

## Brazil: The Land of Today

Long known as the “land of the future”—with economic progress always just around the corner—Brazil has at last begun to meet its potential.

Now one of the world’s 10 largest economies, Brazil was also one of the last countries of significant size to feel the effects of the global financial and economic crisis. Thanks to strong sovereign fundamentals, a well-regulated banking system and rising domestic-driven growth, Brazil has avoided much of the damage felt by other economies and is on track to recover faster than many other nations. In fact, the Brazilian economy is expected by some analysts to grow as much as 4.5% in 2010. That Brazil would be in such a strong position in the face of a global financial crisis would have seemed unthinkable just a few years ago.

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### Financial Stability

Lessons learned from the past have helped put Brazil in a stronger position than many countries, including the developed nations, to ride out the current financial upheaval.

In the late 1990s, Brazil suffered more than many economies as contagion from the Asia/Russia crisis led to capital outflows and slower economic growth. During this period, Brazil was forced to implement pro-cyclical fiscal policies and cut government spending, further dampening economic activity. The country’s economy was also hurt during the global slowdown in 2002, when its large foreign currency debt contributed to significant pressures on the *real*, forcing officials to abruptly and dramatically hike interest rates.

As a result of this experience, the Brazilian government, banks and corporate leaders took steps to prepare themselves for future episodes of global financial stress. These measures included more stringent banking regulations than in developed countries such as the US. Brazilian banks have been managed more conservatively, with substantially less leverage than their developed-market counterparts. Therefore their capital ratios are much higher, and they have never owned any of the toxic securities that helped compromise other banking systems.

The stable financial system in Brazil has put its banks a step ahead of competitors headquartered elsewhere, many of which have had to retrench, in some cases selling at least part of their Brazilian (and other) operations. Brazilian banks, on the other hand, particularly the bigger ones, have the means to extend their already dominant market position and continue to grow profits, in one of the world’s most promising financial marketplaces. As in India and China, Brazil’s populace—190 million strong—includes a growing middle class with rising incomes and the desire to invest as well as purchase goods.

Brazil also has large government-led banks, including Banco do Brasil, which is controlled by the federal government and publicly traded. In addition, a development bank known as BNDES plays a key role in providing financing to companies in a wide range of industries and sizes, particularly when market financing is not readily available, as has often been the case in recent months.

Like the banks, neither the Brazilian government nor the corporate and consumer sectors are highly leveraged, particularly by developed-country standards. In the past four years, for example, the government has quadrupled the country's foreign currency reserves. For consumers, one of the more popular lending mechanisms is the "payroll loan," where payments are automatically deducted from paychecks, helping individuals to conveniently manage their debt.

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### Monetary and Fiscal Flexibility

This time around, Brazilian officials are enjoying unprecedented policy flexibility on both the monetary and fiscal fronts.

On the monetary side, the proactive Central Bank of Brazil, which has built up substantial credibility over the last few years, set interest rates so high in 2008, particularly in *real* terms, that it has been able to implement a series of aggressive rate cuts in 2009. Nonetheless, rates remain high enough—8.75% at the end of July—to make Brazil one of the few countries where significant reductions could still be possible without creating inflationary pressures.

Brazil is somewhat less flexible in terms of fiscal policy because of a nominal budget deficit. However, the deficit is due primarily to interest payments on government debt (the country actually runs a primary fiscal surplus). Thus, as the central bank reduces interest rates, it not only helps stimulate economic activity but also helps improve the fiscal balance. Brazil has a "big government," and this is evident in the relatively high level of taxation and government spending as a share of GDP.

The Brazilian government does have sufficient flexibility to implement economic stimulus measures. To help counteract the current global slowdown, officials introduced a \$15 billion housing program earlier this year, along with tax breaks on major consumer expenditures and capital goods. During previous crises, Brazilian officials would have had to apply pro-cyclical policy measures by raising taxes or cutting spending, often as part of financial support agreements with multilateral organizations such as the International Monetary Fund (IMF).

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### Rising Importance in the Global Economy

Part of Brazil's strength lies in its increasingly prominent role in the global economy. Fortune, perhaps more than foresight, has given Brazil the wherewithal to succeed on a global basis. While Mexico was making important oil discoveries in the 1970s, Brazil worried that it had no significant oil reserves, and the energy crises of that decade pushed the oil-poor country to explore alternative sources. Brazil is now a global leader in the use of ethanol, as the vast majority of new cars manufactured there can run on any mix of ethanol and gasoline, up to 100% ethanol. Ethanol in Brazil is produced much more efficiently than elsewhere in the world, using sugar cane as the raw material. It is available at all service stations, so consumers choose their fuel freely and even opportunistically at any point of sale.

Brazil is also a global leader in electric power, with well over 70% of its energy generated by hydroelectric plants. The country's favorable hydrology is clearly an important factor. Its relative lack of coal, and the belief until recent decades that the country did not have important natural gas resources, also contributed to the development of a major hydroelectric infrastructure. As a result, Brazil has already progressed on the energy front to where much of the world aspires to be.

In terms of global trade, Brazil has shifted its focus from the ailing US and European economies to emerging markets in Africa, the Middle East and Asia—especially China, which in some regards has taken the role that the US has traditionally occupied as the key pillar of the world economy. In the aftermath of the late-1990s crisis, it was the US that provided what was then called the consumer of last resort. This time it is the Chinese economy that has remained most resilient, and China has overtaken the US this year as the number one destination for Brazilian exports, primarily commodities. The Asian giant recently made significant purchases of Brazilian iron ore to fuel its massive steel production, for instance. As another benefit, the Brazilian equity market is increasingly perceived by global investors as a way to play the strong Chinese economy.

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## **The Future is Here**

Brazil offers the ingredients for lasting economic success, including financial stability, global competitiveness and increasing domestic-driven growth—along with one of the world’s largest equity exchanges. Ahead of many developed and emerging countries, it has already shown signs of recovery from the global economic slowdown, with a manageable level of consumer debt and rising real-estate prices, for example. In fact, the IMF recently noted Brazil’s favorable position, based on its fiscal discipline and solid economic structure.

From an investment standpoint, Brazil is no longer the land of the future—it is the land of today and a rich source of promising long-term opportunities.

## **Important Information**

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