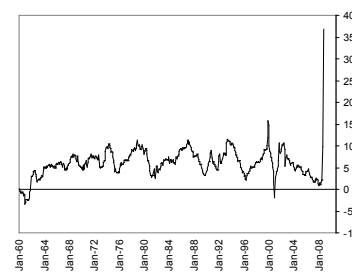
Also, check out excess reserve balances with the Fed, essentially the cash that has been placed into bank vaults by Bernanke and co., which is available for lending into the fractional reserve system. This went from US\$1.9bn in August to US\$267.9bn in October 2008. That is an increase of 13,376% over that span, and of 18,262% y-o-y. And this measure surely went higher in November, and will go higher further.

The most crucial economic identity, at least in an abstract sense, is $PQ=MV$. GDP (the general price level times real level of GDP) is equal to the quantity of money in circulation times the velocity of that money, or in other words, demand. The 'V' here is crucial: 'velocity' refers to the number of times a dollar bill is put through the economy to produce that level of GDP (so GDP divided by the money supply equals velocity, as the equation indicates). Unfortunately for the Fed, the velocity of money has collapsed. By how much, it is difficult to tell, but the massive quantities of money being pumped into the economy, and the lack of any visible inflationary effects, indicate that velocity is headed down, and that the rise in the quantity of money is not yet enough to offset it. Velocity soared through the late 1990s and 2000s, primarily due to financial innovations such as asset-backed securitisation. Leverage took off, and thus a dollar created by the Fed could turn into US\$60 in the hands of a hedge fund or aggressive investment bank, which in turn had multiplier effects in the real economy. Now, clearly, deleveraging is on.

One of many gauges: money zero maturity (MZM) is M2 minus time deposits, which is the quantity of money available on demand. This helps gauge how much money is available for immediate liquidity purposes (not what needs to be sold to raise cash, for example). And despite significant Fed easing since August 2007, MZM has come down significantly. While money supply measures have been distorted by the credit crunch, this is an illustration of how liquidity remains tight despite the Fed's best efforts, as quantitative easing may increase the monetary base but not necessarily more broad measures such as MZM or M3.

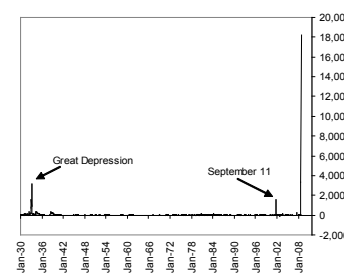
Given the deteriorating situation, the Fed is going to get more and more aggressive in its attempts to ward off a deflationary depression, and get the fractional banking system on its feet again. This will involve the purchase of increasing quantities of 'non-traditional' assets. While we have already seen this action take place on the Fed's balance sheet, with

Desperately Pumping Liquidity
US – Monetary Base (% chg y-o-y)



Source: Federal Reserve

Like No Other Easing
US – Excess Reserves Of Depository Institutions (% chg y-o-y)



Source: Federal Reserve

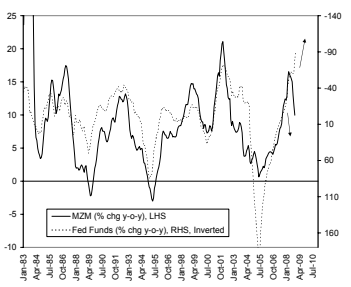
commercial paper purposes, the Fed will now turn its attention to doing so in ways that will more directly affect credit market yields. For example, Bernanke, in his now-legendary 2002 ‘helicopter’ speech, telegraphed his latest announcement that the Fed would buy long-end US Treasuries as a way of anchoring long-term interest rate expectations. All that is missing is an explicit yield target (say, 2.0% on the 10-year Treasury), which would give some guidance to the market. It is no coincidence that the 10-year Treasury yield plummeted to its lowest-ever level in December 2008, following Bernanke’s statement. No asset class is likely to be off the table. The damage that this could do to the Fed’s balance sheet is a definite concern, but it does not appear to be Bernanke’s concern at the moment, as the US Treasury looks ready and willing to recapitalize the central bank if necessary.

Can the Fed avoid deflation and achieve inflation? Reluctantly, we say yes. ‘Reluctantly’, because we are firm believers in the deflation story, as we think the US banking system will remain broken for at least the next several months. A functional banking system is virtually a prerequisite for getting the lending markets, and the money multipliers, going again. ‘Yes’, because at some point, the Fed can induce inflation, due to its unique ability to print infinite quantities of US dollars. Even if the main transmission mechanisms (eg. commercial banks) are out for the count, the Fed can (conceivably) purchase everything from home mortgages to commodities to credit card debt to automobiles. Recall that our definition of ‘deflation’ is that a dollar is worth more tomorrow than today. By purchasing everything under the sun, the Fed will eventually ensure that the value of dollars declines, and inflation would ensue. That, however, would take a while. But, if while the Fed is buying up all these assets, the banks were to get back on their feet and begin using the trillions of US dollars in reserves that are sitting in their vaults, then the Fed may lose control of inflation. The US dollar would almost surely begin to depreciate against other currencies (which are, in their own ways, assets of themselves). Add to this hundreds of billions of US dollars in fiscal stimulus, and there is a recipe for high levels of inflation.

So by avoiding one type of crisis, the Fed may enter directly into another. With its mandate to maintain price stability, the policymakers then have the dilemma of having to deal with higher levels of inflation. It was only seven years ago, after all, that the Fed tried to stave off a potential post dot-com deflationary bust by slashing the funds rate and pumping liquidity into the system. The circumstances at present are much less likely to produce the same kind of bubble that Greenspan blew, but it is worth keeping recent history in mind. None of this will happen, in our view, unless either the Fed gets unusually aggressive in buying non-traditional assets (e.g. automobiles), or banks start lending again, or both. And the latter looks unfeasible for several months at least, since several major financial institutions remain on the brink. Without the Fed’s money market crutches, the system would fall apart, and there appears to be little effort to wean the market off the bottle.

We are, however, open to the possibility of a turn toward inflation. Recall that it was only in July 2008 when inflation was the buzzword, and the likes of the European Central Bank were hiking interest rates in an attempt to stave off a ‘wage-price spiral’ despite several eurozone countries being in technical recession by that point. At the time, deflation was far from most peoples’ minds, but four months later, there we were. Therefore, perceptions can change extremely quickly. Just as we were prepared to move to a deflationary/dis-inflationary view at that time, given the right criteria (which we saw, and we accurately pivoted), we would be prepared to do so again now. We would have to see at least a few

Unusual Divergence: Fed & Liquidity
 US – Money Zero Maturity & Fed Funds Rate (%
 chg y-o-y)



Source: Federal Reserve

of the following signs, though: 1) gold prices moving decisively higher, both in dollar and foreign currency terms; 2) inflation breakevens and expectations showing signs of life; 3) short-end bond yields beginning to move higher, perhaps ending the yield curve steepening trade; 4) the yen and dollar begin to weaken, as risk appetite and the re-leveraging trade return; 5) a bottom in the US housing market (not likely until late 2009 at the earliest, and probably not until 2010).

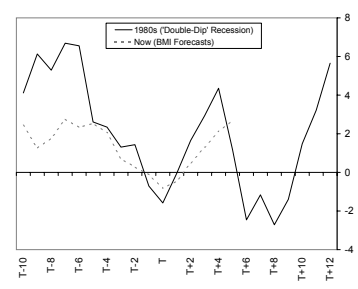
A Double-Dip Recession?

If an inflationary scenario emerges, the Federal Reserve would have little option but to tighten policy. The difficulty is that nobody seems to have given any thought to how quantitative easing will end. Given the degree of monetary stimulus injected into the economy over the past 12 months, and the unconventional means through which it has taken place, it could be extremely difficult to unwind. Suddenly unloading unconventional assets from its balance sheet, including illiquid assets, could cause major market ructions, for example. The Fed would also have to decide whether it would be better to attack inflation aggressively and quickly, or to change policy gradually, hoping for a soft landing. We think that either way, serious dislocations in the economy would ensue.

We can envisage a deep contraction in the US, with a trough in mid-late 2009, but with a subsequent return to trend growth stunted by the Fed's obligation to begin unwinding quantitative and conventional monetary easing. This would coincide nicely with our expectation of a major bear market rally in equities at some point (it could be happening now), followed by a crash. The scenario here would be most similar to the 1980-1982 double-dip recession, punctuated by then-Fed chairman Paul Volcker's decision to shoot the funds rate up to 20% in an effort to kill inflation once and for all. Anyway you look at it, the Fed's choices are going to become more difficult, not easier.

In this highly uncertain environment, there is very little reason to own equities, in our view. Yes, stocks and other assets can be an inflation hedge, but for that purpose TIPS bonds would suffice, particularly at such unbelievable yields. And in fact, while the double-dip scenario seems bearish, the likely alternate scenario would be outright deflation, which has not served Japanese investors well (the Nikkei's 19-year bear market continues, with losses of 80% from the peak). Furthermore, the questions surrounding the US economy are increasing, not decreasing, and government policy, with a new administration coming into power in Washington, looks muddled. Just about every major one-day decline in US equity markets since the beginning of the credit crunch has coincided with some development (Congress rejecting the TARP), or non-development (the government not bailing out Lehman Brothers). We have not even touched on the ex-US environment, including our increasingly bearish outlook on China, and the declining prospects for a 'rebalancing act' in the global economy whereby erstwhile savers become spenders.

Impression Of A Double-Dip Recession
US - Quarterly y-o-y GDP Growth Comparison
Between (T=Q209 & Q480)



Source: BEA, BMI

BMI VIEW

The deteriorating global macroeconomic outlook, high levels of leverage, and a broken business model will combine to spell trouble for the financial services sector in 2009. The biggest worries come out of Europe, where eurozone, UK and Swiss banks alike have the deadly combination of high financial leverage and heavy exposure to emerging markets.

Europe

Big Trouble For European Banks In 2009

After the collapse of austere institutions such as Bear Stearns and Lehman Brothers in 2008, the financial services industry is hoping for a breather as we enter 2009. But as transformative a year as 2008 was for major banks, 2009 may hold some surprises yet. The long-term business models of several banks are no longer viable, and investment banking, as a business, is going to be in rough shape until 2011, in our view. And the excessive levels of leverage which coursed through the industry are unlikely to return any time soon. Importantly, risk appetite is unlikely to resume until bad loans have already flushed through the pipeline.

TABLE: BANKS' LEVERAGE RATIOS

Deutsche Bank	56.3
ING	53.7
Barclays	41.6
Commerzbank	39.9
UBS	36.4
Credit Agricole	35.4
Lloyds TSB	33.2
BNP	32.4
Morgan Stanley	27.6
Soc Gen	26.7
Credit Suisse	24.2
Bank of Nova Scotia	22.9
Merrill Lynch	22.8
Goldman Sachs	22.0
State Street	21.9
Mitsubishi UFJ	21.5
BBVA	19.3
HSBC	19.0
Standard Chartered	19.0
RBS	18.8
Uni Credit	17.5
Industrial and Commercial Bank of China	17.0
Banco Santander	16.9
Banco do Brasil	16.5
Citigroup	16.3
JP Morgan	15.4
Wachovia	14.4
Bank of China	14.1
Wells Fargo	13.3
Bank of America	11.4
ICICI	10.6
American Express	10.2

Source: BMI, Bloomberg, Bank Financial Statements

As the credit crunch begins to reverberate into the real economy already impaired assets are set to be written down further. This potentially spells bad news for heavily leveraged institutions – and, in particular, for those in Europe. The following table shows the leverage ratios (book assets to equity) of the world’s largest banks, as of their most recent quarterly financial statements. Although these may have changed since the most recent reported quarter, as equity stakes have been rebuilt and leverage reduced, the ratios are unlikely to be very different today. This is important because high levels of leverage mean that relatively small asset writedowns can quickly wipe out shareholder equity, requiring investor cash calls and the dilution of existing shareholdings (or else the bank goes bust).

The situation is even more alarming when the asset side of banks’ balance sheets are put alongside national GDP.

TABLE: ASSETS AS % OF HOME COUNTRY GDP

UBS	406.9
Credit Suisse	284.0
ING	239.2
RBS	138.1
BNP	100.1
Barclays	96.8
HSBC	90.7
Banco Santander	88.5
Deutsche Bank	84.4
Credit Agricole	80.7
Uni Credit	68.1
Soc Gen	59.3
BBVA	49.1
Mitsubishi UFJ	38.2
Industrial and Commercial Bank of China	31.9
Commerzbank	28.2
Bank of Nova Scotia	27.6
Lloyds TSB	26.1
Bank of China	22.0
Banco do Brasil	16.8
JP Morgan	15.7
Citigroup	14.3
Standard Chartered	14.1
Bank of America	12.8
ICICI	11.3
Goldman Sachs	7.6
Morgan Stanley	6.9
Merrill Lynch	6.1
Wachovia	5.3
Wells Fargo	4.3
State Street	2.0
American Express	0.9

Source: BMI, Bloomberg, Bank Financial Statements

European Banks: Too Big To Fail?

US banks may be gigantic, but as a proportion of US GDP (at least on an individual basis), they are not so unmanageable. European banks, by contrast, may be truly too big to fail. Take a look at financial ratios for some key European banking giants: Deutsche Bank has a leverage ratio of 56 times, compared with just 21 or 22 for the likes of Goldman Sachs and Merrill Lynch, both of which have had considerable difficulties in 2008. Deutsche does not stand alone in this respect: ING, Barclays, Commerzbank, UBS, Credit Agricole, Lloyds TSB (pre-HBOS merger) and BNP all have leverage ratios of over 30.0. In fact, of the world's largest banks, 10 of the top 11 in terms of leverage are based in Europe. This is important because high levels of leverage mean that relatively small asset writedowns can quickly wipe out shareholder equity, requiring investor cash calls and the dilution of existing shareholdings (or else the bank goes bust).

TABLE: ASSETS AS % OF HOME COUNTRY GDP WHEN EUROZONE IS CONSIDERED 'HOME COUNTRY'

UBS	406.9
Credit Suisse	284.0
RBS	138.1
Barclays	96.8
HSBC	90.7
Mitsubishi UFJ	38.2
Industrial and Commercial Bank of China	31.9
Bank of Nova Scotia	27.6
Lloyds TSB	26.1
Deutsche Bank	22.9
BNP	22.6
Bank of China	22.0
Credit Agricole	18.2
Banco do Brasil	16.8
JP Morgan	15.7
ING	15.3
Citigroup	14.3
Standard Chartered	14.1
Soc Gen	13.4
Bank of America	12.8
Uni Credit	11.7
ICICI	11.3
Banco Santander	10.6
Commerzbank	7.6
Goldman Sachs	7.6
Morgan Stanley	6.9
Merrill Lynch	6.1
BBVA	5.9
Wachovia	5.3
Wells Fargo	4.3
State Street	2.0
American Express	0.9

Source: BMI, Bloomberg, Bank Financial Statements

Switzerland stands out in terms of major bank assets to GDP. The combined assets of UBS and Credit Suisse make up 690% of Swiss GDP, dwarfing the equivalent ratio in other countries. If Standard Chartered and HSBC, which are both heavily focused on Asian markets, are included in the UK's ratio, that is roughly 340% of UK GDP (RBS and Barclays combined are 235% of UK GDP). By contrast, the US, despite its financial sector difficulties, barely registers in our table. To be fair, if eurozone banks are put alongside euro area GDP rather than national GDP, some of the ratios look better (like ING's 239% of Dutch GDP becoming just 15% of eurozone GDP), but that only makes Swiss and British banks stand out more.

We are not suggesting that any of the banks on the list are necessarily going to collapse – after all, many have already begun to clear up their equity positions since this snapshot of their balance sheets was taken a quarter ago. But the potential failure of a major European bank thus throws up the question of what or who would be in a position to perform a rescue. The Swiss banks, for example, are outside the eurozone, and have relied at least initially on the Swiss government and Swiss National Bank (SNB) for a bailout, rather than be saved by the ECB. The UK banks fall under the jurisdiction of the Bank of England (BoE), and their size relative to the UK economy helps explain the urgency with which the government has intervened on their behalf. Would Germany be solely responsible for Deutsche Bank, or France for BNP? Or would the ECB play a dominant role? These questions have no clear answers, which is particularly worrying considering that the biggest problems for European banks may lie ahead. One potential model stems from the bailout and sell-off of Fortis, which involved a combined (if contentious) effort between the governments of Luxembourg, Belgium and the Netherlands, as well as French bank BNP Paribas.

EM Exposure Also Throws Up Major Concerns For Europe

Adding to our concern about the perilous nature of the European banking system is the exposure that European banks have to emerging markets. This becomes clear when looking at Bank for International Settlements (BiS) data released in December 2008, which gives a snapshot of banks' foreign exposure as of June 2008.

The first table shows the exposure that major countries' banks have to different regions, including emerging markets. Worldwide, foreign exposure came to US\$36.2trn as of June 2008, with US\$4.9trn of that accounted for by exposure to emerging markets. European banks' foreign lending exposure (nearly 70% of total global foreign lending by banks) proportion is inflated by intra-European exposure. But the third line down in the table,

TABLE: EXPOSURE AS % OF TOTAL EXPOSURE TO REGION

	Australia	Austria	Germany	Italy	Japan	Switzerland	UK	US	Spain	Sweden	Europe (includes SE, CH & UK)	Europe (ex-SE, CH & UK)
All countries	1.3	1.7	12.6	3.7	6.6	7.0	11.4	4.8	3.6	2.2	69.7	51.3
To Developed States	1.5	0.9	13.2	3.6	6.1	7.2	10.1	3.6	3.2	2.3	69.2	49.7
To EM	0.5	6.3	9.2	5.2	4.4	4.5	13.9	10.4	7.4	2.5	74.2	53.3
To Emerging Asia	1.4	0.6	8.2	0.7	9.4	5.6	21.7	14.9	0.4	0.5	55.3	27.6
To Emerging Europe	0.0	16.6	13.2	13.3	1.6	3.7	2.6	3.6	0.6	6.4	91.0	78.4
To LatAm/Caribbean	0.1	0.1	3.6	0.6	2.2	4.6	10.6	17.4	32.2	0.3	70.1	54.7

Source: Bank for International Settlements

which shows exposure to emerging markets, indicates that European banks, including the UK, Switzerland, and Sweden, account for 74% of total foreign loan exposure to EM, compared with the US at just over 10% and Japan at 4.4%. The UK has the largest exposure of any single country to EM, at nearly 14%, while Germany (9.2% of EM lending) and Spain (7.4%) are just behind the US in that category.

European banks are by far the most heavily exposed to emerging Asia, emerging Europe and Latin America & The Caribbean. European banks have 55% of the total exposure to emerging Asian countries, with Japan and the US at just 9.4% and 14.9% respectively. Again, the UK is alarming in this respect, with a whopping 21.7% of all foreign bank exposure to emerging Asia (presumably because of HSBC and Standard Chartered). Likewise, the lending statistics to Latin America and the Caribbean are not necessarily intuitive in geographical terms: while US banks account for 17.4% of the foreign lending to the region (and then, mostly to Mexico), European banks are responsible for 70.1%, with Spain on the hook for 32.2% and the UK on 10.6%. Finally, as one would expect, European banks are the dominant lenders to emerging Europe, accounting for 91% of the total exposure to the region. And troublingly, Austria is the most heavily exposed single country, with its banks making up 16.6% of all lending to the region.

But where this becomes especially troubling for European states is the level of bank lending to emerging markets as a percentage of national GDP. Loans to EM by Austrian banks make up 78.9% of Austrian GDP, and emerging Europe is the bulk of that, at 74.4% of GDP.

TABLE: BANKS' FOREIGN EXPOSURE (US\$ MN)

	Australia	Austria	Germany	Italy	Japan	Switz.	UK	US	Spain	Sweden	Europe (includes SE, CH & UK)	Europe (ex-SE, CH & UK)	Total Global Foreign Exposure
To:													
All countries	466,163	598,291	4,571,116	1,322,884	2,407,281	2,537,514	4,128,800	1,722,788	1,318,887	806,208	25,246,656	18,580,342	36,212,222
To Developed States	426,933	273,848	3,802,303	1,039,450	1,771,704	2,075,347	2,913,956	1,035,415	932,228	651,431	19,979,600	14,338,866	28,859,977
To EM	23,053	307,493	450,148	255,261	216,725	220,335	680,736	508,241	359,342	123,724	3,624,215	2,599,420	4,881,396
To Emerging Asia	20,024	8,466	121,242	9,964	139,051	82,350	322,080	221,295	5,853	6,695	819,487	408,362	1,481,853
To Emerging Europe	118	289,715	229,647	232,129	28,422	64,072	45,479	62,925	10,752	111,156	1,587,954	1,367,247	1,744,904
To LatAm/Caribbean	1,309	1,508	38,131	6,082	23,405	47,933	111,402	182,150	337,586	2,685	734,264	572,244	1,047,000

Source: Bank for International Settlements

TABLE: EXPOSURE AS % OF NATIONAL GDP

	Australia	Austria	Germany	Italy	Japan	Switzerland	UK	US	Spain	Sweden
All countries	52.0	153.6	133.2	60.8	50.3	580.1	147.0	12.0	87.1	152.5
To Developed States	47.6	70.3	110.8	47.8	37.0	474.5	103.8	7.2	61.6	123.3
To EM	2.6	78.9	13.1	11.7	4.5	50.4	24.2	3.5	23.7	23.4
To Emerging Asia	2.2	2.2	3.5	0.5	2.9	18.8	11.5	1.5	0.4	1.3
To Emerging Europe	0.0	74.4	6.7	10.7	0.6	14.6	1.6	0.4	0.7	21.0
To LatAm/Caribbean	0.1	0.4	1.1	0.3	0.5	11.0	4.0	1.3	22.3	0.5

Source: Bank for International Settlements

While this is by far the highest proportion of the countries we have looked at, Switzerland (50.4% of GDP to EM), the UK (24.2%) Spain (23.7%) and Sweden (23.4%) are not too far behind. Italy and Germany are also in double digits, percentage-wise. Compare these figures with those of Japan and the US, at 4.5% and 3.5% respectively, and the European banks are clearly more heavily exposed.

If emerging markets have a tough go of it in 2009, as we expect them to (with global trade falling off a cliff and real GDP growth slowing to 2.2%, down from 7.3% as recently as 2007), impaired loan assets will almost certainly result. We believe that while 2008 was a disaster for US banks, the storm may only be getting under way for Europe's financial giants.

chapter 5 Business Environment

SWOT Analysis

Strengths

- In complying with orthodox economic measures and encouraging financial intermediation, Lula has won the support of the IMF and much of the business community. This has contributed to a more stable and welcoming business climate.
- The Brazilian economy is one of the largest in the world, and benefits from a rich abundance of agricultural and mineral resources.

Weaknesses

- Despite economic liberalisation, significant trade barriers and a complex customs system increase business risk.
- Despite improvement in external debt ratios, a high debt burden will weigh on investor sentiment during the forecast period.

Opportunities

- The government has shown a commitment to improving the country's infrastructure, highlighted by the participation with the IMF on the public investment programme.
- Recent onshore and offshore oil discoveries have catapulted Brazil to become a global oil giant almost overnight. This should help the country to attract a wide range of investors and businesses over the long term.

Threats

- Ongoing tax reform and new labour legislation is needed to simplify the very complex and onerous tax system, and highly inflexible labour market.

BMI Business Environment Risk Ratings

State energy giant **Petrobras** will be charged a five-year high premium for tapping international capital markets, as the company seeks to raise money to finance a record investment project and rollover some US\$3bn in maturing debt. A 10-year US\$1bn bond issued by the company on January 6 is yielding 91 basis points (bps) over Brazilian sovereign debt of a similar maturity, as this time around markets are more wary of Petrobras's credit worthiness in light of the sharp drop in oil prices. Only a year earlier, the company's bonds yielded 9bps less than government debt. Since Brazil obtained investment grade status by two major ratings agencies early in 2008, and oil prices dropped over 70% since their record high in July, Petrobras bonds will likely continue to yield more than government debt.

	Business Environment	Rank	Trend
Chile	71.2	1	=
Uruguay	62.0	2	=
Barbados	55.7	3	=
Mexico	54.8	4	=
El Salvador	54.6	5	=
Trinidad & Tobago	53.6	6	=
Brazil	48.9	7	=
Peru	48.7	8	=
Guatemala	48.4	9	=
Panama	47.9	10	+
Argentina	45.7	11	=
Jamaica	45.0	12	=
Colombia	44.2	13	=
Ecuador	44.0	14	=
Paraguay	39.0	15	=
Guyana	38.1	16	=
Bolivia	37.6	17	=
Venezuela	34.0	18	=
Dominican Republic	26.3	19	-
Nicaragua	25.8	20	-
Honduras	23.3	21	-
Regional average 61.5	Global average 63.2	Emerging Markets average 60.5	

Business Environment Outlook

Introduction

With an abundance of agricultural and mineral resources, and a government that is actively encouraging of foreign investment, Brazil is one of Latin America's increasingly attractive places to operate business activities, in our view. Furthermore, President Luiz Inácio Lula da Silva's ambitious infrastructure investment plans should unlock opportunities across all major sectors, most notably the transport and energy industries. Over-regulation, corruption-fighting and gang crime represent the key threats to the business environment.

Recent Developments

- German auto maker **Volkswagen (VW)** has declared that it will not renew contracts expiring in January and February 2009, with 150 out of 800 temporary workers at its facility in Taubate, southeastern Brazil. VW's decision comes on the back of job cuts announced across several sectors of the economy since January. Brazil's textile

TABLE: BMI BUSINESS AND OPERATIONAL RISK RATINGS

	Infrastructure	Institutions	Market Orientation	Overall
Argentina	51.4	39.4	46.3	45.7
Barbados	52.7	65.1	49.4	55.7
Bolivia	37.4	40.2	35.1	37.6
Brazil	59.7	41.7	45.3	48.9
Chile	72.7	68.4	72.4	71.2
Colombia	43.5	48.9	40.0	44.2
Costa Rica	57.2	54.8	45.4	52.5
Dominican Republic	40.1	38.9	49.5	42.8
Ecuador	32.2	32.5	67.3	44.0
El Salvador	35.2	49.2	79.3	54.6
Guatemala	44.1	36.4	64.9	48.4
Guyana	36.6	33.6	44.1	38.1
Haiti	24.9	23.1	62.0	36.6
Honduras	36.6	33.3	45.3	38.4
Jamaica	37.2	54.5	43.2	45.0
Mexico	57.2	49.7	57.4	54.8
Nicaragua	36.2	41.2	46.0	41.1
Panama	49.7	45.9	48.1	47.9
Paraguay	35.3	34.1	47.6	39.0
Peru	39.1	44.4	62.6	48.7
Puerto Rico	42.0	54.0	51.2	49.0
Trinidad & Tobago	46.1	45.1	69.8	53.7
Uruguay	53.5	61.5	71.1	62.0
Venezuela	45.8	23.5	32.6	34.0
Global average	47.4	47.5	48.6	47.7
Region average	47.9	47.2	53.4	49.5

Source: BMI. Scores out of 100, with 100 representing the best score available for each

industry is also planning to axe 15,000 out of a total 58,000 registered jobs in the industry over the coming months.

- In addition to a series of recent offshore oil discoveries in the subsalt oil fields in the Santos basin, state energy firm **Petrobras** announced the discovery of oil in the onshore POT-T-520 bloc. It remains to be determined, however, whether the latest find is commercially viable.
- The **Banco Central do Brasil** has changed its rules on remittance flows into Brazil, allowing companies and individuals to send money to Brazil, already denominated in *real*. The measure is aimed at reducing the costs of currency conversion for the recipients.
- As the construction sector is starting to feel the pinch of the economic slowdown, the government has proposed to cut taxes on selected homebuilders, to reduce housing costs and provide a boost to the industry. We believe that this is a sign of the government exploring measures to avert a sharp decline in key Brazilian industries at risk from falling domestic demand.

Institutions

Legal Framework

The Brazilian legal system is becoming increasingly sophisticated in order to complement an expanding and diverse economy. The upshot of this has been a more dynamic and more competitive legal market. While the system is now well structured by Latin American standards, inefficiencies do slow the judicial process and this has contributed to a major backlog in cases.

The legal system is mainly based on Portuguese law and is underpinned by the terms of the Federal Constitution, effective since 1988. Judicial power is divided between the state and federal branches. Each state is divided into judicial districts (*comarcas*). These *comarcas* have trial courts, acting as the court of first instance. Some districts also have extra courts to rule on family and bankruptcy issues. Crimes against the person are heard by a jury, otherwise most cases are heard by a judge only. Judgments from these courts can be appealed against in the courts of second instance.

Property Rights

Property rights protection is reasonably sound. Brazil is ranked in the third quartile of the International Property Rights Index, coming in 42nd place out of the 70 countries surveyed. The country does enjoy an above-par score for gender equality (in terms of access to land), scoring an impressive 9.3 out of 10.0. Property rights are still a relatively abstract concept in the slums (*favelas*) of major cities and rural areas at the periphery.

Intellectual Property Rights

Brazil is a member of the World Intellectual Property Organisation (WIPO) and has signed several relevant WTO accords. Enforcement remains patchy, a state of affairs that has drawn criticism from the country's main trading partners. However, the overall intellectual property rights situation has improved considerably. Several court cases concerning trademark infringements have been successfully brought by international companies.

A 1996 industrial property law generally brought patent and trademark legislation up to international standards. A law of 1998 also brought copyright protection legislation up to international standards, though piracy of copyrighted materials, such as music and videos, and trademarks remains a problem. Brazil has yet to ratify WIPO Treaties on Copyright and Performances and Phonograms. As a result of protection problems, Brazil remains on the Special 301 priority watch list in the 2006 WIPO review. Despite these shortfalls, Brazilian patents, copyrights and trademark laws are generally considered to meet international standards.

TABLE: BMI LEGAL FRAMEWORK RATINGS

	Investor Protection	Rule of Law	Contract Enforceability	Corruption
Argentina	30.9	38.9	51.2	43.3
Barbados	48.9	86.8	47.1	86.0
Bolivia	67.8	22.8	43.7	34.7
Brazil	51.7	45.5	37.8	54.7
Chile	37.7	88.0	50.3	88.0
Colombia	42.5	32.3	27.3	65.3
Costa Rica	46.9	71.3	39.5	68.0
Dominican Republic	37.0	43.1	42.3	38.7
Ecuador	62.3	18.6	44.1	15.3
El Salvador	30.9	41.3	38.7	66.0
Guatemala	49.2	61.7	16.1	28.7
Guyana	27.9	30.5	37.0	23.3
Haiti	35.4	3.0	43.5	0.7
Honduras	53.4	23.4	36.6	23.3
Jamaica	58.4	36.5	61.2	63.3
Mexico	29.4	44.3	45.4	54.7
Nicaragua	52.0	28.1	58.8	28.7
Panama	57.5	56.9	15.4	48.0
Paraguay	42.3	21.0	26.8	28.7
Peru	39.3	28.7	46.7	54.7
Puerto Rico	58.3	71.9	35.1	46.3
Trinidad & Tobago	74.9	53.3	20.3	51.3
Uruguay	64.4	67.1	38.0	84.0
Venezuela	35.9	6.6	35.3	15.3
Global average	36.8	48.8	49.9	40.2
Region average	48.8	46.5	42.8	49.7

Source: BMI. Scores out of 100, with 100 representing the best score available for each indicator.

Corruption

With a score of 3.5 (and a ranking of 70th of out of 180), Brazil's 2008 performance in Transparency International's Corruption Perceptions Index showed a slight improvement from the previous year. However, this should not mask the significant deterioration in corruption perceptions since the start of the decade, at which point the country's fared markedly better with a score of 4.0. In regional terms, corruption in Brazil – especially in government procurement and at some levels of the judiciary – is considered far more of an obstacle than in many of its peers, most notably Chile, Mexico and Colombia. The authorities are, at least, ostensibly trying to eradicate endemic corruption: the country has signed the signatory to the Organisation for Economic Cooperation and Development (OECD) Anti-Bribery Convention. While federal government authorities generally investigate allegations of corruption, there are inconsistencies in the level of enforcement among individual states.

At the federal level, a spate of high-profile corruption cases in recent years have rocked the Lula administration. In December, the government suffered a political blow following the resignation of Walfrido dos Mares Guia, Brazil's minister for institutional affairs, in the wake of a prosecution into illicit campaign funding in 1998, in the latest corruption case implicating the allied Partido Trabalhista Brasileiro in matters relating to the allocation of public funds. Earlier in the year, President Renan Calheiros of the Partido do Movimento Democrático Brasileiro (PMDB), went on an extended leave of absence from the senate presidency. While Calheiros was absolved of accusations of corrupt and fraudulent activities in September, substantial political damage was incurred, in particular to the senate, and he still faces three more accusations of fraud, including allegations of spying and intimidating two senators from the opposition parties.

Infrastructure

Physical Infrastructure

Brazil possesses well-developed agricultural, mining, manufacturing and service sectors. Development in infrastructure is being driven by public-private partnerships (PPP), whereas the Brazilian construction industry is being spurred by strong government investment. Private-sector interest in the construction segment has been increasing, as is evident from the growing number of public offerings on the stock exchange.

The leading construction companies are well entrenched in the country and are significant players outside Brazil. The federal government's growth acceleration plan Programa de Aceleração do Crescimento (PAC) was unveiled in January 2007. It is expected to facilitate faster turnaround of construction projects that are in the pipeline. The programme also involves funding projects in the oil and gas, transportation and sanitation sectors and aims to spur BRL500bn (US\$235bn) of infrastructure development during 2007-2010. For instance, the government announced in January the expansion and modernisation of the country's main international airport, Guarulhos, at a cost of US\$832mn. The government has also announced the allocation of funds for various states for urbanisation, slum rehabilitation and sanitation, among other developments.

However, the nation's transport infrastructure suffers from inadequate funding and lack of focus, leading to slow progress in the development of roadways and port terminals. Private investment generated through PPP has been beneficial only at the regional level. The laws regarding foreign companies are not liberal and stipulate that they either have a Brazilian partner or be established in Brazil in order to provide construction services. The government is also considering revising its existing toll tariffs system, but we expect protracted negotiations on this front. The current set of concessions have been in place since 1996, when the country's macroeconomic fundamentals were riskier and high tariffs were required to recover roads in deplorable condition.

The railway concessionaires operating in Brazil announced plans to invest BRL3.5bn (US\$1.83bn) in 2007 to drive the growth of transport volume to 435mn tonnes. The original investment projection in 2007 by the National Association of Railway Carriers (ANTF), which represents five railway groups in Brazil, was BRL2.5bn (US\$1.3bn). However, the projection was increased, owing to the growth of the economy.

Labour Force

Brazil has a labour force of approximately 90mn people out of a total population of some 180mn, though inaccurate census information makes these figures extremely approximate. Around 65% work in the service sector, 20% in agriculture and 15% in industry. Unemployment was running at about 7.6% at end-2008, which although still high, reflects the lowest rate end-year rate in five years. Wages are generally low, but up to a third of employers' labour costs can be accounted for by various taxes and other charges.

The high numbers employed in the services and industrial sectors reflect the changing shape of Brazilian society, as the country's urbanisation continues apace. The proportion of working women is also growing, approaching half of the labour force. According to some estimates, more than a third of all workers still operate in the informal market and so do not pay taxes or receive employment benefits. Average real wages, which had been falling over a number of years, started to nudge upwards again from in 2005. However, huge disparities exist between the amount of earnings and types of employment, as well as regional variations.

Brazil's labour code, based on the Consolidated Labour Laws, is comprehensive with fairly extensive labour benefits. Workers receive an annual bonus, based on overall earnings, at least 30 days of vacation annually and are entitled to recompense when dismissed without cause. The 1988 constitution establishes a 44-hour working week and overtime pay of 50% of base pay. Labour courts exist to hear routine employment cases, involving wage disputes, unfair dismissal, working conditions etc. Despite federal efforts to speed up the system, the backlog of such cases stretches back five years in some instances. These courts are effectively empowered to arbitrate on employer-union negotiations by imposing an agreement if talks break down and one side seeks a legal resolution. Greater flexibility in labour relations recently has resulted in less recourse to the courts for dispute resolution in this manner. Unions are often strong with membership running at more than 10% of the workforce directly and representing many more through their role in collective bargaining. Unions are obliged to represent all workers in their sector or region, whether they are members or not. There are estimated to be more than 15,000 unions operating across

Brazil. Employers' federations are also powerful players in workplace negotiations. More sophisticated labour-management negotiations have led many firms to overhaul their practices and hire more skilled negotiators, in many cases resulting in improved relations.

Market Orientation

Foreign Investment Policy

In terms of market openness, Brazil is a frontrunner in Latin America and a major recipient of foreign capital. Total FDI inflows of US\$71.8bn in 2008 were almost US\$22bn more than Brazil attracted in 2007 and also, in nominal terms at least, higher than flows attracted at the beginning of this decade when the government's privatisation campaign was in full swing. Despite the current uncertainty regarding global credit conditions, FDI should remain buoyant in 2009.

The foreign investment framework has been an evolving process over the past few decades. For instance, foreigners have been able to invest in the stock market since 1991. A series of rules and constitutional amendments introduced in 1995-2000 gave foreign investors the same opportunities as domestic investors in most sectors. That said, the catalyst for recent FDI activity has undoubtedly been a loosening of regulation under the Lula administration. Foreign suitors, satisfied with the improved level of economic and political stability, are take advantage of the country's extensive privatisation programme. A landmark reform took place in December 2004, when Brazil's senate approved the Public-Private Investment Bill, allowing private firms to invest jointly with the government in projects backed by a state guarantee. Companies taking up the contracts must invest at least 20 million reais for 5-35 years. One aim is to speed up infrastructure development, including roads, railways and water systems. The bill also introduces improved levels of transparency. Foreign water companies have expressed concerns that their sector still needs stronger regulation and a more developed institutional framework before it becomes sufficiently attractive to bring in large FDI flows.

Brazil has eight free trade zones (FTZ) in total, of which the most important for foreign investors is the Manaus FTZ, which covers nearly 4,000 square miles in the middle of the Amazon basin. Here goods originating outside the country enter without attracting customs

TABLE: LATIN AMERICA ANNUAL FDI INFLOWS

	2006		2007	
	US\$bn	Per capita	US\$bn	Per capita
Argentina	5.04	128.7	5.72	144.7
Brazil	18.82	100.8	34.59	182.6
Chile	7.36	446.0	14.46	866.3
Colombia	6.46	139.4	9.03	191.6
Mexico	19.29	183.7	24.69	232.9
Peru	3.47	122.2	5.34	185.6
Trinidad & Tobago	0.79	607.1	1.04	794.1
Venezuela	-0.59	-21.6	0.65	23.3

Source: UNCTAD, BMI.

levies or any import taxes. Goods may also be exempt from certain other taxes.

Foreign Trade Regime

Brazil joined the WTO in 1995. It was a founding member of the Mercosur free trade area in 1991 with Argentina, Paraguay and Uruguay (Bolivia and Chile have observer status). Mercosur and the neighbouring Andean Community (Peru, Bolivia, Ecuador, and Colombia) signed a pact in October 2004, under which the two trading blocs agreed to phase out import tariffs over 15 years.

Mercosur is in the process of negotiating a trade agreement with the EU and also with the US and others through the proposed Free Trade Area of the Americas. Separately and through Mercosur, Brazil has been strengthening bilateral ties with other countries, notably India, for which Brazil is its biggest Latin American trading partner. Brazil and India have set a target of bilateral trade of US\$10bn by 2010.

After many months of brinkmanship and round-table discussions, the Brazilian government looks likely to give the green light to Venezuelan membership of Mercosur. Brazil's

TABLE: BMI TRADE RATINGS

	Protectionism	Bureaucracy
Argentina	32.7	67.7
Barbados	6.8	50.6
Bolivia	55.8	26.9
Brazil	44.9	62.0
Chile	66.7	52.6
Colombia	32.7	40.2
Costa Rica	66.7	27.5
Dominican Republic	41.5	54.5
Ecuador	37.4	30.8
El Salvador	48.3	41.4
Guatemala	61.2	47.7
Guyana	23.1	24.7
Haiti	74.1	26.9
Honduras	55.8	35.8
Jamaica	29.9	66.6
Mexico	68.7	62.5
Nicaragua	66.7	50.7
Panama	47.6	56.2
Paraguay	49.7	27.2
Peru	38.8	38.2
Puerto Rico	40.6	51.1
Trinidad & Tobago	54.4	80.7
Uruguay	63.9	44.2
Venezuela	21.1	22.6
Global average	47.1	45.2
Region average	50.3	48.6

Source: BMI. Scores out of 100, with 100 representing the best score available for each indicator.

apprehensions have been more political than economic in nature, with reservations held in some quarters of congress over Venezuelan President Hugo Chávez.

Tax Regime

The tax regime is highly complex, making the overall burden difficult to predict. Rates are among the highest in Latin America. Reform of the regime has been high on the government's agenda.

On January 2 2008, the government announced the introduction of three measures to compensate for the losses incurred with the expiry of the CPMF financial transaction tax (worth an estimated BRL40bn – 1.5% of GDP – per annum). These include the increase of an IOF financial operations tax on individuals at a daily rate of 0.0082% (this will be roughly equivalent to an annual cost of 1.5%). Mortgages are exempt from this tax hike. A similar IOF tax burden will be placed on the credit operations of companies.

The CSLL tax – a social contribution on net profits – could tick higher in 2008. The tax could increase to 15% from 9% for financial institutions, subject to a congressional approval.

Corporate tax: effectively 34%. Companies pay corporate income tax, income surtax and a social contribution. Corporate income tax is 15%. The income surtax is 10% on profits above BRL240,000 per year. The social contribution is charged at 9%. Resident companies pay tax on global income. Non-resident firms pay tax on Brazilian-sourced income only. In August 2007, legislation (Complementary Law 127/2007) was introduced, aimed at simplifying the tax regime for small businesses.

Individual tax: rises progressively to 27.5%. Residents are taxed on global income. Non-residents are taxed on Brazilian-sourced income only.

Indirect tax: Brazil has separate VAT regimes run by the federal and state governments, which are not harmonised, however an 18% rate is used in some of the most developed states. Recent reforms have included invoice taxes to VAT. An attempt to harmonise VAT failed in 2003. Further efforts are now being made to do so.

Capital gains: Gains of companies are taxed as income in most cases. Individuals are taxed on gains at 15%. Capital gains made by non-residents on investments registered with the

TABLE: TOP EXPORT DESTINATIONS

	2000	2001	2002	2003	2004	2005	2006	2007
GERMANY	110	149	137	120	88	85	339	807
NIGERIA	69	51	467	164	494	578	588	762
NETHERLANDS	350	511	941	973	710	798	788	700
FRANCE	543	508	618	1,045	1,549	1,327	1,486	606
UNITED STATES	300	272	375	389	666	1,024	738	581
Total exports	3,850	3,887	4,963	5,493	6,545	7,251	8,134	8,318
Top 5, % of total	35.6	38.4	51.1	49.0	53.6	52.6	48.4	41.5

Source: IMF, Direction of Trade Statistics.

central bank are generally subject to a 15% withholding tax.

Operational Risk

Security Risk

The most serious threat to domestic security in Brazil comes from organised crime, in our view. This risk is particularly widespread in drug trafficking, which is largely controlled internally by the criminal gangs of Rio de Janeiro and São Paulo. The strongest of these groups are the Primeiro Comando da Capital (PCC) in São Paulo and the Comando Vermelho (CV) in Rio de Janeiro, who have started to explore joining forces in order to expand their regional power at a national level. Their influence has grown to such an extent that in many parts of Rio de Janeiro they are seen as a parallel power to the state.

Although the Colombian border attracts the most attention, drug trafficking is a problem along all sections of Brazil's frontier, especially given increasing production in Peru and Bolivia. New drug smuggling routes are opening up across the Peruvian and Bolivian borders into the states of Acre, Rondônia and Mato Grosso. These borders are heavily forested, difficult to patrol and have yet to gain the increased attention from the Brazilian armed forces and federal police. An unprecedented 15 tonnes of cocaine were confiscated in 2005, compared to just over five tonnes 10 years ago. Of the total amount of cocaine that entered Brazil in 2005, it is estimated that 37 to 40 tonnes were exported and the rest consumed in Brazil.

Brazil is the second largest producer and exporter of small arms and ammunition in the Americas after the US, with both civilian and military production. Brazil also has one of the highest rates of death by firearms in the world, with around 90 per cent of these being murders. The main increases in murders have occurred in the urban capitals, such as Rio de Janeiro and São Paulo. The majority of illegal weapons seized by the security forces are locally manufactured handguns and ammunition.

Although Brazil has no active domestic insurgent groups, there are growing concerns about the presence of illegal armed and organised crime groups in the Tri-Border Area (TBA) on the border with Argentina and Paraguay. In particular, there are anxieties that Islamist terrorists are using organised crime to fund activities in South America and abroad.

Food and Drink

Executive Summary

Brazil has one of the largest and most dynamic drinks industries in the world. Indeed, according to **BMI**'s new forecasts, the alcoholic drinks sector should reach a value of US\$15,775mn in 2013, up from an estimated US\$14,342mn in 2008. Meanwhile, the soft drinks sector should reach a value of US\$20,219mn, up from an estimated US\$14,512mn in 2008, representing growth of almost 40%.

However, alcohol sales are being impacted by strict new drink-driving laws in the country. On June 19 2008, Brazil passed a tough new law against drinking and driving that included tougher penalties and a lower intoxication threshold. The new law, which has been combined with a major police crackdown on drink-drivers, is the strictest in Latin America and was deemed necessary because Brazil has some of the most unsafe roads in the world. **BMI** believes the new law could have a pronounced effect on beer sales for the year, and, in recognition of this, all of the country's leading brewers have stepped up their focus on low-alcohol alternatives.

Despite this, **AmBev**, which controls 70% of the Brazilian beer market, has reported organic sales growth of 10.1% in the three months to the end of September 2008. Over the period, volume sales increased by 6.1% on an organic basis while earnings before interest, tax, depreciation and amortisation (EBITDA) increased by 6.4%. One of the reasons why AmBev has been able to continue growing is that it has diversified away from alcoholic drinks into soft drinks and also has a presence on a number of major international markets. As a result, negative but localised events can be shrugged off.

However, all areas of the food and drink market could be impacted by the global financial crisis, which is beginning to affect consumer-spending habits. According to Fresh Plaza, the Getulio Vargas Foundation's Index of Consumer Confidence (ICC) indicates a 10% fall in Brazil in October 2008, to 101.4, which is the lowest it has been since June 2006 when the index was 101.0. This could have a negative impact on food consumption in Brazil as consumers become increasingly wary of spending. Brazil remains in a strong position in **BMI**'s Business environment Rankings for Q109, owing to the sheer size of the market, and booming foreign direct investment (FDI), especially in the coffee sector.

BMI VIEW

Per-capita food & drink consumption in Brazil is among the lowest in the Latin American region. This is primarily a result of large income inequalities, with around a third of Brazilians living on or below the poverty line. However, this low base also means that total food consumption is growing at a tremendous rate.

Market Overview

Prepared Food/Canned Food – Nestlé is the clear leader in the Brazilian packaged-food industry with a market share of 7%, followed by **Parmalat** and **Unilever**. Small- and medium-sized regional manufacturers also have a strong presence, benefiting from an intrinsic understanding of the local market and, often, cheaper prices. They account for around 24% of total packaged-food value sales.

Nestlé produces food and nutritional products in a variety of segments, including milk, coffee, cereals, biscuits, chocolate, frozen goods and ice cream. The firm produces 1,300 different items under 200 marks. There are 26 production plants in the states of São Paulo, Minas Gerais, Rio Grande do Sul, Goiás, Rio de Janeiro and Espírito Santo.

Unilever has 14 production plants in São Paulo, Minas Gerais, Goiás and Pernambuco that produce food, ice-cream, hygiene and beauty products.

Confectionery – High consumption rates and the good prospects for future growth have driven many of the main international players to enter the Brazilian confectionery market. International majors such as US-based **Hershey** and Switzerland's Nestlé now compete with the major South American confectionery producers. Industry figures suggest that Brazil is now the world's fifth-largest consumer market for chocolates and the third-largest market for sweets. Very high consumption rates are partly due to the low cost of products thanks to the close proximity of raw materials. High consumption rates can also be attributed to Brazil's large youth population, accounting for more than 50% of the total, which makes up the main consumer market for chocolate and sugar confectionery.

Domestic production reached around 500,000 tonnes of candies and sweets and 350,000 tonnes of chocolate in 2006. The country's strong position in terms of confectionery production is the result of a late-1990s' influx of foreign manufacturers setting up production facilities to supply both the Brazilian and neighbouring markets. Examples include **FINI** (Spain), **Perfetti** (Italy), **Canel's** (Mexico) and **Arcor** (Argentina). As a result, the market is strongly competitive and profit margins are comparatively low. The industry is predominantly based in the south of the country, with the state of Sao Paulo hosting more than 50% of manufacturing facilities.

The leading player in the overall Brazilian confectionery market is Argentina's Arcor Group. **Arcor do Brasil** operates two production plants — a chocolate facility in Bragança Paulista and a sugar confectionery and chewing gum facility in Rio das Pedras. The company offers more than 50 brands across product categories in Brazil, with popular brands including Sambapito, Big Big, Poosh, Samba, Blow Up and Tortuguita.

Further important players are **Cadbury Adams**, which commands a market share of around 14%, with main brands including Trident, Ping Pong Ploc, Clorets and Plets. It is followed by **Nestlé Brasil** with a market share of around 10%, with leading brands including Especialidades Mentex, Nestlé Classic, Alpino, Chokito, Galak, Nescau, Seducao, Milkybar, Crunch, Charge and Magic. Ranked third is **Kraft Foods Brasil** with a market share slightly below that of Nestlé, with the most popular brands including Bis, Lacta, Sonho

de Valsa, Diamante, Negro, Confeti, Ouro Branco, Trakinas, Lancy, Brek and Pascoal. In the chewing gum subsector, Cadbury dominates.

Dairy – The Brazilian dairy sector is rapidly consolidating, with all of the leading firms keen to secure market share. With the number of remaining opportunities diminishing, all the big firms are now concentrating on soaking up the smaller, regional firms that can help their expansion in less-consolidated regions. With dairy produce one of the fastest-growing food sectors in Brazil, with growth of around 20% in 2007, this process of consolidation was expected to have continued at a rapid rate throughout 2008. Indeed, a recent report from Rabobank suggests that Brazil's dairy sector is expected to grow rapidly in the coming years driven by the yoghurts and cheese markets, which are both relatively immature.

Global food giant Nestlé is the largest dairy producer in the country and in January 2008 invested US\$40mn in a JV with New Zealand dairy co-operative Fonterra to set up and run a new dairy to maintain its leading position. Perdigão is the second-largest milk producer in the country following its acquisition of dairy firms Batávia and Eleva Alimentos in 2006 and 2007, respectively.

Danone entered Brazil in 1970 and is today a leading producer high-margin processed dairy products such as probiotic yoghurt. The firm is also a leading producer of biscuits and snack foods, as well as bottled water. The company has four production plants, in Minas Gerais and São Paulo. **LAEP Investments**, which gained control over **Parmalat Brasil** when the firm had financial difficulties, is another major dairy firm.

Brazil's milk production has increased over the review period, from 20.53mn tonnes in 2000 to 23.85mn tonnes in 2006, owing mainly to improvements in productivity and the fact that the dairy sector has benefited from the overall improved economic conditions. These figures, however, do not include non-commercial and informally marketed milk, estimated to be around 35% of total milk production.

Consumption of dairy products is also on the rise, supported by higher purchasing power and lower unemployment rates, with milk consumption further driven by the government's social programmes. Growth in consumption, however, has not kept up with production growth, increasing at a much slower rate from 19.98mn tonnes in 2000 to 21.53mn tonnes in 2006

Industry Forecast Scenario

Total Food Consumption – Per-capita food consumption (food and drink, excluding

TABLE: BRAZIL FOOD CONSUMPTION INDICATORS – HISTORICAL DATA & FORECASTS

	2006	2007	2008e	2009f	2010f	2011f	2012f	2013f
Food consumption (BRLbn)	238.0	265.7	303.1	333.1	360.3	394.5	415.0	434.8
Food consumption (US\$bn)	109.7	136.7	162.4	178.6	207.7	234.8	250.0	262.7
Per-capita food consumption (BRL)	1,275	1,403	1,578	1,711	1,825	1,980	2,050	2,130
Per-capita food consumption (US\$)	587.3	721.9	845.9	917.2	1,051.8	1,178.5	1,234.7	1,287.1
Total food consumption y-o-y growth (local currency, %)	1.08	1.12	1.14	1.10	1.08	1.09	1.05	1.05
Food consumption as % GDP	10.2	10.4	10.6	10.8	10.9	11.0	11.1	11.1

NB nominal growth rate. e/f = BMI estimates/forecasts. Source: Agency for Statistical and Geographic Information, BMI

alcoholic drinks) in Brazil is among the lowest in the Latin American region. This is primarily a result of large income inequalities, with around a third of Brazilians living on or below the poverty line. However, this low base also means that total food consumption is growing at a tremendous rate.

Between 2004 and 2008, per-capita food consumption (in local currency terms) increased by 125%, representing a compound annual growth rate (CAGR) of over 17.6%.

In the next five years, food consumption is expected to continue along this growth path. Between 2008 and 2013, per-capita consumption is forecast to grow by 35% (nominal growth rate in local currency terms) representing a CAGR of 6.2%. With the size of the Brazilian population forecast to increase by 6.3% over the same period, total food consumption is expected to grow by 43.5%, representing a CAGR of 7.5%.

In US dollar terms, the picture looks even healthier. **BMI** is currently forecasting that the value of the Brazilian real will strengthen against the US\$, as it has done over the last five years. Under **BMI**'s current currency forecasts, total Brazilian food consumption in US dollar terms is expected to increase by 61.8%, representing a CAGR of 10.1%.

This growth is expected to be driven by consumers trading up to higher-value, branded and premium products and by lower-income consumers simply buying more. In urban locations, there is also an ongoing trend towards value-added convenience foods as consumers' working lifestyles increasingly come to mirror those in the developed world.

Investment in the food and drink sector rose once more in 2007, and the evidence of strengthening consumer demand, combined with positive external signals, stimulated higher levels of capital expenditure. As a result, food and drink manufacturers appear to remain confident in the sustainability of economic growth in 2008.

Industry confidence in the continued growth of domestic demand is reflected both in investments in production facilities and in a renewed focus on popular multinational brands. For example, **Unilever** and **Perdigão** have agreed to co-operate in the production and sale of the Becel and Becel ProActiv brands in Brazil.

According to Fresh Plaza, the Getulio Vargas Foundation's Index of Consumer Confidence (ICC) indicates a 10% fall in Brazil in October 2008, to 101.4, which is the lowest it has been since June 2006 when the index was 101.0. This could have a negative impact on food consumption in Brazil as consumers become increasingly wary of spending. In fact, **BMI** now feels that liquidity conditions in Brazil will be even tighter than initially assumed. In addition to rapidly rising interest rates, drying up liquidity on international money markets will further affect lending in the Brazilian financial system. This, in turn, will weigh on overall consumption and the economy as a whole. **BMI** expects household consumption growth to come in at 3.6%, down from a previous projection of 4.8% earlier this year

Brazil has a highly positive food and drink trade balance thanks to the country's highly developed agricultural sector. Brazil is the world's largest exporter of coffee, soybean, poultry, beef, orange juice and sugar.

Canned Food – Brazilians are very fond of canned foods, especially vegetables, meat, fish and beans, sales of which are expected to increase over the forecast period. This is especially true among the poorer segment of the population, where these comparatively cheap and easy-to-store products are a substantial part of the average person's diet.

Confectionery – In 2008, an estimated 71% of the overall market was accounted for by chocolate confectionery, followed by sugar confectionery and gum with market shares of 16% and 13%, respectively. Between 2008 and 2013, value sales are forecast to increase by a further 44.9%, with all subsectors expected to continue to grow rapidly thanks to the country's strong economic growth and large youth population.

There is a gradual trend towards premium confectionery products, particularly among Brazil's growing middle-class population. This trend explains the success of premium chocolate manufacturer and retailer **Kopenhagen**, which has retail outlets in most Brazilian malls. As a result of this trend, value sales of confectionery are expected to increase slightly faster than volume sales.

Discussions about obesity levels and dietary choices have been intensifying, with busier lifestyles and consumption of convenience foods having led to an increase in related diseases. Thus, demand for healthier food and confectionery options, which retail at a premium, is increasing in Brazil — in line with global trends — as consumers try to adopt healthier lifestyles. A key challenge and opportunity for manufacturers is to serve the north and north-east of the country, with distribution so far having mostly focused on the more affluent south-east.

Freight Transport

Executive Summary

At the beginning of October 08, **LLX Logistica**, the logistics arm of the **Grupo EBX** mining company, said that its decision to suspend its Porto Brasil investment project was not indicative of a paucity of liquidity for the company, but instead represented a prudent move amid tightening global credit markets. Porto Brasil was to be built at Peruibe, 70km south of the country's main port at Santos, and designed to handle 20mn metric tonnes a year of iron ore exports, along with 29mn mt of farm products and 17.5mn mt of fertilizers and bulk liquids. LLX CEO Ricardo Antunes said that the port development project had been frozen, reflecting the company's 'financial conservatism.' LLX would instead concentrate on building the Acu port already under construction and due to be completed in 2010; and Porto Sudeste, due to be completed in 2011. LLX is raising 25% of the cost of building these two ports, with **BNDES** (the Brazilian Development Bank) raising the other 75%. LLX shareholders **Eike Batista** (the owner of Grupo EBX) and **TPP**, an international teachers' fund, had committed to raising the company's capitalization to allow it to progress the two port projects. Total investment by LLX for the two projects was estimated at US\$2bn (compared to US\$3.9bn for the three projects before the decision to freeze Porto Brasil). In our latest Brazil Freight Transport Report, **BMI** has set its forecast for annual average growth in shipping freight over the 2009-2013 period at 8.3%.

BMI VIEW

Brazil performs reasonably well in our freight transport industry rating, scoring 66.5 out of 100, significantly above the regional average. Freight growth, infrastructure growth, and the regulatory and competitive environment all score well. Economic and political risk is comparable to the Latin American peer group. Foreign trade still represents only around 20% of GDP, although on the other hand the sheer geographical size of the country means there will be healthy internal demand for freight transport.

Various factors support this prediction. At base, we believe the despite global economic cooling the Brazilian economy will manage a period of moderate growth, with shipping as a key transport mode. In short, the fundamentals still point to expansion. Annual Brazilian GDP growth will average 4.1% during the 2009-2013 period (down from 4.6% in the preceding five-year period). This will underpin general shipping demand.

The overall freight picture is encouraging – although work to improve and repair the highway network is still lagging – as road haulage will grow by an average of 5.4%. The largely privatised rail freight sector will do better, aided by Brazil's commodity export boom, particularly in mining. The rail freight growth figure in 2009-2013 will average of 6.3% annually.

Brazil performs reasonably well in our freight transport industry rating, scoring 66.5 out of 100, significantly above the regional average. Freight growth, infrastructure growth, and the regulatory and competitive environment all score well. Economic and political risk is comparable to the Latin American peer group. Foreign trade still represents only around 20% of GDP, although on the other hand the sheer geographical size of the country means there will be healthy internal demand for freight transport.

According to our latest estimates, the total value of transport and communications GDP will rise to US\$127.9bn in nominal terms by 2013, representing 5.4% of Brazil's GDP. The transport and communications sector employed 4.725mn people, or 4.9% of the labour force, in 2008. We see these figures rising to 6.0mn — and 5.4% — by 2013.

Industry Forecast Scenario

Jet Levelling Out? – With the global aviation industry facing an increase in fuel costs of at least US\$80bn in 2008, there are indications that the 100%-plus price rise between July 2007 and July 2008 could trigger some significant market changes. To the time of writing in 2008, jet has risen more than 50%, remaining ahead of both diesel and gasoline in terms of price expansion. Based on **BMI's** crude oil price predictions, jet should head lower in Q3, but rally in the closing months of the year. However, the recent surge to US\$180 per barrel (bbl) points to average prices surprising on the upside during the summer and early autumn. Our full-year 2008 assumption of a global jet price averaging US\$157/bbl is currently above the consensus estimate of US\$138/bbl, but we see price risk on the upside unless the industry moves swiftly to cut consumption. This seemingly remote possibility has gained credibility following comments from US airlines, which have warned of capacity reductions later in 2008. If a significant part of the US fleet is grounded, there could be an early levelling out of jet prices followed, perhaps, by a year-end downturn.

American Airlines (AA) and **United Air Lines (UAL)** claim to be gearing up for the biggest cutback in fuel use since 1991, responding to the recent move by jet prices. In June 2008, **Northwest Airlines** said it would ground 14 **Boeing 757** and **Airbus** aircraft during the final three months of this year. Overall, Northwest is reducing its domestic and international flying by up to 9.5%, the airline said in a regulatory filing. According to the Air Transport Association (ATA), the US airline industry plans to ground 413 aircraft, eliminating almost 9% of seating capacity, as rising fuel costs spur losses of as much as US\$13bn among carriers. An increase in the price of jet to an average US\$138/bbl this year

implies additional fuel costs of US\$85bn for the global airline industry. The US Department of Energy has predicted that jet demand could fall by 7.5% in 2008, equivalent to a drop of 95,000 barrels per day (b/d), followed by a further 104,000b/d decline in 2009. This would certainly relieve the upwards pressure on jet prices, but is clearly dependent on drastic action on the part of the airlines.

Consumer demand for refined oil products is starting to suffer, with gasoline consumption being hit by record prices, while commercial use of diesel is also under pressure in most markets outside China. US gasoline demand in the four weeks ended July 4 was down 2.1% from the same period a year earlier. If long-haul holiday bookings decline, airlines will be squeezed by high fuel costs and under-used capacity, thus forcing them to cut flights and ground aircraft. There is not yet sufficient evidence to predict a sustained downturn, but there are indications that demand is beginning to slip. During the four weeks to July 4, US jet consumption was reported by the Department of Energy to have fallen by 2.2% y-o-y. The premium of US jet prices over New York heating oil have this year doubled from the five-year average. The price differential seems likely to narrow in Q3 and could be well within the normal range by the year-end if demand and prices ease. In 1991, when US jet consumption fell more than 8% because of the September terrorist attacks, prices for the

TABLE: TRANSPORT INDUSTRY ECONOMIC SCENARIO, 2005-2012

	2005	2006	2007e	2008e	2009f	2010f	2011f	2012f
Annual GDP growth, %	3.2	3.7	5.4	4.7	4.6	4.3	4.3	4.5
GDP index, 1995=100	127.0	131.7	138.8	145.3	152.0	158.5	165.3	172.8
5-year average annual GDP growth, %	2.8	3.3	3.8	4.5	4.3	4.5	4.7	4.5
Annual transport and communications GDP, % growth	5.2	3.3	5.8	8.7	4.6	4.3	4.3	4.5
Transport sector GDP index, 1995=100	144.6	149.4	158.0	171.7	179.6	187.3	195.4	204.2
5-year average annual transport GDP growth, %	3.2	3.0	4.7	6.1	5.5	5.3	5.5	5.3
Transport, % share of total GDP	5.30	5.28	5.30	5.50	5.50	5.50	5.50	5.50
Imports, annual growth, %	17.20	24.05	32.09	26.04	18.42	16.67	9.52	10.87
Imports index, 1995 = 100	147.2	182.6	241.2	304.0	360.0	420.0	460.0	510.0
4-year average annual import growth, %	8.6	18.4	25.8	24.8	25.1	23.3	17.7	13.9
Exports, annual growth, %	22.67	16.29	16.62	5.79	12.94	12.50	11.11	12.50
Exports index, 1995 = 100	254.8	296.3	345.6	365.6	412.9	464.5	516.1	580.6
4-year average annual export growth, %	19.9	23.0	21.9	15.3	12.9	12.0	10.6	12.3
Transport industry GDP, US\$bn nominal	46.83	56.76	69.77	89.50	102.02	112.04	119.54	123.04
Transport industry employment								
Total, '000 employees	4048	4265	4479	4725	4990	5267	5470	5821
% change	5.3	5.4	5.0	5.5	5.6	5.5	6.4	6.1
Total employment	87,101	89,986	92,965	96,025	99,231	102,511	104,864	108,872
% change	3.3	3.3	3.3	3.3	3.3	3.3	3.8	3.5
Transport industry's share of total employment, %	4.6	4.7	4.8	4.9	5.0	5.1	5.2	5.3
Trade								
Total trade, US\$bn	20.5	19.3	22.8	14.5	15.5	14.5	10.3	11.7
% change y-o-y	15.1	16.2	19.7	23.7	24.7	21.4	19.4	17.9
5-year average % growth, y-o-y	21.7	21.3	21.4	19.8	20.1	20.9	21.6	23.5
Trade as % of nominal GDP	3.2	3.7	5.4	4.7	4.6	4.3	4.3	4.5

e/f = estimate/forecast. Source: BMI

fuel in the US fell to a significant discount to heating oil.

Even sustained cutbacks in US jet fuel use are no guarantee of lower prices if other regions take up the slack. The likely continued growth in developing markets demand, particularly in China, could mean that overall consumption trends remain robust and prices hold up. The market's only real hope is that government-backed fuel price increases in the high-growth markets lead to some slowing of demand expansion. It is too early to state with confidence that consumption trends will ease. In addition, pressure on refining margins may actually result in lower processing runs and less fuel being produced, thus negating the impact of weaker demand. US refiners in particular have been reluctant to boost operating capacity, in spite of the tight fuels markets, because soaring crude costs have put profitability under pressure.

Diesel Dilemma – Gasoil prices, dominated by automotive diesel, look set to be the most robust over the near term. While there are signs of demand growth for gasoline and jet being undermined by prices and industry/consumer action, diesel appears well supported. Government-mandated retail price rises in several Asian countries are likely to undermine demand growth to a certain extent, but pricing policy looks unlikely to change dramatically in the key growth centres. Diesel demand in Europe and elsewhere is still surging, in spite of commercial vehicle operators being squeezed. The long-established European trend towards more fuel-efficient diesel cars is not yet at an end, in spite of the growing price premium to gasoline. With China in particular also boosting dramatically its diesel consumption, the outlook remains bleak in terms of pricing. Near-term restarts at the Scottish Grangemouth refinery and the hydrocracker at Porvoo's refinery in Finland help improve the European situation, but there continue to be diesel supply shortages in China.

Distillate crack spreads continued to gain ground in May and June, representing perhaps the biggest single fundamental factor driving the crude markets. Margins are much healthier than for gasoline and jet, so refiners should maintain a high level of output. The European refinery problems mentioned above mean that the region continued to import large volumes of diesel in June. China reportedly imported around 145,000b/d of diesel in May and planned to bring in nearly 160,000b/d in June. This reflects not only shortages in certain regions of the country, but also some stockbuilding ahead of the Beijing Olympic Games. Chinese demand is so far unfazed by higher prices, but other regional consumers such as Indonesia may see a slowing as the market absorbs the impact of higher state-set tariffs.

Price Prospects – According to the US Department of Energy, the price of domestic crude (West Texas Intermediate, or WTI) could average US\$127/bbl in 2008, up from US\$72/bbl the previous year (+76%). At present, the **BMI** price assumption for 2008 is US\$111/bbl for WTI, assuming an OPEC basket price of US\$106/bbl. We are forecasting crude price declines in Q3 (from US\$120/bbl for WTI in Q2 to US\$108/bbl), followed by a rebound in Q4 to an average US\$118/bbl. In 2009, the **BMI** forecast is for a decline in average prices, with WTI slipping to US\$101/bbl. The Department of Energy, however, predicts an increase in 2009 to US\$133/bbl — which may prove rather aggressive in light of weakening demand trends.

In terms of refined products, the **BMI** composite (Rotterdam, Singapore and New York) global indicator price for unleaded gasoline is expected to average approximately US\$129/bbl during 2008, trending lower to US\$137 in Q3, before rebounding towards US\$151/bbl in Q4. The 2007 price, calculated on the same basis, was around US\$84/bbl, implying a y-o-y increase of 54%. Our jet forecast for 2008 is US\$157/bbl, up from US\$89 in 2007. The 76% annual increase represents the second biggest for the key refined products. With gasoil, **BMI** is assuming a still greater 81% gain in 2008, to an average US\$154/bbl. During 2009, we are expecting products prices to follow the underlying crude trend lower, but to prove considerably more resilient than the feedstock — implying a meaningful recovery in refining margins. Gasoline in 2009 is estimated at US\$128/bbl, with jet falling to US\$156/bbl. Gasoil is expected to average a virtually unchanged US\$154/bbl.

Transport Outlook – Since our last report, we have pared back our five-year growth forecast. We now predict GDP expansion of 5.2% in 2008, followed by 3.5% in 2009 and 4.3% in 2010. These figures constitute our latest update and may supersede those in the preceding section. We now expect annual GDP growth to average 4.1% in the 2009-2013 period, down from 4.6% in the preceding five years. We maintain some earlier adjustments to some of our freight-carried-to-GDP intensity ratios for particular transport modes. We have boosted the intensity ratio for maritime freight slightly to reflect a good harvest, as well as a boost in iron ore exports to China. However, we have reduced our airfreight intensity estimates, given signs of a slow recovery from the near-systemic failure of the air traffic control system in mid-2007 and the impact of the fuel price spike in H108. The pipeline throughput forecast has been raised marginally towards the end of the forecast period. Taking into account increased gas demand and the expected growth in ethanol exports. As a result of these changes, our freight carried forecast is for annual average growth of 6.8% in 2009-2013, measured in mntkm.

According to our latest estimates, transport and communications GDP will have risen by 5.6% in 2008, ahead of overall GDP, which we estimate to have increased by 5.2%. For the 2009-2013 forecast period, we expect the transport and communications sector to continue outpacing the economy as a whole. It will achieve average annual growth of 4.5%, versus 4.1% for overall GDP. The total value of transport and communications GDP will rise to US\$127.9bn in nominal terms by 2013, representing 5.4% of Brazil's GDP. The transport and communications sector employed 4.725mn people, or 4.9% of the labour force, in 2008. We see these figures rising to 6.0mn and 5.4% by 2013.

For the rail sector, we see freight carried, measured in mntkm, growing by an annual average of 6.3% during the five-year forecast period, down from 8.7% in 2004-2008. Rail should enjoy a favourable combination of demand and expanding capacity, as new investment flows into the operations of the privatised operators. There continue to be no reliable statistics on Brazilian road freight haulage. However, based on **BMI** estimates we expect freight carried to be growing more slowly than rail, at an average of around 5.4% a year, because investment to improve and repair the highway network will take longer to have an effect. Despite the collapse of Varig, the catastrophic TAM accident of July 2007, and real concern over the ability of the air traffic control system to cope, underlying demand for air freight will remain resilient. We now expect the growth figure in 2009-2013 to be an annual average of 6.6%. Total tonnage handled by Brazil's main seaports will rise by

an average of 8.3% per annum in the forecast period, down on the 10.8% registered in the preceding five years. The main reason for this is that after the foreign trade and export boom in 2004, and a strong year in 2007, we see both import and export growth moderating significantly in subsequent years.

This report is abstracted from our latest Brazil Food & Drink and Freight Transport reports, which include in depth research on the sectors, full five-year forecasts and a thorough analysis of the competitive landscape. BMI currently covers 16 industries across 60 countries. For further information, or to order a report, please contact: subs@businessmonitor.com

chapter 7 BMI Global Assumptions

Here, **BMI** analysts give their view of the state of the world economy and the main challenges faced. In this context, they outline their forecasts for growth, inflation, interest rates and the exchange rate in the US, the eurozone, Japan and China over the forecast period of the report (2009-2013). There are also separate sections on the oil price and commodities markets. The forecasts contained in these sections represent the basic assumptions that underpin the analysis in 's country reports.

Global

Global Contraction On The Cards In 2009

BMI's already below-consensus macroeconomic forecasts take yet another negative turn in our newly-updated set of global assumptions. We project global real GDP growth (weighted by nominal GDP in US\$ terms) to come in at -0.8% in 2009, recovering only modestly to 2.0% in 2010. If 3.0% growth represents a global recession (as per the IMF's definition),

TABLE: GLOBAL ASSUMPTIONS

		2007	2008e	2009f	2010f	2011f	2012f	2013f
Real GDP Growth (%)	USA	2.2	1.2	-2.3	1.0	2.6	2.8	2.8
	Eurozone	2.6	0.9	-2.5	0.4	1.8	2.4	1.9
	Japan	2.1	-0.5	-3.1	0.6	1.4	2.1	2.1
	China	13.0	9.6	5.6	6.8	7.9	7.6	7.3
	World	4.0	2.5	-0.8	2.0	3.5	4.0	4.0
Consumer inflation (avg)	USA	2.9	3.8	0.0	2.3	2.0	2.0	2.0
	Eurozone	2.9	1.6	0.7	1.5	1.7	2.0	2.0
	Japan	0.1	1.0	0.0	0.3	0.6	1.0	1.0
	China	4.8	5.0	0.3	2.8	2.5	2.2	1.7
	World	3.4	5.1	2.5	3.0	2.8	2.8	2.8
Interest rates (eop)	Fed funds rate	4.25	0.00	0.00	1.00	3.00	4.25	4.25
	ECB refinancing rate	4.00	2.50	1.00	2.00	3.50	4.00	4.00
	Japan overnight call rate	0.50	0.10	0.10	0.10	0.75	1.25	1.25
Exchange rates (avg)	US\$/EUR	1.37	1.47	1.28	1.32	1.37	1.34	1.27
	JPY/US\$	115.52	101.35	87.85	97.50	110.00	110.00	110.00
	CNY/US\$	7.60	6.95	6.87	6.75	6.45	6.20	6.00
Goldman Sachs Commodity Index (eop)	Metals (GSIN)	400.0	204.9	190.0	240.0	280.0	280.0	280.0
	Agriculture (GSAL)	320.0	257.8	220.0	240.0	260.0	260.0	260.0
Oil prices (avg)	Opec basket US\$/bbl	69.00	94.07	46.50	58.50	66.50	81.50	81.50
	Brent Crude US\$/bbl	72.50	98.52	50.00	62.00	70.00	85.00	85.00

World forecasts weighted by GDP at US\$ market exchange rates. Source: BMI

then our forecasts indicate a severe one over the coming two years.

We are negative on the prospects for the global economy for many reasons. Firstly, governmental and monetary policy uncertainty is very high, with fiscal stimulus packages and bailouts coming at a blistering pace, and a new administration in the US. When combined with existing macroeconomic concerns, such policy uncertainty, this makes for an extremely uncertain investment climate, even for long-term investors. This will eat away at fixed investment growth, and in several key countries we see capital formation contracting in 2009.

Secondly, the financial deleveraging process is likely to continue well into 2009. This will continue to depress asset prices and keep the deflationary spiral in motion.

Thirdly, the alarming contraction in global commerce shows no signs of abating, and BMI forecasts global trade (imports plus exports) to contract in 2009 by 5.7% y-o-y. If we are correct that will have seriously negative implications for exporting countries, not just in the 'net exports' portion of the GDP ledger, but also in fixed investment and private consumption.

Fourth, and finally, while many forecasters envisage a solid rebound for the global economy in H209, we fail to see what the catalyst for such a rebound will be. The existing economic system, whereby Western consumers borrow from abroad to purchase foreign-made goods, has broken down. It will take time for household balance sheets in the US to be rebuilt via higher savings rates, and in the meantime the export economies of Asia hang in the balance.

Economic Activity

- The developed world will contract by 2.4% in 2009. That growth figure will be sandwiched between 0.8% growth in both 2008 and 2010, meaning that on an aggregate basis, output in developed markets will not return to their 2007 levels until 2011. Emerging markets will post expansion of just 2.1% in 2009, down from 5.8% in 2008. According to our forecasts, it will be well into 2010 before the global recovery is under way.
- Our US real GDP growth forecast for 2009, of -2.3%, represents a downward revision from -2.0% previously. We have, however, bumped up our forecast for 2010, to 1.0% from 0.8%, due primarily to the base effect.

TABLE: GLOBAL AND REGIONAL REAL GDP GROWTH, % CHG Y-O-Y

	2006	2007	2008e	2009f	2010f	2011f	2012f
World	4.2	4.0	2.5	-0.8	2.0	3.5	4.0
Developed States	2.8	2.4	0.8	-2.4	0.8	2.2	2.9
Asia Ex-Japan	8.7	9.0	7.6	4.1	5.4	6.7	6.8
Latin America	5.3	5.5	4.1	0.1	1.8	3.8	4.1
Emerging Europe	7.4	7.1	4.3	-1.2	2.1	4.4	5.3
Sub-Saharan Africa	6.3	7.0	5.6	3.3	5.1	5.3	5.5
Middle East & North Africa	6.0	5.7	5.9	3.4	3.7	4.3	4.1

Weighted By Nominal US\$ GDP. Source: BMI

members of the bloc will be exacerbated by weakening global demand for its exports. The eurozone economy will contract by 2.5% as nations such as Germany (-3.2%), Spain (-3.5%) and Ireland (-3.8%) get pummelled. A potential European banking crisis, which we see as a key risk in 2009, would be the proverbial icing on the cake. Key European states outside of the euro bloc, such as the UK, which we forecast to contract by 3.5% in 2009, have their own serious domestic economic issues. Scandinavia, and in particular Sweden, are vulnerable to the knock-on effects of the crisis in the Baltic states.

- Of the major economies, Japan is forecast to be among the hardest hit, with contraction of 3.1% in 2009. Export weakness will be magnified by the strong yen, which is appreciating versus the currencies of Japan's major rivals primarily due to deleveraging.
- Emerging markets will also weaken considerably, and we are forecasting outright contractions in several key countries. The list includes South Korea, Hong Kong, Singapore, Taiwan, Russia, Turkey, Hungary, Czech Republic, and Mexico. Without China's 5.6% forecast growth, which is itself well below consensus estimates, the global economy would contract by well over one percentage point in 2009.

TABLE: DEVELOPED STATES, REAL GDP GROWTH FORECASTS

	2008e	2009f	2010f
Developed States Aggregate Growth	0.8	-2.4	0.8
G7	0.7	-2.6	0.8
Eurozone	0.9	-2.5	0.4
EU-27	1.0	-2.4	0.5
Selected Developed States			
Australia	1.9	0.9	2.7
Austria	1.5	-1.8	0.8
Belgium	1.3	-2.0	0.2
Canada	0.6	-1.4	2.9
Denmark	-0.9	-2.2	0.4
Finland	1.5	-1.6	1.2
France	0.8	-2.0	0.4
Germany	1.1	-3.2	0.2
Ireland	-2.4	-3.8	0.6
Italy	-0.6	-2.4	0.4
Japan	-0.5	-3.1	0.6
Netherlands	2.0	-2.2	0.6
Norway	1.4	-2.3	0.7
Portugal	0.3	-2.0	0.3
Spain	1.0	-3.5	0.0
Sweden	0.4	-1.9	0.8
Switzerland	1.8	-0.3	1.4
United Kingdom	0.7	-3.5	0.2
USA	1.2	-2.3	1.0

Source: BMI

TABLE: EMERGING MARKETS, REAL GDP GROWTH FORECASTS

		2008e	2009f	2010f
Emerging Markets Aggregate Growth		5.8	2.1	3.9
Selected Emerging Markets				
Latin America	Argentina	6.0	0.6	-0.9
	Brazil	5.7	0.8	2.6
	Mexico	0.0	-1.3	1.9
Middle East/Africa	South Africa	3.0	1.4	3.7
	Nigeria	6.3	3.6	5.4
	Saudi Arabia	5.7	4.2	3.6
	UAE	6.6	1.0	3.4
	Egypt	7.2	3.7	3.0
Asia	China	9.6	5.6	6.8
	Hong Kong	3.1	-2.2	1.1
	India	9.0	6.8	5.0
	Indonesia	6.1	3.6	4.6
	Malaysia	5.5	1.4	3.2
	Singapore	1.5	-2.8	2.3
	South Korea	3.5	-0.5	3.0
	Taiwan	1.5	-1.5	2.5
	Thailand	4.2	1.0	3.0
	Europe	Russia	4.6	-1.0
Turkey		2.2	-3.3	1.7
Czech Republic		4.3	-1.2	1.2
Hungary		1.1	-3.4	0.1
Poland		5.4	1.6	2.8

Source: BMI

Monetary Policy

- Disinflation will remain a dominant global theme, and there will be periods of outright y-o-y deflation in the world's largest economies. Consumer prices, on an annual average basis, will not rise in the US. Eurozone inflation will average just 0.7%, despite European Central Bank (ECB) concerns of potential inflation in the pipeline. Five of the G7 members will have inflation of under 1.0%, with Canada and Italy just above that level. In China, where we think outright deflation is a real possibility, we are forecasting just 0.3% average annual inflation.
- Therefore, we believe that where there is room for central banks to cut rates, they will be cut. The ECB will bring the refi rate down to 1.0%, matching the Bank of England. The Federal Reserve and Bank of Japan, having reached the lower bound of nominal rates, will continue to quantitatively

TABLE: DEVELOPED MARKET EXCHANGE RATES

		2006	2007	2008e	2009f	2010f
Eurozone	US\$/EUR, ave	1.25	1.37	1.47	1.28	1.32
Japan	JPY/US\$, ave	118.48	115.52	101.35	87.85	97.50
Switzerland	CHF/US\$, ave	1.25	1.20	1.21	1.30	1.41
United Kingdom	US\$/GBP, ave	1.85	2.00	1.85	1.37	1.49

Source: BMI, Reuters

ease. By and large emerging market central banks will reduce rates as the inflationary pressures caused by rising food and energy prices continue to reverse.

- We do not see policy rates beginning to normalise until well into 2010. Rather, quantitative easing will be the watchword over the next two years as the monetary authorities try their best to reflate. Regardless, we see inflation heading lower into 2009 and remaining at historically low levels in 2010 as deflationary forces prove hard to resist.
- Among the major currencies, the US dollar will continue to fluctuate, with additional legs of deleveraging generating periodic dollar strength in 2009, but structural problems including fiscal profligacy and loose monetary policy will eventually drive the greenback lower. The yen, meanwhile, will continue to strengthen in 2009. We still see little reason to like the euro or sterling, as both currencies will feel the brunt of domestic economic worries.
- Among emerging market currencies, depreciation will be the theme in 2009. Notably, we expect the Chinese authorities to put the brakes on yuan appreciation, and even manage a controlled depreciation of the unit.

TABLE: EMERGING MARKET EXCHANGE RATES

		2006	2007	2008e	2009f	2010f
China	CNY/US\$, ave	7.97	7.60	6.95	6.87	6.75
South Korea	KRW/US\$, ave	955.3	929.4	1,217.9	1,350.0	1,100.0
India	INR/US\$, ave	44.18	45.12	40.12	42.71	48.0
Brazil	BRL/US\$, ave	2.17	1.95	1.84	2.48	2.48
Mexico	MXN/US\$, ave	10.90	10.92	11.15	13.08	12.25
Russia	RUB/US\$, ave	27.17	25.57	24.86	31.70	33.50
Turkey	TRY/US\$, ave	1.44	1.30	1.30	1.49	1.44
South Africa	ZAR/US\$, ave	6.75	7.08	8.25	10.12	9.60

Source: BMI, Reuters

Commodities

We expect two themes to dominate commodity markets in 2009. First of all, we expect further downside in 2009, although the price declines will be of a lesser magnitude than in 2008. Indeed, as the global economy slows and the process of deleveraging continues over the course of the next several quarters commodity prices will remain under pressure. Secondly, we expect much more price volatility across the global commodity complex. Indeed, large accumulated losses, combined with the potential for further US dollar fluctuations will likely result in higher levels of volatility as participants trade the market rather than build solely long or short positions.

That said, as the global economy starts recovering in 2010 and 2011, we expect commodity prices to start coming back. As such, we are forecasting Brent crude to average US\$50.00/bbl in 2009, with downside risks, after which it will rise to US\$62.00/bbl in 2010. A similar trend is projected for the Goldman Sachs Agricultural and Metals Indices, with the agriculture index declining from 258 in 2008 to 220 in 2009, and then rising to 240 in 2010. The industrial metals index is projected to fall from 205 in 2008 to 190 in 2009, and then rising to 240 in 2010.