Brazil Economic Outlook

Third Quarter 2014
Latin America Unit

- The Brazilian economy is in stagflation, due to its significantly below-potential growth rate and its rising inflation, which is well above target.
- We estimate that GDP will only grow at 1.3% in 2014 and, unless there is a recovery, at 1.6% in 2015. Confidence, which is below its 2009 crisis levels, is one of the barriers to increased economic momentum.
- Inflation will close 2014 at 6.2%, after staying above the target range for several months. A slight moderation from the end of 2014 onwards will contribute to 2015 closing at 5.8%. It will also enable Brazil to emerge from the present stagflation.
- The expansive tone of fiscal policy is helping to keep interest rates and the exchange rate high, making difficult the necessary adjustment towards a growth model sustained less by consumption and more by exports and investment.

Index

Closing date: 5 August 2014

1 Summary

A slower global recovery, in a complex environment. There have been no visible tensions in the financial markets in the last three months, with activity keeping up a good pace after the bad patch in the first quarter in the US. Global growth slowed in the first half of 2014, but we still think that it will speed up again, from 3.3% this year to 3.8% in 2015. By areas, we are sticking to our positive prognosis for developed economies in 2015, while we anticipate a very limited deceleration in China, to 7% in 2015.

In Brazil, we are revising our growth forecast for 2014 from 2.0% to 1.3%, due to slow growth in the first quarter, affected by the contraction in investment and the absence of good reasons to expect any significant uptick for the rest of the year, in an environment of high uncertainty and low confidence. We estimate that growth will reach 1.6% in 2015, a year which we expect to be one of adjustments whatever the result of the October 2014 elections.

Inflation has risen since the beginning of the year and is above the target range of 2.5%-6.5%. We expect it to remain above this range until November, before falling slightly and closing the year at 6.2%. Despite the moderation in activity, there are no signs of a significant moderation in prices, due to the convergence of administered prices with market-set prices, where the gap is currently 13%, and of the exchange rate with its equilibrium level, which could imply a depreciation of 10%-15%. We estimate that inflation will close 2015 at 5.8%.

The deterioration in economic activity and the rising trend in inflation (already above the target) indicate that the economy is currently in stagflation. The economy is growing below potential, which we estimate at 2.8% (see Box 1). A number of supply-side issues are contributing to this, such as the deterioration in the terms of trade and the loss of competitiveness (Box 3). Likewise, according to our methodology (see Box 2), the country will emerge from stagflation in 4Q14 and will have distanced itself from it in 2015 as a reflection of the slowdown in inflation.

Fiscal policy is being focused on supporting domestic demand, as confirmed by the recent measures supporting activity. Low growth is the justification for this more expansive tone. Nevertheless, a more neutral tone would help to improve the credibility of public policies and reduce pessimism about the country as a whole. It would also assist in fighting inflation, reducing pressure on interest rates and leaving more margin for the real to depreciate, thus supporting exports. We expect the primary deficit to reach 1.4% of GDP this year, below the 1.9% target, and after a moderate correction in the next government’s first year, to approach 1.9%.

The Brazilian central bank signals that it will keep the Selic stable at 11% and, at the same time, inject liquidity into the economy by reducing reserve requirements. It appears that the central bank will use the Selic as an instrument for controlling inflation and reserve requirements as a tool for stimulating credit markets and growth. The latter may make it trickier to anchor long-term inflation expectations. We are sticking to our forecast that the Selic will stay at 11% for the rest of the year and that it will correct upwards in 2015 as the US normalises its monetary policy.

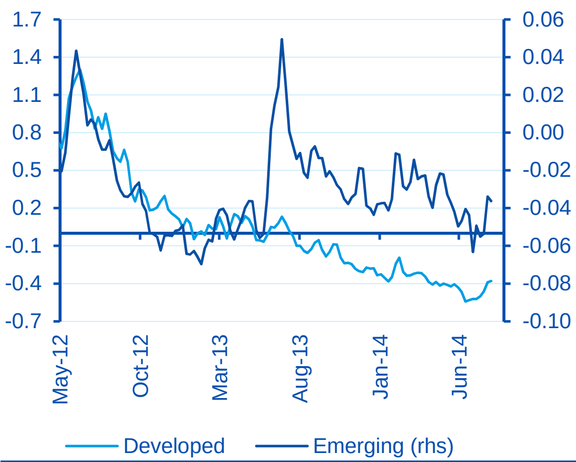
The real has appreciated 8% so far this year and is trading 10%-15% above its equilibrium level. We expect this gap to close towards the end of 2015. Most of this correction will happen next year, made possible by less intervention expected on the part of the Brazilian central bank in the FX markets and by the normalisation of US monetary policy. Despite the impact on inflation, exchange-rate depreciation is necessary if the economy is to correct towards a growth model that is sustained less so by consumption and more by exports and investment.

2 Global scenario: a slower global recovery in a complex environment

Low financial tensions, dominated by the Fed, support a favourable scenario for growth

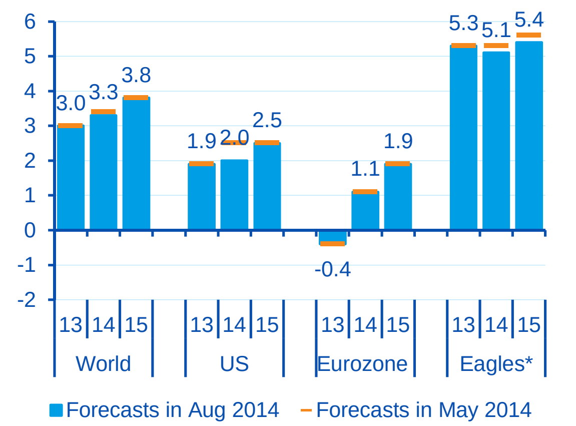
The global leading indicators are consistent with a favourable scenario for growth. First, tensions in financial markets remain low, according to our indicators, in both emerging and developed markets (Figure 2.1) – the recent uptick is due specifically to Russia. Second, industrial activity and global trade are keeping up a good momentum. All of this is taking place in a global environment in which geopolitical risk events, while not causing outright disruption to economic activity, are cropping up everywhere, and as such increasing uncertainty. For the moment, financial volatility is at historically low levels, since the factor dominating the behaviour of global financial markets is the Fed, and this institution is carefully managing a very gradual exit from the exceptional monetary measures implemented in the last few years.

Figure 2.1
BBVA Research's Financial Stress Index



Source: BBVA Research

Figure 2.2
GDP growth forecasts (%)



* EAGLEs is the emerging markets group which will contribute most to world GDP in the next 10 years. The group consists of China, India, Indonesia, Brazil, Russia, Turkey and Mexico.
Source: BBVA Research

In China, the risk of a hard landing is receding and growth will remain above 7%

The risk of a hard landing in China, predicted by some a few months ago, is receding, thanks to the improvement in exports and in fiscal and monetary support measures. Increased external demand and the brake put on the appreciation of the yuan have helped exports to recover, while monetary policy has been relaxed by cutting the bank reserve ratios, thus favouring credit. Shadow banking controls and plans to liberalise the more regulated part of the banking sector are enabling most of this new financing to be provided by the latter segment. This combination of supervisory measures and simultaneous liberalisation to help traditional banking entities compete (freedom to set interest rates, easing the entry of private investment, promoting lending to private companies over those in the public sector) should enable the deleveraging process to take place in an orderly manner, without any sharp corrections. Finally, more focused fiscal policy measures than on other occasions have also been introduced, above all in relation to the increase in infrastructure spending.

All in all, our outlook is for a very controlled deceleration, with growth easing to 7% in 2015, from 7.7% in 2013. Furthermore, this movement is linked to a long-term trend of an increase in household consumption over business investment, while at the same time the Chinese currency returns to its previous appreciation trend against the dollar. In short, an economic rebalancing, with a moderate increase in debt, for which the authorities have the room for manoeuvre provided by their high level of reserves, the control of their current account with high levels of private savings and relatively low public-sector debt.

Transitory hiccup in US growth. The Fed's communication policy will be key in lowering market volatility

The fall in US GDP during the first quarter of 2014 was mainly due to transitory factors, but the intensity of the correction made us revise our growth forecast downward for 2014 from 2.5% to 2% (Figure 2.2). The 2.1% quarterly drop, in annual terms, of US GDP is one of the sharpest of the historical series in a cyclical growth phase. The most recent data show that the US economy has recovered from the intense, but transitory, effect of the bad weather and from the steep fall in the accumulation of stocks.

There is greater uncertainty about the perspective of monetary tightening by the Fed and, in particular, about the global impact this will have on financial markets. The Fed will stop expanding its balance sheet in October, starting a phase in which rates and monetary measures will be determined based on the incoming information about the strength of the economic cycle and the anchoring of inflationary outlooks. In our most likely scenario, the first rise in the Fed funds rate will be in 3Q15, with a bias towards this happening closer to the middle of that year. In this scenario, the US central bank's communication policy will become more important; as such, an increase in global financial market uncertainty and volatility is also a possibility.

The outlook in the eurozone is improving thanks to supportive domestic demand policies and progress in banking union

Leading indicators in the eurozone are consistent with a slight recovery in GDP, in line with our forecast of 1.1% for the year as a whole, the first positive annual growth since 2011. Sustained improvement in access to financial markets, particularly for more stressed economies on the periphery of the eurozone, is the main factor supporting the area's growth, together with the relaxation in public deficit targets in the short term and a more positive external environment. Ultimately, there are essentially two reasons for this virtuous circle. First, the confidence gained as a result of the decisions taken by the euro area authorities to strengthen the single market in the financial sector, and the support of the monetary policy implemented by the ECB, which goes beyond what might have been foreseen just a few quarters ago. Second is the anchoring of global financial tensions at minimum levels. In addition, the reforms undertaken in the markets of productive factors in some economies, designed to improve competitiveness, are another positive factor.

All in all, although we are sticking to our growth forecasts of 1.1% in 2014 and 1.9% for 2015 (Figure 2.2), the bias for these is to the upside if the potential impact of the measures announced by the ECB is taken into account. All this does not, however, rule out the existence of risk to the downside which could be triggered by the worsening crisis in the Ukraine and the knock-on effects of economic sanctions imposed on Russia, to which the eurozone would be far from immune.

In summary, global growth will strengthen from the second half of 2014 onwards

In our most likely scenario, the slowdown in global growth in the first part of 2014 has already ended. The most recent indicators of cyclical confidence and financial volatility are consistent with a gradual improvement, which should enable worldwide growth to reach 3.3% in 2014, 30bp higher than in 2013 (Figure 2.2). Maintaining favourable global financing conditions and supporting economic demand policies will help growth to accelerate faster in 2015 at rates close to 3.8%, with an increase in the contribution made by the more developed economies, which could gradually start positioning themselves for the withdrawal of the exceptional stimulus of the last few years.

The uncertainty within this baseline scenario continues biased to the downside because of the re-emergence of geopolitical risks and the doubts about the global impact on capital flows and asset prices caused by the proximity of interest-rate hikes in the US.

3 Brazil: stagflation

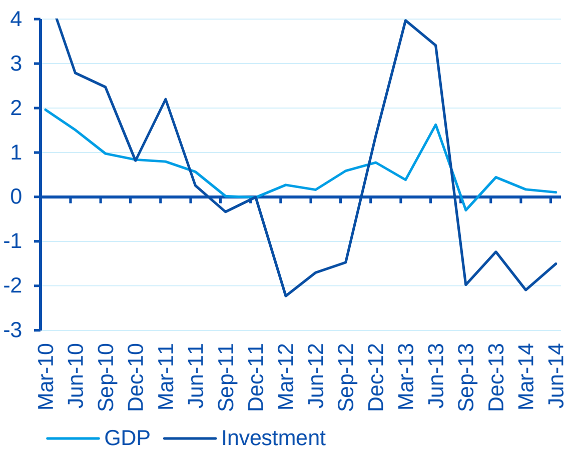
After further signs of weakness, we have revised our growth forecast to 1.3% in 2014. Nor is a significant recovery on the horizon for 2015, with the economy set to grow just 1.6%

Brazil's GDP only grew 0.2% QoQ in the first quarter, significantly below expectations. Evidence available for the second quarter suggests an additional moderation of economic activity over the period (Figure 3.1). Specifically, we expect growth of just 0.1% QoQ of GDP over the period, but a slight contraction would not be surprising either.

Activity has been weak across the board, but particularly so in the fixed capital investment component, which fell 2.1% QoQ in 1Q14 and we forecast that it will fall for the fourth consecutive quarter in 2Q14. In terms of the contribution to growth of consumption and net exports, we expect this to be more positive in 2Q14; in the case of net exports, this is mainly due to a moderation in imports.

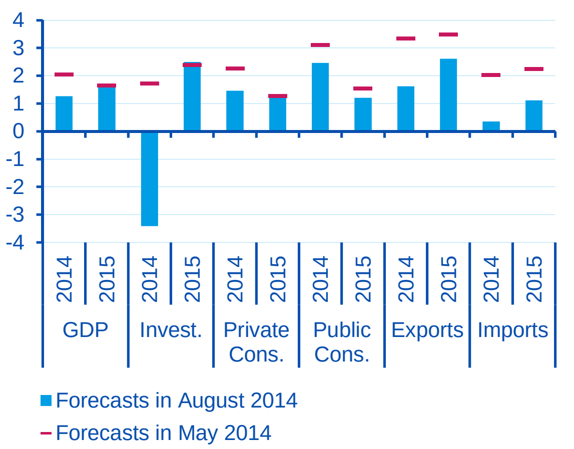
In view of the very low growth in the first half of the year and the lack of good reasons to expect a significant uptick in the remainder, we have revised our growth forecast for the Brazilian economy in 2014 from 2.0% to 1.3%. This downwards revision is particularly significant in the area of investment, which we now estimate will contract by around 3% this year. Despite the downwards revisions, consumption and exports will make a positive contribution to growth (Figure 3.2).

Figure 3.1
GDP and investment * (% QoQ)



* 2Q14 data are BBVA Research forecasts.
Source: IBGE and BBVA Research

Figure 3.2
GDP and demand components: forecasts (%)

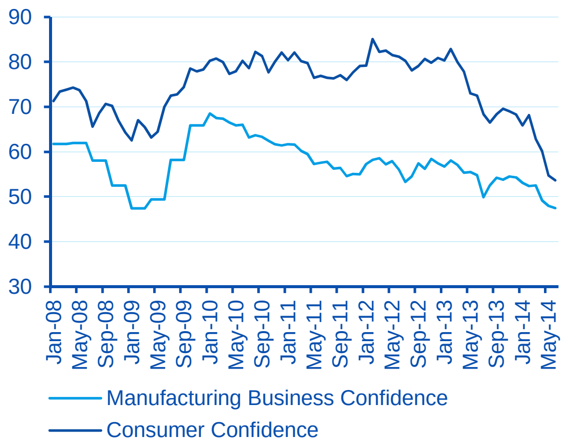


Source: BBVA Research

As well as a series of structural problems, such as, for example, the increasing loss of competitiveness in the economy (Box 3.3), activity - and investment in particular - is still suffering the negative impact of uncertainty about domestic government policy and economic developments in the future, to a certain degree because of the national and regional elections in October 2014. Another factor adding to uncertainty is the deterioration in the economy in the last few years, creating a negative cycle which is clearly unfavourable.

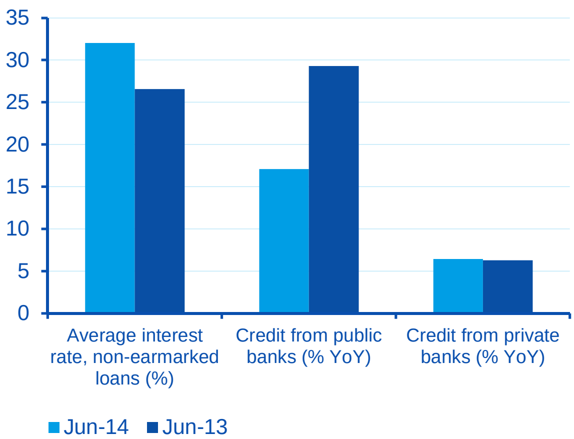
Reduced business and household confidence is a clear reflection of the current problems in the economy, especially the increased uncertainty mentioned above. The consumer confidence index has shown a strong downwards trend since the beginning of last year and is at significantly lower levels than during the 2009 crisis. The business confidence indicator, where the downwards trend started at the beginning of 2010, is currently very close to its 2009 lows (Figure 3.3).

Figure 3.3
Consumer and business confidence



* The consumer confidence indicator has been adjusted to the 0-100 range.
Source: Fecomercio, CNI and BBVA Research.

Figure 3.4
Credit markets



Source: BCB and BBVA Research

Recent fragility in economic growth is also related to the restrictive tone of monetary policy after the 375bp adjustment in the Selic rate between March 2013 and April 2014. This adjustment has contributed, among other things, to the recent appreciation in the exchange rate, with a negative impact on net exports, and to the increase in interest rates on bank loans. This last has contributed to a further moderation in the credit markets, in a context marked by a growth of only 13% YoY in credit stock (approximately 6% in real terms), in comparison with around 32% YoY (25% in real terms) in 2008, as a consequence of the recent slowdown in public loans and of the stagnation in loans made by private banks (Figure 3.4).

There were more factors contributing to moderate activity, especially through their impact on exports: the approximately 4% deterioration in the terms of trade in the first half of the year and the moderation of demand from Argentina, the traditional destination for around 8% of Brazilian exports (Figure 3.5). On that final point, there is a risk that Argentine demand for Brazilian exports will moderate even more because of the impact of the recent suspension of payments on the trade channel, (see Box 1 of our 1Q14 Brazil Outlook for more details on the impact on Latin American countries of a stress situation in Argentina).

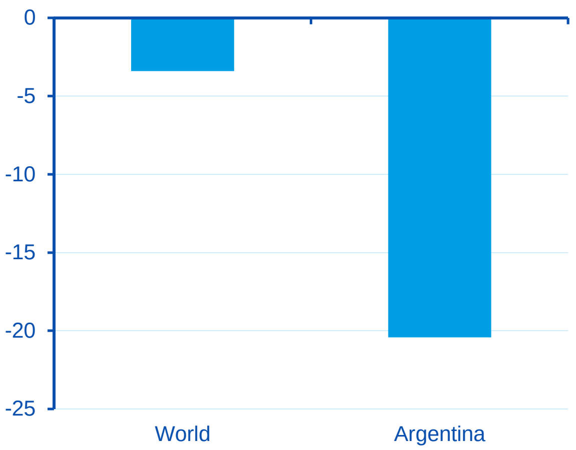
In line with expectations, preliminary evidence suggests that the recent Football World Cup had little positive impact on Brazil, restricted to a few services sectors. By contrast, the fewer working days as a result of the national holidays decreed during the event has exacerbated the negative trend in industry and other segments.

We expect the Brazilian economy to show some signs of recovery, after this particularly weak first half. This prognosis is based on the greater momentum expected in the global economy over the period and the impact - although a limited one - of some fiscal stimulus and macroprudential measures adopted recently by both the government and Brazil's central bank, the BCB (see later sections below for more information). These measures, notably the fiscal ones on the automotive sector, those supporting the export sector and capital markets and, in particular, the injection of liquidity via the reduction of reserve requirements, show that the further deterioration of economic activity has given the authorities a marginal bias in the direction of supporting growth instead of prioritising the fight against inflation.

Similarly, if this expected partial recovery does not materialise, growth this year will be around 0.5pp below our official forecast of 1.3% for this year.

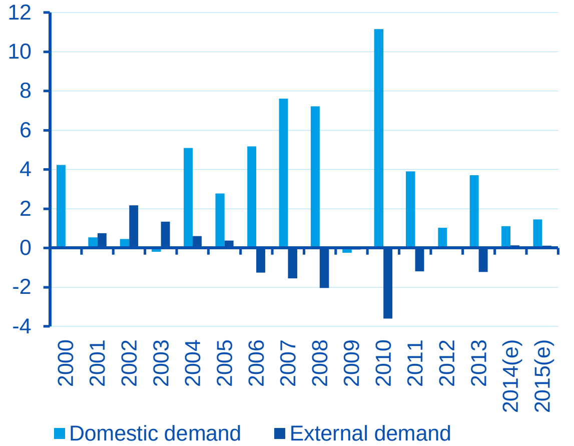
The general election in October 2014, which will, among other things, decide the President of Brazil between 2015 and 2018, increases the uncertainties about the economy's performance in the next few years. Recent surveys carried out after the Football World Cup show that, despite the increasing popularity of the opposition candidates, President Dilma Rousseff (from the *Partido dos Trabalhadores*, or Workers Party) is still the favourite in the battle against candidates Aecio Neves (of the PSDB party) and the late Eduardo Campos (PSB), both defenders of more orthodox economic policy management. In any event, even though Dilma Rousseff is the favourite, victory by one of the opposing candidates cannot be ruled out, especially Aecio Neves. This is particularly true given the desire for change revealed in recent surveys and the likely impact of the current economic scenario on voter decisions.

Figure 3.5
Goods exports, first half 2014 (% YoY)



Source: ALICEWEB and BBVA Research

Figure 3.6
Contribution of external and internal demand on GDP growth (pp)



Source: BCB and BBVA Research

Whatever the result of the general elections, we believe that 2015 will be a year of corrections, marked by the readjustment of regulated prices and a more restrictive tone in economic policies (see sections below for more detail). Without these adjustments, inflation expectations could deteriorate further, uncertainty and the lack of confidence could continue to prevent greater momentum in economic activity and doubts about public accounts could generate new downgrades in the country's credit rating[1].

In the short term, i.e. in 2015, these corrections mean that a solid recovery of economic activity is unlikely, despite greater growth in the global economy. More specifically, we believe that, after growing 1.3% in 2014, GDP will rise by 1.6% in 2015, which is the same as we were forecasting three months ago. In terms of demand components, investment and exports will contribute more to growth next year than this, because of reduced uncertainty about public policies and the expected depreciation of the real (Figure 3.2).

1: In March 2014, S&P downgraded Brazil's sovereign debt from BBB to BBB-.

Note the more positive contribution of external demand to GDP in both 2014 and 2015, compared with earlier years, which reflects in part a lower growth in imports, consequence of the moderation in internal demand (Figure 3.6). Similarly, as we have been pointing out in our reports, solid export growth, as well as investment, is a necessary condition if the country is to return to growth rates of around 3%, close to potential growth (Box 3.1). In order for exports to recover competitiveness momentum to increase, we consider that sharper currency depreciation is vital, since it is still trading at high levels, partly as a result of the central bank's exchange-rate interventions (see later sections for more details).

Box 1. The Brazilian economy's growth potential

We have updated our potential GDP growth forecasts for Brazil, incorporating real data from recent quarters in our estimation process, together with our forecasts for key variables over the coming years.

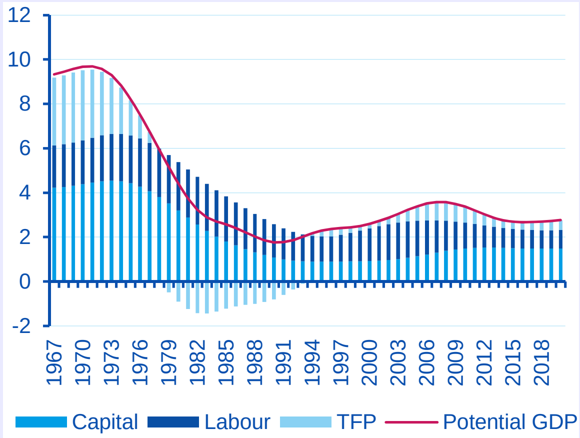
We estimate that the economy's growth potential is currently close to 2.8% and that it will stay at these levels over the next few years (Figure B.1.1).

The key contribution to this 2.8% growth comes - and will continue to come - from the capital factor, practically unchanged at 1.5pp. The labour factor and total factor productivity (TFP) currently contribute 0.9pp and 0.3pp, respectively. By 2020, the labour factor contribution will have softened very slightly, offset by the uptick in TFP. The former is partly due to a gradual reduction in the working-age population and the latter to an increase in TFP thanks to marginal positive progress in the institutional arena.

This growth rate is lower than in earlier years. Between 2007 and 2008, the potential growth rate, according to our current estimates, was close to 3.6%, thanks to higher contributions of the labour factor, helped at that point by more favourable demographic factors, and TFP.

The current potential growth rate, of 2.8%, is also lower than our 3.8% estimate a year ago (Figure B.1.2). This downward revision is due to the smaller contribution made by the capital factor, and, particularly, of TFP. In terms of the capital factor, this downwards revision is explained by the disappointing recent performance of investment (which have fallen as a proportion of GDP) and by the absence of indications of an uptick in the near future. On the other hand, we have cut our expectations for institutional progress and the business environment, partly because there is no sign of a reform agenda which would contribute to increase productivity. The deterioration of economic debate is an illustration of this, focused as it is more on macroeconomic policies than on reforms and productivity. These are the factors keeping down TFP's contribution to growth.

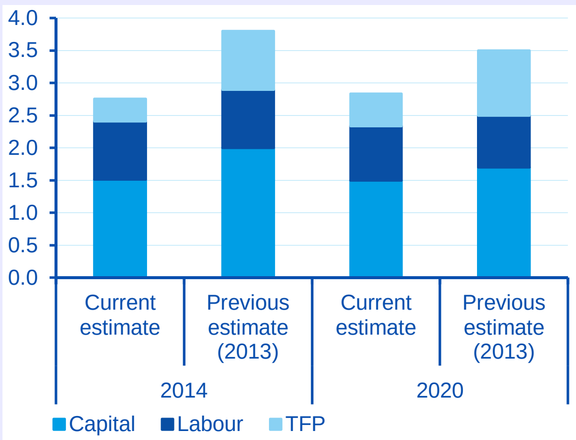
Figure B.1.1
Potential growth, by components, 1967-2020 (%)



Source: BBVA Research

Finally, bearing in mind our estimate of potential growth of close to 2.8%, we conclude that the economy's recent moderation is temporary and that activity should recover in the medium term. To be specific, we believe it will do so after the corrections we expect to be adopted once the elections have taken place, in 2015 (see earlier sections).

Figure B.1.2
Potential growth, by components, 2014 and 2020, current and previous estimate (2013)

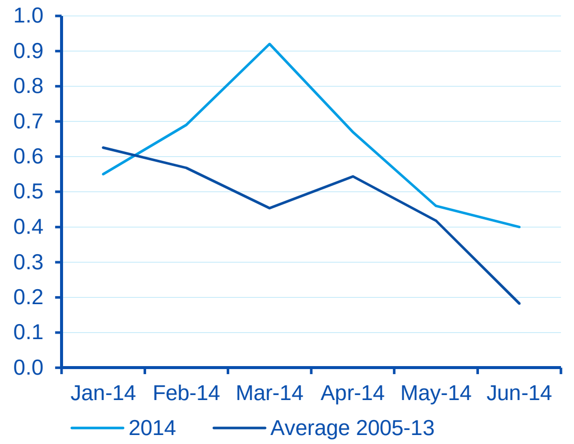


Source: BBVA Research

Inflation: above the target range and with no signs of a significant moderation resulting from any corrections to administered prices and to the exchange rate

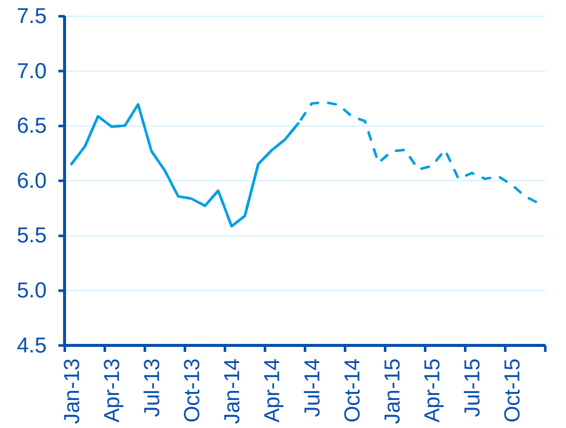
MoM inflation has been slowing every month since March, when it reached 0.92% MoM. The waning impact of the drought affecting the country earlier in the year has contributed to this downwards trend. In any event, this moderation of monthly inflation is due to a large degree to seasonal factors and has often occurred over the same period in earlier years (Figure 3.7).

Figure 3.7
Inflation (% MoM)



Source: IBGE and BBVA Research

Figure 3.8
Inflation (% YoY)



Source: IBGE and BBVA Research

Similarly, despite deceleration in monthly terms, annual inflation has risen continuously since the beginning of the year (Figure 3.7). The most recent rise, up to 6.5% YoY in June, has been affected by the heavy increase in the price of certain services, which enjoyed significantly increased demand as a result of the Football World Cup (hotels: 25% MoM, plane tickets: 22% MoM).

Although inflation will benefit in July and August from the fall in the prices of these same services which rose because of the World Cup, we forecast that in annual terms it will continue to rise over the next few months, remaining above the target ceiling of 6.5% YoY set by the central bank (Figure 3.8) until November, then slowing slightly in December, helped by a positive base effect, closing the year at 6.2% YoY, the same figure as we forecast three months ago.

As well as more structural factors, such as the economy being highly indexed, the still-significant increase in labour costs, together with the acceleration in inflation of administered products, are preventing the recent hike in interest rates and the slowdown in activity from bringing inflation down to any noticeable degree.

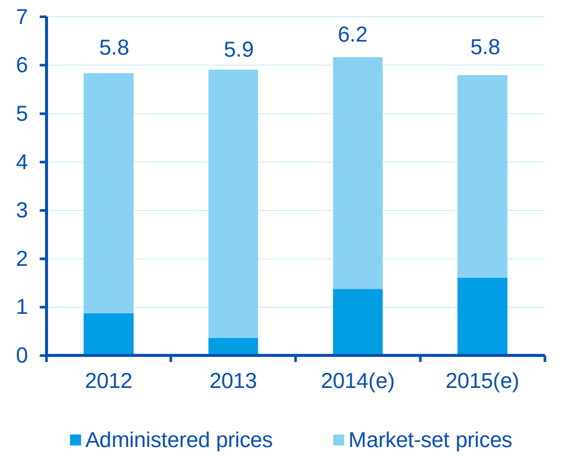
On labour costs, these are currently increasing at round 3% YoY in real terms (9% YoY in nominal terms), sustained by the very low level of unemployment (5.1%) and by the policy of raising the minimum wage, and in spite of the moderation in new job creation in the economy[2].

On the other hand, inflation of administered products is accelerating due to the lack of margin for retaining the subsidies that had been awarded in the past. Specifically, inflation of products supervised by the

2: Although new job creation in the economy has been slowing recently, the unemployment rate remains at particularly low levels because of the contraction in the workforce.

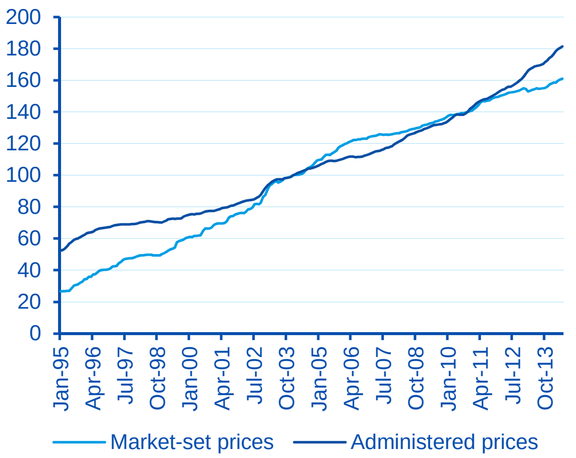
government, whose weighting in the IPCA basket of goods is around 24%, has risen from 1.5% YoY at the end of 2013 to 4.0% YoY in June 2014.

Figure 3.9
Contribution of regulated and free-market prices on annual inflation*



* The weighting of products regulated by the government in the HICP basked is about 24% in the period analysed.
Source: IBGE and BBVA Research

Figure 3.10
Free-market and regulated prices, index Jan 04=100



Source: Central bank and BBVA Research

The acceleration in inflation of products regulated by the government will continue for the next few months. We expect it to reach 6.0% YoY by the end of the year, as such contributing in a much more significant manner to inflation in 2014 than in past years (Figure 3.9).

The additional pressure expected on administered products in the coming year, when we forecast they will top 7% YoY, as well as the impact of the expected depreciation of the exchange rate, will not leave room for a reduction of any significance in inflation, even though slowing internal demand contains the upward pressures on market-set prices. The fact that long-term expectations, currently at around 6% YoY, are not anchored, is also a barrier to a sharper slowdown in inflation. In the light of all this, we forecast inflation to come in at an average of 6.1% YoY in 2015 (6.3% YoY in 2014) and to close next year at 5.8% YoY.

The convergence processes currently underway between administered and market-set prices, and between the current exchange rate and its equilibrium rate, and which the central bank has pointed up in its recent communication, should continue not only for the rest of 2014 and into 2015, but even beyond this period (see our section on the exchange rate for more details on the future outlook for the real).

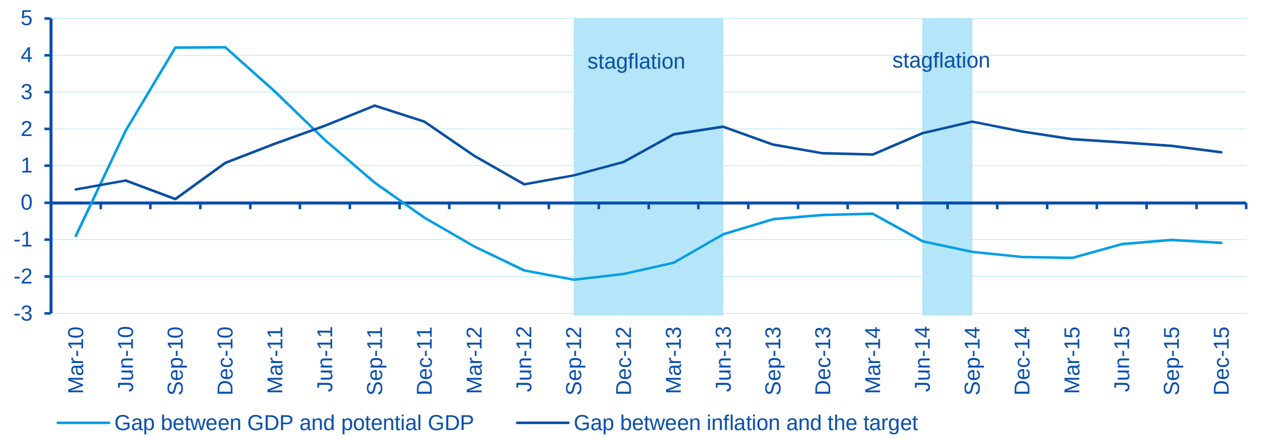
The gap between administered and market-set prices is about 13% (Figure 3.10). If we use our forecast figure for this year (inflation of market-set and administered products at 6.2% YoY and 6.0% YoY, respectively) and that of free prices for 2015 (5.5% YoY), closing the gap would require 19% inflation on administered products in 2015. However, in our opinion it is more likely that this correction will occur gradually over the next few years. In line with this view, our estimate is that administered prices will grow by 7.0% in 2015.

On the other hand, we estimate that the real is trading 10%-15% above its equilibrium rate. Convergence towards this point would have an impact of around 0.60pp-0.80pp on inflation.

The severe and persistent deterioration in economic activity and inflation rising beyond its target both signal that the economy is going through a period of stagflation

Recently observed data and our forecasts for economic activity and inflation indicate that the Brazilian economy is going through a period of stagflation in the second and third quarter of this year, in line with the identification method we have developed based on the literature on the subject (see Box 3.2).

Figure 3.11
Recent periods of stagflation (shaded areas)*



* See Box 3.2 for a precise definition of stagflation periods.
Source: BBVA Research

Put simply, our definition of stagflation is a situation in which growth remains persistently and significantly below potential GDP, at the same time as inflation rises above its target.

If we assume this methodology and our forecasts, the country will come out of stagflation in the fourth quarter and gradually distance itself from this situation in 2015 because of decelerating inflation, in spite of continuing above the central bank's 4.5% target and growth remaining noticeably below potential (Figure 3.11).

If we apply this methodology but use market consensus forecasts (inflation reaching 6.4% YoY by the end of the year) instead of our own (6.2% YoY), or if we consider the risks arising from a less gentle than expected closing of the gap between administered and market-set prices and between the current exchange rate and its equilibrium, it is not difficult to spot a risk that inflation may not decelerate and that, in this case, the economy could remain in stagflation beyond the third quarter of this year.

Finally, the high number of quarters in stagflation since the beginning of 2012 shows how weak the economy is at the moment (Figure 3.11). It also supports our analysis, above, that we cannot rule out the current stagflation period lasting beyond the third quarter, nor that other episodes such as this will occur again in the future, although at this point this is not our central scenario.

Box 2. Identifying periods of stagflation in Brazil

The dual concern about low growth and high inflation in Brazil, together with recent discussions as to whether the country is in stagflation or not, have led us to look to the economic literature for a method for identifying these situations.

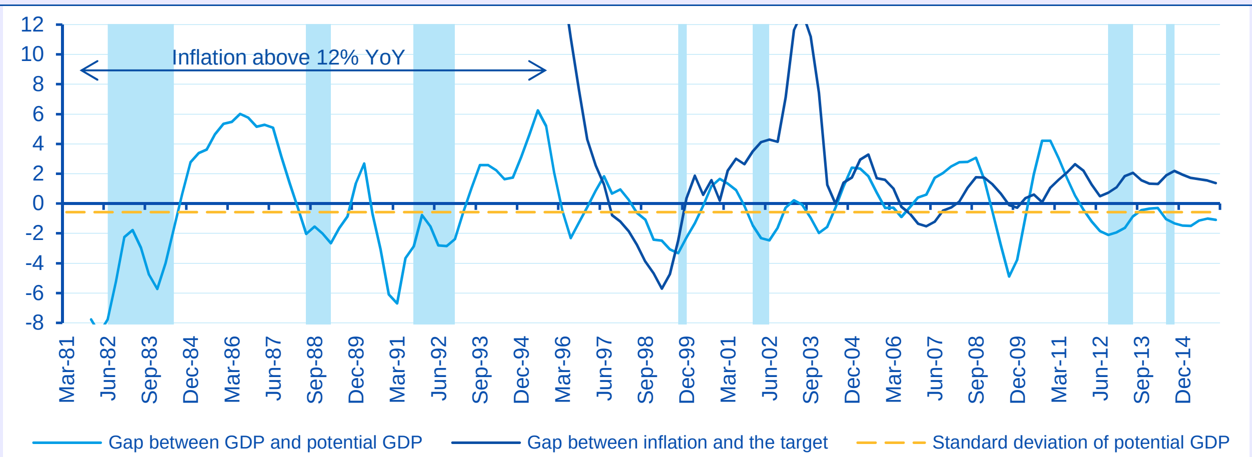
Based on the method proposed by Berthold and Grundler (2012)[3] and on an application created recently for the Chilean[4] economy, we have defined stagflation as a persistent period of below-potential growth, at least one standard deviation from the latter, at the same time as growing consumer inflation above the explicit inflation target (or of historic averages in periods before the target system was adopted).

For this identification exercise, we have employed the quarterly figures from 1981 to 2015, using our growth forecasts from 2Q14 onwards, and our inflation forecasts from 3Q14.

The GDP growth figures are the annual variation of the moving average in the last four quarters, which helps us to justify the use of the term "persistent" in our definition of stagflation. For potential GDP we have used our estimates (average potential GDP over the period being analysed: 2.72pp; standard deviation: 0.57pp). Finally, for inflation we have taken the quarterly average of the YoY inflation rate measured by the IPCA.

Figure B.2.1 shows us the periods of stagflation through which the country has passed since the early 80s and those on the forecast horizon, as far as 2015. They are as follows: 2Q82-2Q84 (the longest recession in the period under analysis), 2Q88-1Q89, 3Q89, 3Q91-4Q92, 3Q99-4Q99, 4Q01-2Q02, 3Q12-2Q13 and 2Q14-3Q14.

Figure B.2.1
Stagflation periods in Brazil (shaded areas)



Source: BBVA Research

3: Berthold, N. & Gründler, K. (2012): "Stagflation in the World Economy: A Revival?" Bayerische Julius-Maximilians-Universität, Würzburg (Germany), April 2012.
4: BBVA Research (2014):"Stagflation in Chile: More a myth than a reality", Chile Economic Watch.

As well as confirming that Brazil is currently going through a (short) stagflation, these results show us that another situation of this type occurred recently, during the second half of 2012 and the first of 2013 and that, prior to this, the period between the second half of 2002 and the second half of 2012 was the longest the country has enjoyed without a stagflation episode since the beginning of the 80s.

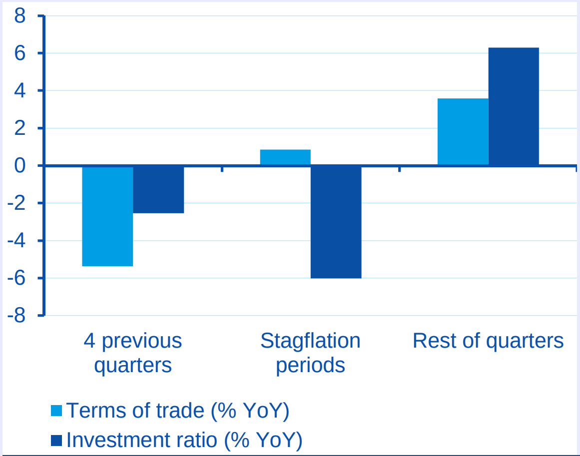
Although the results vary slightly depending on the precise definition of stagflation, even if we were to take the ceiling of the inflation range (6.5% YoY) instead of the central target (4.5% YoY) as our parameter for defining whether inflation is high, or even if we were to take two standard deviations, instead of one, to establish whether GDP deviation from its potential is significant, we would still identify the second and third quarters of 2014 as stagflation periods.

Episodes of stagflation are generally linked to supply-side problems, but there are other interpretations, such as economic policy management[5], for example.

In the case of Brazil, among the variables that are potentially correlated with periods of stagflation, terms of trade and fixed capital investment (Figure B.2.2) are the most important. In particular, a fall in terms of trade tends to herald a period of stagflation[6] and a sharp fall in investment also tends to coincide with periods of stagflation[7].

Figure B.2.2

Change in terms of trade and investments in fixed capital (% YoY): during periods of stagflation, in the four preceding quarters and in other quarters



Source: IPEADATA, IBGE and BBVA Research

The present episode of stagflation in Brazil in the second and third quarter obeys the general rule: we estimate an average fall of 5.5% YoY in investment over the period and an average deterioration of 2.8% YoY in the terms of trade in the four previous quarters.

In the future, we expect a fall of approximately 3% YoY in the terms of trade and a recovery of investment in 2015. Our previous analysis recommended caution because of the deterioration in terms of trade. It also indicated that, should the expected uptick in investment go awry for some reason, the risk of the country having to face another stagflation period next year would increase.

5: For more on this subject, see: BBVA Research (2014):"Stagflation in Chile: More a myth than a reality", Chile Economic Watch".
6: In very few cases only, the period analysed, of a strong and persistent fall in the terms of trade was not followed by a period of stagflation. In addition, it is unusual for there to be stagflation without a fall in terms of exchange.
7: Investments may be falling during stagflations as a result of the latter. They are not necessarily a leading indicator, unlike terms of trade, which appears to be.

Box 3. More about the competitiveness of the Brazilian economy

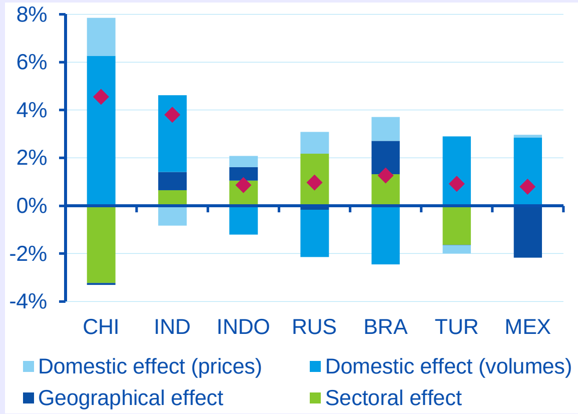
A few months ago we published several studies showing, among other things, the loss of competitiveness in the manufacturing sector in Brazil over the last decade (see "Competitiveness in the Latin American manufacturing sector: trends and determinants" and the Brazil Economic Watch "The Brazilian manufacturing sector loses competitiveness").

We are returning to the subject because of its importance for the Brazilian economy and because of a new database on the competitiveness of exports, developed jointly by the World Bank and the French central bank, which breaks down the growth of a country's exports in an innovative manner into three separate elements: sector, geography and domestic effects[8].

The first two capture the effect of the composition of a country's export portfolio in terms of sector and geographical specialisation, while the third effect isolates the country's specific determinants[9]. This domestic effect can be used as a proxy for competitiveness if we consider that a country is becoming more competitive when its exports behave more favourably than those of countries whose exports have the same geographic and sector orientation. In other words, we can isolate the sector and geographical factors in an interesting an innovative way, to analyse export performance and, as such, competitiveness.

Figure B.3.1

EAGLEs: Differential between export growth in the country and in the world (YoY avg., 1Q06-1Q14, in values)



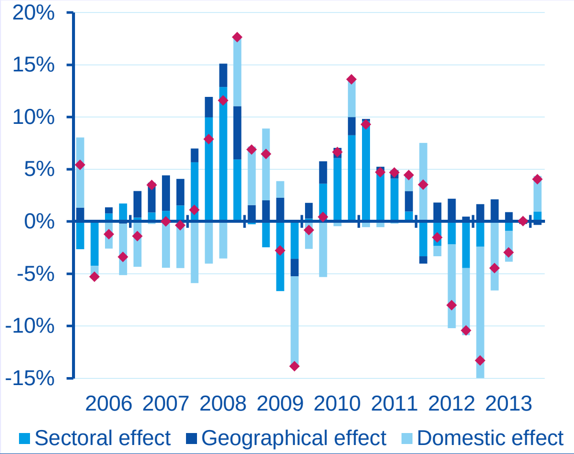
Source: World Bank, French central bank and BBVA Research

Brazilian exports grew at an annual rate of 7.4% between 1Q06 and 1Q14, compared to an average growth in global exports of 6.1%, implying a differential in Brazil's favour of 1.3pp, which, compared with other EAGLEs[10], is slightly higher than Russia, Turkey, Indonesia and Mexico, but well below China and India (Figure B.3.1).

If we break down this positive differential for Brazil and isolate the geographical and sectorial effects deriving from its export exports (+1.4pp and +1.3pp, respectively), the remaining domestic effect is negative (-1.5pp), meaning that Brazil would have lost share in global exports were it not favoured by the composition of its exports. Indeed, once the sector and geographic effects have been eliminated, Brazil is the worst-performing EAGLE member in terms of exports; and if we break down the domestic effect in terms of price (1.0pp) and quantity (-2.5pp) components, we see that Brazil's export performance is even worse.

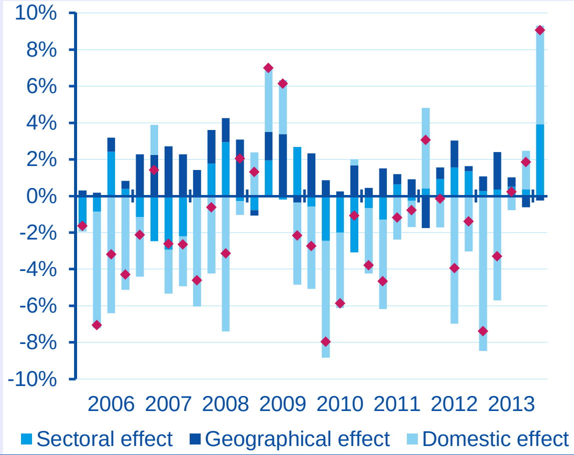
8: The data base, together with several computer graphics, is on http://ecd.bluetundra.com/.
9: For methodological details, see Working Paper "Market Shares In the Wake of the Global Crisis: The Quarterly Export Competitiveness Database" published by the Banque de France (BdF, the French central bank) and the World Bank in December 2013.
10: EAGLEs is the group of emerging economies which will contribute most to global GDP growth in the next 10 years. The group consists of China, India, Indonesia, Brazil, Russia, Turkey and Mexico.

Figure B.3.2
Differential between Brazil and global export growth (1Q06-1Q14, in values)



Source: World Bank, Banque de France (BdF, the French central bank) and BBVA Research

Figure B.3.3
Differential between Brazil and global export growth (1Q06-1Q14, in quantities)



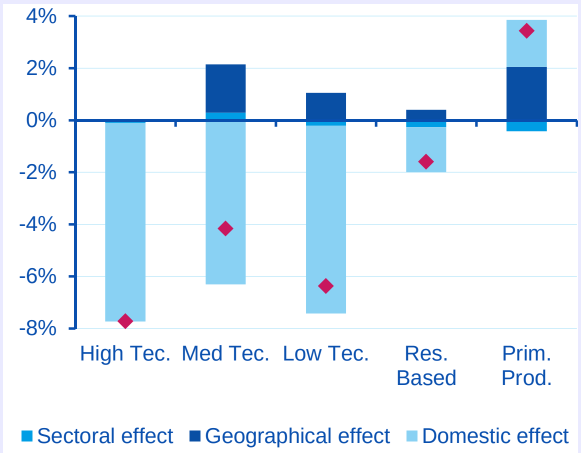
Source: World Bank, the BdF and BBVA Research

Brazilian exports performed better than the world average between 2008 and 2011 (except in the second half of 2009) and worse in 2012 and 2013 (Figure B.3.2). In any event, the domestic effect (the competitiveness proxy) was generally negative throughout the eight years analysed, with the drivers being the composition (geographical and sectorial) and price effects (Figure B.3.3).

The deterioration in Brazil's competitiveness between 2006 and 2013 was most notable in manufacturing of all kinds, whether high, medium or low technology. Gains were only made in the primary products segment (Figure B.3.4).

These results reveal new features in the process of the loss of competitiveness in the Brazilian economy in the last few years, very concentrated on the manufacturing sector, and these features support the conclusions of our earlier studies on the subject.

Figure B.3.4
Differential between Brazilian and global export growth by technological categories (annual average 1Q06-1Q14, in quantities)



Source: World Bank, the BdF and BBVA Research

4 The lack of fiscal tightening is having a negative impact on economic activity, with both interest rates and the currency being higher

Fiscal policy is concentrated on supporting domestic demand

Just a few months ago, at the beginning of the year, the debate was whether fiscal policy would concentrate on stopping the deterioration in public accounts, bringing down the possibility of a downgrade in the sovereign debt rating and contributing to reducing pressure on inflation; or whether it would rather focus on continued support of economic activity. Although we believe that the former continues to worry the tax authorities, recent signs suggest that after the additional proof of weakening growth, the present priority is to support economic activity.

There is an important reason for this choice and for sticking to the present expansiveness of fiscal policy: growth remains consistently and significantly below potential. However, we think that in the current environment a more neutral tone would favour the economy, since it would help to increase the credibility of public policies, reduce pessimism about the country's future, and contribute to the central bank's efforts to keep inflation under control. On this final point, a fiscal correction should help bring down interest rates and would also reduce the need for the central bank intervening in the FX markets to keep the real stronger in order to take the pressure off inflation.

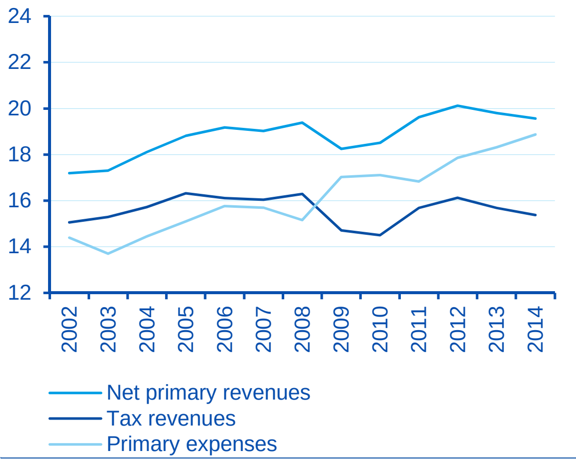
What is more, the evidence of the last few years shows that, despite its expansive tone, fiscal policy has been unable to sustain economic activity, partly because of the emphasis on supporting consumption instead of investment, and because the country's main problem, in our opinion, is not weak demand, but weak supply.

Similarly, among the signals given recently by the government in support of economic activity, we highlight: i) the decision to keep the tax on industrialised products (the IPI) for vehicles and the furniture industry at low levels until the end of the year, instead of only until the end of the first half, with an additional fiscal cost of approximately BRL 0.8bn; ii) the decision to make permanent the substitution of a payroll tax with another on companies' gross revenues from 2015 onwards, thus waving goodbye to an estimated BRL24bn in 2015; iii) the announcement of fiscal incentives for the export sector, at a cost of approximately BRL0.2bn to the end of the year, and iv) stimulus measures for capital markets.

These recent announcements reinforce our opinion that the government will not comply with the target of generating a primary fiscal surplus of BRL97bn (1.9% of GDP), although some measures, such as the one making it easier for households and companies to pay their debts with the government, may increase public revenues this year. Similarly, even bearing in mind the significant non-recurring revenue, we estimate the public sector surplus will be only 1.4% of GDP, slightly below our estimate three months ago (1.5%). In view of the expense of interest payments, we expect public deficit to reach 3.9% of GDP this year, well above last year's deficit of 3.3%.

The recent performance of public spending and revenue backs this view that the fiscal goal will not be reached this year. Data available on the central government show that primary expenditure remained relatively strong during the first half of the year, while net revenue lost momentum because of the impact of the slowdown in activity and of the fiscal stimuli in tax collection (Figure 4.1). The public sector's accumulated primary surplus in the first half of the year is by far the lowest of the available series (Figure 4.2).

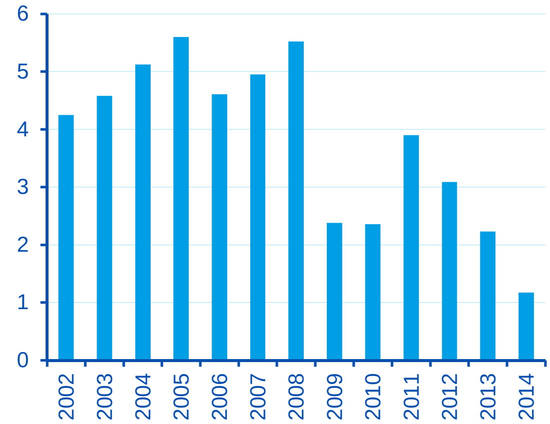
Figure 4.1
Net central government primary revenues, tax collection and primary expenditure, first half of the year (% of GDP)*



* Public revenues are net of transfers to regional governments (state and municipal). The central government includes the national treasury, social security and the central bank.

Source: Central bank and BBVA Research

Figure 4.2
Primary surplus in the public sector, first half of the year (% of GDP)



Source: BCB and BBVA Research

Despite a more expansive tone than we were expecting in the first half of the year - and probably in the second too - as well as the outlook of low economic growth, we still expect the next government, whether it is led by the present President Dilma Rousseff or by one of the opposition candidates, to announce a fiscal correction capable of generating a primary surplus of at least 1.9% of GDP in 2015. Although this value is lower than the average surplus from the previous decade (3.0% del GDP), reaching it would, in our opinion, be a sufficiently positive sign to help allay the concern about Brazil's public accounts and salvage the credibility of its macroeconomic policy, particularly if this increase in the surplus is matched with greater transparency in fiscal accounts and signs of commitment to a similar surplus in the coming years.

The increase of the primary surplus in 2015 would imply a proportional fall in the total deficit of the public sector, from 3.9% of GDP in 2014 to 3.4% next year.

Finally, in terms of quasi-fiscal policy, i.e. credit offered by state-owned banks, our central scenario continues to be a gradual moderation, not only for the rest of the year, but more notably in 2015. However, the reduction in reserve requirements announced by the central bank in July and the increasing focus on economic activity suggest that an alternative scenario, characterised by an uptick in public credit, cannot be ruled out.

Monetary policy: Selic stable at 11% and injection of liquidity with lower reserve requirements

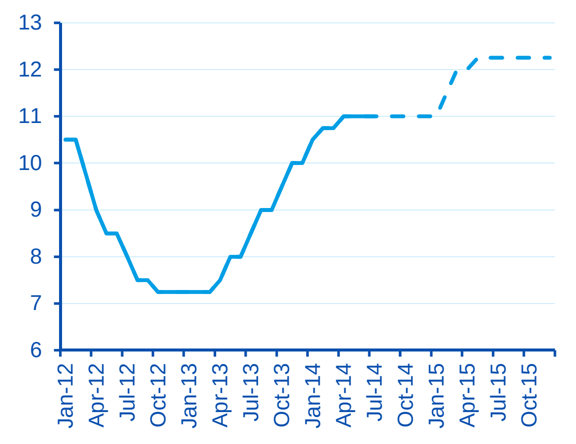
At its most recent monetary policy meeting, the central bank announced that its strategy for inflation to converge on the target of 4.5% at the beginning of 2016 does not include a reduction in the Selic, which is currently at 11% (Figure 4.3). In our opinion, it is no surprise that the monetary authority is not cutting short- and medium-term interest rates: the surprise is that it is being stated so clearly.

Likewise, the day after this announcement, the central bank reduced reserve requirements, injecting around BRL50bn (0.6% of GDP) into the economy (Figure 4.4).

Our interpretation of these two potentially contradictory announcements is that the central bank will use the Selic rate to try to control inflation and reserve requirements as a tool for stimulating the credit market and, as such, growth. In our opinion, relaxing reserve requirements is consistent with the apparent change in tone of fiscal policy and with greater concerns about the slowdown in growth. Nevertheless, it may be difficult to anchor inflation expectations in the long term.

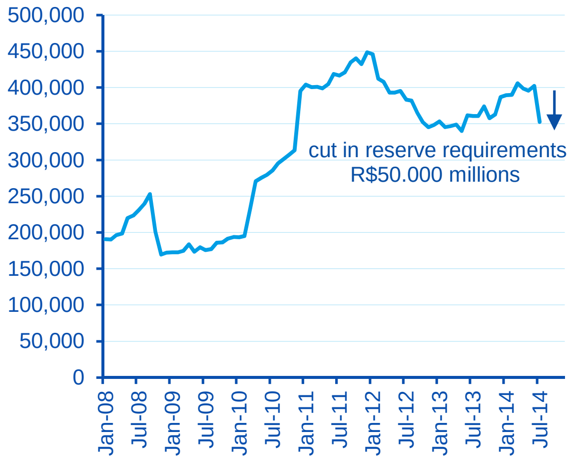
In this context, we hold to our forecast that the Selic rate will remain stable at 11% for the rest of the year: although, on the one hand, the inflationary pressures and the communication by the central bank rule out an interest rate cut (although not a new injection of liquidity through another cut in reserve requirements), on the other, the concerns about growth mean that an increase in the Selic in the second half of 2014 is highly unlikely.

Figure 4.3
Selic (%)



Source: BCB and BBVA Research

Figure 4.4
Reserve requirements at the central bank (BRLmn)



Source: BCB and BBVA Research

Although it is not impossible that the Selic rate will remain steady at 11% throughout next year too, we still think that the most probable scenario is for another adjustment in monetary policy and interest rates at 12.25% by the end of 2015.

Our central scenario takes into account the normalisation of monetary policy and a rise in interest rates in the US, as growth consolidates next year (see the first section about the global environment for more details). In this context, we think that the central bank has no option but to raise domestic interest rates. Pressures on inflation and the need to recover the credibility that has been lost in recent years ought to contribute to this correction in monetary policy in 2015.

With the help of the central bank and abundant global liquidity, the expected and necessary currency depreciation will be postponed

The Brazilian real has appreciated around 7% in nominal terms since the beginning of the year (Figure 4.5), in line with the increase in capital flows after the increase in the Selic, abundant liquidity in international markets and continued central bank intervention in the FX markets. After this appreciation, we estimate that the Brazilian currency is trading 10%-15% above its equilibrium rate.

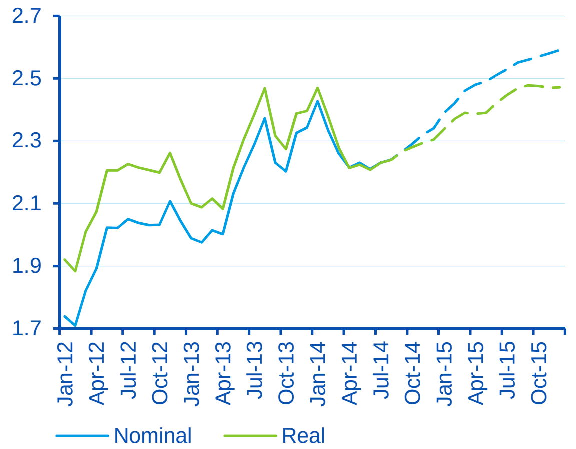
We expect the exchange rate to converge at its equilibrium rate towards the end of 2015. In our opinion, most of this correction will take place next year, and only a small part in the remainder of this. Specifically, we estimate that the exchange rate vs. the USD will depreciate from the present 2.24 to 2.34 at the end of 2014 and 2.59 at the end of 2015 (Figure 4.5).

This marks a change from our earlier forecasts, in terms of a higher share of the correction falling next year and a lower share in 2014. This change is related to the greater intervention by the central banks in the exchange markets. Specifically, in June the monetary authority announced an extension until the end of this year of its intervention programme in FX markets. Instead of reducing the injection of liquidity in dollars, as we had been expecting, the central bank left the programme conditions unchanged. Thus, the monetary authority will continue to offer USD120mn a day through currency swaps and dollar auctions with repurchase agreements depending on liquidity needs.

The gradual normalisation of monetary policy in the US is one of the main determinants of the currency's expected depreciation in forthcoming periods. Furthermore, we expect the FX policy to be used less, and fiscal and monetary policies more, to try to anchor inflation next year and so that the central bank's intervention programme is not extended beyond the end of 2014 - at least not in the same conditions. This will also contribute to the real depreciating in line with the economy's fundamentals: moderation in growth, high internal inflation, fall in the terms of trade, loss of competitiveness in exports, increase in the current account, etc.

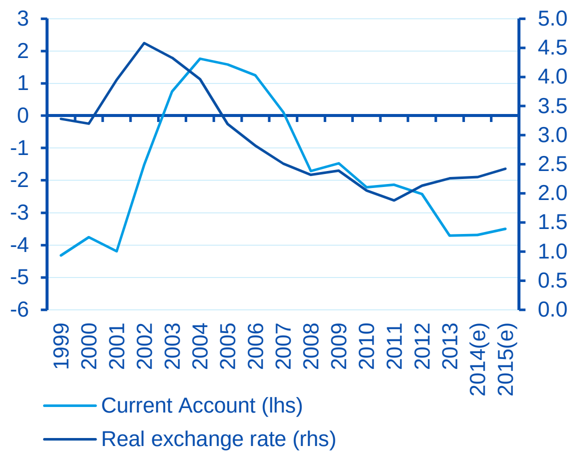
In terms of external accounts, the depreciation in the exchange rate and the impact of the moderation of internal demand on imports should create space for the current account deficit to stabilise at around 3.7% of GDP this year and fall slightly to 3.5% in 2015 (Figure 4.6).

Figure 4.5
Nominal and real exchange rate (USDBRL)



* Real exchange rate, at July 2014 prices.
Source: BCB and BBVA Research

Figure 4.6
Real average exchange rate (at July 2014 prices) and current account (% of GDP)



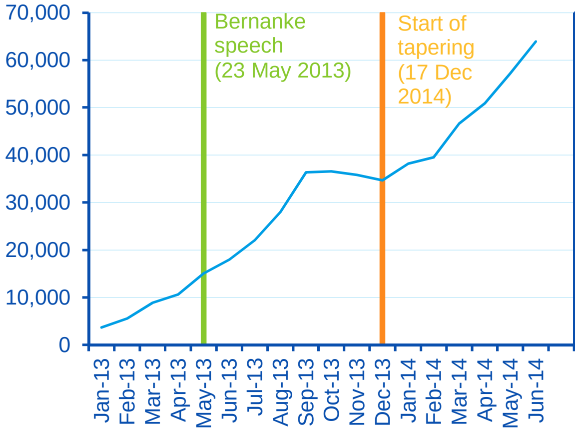
Source: BCB and BBVA Research

Despite the negative impact on inflation (see the section above for more details), the depreciation in the exchange rate is, in our opinion, necessary to incentivise exports in the manufacturing sector and contribute to the correction of the economy towards a growth model that is sustained more by exports and investment, and less by consumption.

The upswing of financial markets continues, in contrast with the performance of economic activity

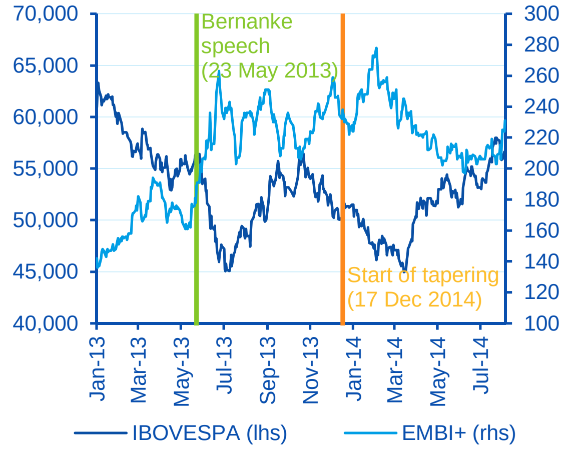
Abundant liquidity on international markets and high domestic interest rates have continued to be critical in increasing capital flows towards Brazil in the last few months (Figure 4.7) and, as a result, there has been an appreciation not only in the exchange rate, but also in other local assets, such as the stock exchange and the sovereign spread (Figure 4.8). Gains have accumulated on Brazilian financial markets in recent months despite the turbulence generated in the first few days of August because of Argentina's default (which we do not expect to have a very significant effect on Brazilian assets), and because of geopolitical tensions in Ukraine.

Figure 4.7
Non-resident portfolio flows, cumulative since January 2013 (USDmn)*



* Data from Brazil's balance of payments.
Source: BCB and BBVA Research

Figure 4.8
Sao Paulo Stock Exchange Index (IBOVESPA) and sovereign spread (EMBI +)*



* Up to 5 August
Source: BCB and BBVA Research

Despite the gains in the Brazilian financial markets since the start of the year, most assets are still priced below previous highs. The Brazilian real is trading 15% below its value at the beginning of 2013 and 45% below its mid-2011 peak. Similarly, the IBOVESPA is still 7% below its level at the beginning of 2013 and 22% below its peak, reached in May 2008. The sovereign spread stood at 231bp at the end of July, 95 points above its all-time low at the beginning of 2013.

Likewise, although the prices of domestic assets are well below their highs, there is a significant risk that the decoupling between financial market movements and economic activity indicators may end during the process of US monetary policy normalisation and liquidity reduction.

5 Forecast table

Table 4.1
Macro Forecasts

	2012	2013	2014	2015
GDP (% YoY)	1.0	2.5	1.3	1.6
Inflation (% YoY, eop)	5.8	5.9	6.2	5.8
Exchange rate (vs. USD, eop)	2.04	2.34	2.34	2.59
Interest rates (%, eop)	7.25	10.00	11.00	12.25
Private consumption (% YoY)	3.2	2.6	1.5	1.2
Government consumption (% YoY)	3.3	2.0	2.5	1.2
Fixed investment (% YoY)	-4.0	5.1	-3.4	2.5
Exports (% YoY)	0.5	2.5	1.6	2.6
Imports (% YoY)	0.3	8.3	0.4	1.1
Fiscal balance (% GDP)	-2.5	-3.3	-3.9	-3.4
Current account (% GDP)	-2.4	-3.6	-3.7	-3.5

Source: BBVA Research

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