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BRAZIL: WIDER CURRENT ACCOUNT DEFICIT RAISES EXTERNAL FINANCING NEEDS

October 1st 2013

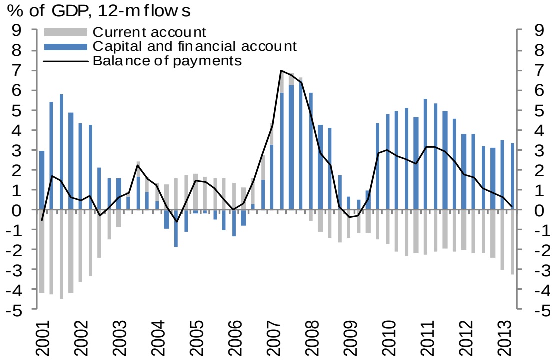
Balance of payments: Eroded surplus

Brazil's balance of payments displayed a widening current account deficit and higher external financing needs in the 12-months through August. The annual balance posted a deficit of USD2.3bn, down from a surplus of USD1bn through July and USD25.1bn a year ago. The current account—the balance of trade in goods, services, and income between Brazil and the rest of the world—widened to a deficit of 3.6% of GDP, its largest since 2002. (Figure 1.)

In terms of financing, inflows of foreign direct investment (FDI) are covering most of Brazil's funding needs but, since March, no longer completely. In the 12-months through August, the current account deficit exceeded net FDI inflows of 2.7% of GDP. External financing needs—the difference between the current account deficit and FDI—increased to 0.9% of GDP. Larger portfolio flows covered the financing gap in August. Brazil's ample stock of international reserves—which is 80% higher than at end-2008, amounts to 15% of GDP, and covers short-term external debt obligations by 4:1—mitigates balance of payments risks; yet the weakened fundamentals are supportive of a depreciated BRL in an environment of global uncertainty and prospects for tighter financial conditions.

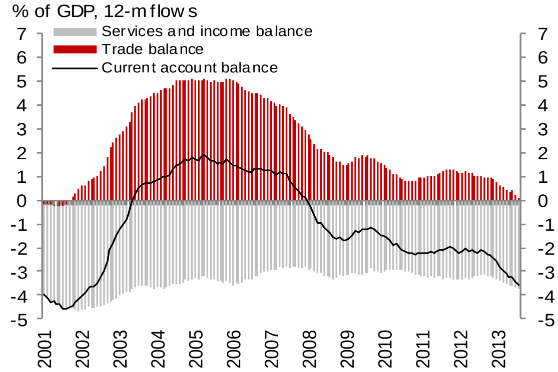
Following this year's widening trend, the current account deficit should stabilize in the next few months and narrow towards 3% of GDP in 2014, as a weaker BRL and slow GDP growth ease Brazilian import demand.

Figure 1: Balance of payments



Note: Quarterly figures through 2Q13.
Source: Central Bank; BTMU Economic Research (NY).

Figure 2: Widening current account deficit



Source: Central Bank; BTMU Economic Research (NY).

Narrowing trade surplus widens current account deficit to 3.6% of GDP

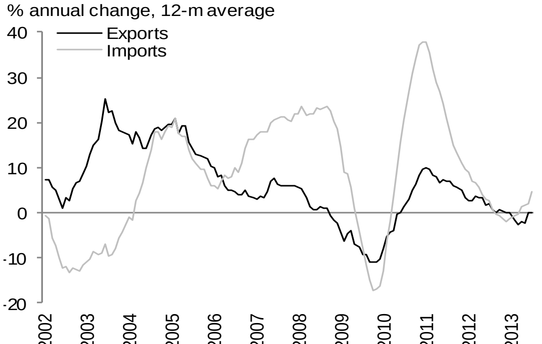
The current account deficit came in at USD5.5bn in August, decreasing from a deficit from USD9bn in July but widening from a deficit of USD2.5bn a year ago. The 12-month deficit widened to USD80.6bn, or 3.6% of GDP, from 3.5% in July and 2.4% at end-2012. The result—Brazil's widest current account deficit since 2002—reflects deterioration in its major components: the trade balance and services and income balances. However, it is primarily the marked erosion of the trade surplus that has been driving the widening of the current account deficit. (Figure 2.)

The 12-month trade surplus has steadily narrowed from 5% of GDP in 2006 to just 0.1% of GDP in August 2013, despite the high commodity prices and favorable terms of trade (the price of exports vs. imports) that reigned during most of this period. In terms of volume growth, imports outpaced exports in an environment of a strong BRL, reduced competitiveness, and government policies to stimulate consumption. In the 12-months through August, the trade surplus totaled USD2.5bn, less than USD22.9bn through August 2012. The trade surplus of USD1.2bn in August improved from a USD1.9bn deficit in July, yet volume growth of imports continues to outpace exports, which have picked up notwithstanding less favorable export prices and terms of trade. (Figures 3 and 4.)

The services and income balances maintain structurally wide deficits. In August, the services deficit rose to USD4.2bn—a 41.6% yoy increase—owing to strong travel spending of Brazilians abroad despite the recent BRL weakness. The income deficit totaled USD2.7bn in August.

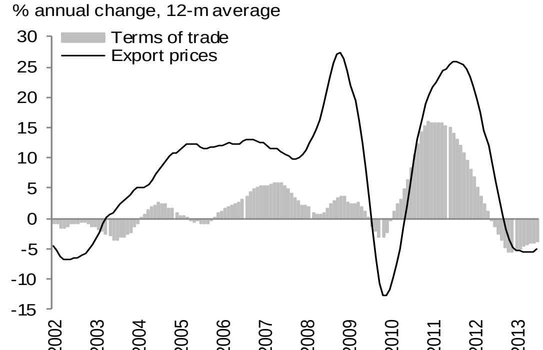
Going forward, the pace of current account deficit deterioration should lose momentum to stay in line with the present level of 3.6% in 2013 and narrow towards 3% of GDP in 2014 on account of the recovery of a modest trade surplus. We expect that import volume growth will begin to slow on account of BRL weakness and lackluster economic growth, thus easing widening pressures on the current account deficit. There remain, nonetheless, downside risks from the structural imbalance of the domestic economy in favor of private consumption and government spending, and the still uncertain external environment.

Figure 3: Volume growth of exports and imports



Source: Funcex; BTMU Economic Research (NY).

Figure 4: Lower export prices and terms of trade



Source: Funcex; BTMU Economic Research (NY).

Capital flows: FDI and portfolio flows are financing the current account deficit

External funding is available to Brazil, although the composition of financing has registered an important change this year since the wider current account deficit has coincided with changes in the allocation of global capital flows amid the prospect of eventual QE tapering by the US Federal Reserve and shifts in investors' risk sentiment.

Brazil's current account deficit is being financed by net inflows to the financial account. Net inflows of long-term FDI totaled USD61bn in the 12-months through August, or 2.7% of GDP. (Figure 5.)

Despite this solid FDI inflow, since March, the current account deficit requires that shorter-term financial flows cover the funding gap. Indeed, external financing needs—the difference between the current account deficit and FDI—rose to 0.9% of GDP in the 12-months through August 2013, reversing from a surplus of 0.7% in the same month a year ago. (Figure 6.)

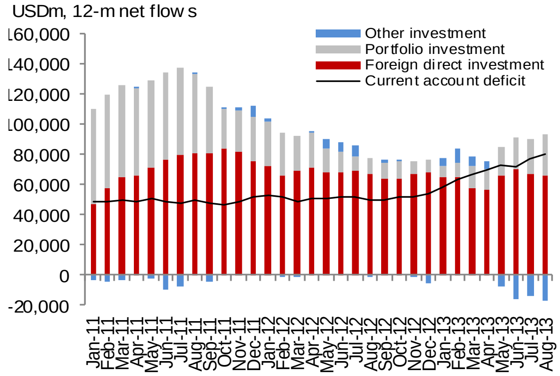
In August, larger portfolio investment made up the financing difference. The 12-month net flow of portfolio investment totaled USD27.1bn, up from USD23.0bn in July. Net portfolio flows in the month of August increased to USD5.8bn from USD3.9bn in July. Portfolio investments to debt securities, which totaled USD5.0bn, have been boosted by the removal of the 6% IOF tax on foreigners' fixed income investments in June. On the other hand, equity investments rose to USD882m from 268.8m in July, but were restrained by global risk aversion amid uncertainty regarding the timing of the US Federal Reserve's tapering of QE.

Meanwhile, there was a large outflow of other investments amounting to USD6.4bn in August, raising the 12-month outflow of USD16.7bn from USD13.3bn the previous month. (Figure 5.)

Balance of payments risk is mitigated by Brazil's ample international reserves coverage. The reserves stock totals USD367bn, an 80% increase from end-2008. Reserves account for 15% of GDP and cover short-term external debt by 4:1. Nevertheless, the weakened balance of payments fundamentals are supportive of a depreciated BRL. The consensus expects the currency, which should receive near-term support from the Central Bank's FX intervention program and the Fed's ongoing QE, to trade at 2.3:USD1 in 2013 and 2.4:USD1 in 2014.

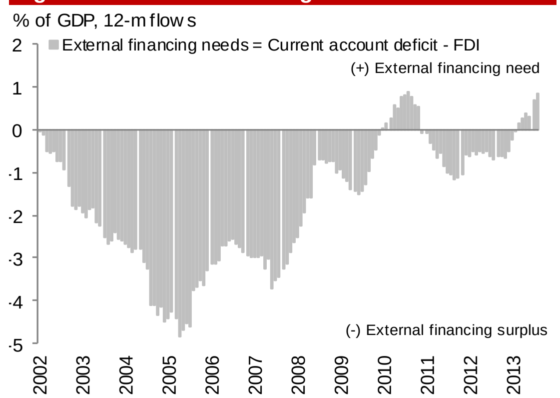
In this context, the size of the current account deficit and composition of its financing will remain key determinants of balance of payments' fundamentals and the BRL. Moderated, though firm, FDI inflows should cover most of the current account deficit, which we expect will narrow to 3% of GDP in 2014 upon a weaker currency and below potential growth. Yet, in an environment where external financing conditions look to eventually become less abundant and more expensive, covering the current account deficit will also rest on short-term financial flows.

Figure 5: Flows of the financial account



Note: Current account deficit is denoted by (+).
Source: Central Bank; BTMU Economic Research (NY).

Figure 6: External financing needs



Source: Central Bank; BTMU Economic Research (NY).

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