ECONOMICS

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External Sector and Economic Activity

Can the External Sector Lead the Way to Recovery?

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- **The sharp BRL depreciation, in response to both external drivers and local uncertainties, has already started to produce an improvement in the external deficit, led by the most currency-sensitive items such as the trade balance, international travel and profits & dividends remittance. Under our assumptions for BRL and growth, the trade surplus is expected to widen to some USD40 billion in 2016 and 2017.**
- **The strong response from the trade balance also brings good prospects for local economic activity, as it signals a recovery in exports and some degree of import substitution, albeit at a very gradual pace. In fact, we estimate that the improvement in the trade balance will contribute with 1.7 pp to GDP in 2016, preventing a wider contraction in activity and limiting the potential downside for the economy going forward.**
- **From a sector point of view, we note that industrial output in traditional export sectors such as pulp and paper, food, leather & footwear, and metallurgy have shown the greatest response. There has also been some decline in import penetration in sectors that produce intermediate goods – chemicals, machinery and equipment, rubber and plastic. We expect the export coefficient (the share of manufacturing production exported) to rise from the current 19.3% to 22.4% until end-2016, while the import coefficient is likely to decline from 18.8% to 16.0%.**

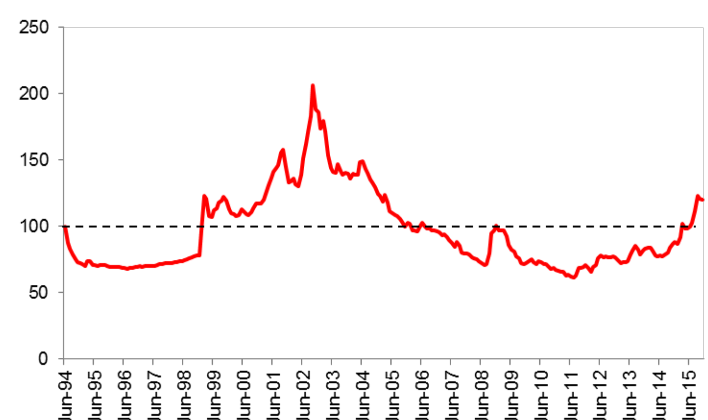
EXTERNAL CORRECTION: EN ROUTE

In the midst of a difficult economic scenario, one factor stands out as a positive fundamental of the Brazilian economy: the correction of the external imbalances seems to be underway, thanks to a combination of a substantially weaker BRL and contracting domestic demand. Indeed, the BRL seems to be an important driver of such a correction, highlighting the virtue of a floating currency: the sharp BRL depreciation seen over the last 12 months – with the *real* trading weaker than BRL 3.80/USD, versus BRL 2.50/USD about one year ago – seems to be a reflection of lower commodity prices, potentially higher interest rates in the US and uncertainties in the domestic scenario, and it is doing its job in adjusting the country's external needs accordingly, to a level that can be financed even under a more adverse condition.

Figure 1. BRL/USD

Nominal terms. Source: BCB.

Figure 2. Real effective exchange rate

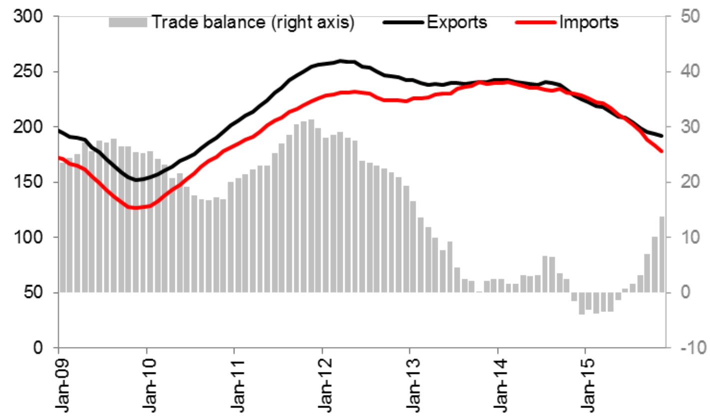


1988-2014 average = 100. Measured against a basket comprised of the currencies of the country's main trade partners, and deflated by inflation differential (IPCA for Brazil). Sources: BCB and Santander.

We believe that most of the recent depreciation can be explained by unfriendly external conditions (the prospect of tighter US monetary policy, weaker Chinese growth) and by the loss of the investment grade status. None of these factors seem to be about to see a reversal in the foreseeable horizon, which suggests that, to a large extent, the recent movement represents a level shift rather than a temporary turbulence. In fact, our exercises suggests that, under such conditions, a "fair value" for the *real* would be in the range of BRL 3.40-3.60/USD. In light of this, we expect that, even if all domestic-driven pressures subside, the BRL would still trade on a level substantially weaker than the one that prevailed over the previous ten years, in both nominal and in real effective terms – an eventual appreciation beyond these levels would be possible but not sustainable for long, in our view.

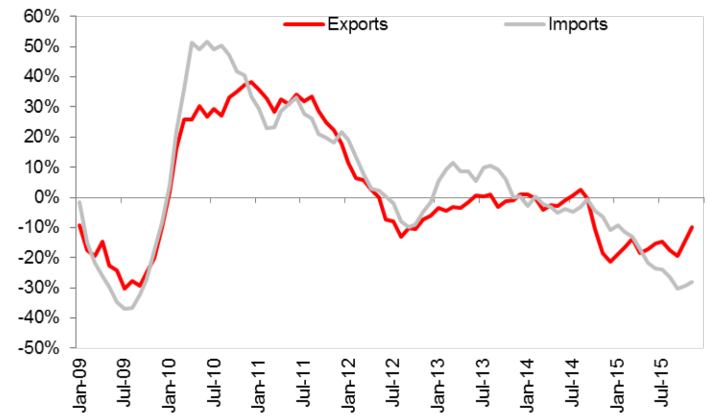
Combined with the ongoing recession (which both curbs some local costs and mitigates the inflationary impact of the currency weakness), such a shift has helped to restore part of the country's lost competitiveness, producing a reversal in the trade balance, which moved from a USD6 billion deficit in 2014 to a surplus in excess of USD16 billion this year. So far, the improvement in trade performance has come on the back of a decline in both exports and imports, with the latter plunging at a pace nearly three times faster than the former.

Figure 3. Trade balance



12-month flows, in USD billion. Source: MDIC.

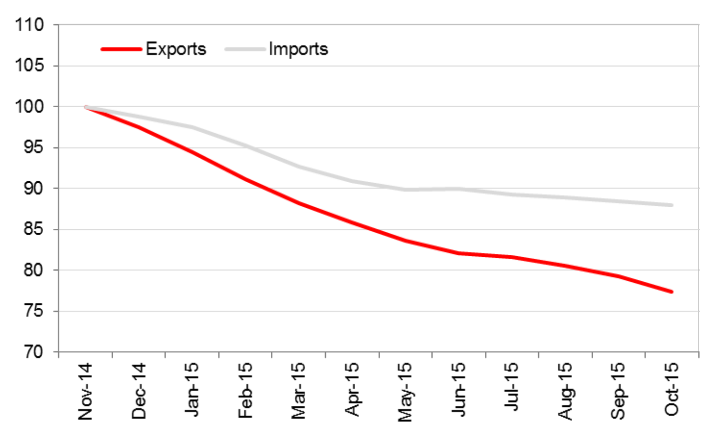
Figure 4. Exports and imports



3-month moving average, y/y change, adjusted for working days. Source: MDIC.

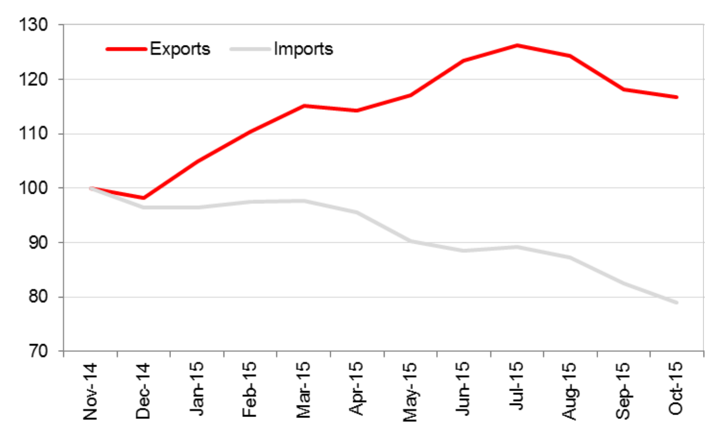
However, a closer inspection indicates that the better trade results are indeed reflecting the improved competitiveness. The breakdown in quantities and prices show that, while prices have declined both for exports and imports, quantities imported plunged but quantities exported are in positive territory – consistent with the response expected to face a sharp currency weakening. The charts below show that export prices contracted 23% at the margin versus those prevailing 12 months ago, a plunge deeper than the 12% decline in import prices. Meanwhile, quantities exported rose an impressive 17%, whereas quantities imported declined more than 20% in the same period. Note that the decline in export prices reflect not only the lower commodity prices, but also a decline in the dollar prices of manufactured goods by virtue of the BRL depreciation – the latter being the very driver of the recovery in competitiveness that leads to higher export volumes.

Figure 5. Export and import prices: recent evolution



3-month moving average of seasonally adjusted data, Nov/14 = 100. Source: Funcex.

Figure 6. Exports and imports quantities: recent evolution

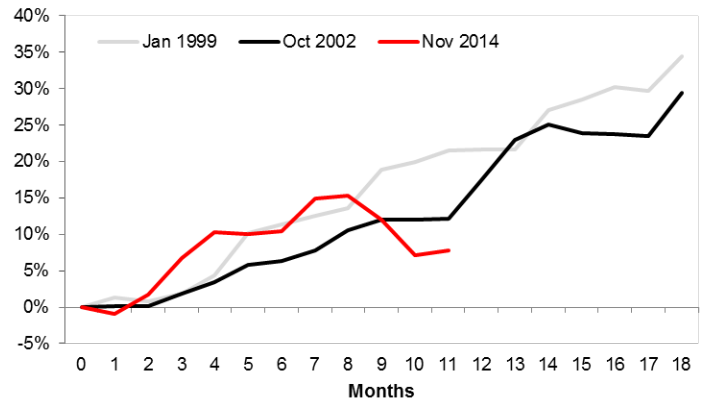


3-month moving average of seasonally adjusted data, Nov/14=100. Source: Funcex.

INDUSTRY: AN EXTERNAL WAY OUT OF THE CRISIS?

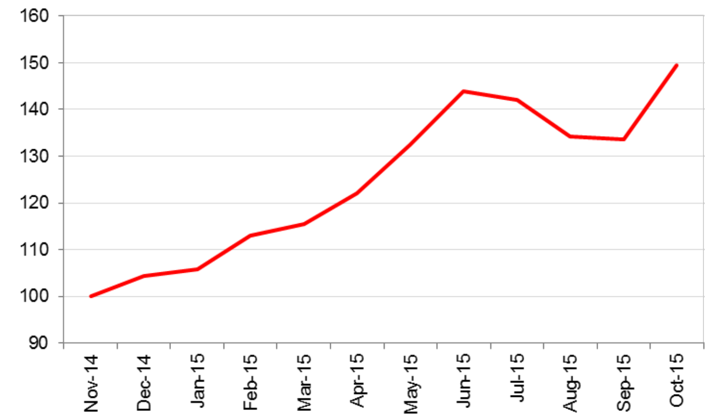
The pace of recovery in manufactured exports seems similar, albeit a bit more timid compared to previous waves of sustained BRL weakness (January 1999 and October 2002). If the past is a guide, manufactured exports still have a lot of room for expanding in response to the BRL weakness, and for many more months. A ratio between manufactured exports and the average of capital goods and consumer durable imports (the two usage categories entirely manufactured) also yields an interesting observation: since last November, this ratio rose by nearly 50%, reflecting the expansion of the former and the contraction of the latter. These dynamics favor local industrial production in that not only does it signal a push from external demand (face to restored competitiveness) but also suggests some degree of import substitution.

Figure 7. Manufactured exports post-devaluation rounds



Considering BRL weakness rounds started in Jan 1999, Oct 2002 and Nov 2014 (each round with different intensity), based on 3-month moving average of seasonally adjusted data of quantities exported. Sources: Funcex and Santander.

Figure 8. Manufactured exports/imports



Ratio between quantities of manufactured exports and quantities of capital goods and consumer durables (simple average), based on 3-month moving average of seasonally adjusted data, Nov/14=100. Sources: Funcex and Santander.

Such a process could represent a breath of fresh air into an industrial sector that has been shrinking continuously at least since the 2H13. Due to rising labor costs and the strong exchange rate, there was a significant substitution of domestic production by imported goods in the post-crisis period, leading to a sharp rise in the import penetration ratio, which jumped from 13.0% in 2009 to 22.7% in 2014, according to our calculation.[1] Based on our econometric exercises, **we estimate the strong expansion of unit labor cost accounted for 45% of the increase of nearly 10 pp in the import penetration ratio over that period.**[2]

In the wake of the recent level shift of the BRL, which we perceive as mostly permanent, we see a window of opportunity for some industrial activities to reverse such a trend. Evidently, the weaker BRL alone is not enough to offset the loss of competitiveness of the manufacturing industry in recent years; however, it outlines a more favorable scenario for the manufactured goods trade balance. With this, we see room for a recovery in manufactured exports and some degree of import substitution. Nevertheless, we think this process will be very gradual, since: (i) the recessionary scenario has imposed heavy financial constraints on industrial companies; (ii) infrastructure linked to the external sector remains as a bottleneck; and (iii) there are still many challenges with respect to the access to foreign markets and implementation of trade agreements.

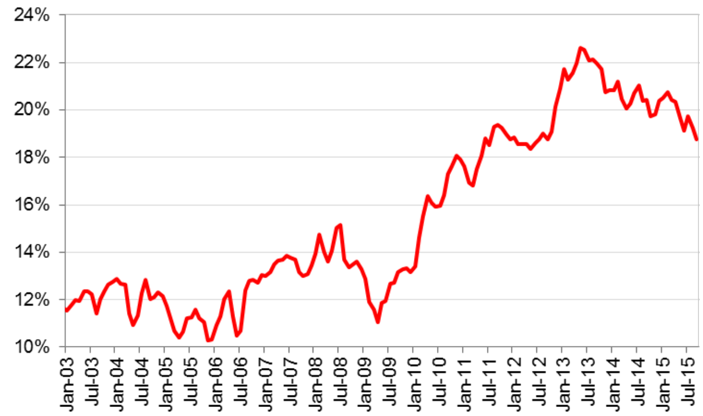
Despite these known obstacles, trade will exert a positive and significant contribution to the dynamics of the Brazilian economy in the coming years, and we do already see some signs of that effect on recent data. Import penetration seems already to be on a descent, having declined nearly 7 percentage points from its peak. The export coefficient[3] has also shown a relevant shift, jumping over 4 percentage points since mid-2014.

[1] Import Penetration Ratio = [Imports / (Domestic Production + Imports – Exports) * 100
Regarding the pre-crisis period, we calculate a less pronounced expansion from 11.9% in 2004 to 12.8% in 2008.

[2] Import Penetration Ratio = f (Unit Labor Cost; Relative Price of Industrial Goods adjusted by the Exchange Rate; Economic Activity Index).
Based on our estimates, the relative price of industrial goods (exchange rate impact) and economic activity were responsible for 26% and 22% of the increase in the import penetration ratio after the 2008/09 international crisis, respectively.

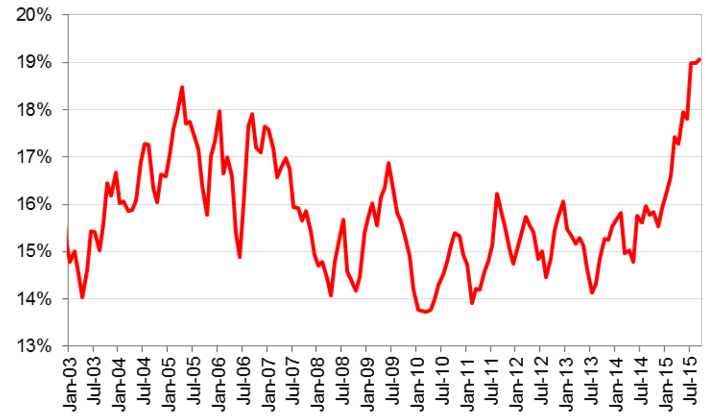
[3] Export Coefficient = (Exports / Domestic Production) *100

Figure 9. Import penetration ratio - manufacturing



3-month moving average of seasonally adjusted data. Sources: IBGE, Funcex and Santander.

Figure 10. Export coefficient - manufacturing



3-month moving average of seasonally adjusted data. Sources: IBGE, Funcex and Santander.

We forecast the import penetration ratio will decline from 20.2% in 2014 to 18.4% in 2015 and 16.0% in 2016 (year-end), in seasonally adjusted terms. Our econometric exercises show the variable 'relative price of industrial goods' accounting for around 70% of the overall decrease in this ratio, suggesting a dominant effect of the BRL weakness in this process. **Likewise, we expect the export coefficient (year-end, seasonally adjusted) to increase from 15.9% in 2014 to 19.3% in 2015 and 22.4% in 2016.**

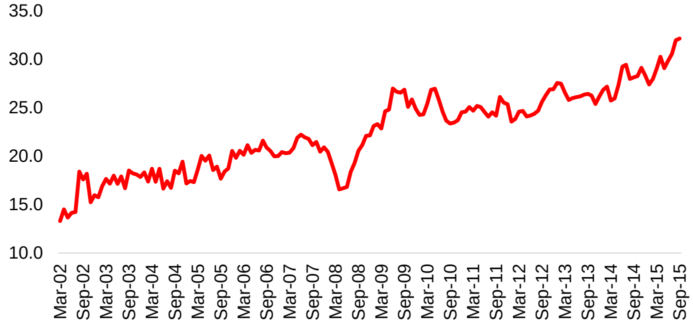
These movements are not homogeneous across sectors, as shown in the charts on the following page. Import substitution seems to take place first in sectors related to basic inputs (intermediate goods) and/or with lower technological complexity, e.g., chemicals, metallurgy, machinery and equipment, rubber and plastic. On the side of exports, we note the strongest response from traditional export sectors such as pulp and paper, food (e.g., meat, oil), leather and footwear, and metallurgy (e.g., pig iron, alloy iron). The export of goods with higher technological level, however, tend to respond less intensely to the BRL weakness, mostly due to the low productivity of national industry. In fact, we view the BRL shift as supportive to manufactured exports, but far from sufficient to make this variable a meaningful driver of economic activity: in order to achieve that, the country needs to address its structural competitiveness problems (productivity, taxes and infrastructure stand out as some of the main challenges on that ground).

CAN TRADE SAVE THE GDP?

Overall (basic and manufactured goods considered), we estimate that the improvement in the trade balance will contribute 1.7 pp to GDP in 2016, preventing a wider contraction in activity and limiting the potential downside for the economy going forward. We see the contraction in imports accounting for about 60% of the aforementioned contribution (or +1.0 pp). In turn, import substitution through domestic manufacturing will be responsible for nearly 25% of this reduction next year (which corresponds to +0.25 pp), in our view. **In other words, while most part of the shrinkage of imports will be driven by the weakening economic activity, we believe the positive impact from the decrease in the import penetration ratio will not be negligible.**

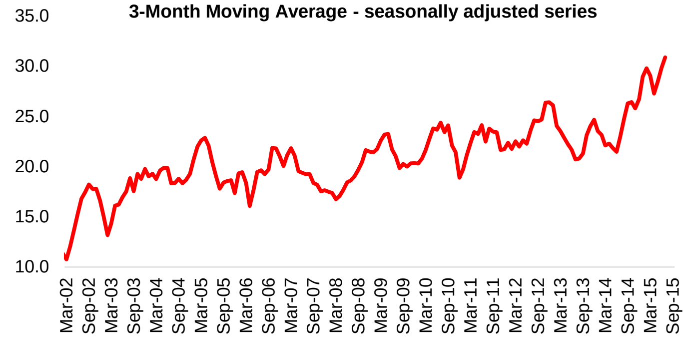
In short, we believe the external sector will be very important for Brazil's economy in 2016 (particularly for the manufacturing industry), preventing a wider contraction of this activity. This dynamic should help mitigate the negative effect of the unfriendly environment comprised of the currently high inventory levels at the industry level (the auto sector, in particular); tighter funding conditions; a steep decline in investments; political and economic uncertainties and extremely low levels of business confidence. As a net result, the industrial sector is likely to continue to contract next year but at a slower pace (-5.5%, versus -9.5% this year). In the absence of economic relief coming from the external sector, industrial output would sink some 8% next year, in our view.

Export Coefficient
Pulp and Paper (%)
3-Month Moving Average - seasonally adjusted series



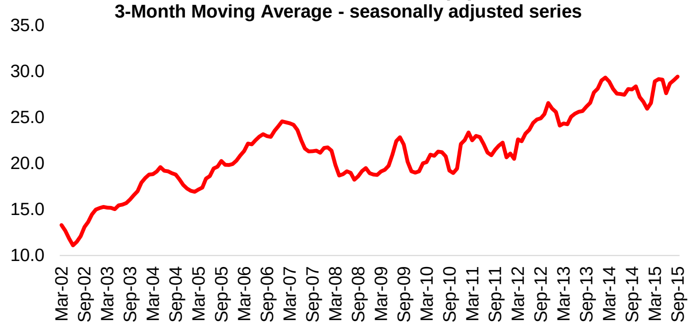
Source: IBGE, Funcex   Estimates: Santander

Export Coefficient
Food (%)
3-Month Moving Average - seasonally adjusted series



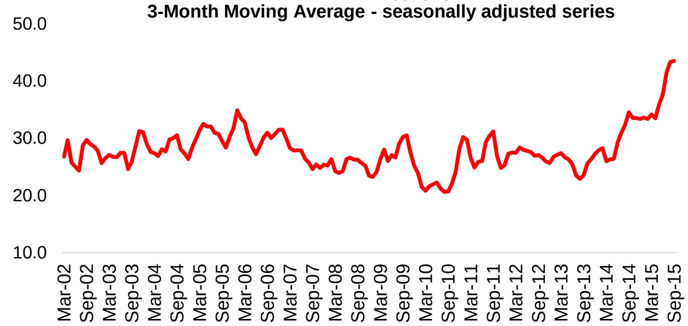
Source: IBGE, Funcex   Estimates: Santander

Export Coefficient
Leather and Footware (%)
3-Month Moving Average - seasonally adjusted series



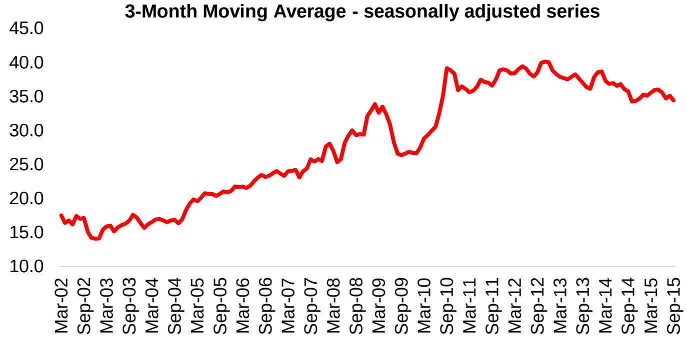
Source: IBGE , Funcex   Estimates: Santander

Export Coefficient
Metallurgy (%)
3-Month Moving Average - seasonally adjusted series



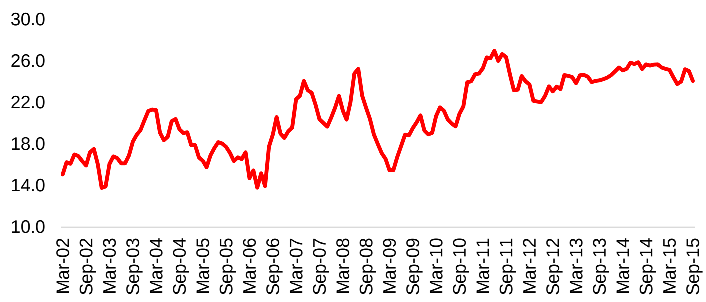
Source: IBGE, Funcex   Estimates: Santander

Import Penetration Ratio
Machinery and Equipment (%)
3-Month Moving Average - seasonally adjusted series



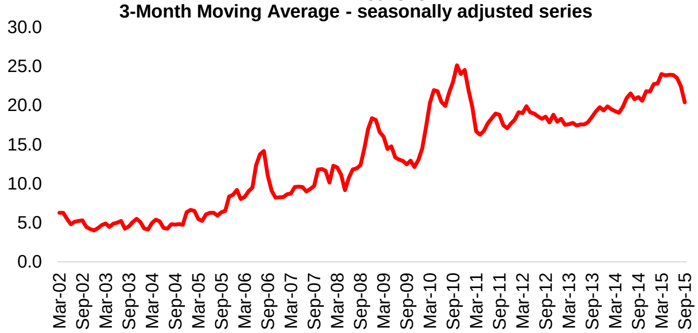
Source: IBGE, Funcex   Estimates: Santander

Import Penetration Ratio
Chemicals (%)
3-Month Moving Average - seasonally adjusted series



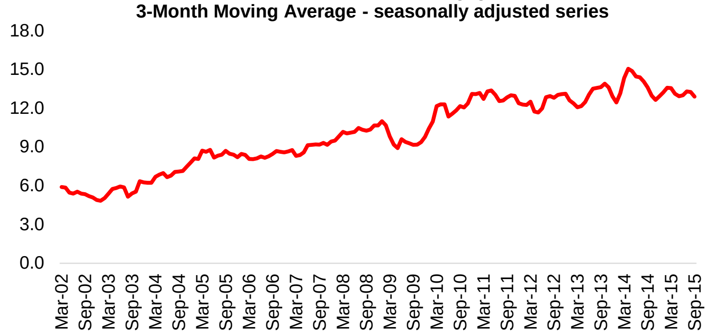
Source: IBGE, Funcex   Estimates: Santander

Import Penetration Ratio
Metallurgy (%)
3-Month Moving Average - seasonally adjusted series



Source: IBGE, Funcex   Estimates: Santander

Import Penetration Ratio
Rubber and Plastic (%)
3-Month Moving Average - seasonally adjusted series



Source: IBGE, Funcex   Estimates: Santander

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