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Brazil Economic Outlook

Fourth quarter 2014
Emerging Economies Unit

- The Brazilian economy will grow very little in 2015, the first year of Dilma Rousseff's second term, following stagnation of GDP in 2014
- The new round of interest rate hikes will soon be joined by fiscal tightening, while the exchange rate will also continue to depreciate. In these conditions, inflation will hold at around 6%
- The Brazilian economy faces major challenges. There is a risk that the next adjustment in economic policy is viewed as either falling short or being temporary

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Closing date: 26 November 2014

1 Overview

Global scenario: slow recovery with greater financial volatility. The world economy continued to grow at a modest pace in the third quarter, so the overall rate should be 3.2% for 2014 and 3.7% for 2015. In this environment, monetary policy in most countries is still geared towards underpinning activity, whereas fiscal policy will have a less restrictive hue than it has in the recent past in the United States, the eurozone or even in China, where further measures to buttress growth are expected. Against this background and anticipation of the first rate hikes by the Fed in mid-2015, there has also been a dramatic aggravation of financial tensions.

In Brazil, GDP will grow by only 0.2% this year and not much more in 2015. After slowing down at the beginning of the year, we forecast that GDP will pick up a bit in the second half to ensure mildly positive growth for 2014. The more restrictive feel to economic policy and the additional decline in terms of trade will keep growth down in 2015. Our estimate is 1.3% for the year, with a substantial downward bias owing to an array of external and domestic risks.

Dilma Rousseff's second term will open with a shift in economic policy. Both the political and the economic situation look gloomy in 2015, the first year of Dilma Rousseff's new government. The need to restore the credibility of economic policy, the recent deterioration in the fiscal situation, the fear of losing investment grade status and persistently high inflation all call for a reversal of the expansive emphasis of fiscal policy and more lifting of interest rates.

After a collapse of the primary surplus, the fiscal adjustment in the pipeline must guarantee a steady improvement in the fiscal balance in the coming years. Thanks to the strong flow of public expenditure and the weakness of revenues, we foresee the public sector primary surplus closing the year at 0.3% of GDP, a long way below the level seen only a few years ago (3.1% in 2011). We are expecting the government to manage to produce a primary surplus of approximately 1% of GDP in 2015 and at least 2% from 2016. This adjustment would be based on both increased taxation and spending cuts.

The toughening of monetary policy has already begun and is set to continue until the beginning of 2015. In line with the approach of a shift in economic policy, the central bank surprised by raising the Selic rate by 25bp to 11.25%. The harsher tone of monetary policy should continue in the next few months. We predict that the Selic rate will close 2014 and 2015 at 11.50% and 12.25% respectively, though there is the risk that the tightening of monetary policy could be even more severe than expected.

Depreciation of the exchange rate is finally starting to happen. The magnitude of the gradual weakening of the real that began in September has come as a surprise. From that time up to mid-November, the US dollar rate jumped from 2.2 to 2.5 on the back of the global appreciation of the dollar, the fall in commodity prices and risk aversion. We expect the real to hold relatively stable in the short term and to reach 2.7 at the end of 2015. Despite the cost in inflation terms, the depreciation ought to allay problems of competitiveness in the manufacturing sector.

Inflation will remain at close to 6% throughout the rest of the year and in 2015. In spite of demand weakness and the direction taken by economic policy, the realignment of administered prices and the exchange rate will head off a heavier fall in inflation.

The Brazilian economy faces major risks. Among these is the chance that the correction of macroeconomic policy might be viewed as inadequate or only temporary. At the same time, besides the external risks, the economy could also receive a setback in 2015 from energy rationing or the fallout from the recent scandal involving Petrobras and several of the country's leading construction companies.

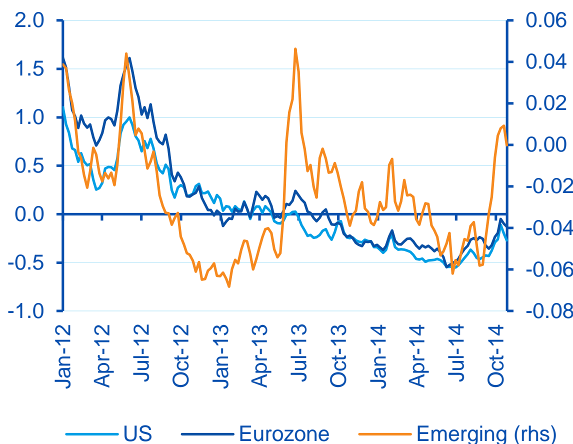
2 Slow global recovery with greater financial volatility

World growth is still rising, closing 2014 at 3.2% in 2014 and 2015 at 3.7%. But financial tensions and geopolitical risks are on the increase as well

Global economic growth continued in the third quarter. However, quarterly growth is very moderate in the more developed economies, and of these, more in Japan and the eurozone than in the US.

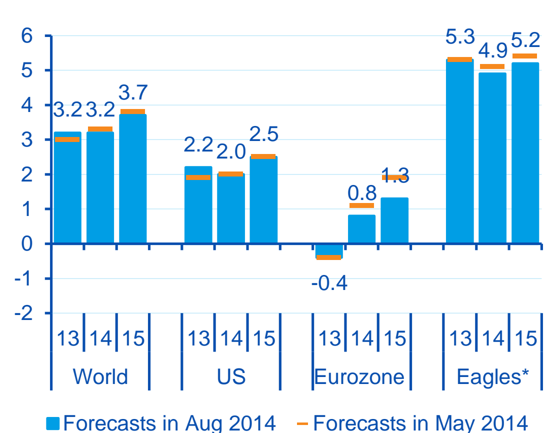
The confidence indicators for September remain consistent with the expansion of manufacturing activity, although it has been some months since they stopped improving in the key economic areas. An additional sign of the fragility of the present cyclical recovery is the uptick of the tension indicators in the financial markets since mid-September. In the case of the emerging economies (EMs), these have reached levels not seen since May 2013 (Figure 2.1). Then the market discounted a rapid withdrawal of Fed stimuli that actually never happened and is still pending. At the same time, geopolitical risks have been multiplying and negative surprises are building up on the consensus in the activity indicators, particularly in the eurozone and South America.

Figure 2.1
BBVA Research Financial Tensions Index



Source: BBVA Research

Figure 2.2
GDP growth forecasts (%)



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

Altogether, the most likely scenario is that global growth improved from the second to the third quarter, rising from 0.6% QoQ to an estimated 0.8%. However, there is downside risk to these figures, given that the industrial activity indicators and world trade in September could still moderate, and the effects of the financial volatility on confidence could be more persistent than we expect. Also, there are the geopolitical risks associated with the situation in Syria and Iraq, and the fragile agreement between Ukraine and Russia. It is worth noting that sanctions are already having an impact on activity in important sectors such as Russian energy.

In this context, monetary policy will remain focused on supporting activity, while fiscal policy will be less restrictive in tone in 2014-15 in both the US and the eurozone than in the recent past. Even in China, together with the budget consolidation at the local and regional government level it is felt that additional measures to support growth could be implemented.

Finally, we must point to the fall in oil prices as a favourable factor for global growth expectations – although not for exporter countries, to the extent that this is a result of a positive supply shock.

Growth in the US remains in line with expectations, and is likely to reach 2.5% in 2015

After the unexpected and transitory drop in activity in 1Q14, the activity, spending and employment indicators have recovered, implying that the pace of GDP growth could be around 2.5% in the second half of the year, and thus average 2% for 2014 as a whole (Figure 2.2). The role of the Fed, which emphasises caution and patience before acting on the signs of improvement in the economy, continues to support our scenario of a cyclical recovery in the US underpinned by the solid creation of employment and the increase in household wealth.

Our outlook for China is unchanged, but with a downward bias due to the external environment and the supervision of shadow banking

In the third quarter GDP growth continued to decelerate, to 7.3%, reflecting the moderation in domestic activity, particularly in the construction and real estate sectors, but partially offset by an unexpected and intense upturn in exports. We maintain our outlook for GDP growth at 7.2% in 2014. Altogether, the risks to growth in China continue to be to the downside from 2015 onwards (7.0%), precisely because of the brake on external demand that the situation in Europe might imply, and the adjustment underway in the real estate sector in a context of high leverage and the introduction of measures to control its less regulated banking system.

China is facing the task of managing the present deceleration of economic growth while reducing its financial risks and rebalancing growth in favour of domestic demand. In this scenario, the authorities will intervene so that the deceleration does not intensify, and growth does not fall below the targets set. Thus we would not be surprised to see additional monetary policy easing (with cuts in the reserve ratio or liquidity injections), expansive central government fiscal policy (albeit with consolidation at the local government level) and on-going execution of structural reforms.

In the eurozone, the recovery will be even slower than we were expecting

The stagnation of GDP growth in the second quarter, with weaker performances in general in the larger economies, has led us to revise our outlook for growth in the region downwards for 2014 and 2015 (Figure 2.2). The Ukraine/Russia crisis is having an impact on trade and the confidence indicators of the economies in the centre of Europe, including Germany. The ECB has continued to take action, with measures designed to bring inflation expectations more closely into line with the objective of price stability, which have been de-anchoring since 2012. In our most likely scenario, euro depreciation has to make a contribution, given the different expectations of Fed and ECB actions, with a withdrawal of stimuli by the former and balance-sheet expansion by the latter.

3 Brazil: new government, new economic policy?

The first year of Dilma Rousseff's second term will be marked by adjustments

After some months of a fierce, see-saw contest with her adversaries, the incumbent president, Dilma Rousseff of the Workers Party (PT, or *Partido dos Trabalhadores*), emerged victorious from the October elections. She will thus remain at the helm of the country between 1 January 2015 and 31 December 2018. Having won the first round of the elections on 5 October, her victory in the second, on the 26th of the same month, over candidate Aecio Neves of the Brazilian Social Democratic Party (PSDB), a proponent of more orthodox economic policy, was far tighter than many had expected, even going into the last few days of the final leg. The PT candidate came away with 51.6% of votes, while her adversary managed 48.4%. President Rousseff's winning margin was not only slimmer than it had been when she was previously elected (12pp), but also the smallest seen in all the presidential contests there have been since the modern democratic era began in the late 1980s.

The narrowness of the victory is indicative of the current division in Brazilian society, and also suggests that the opposition will be stronger during President Rousseff's second term, despite the fact that the parties from her power base managed to hold onto their majority in the Federal Senate and the Chamber of Deputies. The political situation will, in any case, be far less benign for the president at the outset of her second term than it was when she formed her first government in 2011. This will also be partly attributable to the recent corruption scandal concerning Petrobras, the oil company in which the government has a majority holding, and several of Brazil's most prominent construction companies.

Going into President Rousseff's second term, the country's economic plight will also be far more awkward than it was four years ago. Even though mounting inflation in 2011 required fiscal and monetary tightening (which was finally implemented), the 7.5% surge in GDP growth a year earlier softened the adjustment, among other things because it guaranteed higher tax revenues. On the other hand, the current economic situation also warrants a revised approach to economic policy, not just because inflation remains high, but also because monetary policy has lost credibility in recent years and the expansive fiscal policy has to be reversed at the risk of losing investment grade status in the coming years.

At the moment there are clear signs that 2015 will, as with 2011, also be a year of adjustments. On the one hand, the central bank began raising interest rates only a few days after the re-election of Dilma Rousseff was confirmed, and will have to continue doing this in the next few months. On the other hand, recent comments made by the president and the likely confirmation as the new finance minister of Joaquim Levy, from the orthodox school and an old hand at making fiscal adjustments, both on a national and on a regional scale[1], suggest that fiscal policy will also be recast very shortly.

In the baseline scenario for the Brazilian economy which we outline throughout this report, we factor in the view that the government will actually come to carry out monetary and fiscal adjustments in the approaching months (for further details see the relevant sections on monetary and fiscal policy). Our scenario is also based on the assumption that state-owned banks will be used less as a tool to stimulate domestic credit and that there will be less control of the pricing of regulated products.

We also presuppose that the adjustments will be on a sufficient scale to restore some of the credibility lost in recent years, and so will allow Brazil to grow from 2016 at around 2.5%, which we see as its potential level.

1: Joaquim Levy was Brazil's treasury secretary between 2003 and 2006 in Lula's first government, when he helped rein in government spending and generate high primary surpluses (3.5% on average for the period). He has also worked as Finance Secretary of the State of Rio de Janeiro, in the IMF and in the ECB. He has recently been CEO of Bradesco Asset Management.

There is a risk that the economic decline could continue or worsen if the correction of economic policy is viewed as falling short or temporary

Although we see a successful adjustment as the most likely scenario, there is a set of risks that could give rise to a more adverse scenario than that portrayed throughout this report. In particular, there is a risk that the imminent correction of macroeconomic policy could be viewed as lacking in credibility, or being inadequate or only transitory.

The policies announced in the past, and the comments made by certain members of the government, suggest a lack of conviction in orthodox economic policies and lend weight to concerns over the coming correction. If this risk becomes reality and the government fails in its attempt to bolster confidence in the economy, the most likely scenario is one of near zero or even negative growth in the next few years, in which investment grade status would come under threat.

Another risk associated with the correction due to be made soon is that the impact on economic activity in the short term might be more powerful than expected, which could prompt a more marked downturn in the jobs market and mean a less benign growth scenario taking shape.

The risks associated with making the correction are not the only ones facing the country. Besides the external risks, such as a sharper slowdown in the Chinese economy and a slide in commodity prices or bigger upsets from the normalisation of monetary policy in the United States, there are other, substantial domestic risks. Among these we would point to the risk that the pattern of precipitation during the rainy season (from November to March) might fail to raise the already very low level of water reserves, meaning that the country is forced to ration energy[2], and the risk that the recent scandal over the payment of bribes by several of Brazil's foremost construction companies to Petrobras could harm the country, either politically or economically (for example, a reduction of investments by Petrobras or infrastructure projects executed by the construction companies).

2: Hydraulic energy accounts for around 80% of the overall energy supply in Brazil.

4 GDP will grow by only 0.2% this year, and not much more in 2015

We expect a muted yet steady pick-up in activity in the second half after the recession observed at the beginning of the year

The Brazilian economy grew at negative rates in the first and second quarters of the year, by -0.2% QoQ and -0.6% QoQ respectively to be exact (Figure 4.1).

In terms of demand components, the most influential factor behind this first half slip in GDP was gross fixed capital formation, which plunged by 7.9% in the period (-2.8% QoQ in 1Q14 and -5.3% QoQ in 2Q14). This downward correction is particularly striking given that GFCF had fallen 3.6% in the second quarter of 2013.

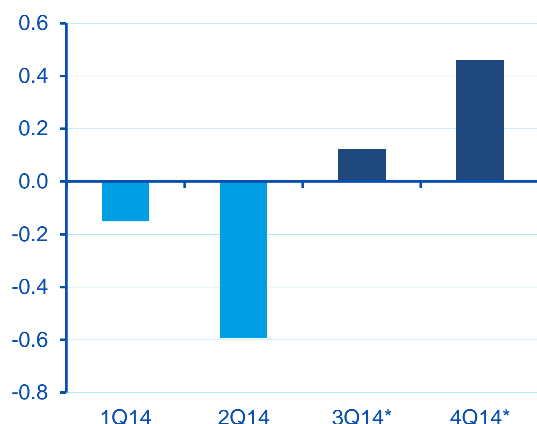
Private consumption held practically stable in 1H14: cumulative growth since the end of 2013 was 0.1% (-0.2% QoQ in 1Q14 and 0.3% QoQ in 2Q14). On the other hand public consumption slipped by 0.3% QoQ in the first half of the year on the sharp drop recorded in the second quarter.

The falls in public consumption, and especially investment, as well as the stagnation in private consumption, meant that imports were lower, dipping 1.3% QoQ in the half. The impact of this correction of imports on GDP was however offset by a 1.1% decrease in exports.

From a demand standpoint, the fall-off in activity in the first half of the year was a consequence of weakness across the board in its various components, with a notably strong cutback in investment.

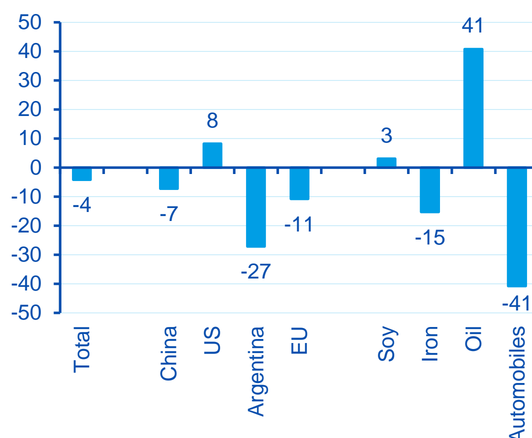
On the supply side, only agriculture made a positive contribution to economic activity in the first half of the year, posting overall growth of 3.3%. The services sector and industry eased by 0.5% and 2.7% respectively. In the former case the slowdown was sharper in the trade and information services sub-sectors and less severe or non-existent in the areas of transport and financial intermediation. In the latter case, the overall fall in the first half was heaviest in the manufacturing and construction industries, whereas it was softer in the electricity, sanitary and gas subsector. Conversely the manufacturing industry grew in the period under review.

Figure 4.1
GDP 2014: observed and expected (% QoQ)



* Estimated.
Source: IBGE and BBVA Research

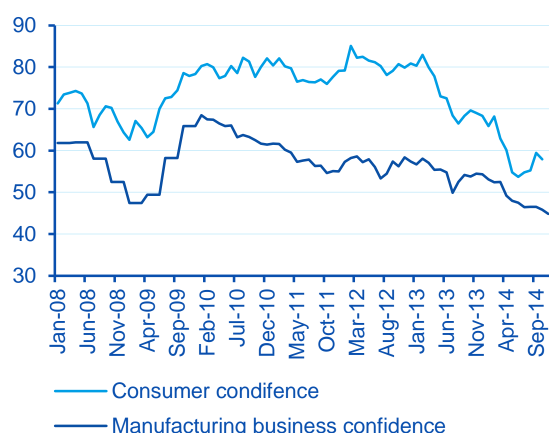
Figure 4.2
Goods exports, cumulative figure from January to October (% YoY)



Source: Aliceweb and BBVA Research.

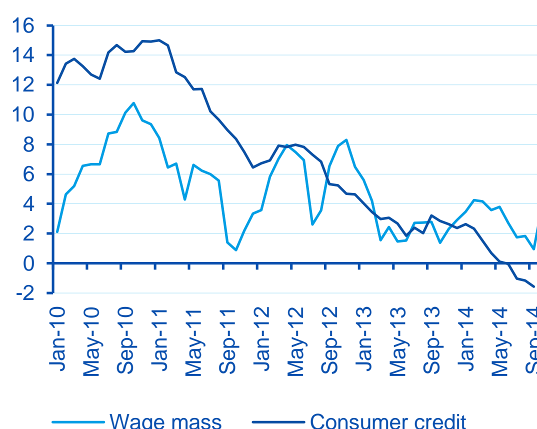
A set of both global and domestic factors combined to bring about the recessionary environment in the first half. On the external side, the slowdowns in China and Argentina hampered the performance of Brazilian exports in spite of the uplifting effect of the recovery in the United States (Figure 4.2). Although the direct impact of the deceleration in Argentina has been stronger, mainly through a reduction of auto sales to Brazil's neighbour, the flatter Chinese economy, as well as its transition towards a model more dependent on consumption and less on investment, has played a part in depressing the price of many commodities exported by Brazil. Besides this and a set of supply factors, the cheapening effect was also influenced by the appreciation of the dollar[3]. Lastly, it is important to note the adverse effect of the financial turmoil triggered by the prospect of a normalisation of monetary policy in the United States.

Figure: 4.3
Confidence indicators



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

Figure 4.4
Real wage bill growth and consumer credit (% YoY)



Source: IBGE, BCB and BBVA Research

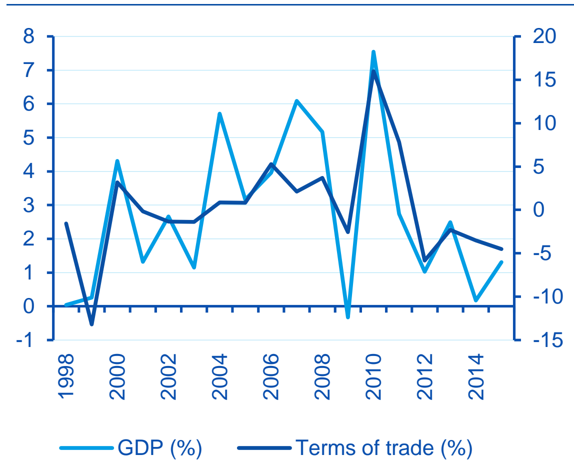
Despite the negative effect of the global environment on domestic growth, internal factors prevailed in our opinion when it came to explaining the recent weakness. Among these we highlight the strongly growing uncertainty and the significant loss of confidence in the economy by agents (Figure 4.3). This has been influenced not only by the election climate, but essentially by the relative unpredictability of the key public policies, including macroeconomic policy, and the inability to bring about a correction of the growth model which has an over-reliance on expanding consumption. Activity, especially consumption, has been hit by the slowdown in the credit markets (Figure 4.4), among other aspects caused by agents' higher leverage. Despite the fact that the unemployment rate is holding at exceptionally low levels, the processes of job creation and real wage rises have lost impetus, resulting in a dampening of wage bill growth (Figure 4.4) [4]. Moreover, the tougher tone of monetary policy and the lack of room for manoeuvre to use a more counter-cyclical fiscal policy help gain an understanding of the recent slowdown in activity. Finally, it should be noted that the economy's serious problems of competitiveness still represent a barrier to growth[5].

Although these factors will, to a greater or lesser extent, continue to play a major role looking ahead, we expect the economy to regain part of the dynamism in the second half which it lost in the first.

3: For a more detailed analysis of the commodities markets, including our forecasts for the main products, see our report Latam Economic Outlook, Fourth Quarter 2014.
4: The unemployment rate is holding at around 5% despite the lower level of job creation, as the labour supply is falling off as a result of the surge in family income seen in recent years. Taking out this effect, i.e. if the participation rate in the labour market had stayed at the levels observed in 2012-2013, the current unemployment rate would stand at close to 7%.
5: For further details on the problems of competitiveness, see our Economic Watch "More on the loss of competitiveness in the Brazilian economy" or our working paper "Competitiveness in the Latin American manufacturing sector: trends and determinants"

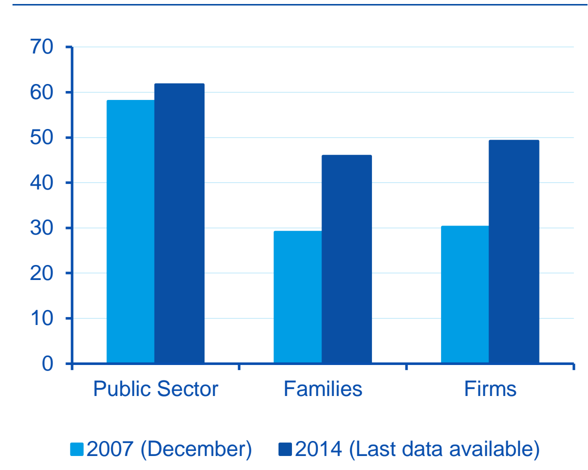
The most frequently published indicators indicate that QoQ growth (%) will bounce back to positive numbers in the second half of the year. The IBC-Br, the central bank's monthly Index of Economic Activity, for example, revealed expansion of 0.6% QoQ in 3Q14. Furthermore, following on from the negative trend registered since the start of the year, consumer confidence has begun to rally a little more strongly as from September. Besides this initial evidence, the very low base, the greater number of working days, the impact on net external demand of the depreciation in the exchange rate and the partial alleviation of uncertainty after the elections all add weight to the picture of a recovery, albeit very slow, of growth in the second half.

Figure 4.5
GDP and terms of trade (% var.)*



* BBVA Research forecasts for 2014 and 2015.
Source: BCB, IPEADATA and BBVA Research

Figure 4.6
Public sector, family and corporate borrowing* (% of GDP)



* Public sector: gross debt; Families: Bank borrowing; Companies: bank, capital market and external borrowing. The initial data for companies is for June 2008 rather than December 2007.
Source: BCB and BBVA Research

The expected recovery of the economy should allow GDP growth in 2014 to stay in positive territory. Specifically we forecast that Brazil will grow at only 0.2% this year. Consumption and net exports should offset the very negative impact on growth which the severe contraction of investment will exert (Figure 4.7 and forecast table at the end of this report). Growth this year will thus be far lower than the figure we were forecasting three months ago (1.3%). This downward revision is primarily due to the huge negative surprise provided by GDP in 2Q14 and the revision downwards of growth for 1Q14, though also because of the prospect of recovery in the second half being more timid than we were expecting before.

The global environment and the tougher tone of economic policy will imply a continuation of low growth in 2015

Estimated growth of 0.2% in 2014 will be the lowest since the 0.3% drop in GDP seen in 2009 after the Lehman Brothers crisis. Unlike what happened at that time, there are no reasons to believe that activity will pick up again in earnest in the near future. Growth over 2015 will thus resemble what was seen in 2014 far more closely than 2010, when the economy surged by 7.5% after the slowdown in 2009.

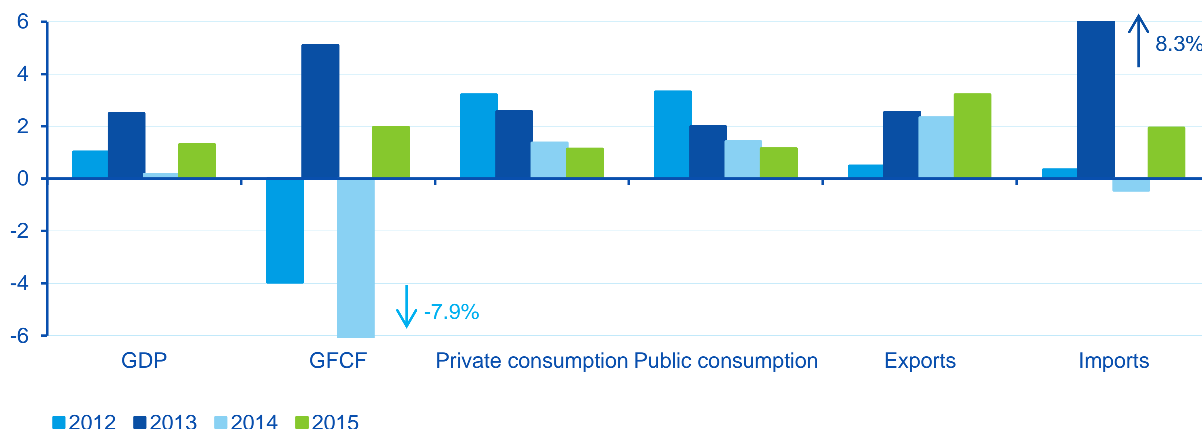
Among the reasons underpinning the view that growth will remain low next year are the further deterioration of the terms of trade which, according to our estimates, should worsen by 5% with respect to 2014, with cumulative falls of 8% and 15% with respect to the readings in 2013 and 2011 respectively. Figure 4.5 illustrates the strong correlation between GDP growth in Brazil and its terms of trade[6].

6: For further details of the inter-relationship between the terms of trade and GDP growth in Brazil, see our report Brazil Economic Outlook, Third Quarter 2014 (pp.15-16).

It is also likely that the financial markets will remain acutely sensitive to how fast monetary policy normalises in the United States and, by extension, the US activity figures which will decide this.

Still on the subject of the global environment, despite the mild recovery predicted for the world economy, Brazil will suffer the effects of the lack of a meaningful pick-up in activity within the economies of two of its key trading partners, China and Argentina.

Figure 4.7
GDP and demand components (%), 2012-2015*



* BBVA Research forecasts for 2014 and 2015
Source: BCB and BBVA Research

With respect to domestic factors, the expected fiscal policy adjustment, which will have to encompass not just a trimming of public spending, but also raising taxes and lower growth of state-owned bank loans, will have a negative impact in the short term on consumption and investment. Along the same lines, the tougher monetary policy stance will reduce the chances of an expansion of domestic demand next year.

Lastly, we again make the point that the drying up of the consumption-based growth model (owing to a structural slowdown of the labour and credit markets), the low competitiveness of the economy and the higher leverage levels of the public sector, families and companies, are holding the country back from being able to grow at a sustained rate of over 2.5%.

In spite of all these factors and the risks highlighted in Section 3, we estimate that Brazil's GDP will grow at 1.3% in 2015 (Figure 4.7), which is a little less than we were predicting three months ago (1.6%).

Even though the correction of economic policy comes at a high price, over next year it should allow uncertainty to subside over the future of the country and even enable the restoration of business confidence, both factors consistent with a gradual resumption of investment, which should benefit from the gathering momentum of investment in infrastructure within the orbit of public-private partnerships.

Moreover, despite the problems in the global context set out previously, the depreciation in the exchange rate should help exports provide more of a springboard for growth in 2015.

Lastly, if, as expected, the labour market remains relatively robust, buoyed for example by the rise of roughly 2.5% in the real minimum wage enshrined in law, private consumption could continue to make a positive contribution to GDP growth.

To summarise, if, in spite of the many risks, the government manages to use public policy adjustment to lay the foundations for a restoration of confidence, Brazil will be able to not only grow at close to 1% in 2015 but also, and more importantly, steer itself into line with its growth potential of approximately 2.5% of GDP from

2016. More solid medium-term growth will require either a more benign global scenario than we have depicted in our baseline scenario or the setting of an agenda of reforms designed to spur productivity, which we still see as unlikely to happen.

Inflation will hold at around 6%, despite wavering demand, on the realignment of administered prices and the exchange rate

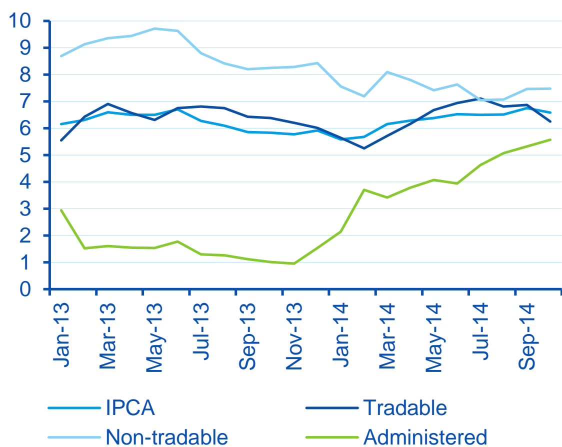
Weak aggregate demand and the upward ratcheting of the Selic rate over the year have created a climate for a downward pattern for inflation of non-tradable goods, which hit 7.5% in October (Figure 4.8), a level that remains very high despite easing recently.

The slowdown for non-tradable goods did not, however, entail a simultaneous relaxation of headline inflation. This comes as a result of the pressures on tradable and regulated goods. Inflation in both groups has crept upwards in the last few months. In the case of tradables it has risen from 5.6% in January to 6.3% in October, largely due to the effects of a depreciation in the exchange rate noticeable since last year. In the case of products with government-administered prices, inflation has climbed more tellingly, doing so from 2.1% in January to 5.6% in October. In this case, the upward pressure has been mainly from the lack of scope to increase or keep up subsidies granted in the past.

The forces at work in these three groups have led headline inflation to trace a steady upward path since the beginning of the year, reaching 6.75% in September, which is above the ceiling for the target range of 2.5% - 6.5% used by the central bank. More recently, in October, inflation abated more than predicted, moving to 6.59%.

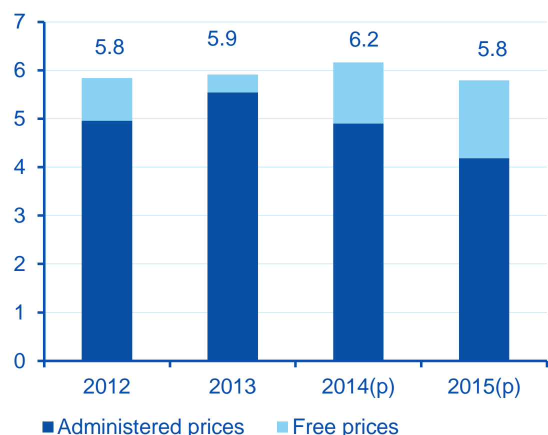
We forecast that inflation will dampen a bit more over the rest of the year, helped by lower inflation for tradables, a lower than expected rise in fuel prices and in particular the relatively kind basis for comparison (i.e. high MoM inflation at the end of 2013). To be exact, we estimate that inflation will reach 6.5% in November and see out the year at 6.2%.

Figure 4.8
Inflation (% YoY)



Source: IBGE and BBVA Research

Figure 4.9
Contribution of regulated and free-market prices to annual inflation (EOY bp)*



* The weight of government-regulated goods in the annual CPI is approximately 24% for the period under review.
Source: IBGE and BBVA Research

We expect recent trends for non-tradable, tradable and administered prices to continue throughout 2015. This means that the faster inflation in administered prices and tradables should continue to forestall any major let-up in the pace of headline inflation. To be precise, in a context of greater fiscal tightening, the

adjustments due for administered prices, for example in the cases of public transport fares and energy rates, should cause inflation of regulated goods to touch 7% in 2015, thereby making a bigger contribution to overall inflation than in the preceding years. Despite the expected depreciation of the exchange rate (8% on average in 2014 with respect to 2013, and 13% in 2015 over 2014), free market price inflation should come down to 5.4% at the close of 2015 from 6.4% in December 2014, given the effect of domestic demand weakness and the raising of the Selic rate on non-tradable prices.

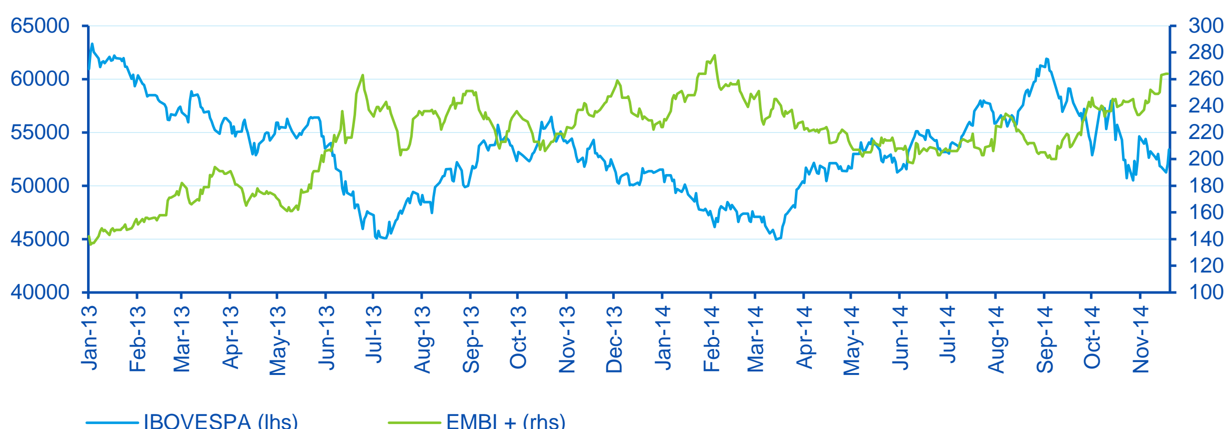
We therefore predict that general inflation will close 2015 at 5.8%, at the high end of the target range.

5 The exchange rate is depreciating and policy rates are rising, while the new government prepares the fiscal adjustment

Jitters are returning to the Brazilian financial market

After some months of relative calm between March and September, volatility has come back with a vengeance to the Brazilian financial market. The country's sovereign spread has begun to rise and the São Paolo Stock Exchange Index (the IBOVESPA) has firmed, in both cases marking levels not observed since the previous bout of turmoil early on in the year following the announcement of Fed tapering (Figure 5.1). In the case of the Brazilian real, the weakness of late has translated into the most heavily depreciated exchange rate in practically a decade in nominal terms, and since the 2008-09 crisis in real terms (see Figures 5.4 and 5.5 in the next sub-section).

Figure 5.1
The Sao Paulo Stock Exchange Index (IBOVESPA) and the sovereign spread (EMBI +)*



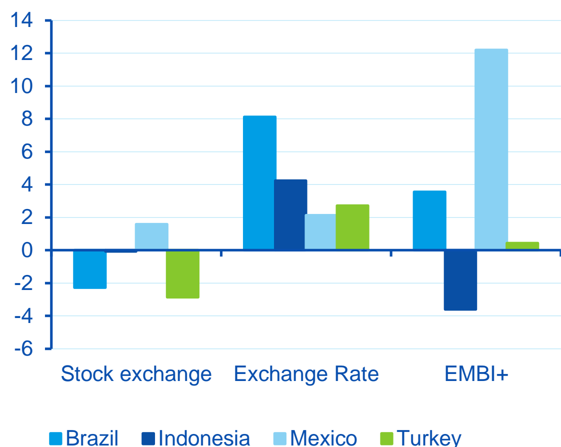
* To 20 November.
Source: Datastream and BBVA Research

The volatility witnessed in world markets was partly brought about by a slowdown in China and the impending Fed interest rate hike, and this was heightened locally by the worsening macroeconomic situation, which has, among other things, engendered debate over the possibility of Brazil losing investment grade status in the not too distant future, as well as by the uncertainty surrounding the October elections and the failure to articulate public policy from 2015.

The losses assailing the Brazilian financial market in the three-month run-up to the elections, i.e. between early August and the end of October, have on the whole been heavier than those noted in other emerging countries (Figure 5.2), as well as those recorded in previous periods leading up to elections (Figure 5.3), which lends weight to the hypothesis that idiosyncratic factors have been playing a particularly important part in the recent upturn in volatility.

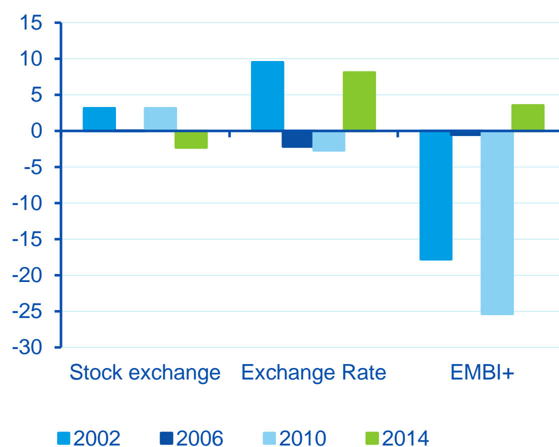
Despite the end of the elections, however, volatility has persisted in November. The doubts as to who would be running the country in 2015-18 were replaced by others over the scale and duration of the correction to economic policy. Besides this, Brazilian asset prices, especially in the stock market, have been battered by the corruption scandals at Petrobras, the oil company in which the government has a controlling interest.

Figure 5.2
Stock markets, sovereign spreads and exchange rates (% var. from August to October 2014)



Source: Datastream and BBVA Research

Figure 5.3
Stock markets, sovereign spreads and exchange rates in election periods in Brazil (% var. from August to October in each year)



Source: Datastream and BBVA Research

The anticipated and much-needed exchange rate depreciation begins to materialise

Although we have - for some time now - been expecting a significant exchange rate correction, the weakening process of the Brazilian real which began in September has come as a surprise, given its magnitude. From then until mid-November, the real has leapt from 2.23 to 2.53 to the dollar, having even recently nudged 2.60 (Figure 5.4).

The recent depreciation in the real was the result of a blend of factors, including dollar strength on world markets, retreating commodity prices (and the adverse effect of this on Brazil's terms of trade), low manufacturing sector competitiveness, the nagging deficit on current account, greater risk aversion and the relatively passive stance of the central bank, which has shied away from stepping up its already considerable level of intervention in FX markets, in contrast to how it has responded historically.

In spite of the fact that, in the short term, the resumption of Selic rate hikes and the flagging of an imminent announcement of a fiscal adjustment programme in line with what the markets were demanding could stabilise, and even generate a small appreciation of the real, in the medium to long term the exchange rate's depreciating trend should continue. This is, among other factors, because the dollar's steady appreciation on the impending interest rate hike in the United States is unlikely to be over yet, and because the terms of trade should stay in decline.

In spite of the cost which this depreciation should bring in terms of inflation, we see this exchange rate adjustment as being positive for the Brazilian economy, given the need to remedy some of the recent distortions, such as, for example, the loss of competitiveness of manufacturing exports.

We thus expect the Brazilian real to close the year at 2.52 and hit 2.70 towards the end of 2015, which would imply a depreciation of 15% in two years since the end of 2013 in nominal terms, and one of 7.5% in real terms over the same time (Figure 5.5).

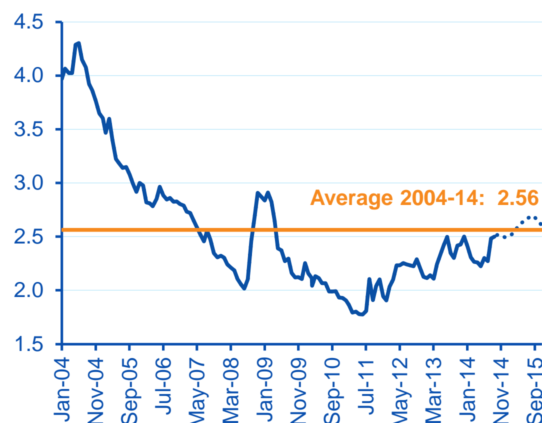
Our forecasts take on board the view that the central bank will scale down its daily programme of offering dollar liquidity, or even stop it altogether, early next year. This is because, among other reasons, the stock of currency swaps offered by the central bank has already passed the USD100bn mark (a level which

represents 27% of the country's international currency reserves, and means a potential cost to the central bank to the extent that the real continues to soften).

Figure 5.4
Nominal USD/BRL exchange rate

Source: BCB and BBVA Research

Figure 5.5
Real exchange rate (at November 2014 prices)



Source: BCB and BBVA Research

The toughening of monetary policy has already commenced, and will continue until the beginning of 2015

Having held the Selic rate at 11% since April, the central bank, which should remain in the charge of Alexandre Tombini over Dilma Rousseff's second term, decided to lift it by 25bp at its October meeting, which came just a few days after the second round of the presidential elections. This decision caught the entire market off guard, as it was counting on rates to hold steady until the end of 2014, as indeed we were.

Quite apart from coming as a surprise, the Selic hike appears at odds with the lowering of bank reserve rates and capital requirements announced halfway through the year to stimulate the credit market, particularly the auto sector.

Whatever the cause, this rate hike in our opinion marks a new change of strategy in the way monetary policy is handled in Brazil (see Box 1). Specifically, it underlies a fresh bid to restore some of the credibility lost in the last few years and to anchor prospective medium- and long-term inflation (the market is currently expecting inflation to be 6.45% in 2014, 5.7% in 2015 and 5.5% in 2017 and 2018, in all cases significantly above the central bank's target of 4.5%).

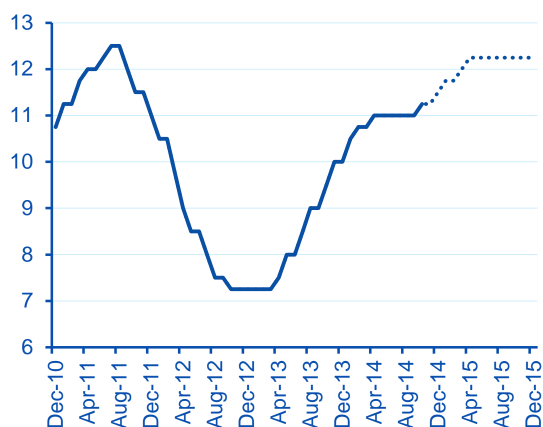
According to the official monetary authority statement, the commencement of a new round of rate hikes is a consequence of the recent exchange rate depreciation. Moreover, the minutes from the last meeting on monetary policy implicitly suggest that the coming adjustments will be decided not only by exchange rate dynamics, but also by the tone of fiscal policy.

The central bank should make further Selic rate adjustments at its upcoming meetings. We think the most likely scenario is one with adjustments continuing in the next few months at a tempo of 25bp per meeting, thus ending 2014 at 11.50% and bringing the upward cycle to a close in April with a Selic rate of 12.25%. The recent slowdown in inflation which we had been expecting and our forecast of a stable exchange rate in the short term support this view.

There is, however, a significant likelihood that from the next meeting in December onwards the COPOM (Monetary Policy Committee) could start lifting rates by 50bp a time. This gives our forecast for the Selic an

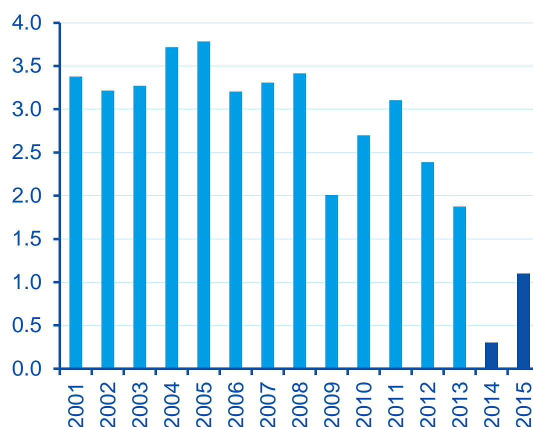
upside bias, not only for year-end 2014, but also for 2015. Both more concerted efforts to bring inflation into line with the target rate of 4.5% in the medium term and a greater impact of the normalisation of monetary policy in the United States could mean the Selic rate hitting a level of over 12.25% next year (see Box 2).

Figure 5.6
The Selic rate (%)



Source: BCB and BBVA Research

Figure 5.7
The public sector primary surplus (% of GDP)



Source: BCB and BBVA Research

President Dilma Rousseff's new government is readying a fiscal adjustment in the wake of the serious decline observed in recent years

After steady corrosion of the public sector primary deficit from 2011, the deterioration has taken a turn for the worse in recent months. In precise terms the primary deficit, which stood at 3.1% of GDP at the end of 2011, had dropped to 1.9% as of the end of 2013 and was 0.6% in September 2014.

This sharp decline of late has been fuelled by low tax receipts as a result of the lack of buoyancy of domestic demand and tax incentives previously given, and the vigour of public expenditure, among other reasons because of the law which obliges the government until 2015 to increase the minimum wage at the outset of each tax year by an amount in line with the GDP two years earlier and inflation the year before. In September primary expenditure by the central government grew by 11% YoY in real terms, whereas government revenues were down 1% YoY.

The fall in the primary surplus has been heavy and marked by measures that are hard to undo, which makes reversal of them impracticable in the short and even in the medium term. Faced with this fact the government has floated a bill which would, in practice, give the central government (i.e. the federal government and the central bank) a mandate to work towards a very low net primary balance, or even a deficit, instead of a surplus of 1.55% of GDP[7].

Similarly, the regional governments and state-owned enterprises showed a primary surplus of close to zero in September, which is below the 0.35% target set for this public sector segment this year[8].

In this context, we expect the consolidated public sector figure to reveal a primary surplus of just 0.3% of GDP this year, some way below the previously established target of 1.9%.

7: In a recent fiscal report the central government suggested that the new target for this year could be around 0.2% of GDP.
8: There are no mechanisms which oblige regional governments and state-owned companies to meet their target or guarantee this. Moreover, from the end of last year a law removed the obligation on the federal government to produce an additional surplus equal to the difference between the target deficit and the surplus actually generated by regional governments and state-owned enterprises.

The weakening of the public accounts, the negative impact of the expansive fiscal policy and the risk of Brazil losing investment grade status in the coming years have squarely placed strong pressure on the government to move back towards a more substantial primary surplus following a fiscal correction[9].

As we have considered in Section 3 of this report, despite the great uncertainty at the moment we believe that Dilma Rousseff's new government will soon embark on a fiscal adjustment programme to enable the generation of more solid primary surpluses from 2015.

Due to the difficulty of going back on the offer of certain tax incentives brought in over the last few years, the traditional rigidity of tax expenditure in Brazil, the obligation of adjusting the minimum wage by 2.5% in real terms this year and the low tax revenues anticipated, the most likely outcome is that the fiscal adjustment to be announced is less ambitious in the short term (i.e. 2015) and more so in the medium term (from 2016).

While we still await the official announcements, we expect the government to try to produce a primary surplus of approximately 1% of GDP next year and at least 2% from 2016. We also think that this adjustment should be based on both an increase in taxes and spending cuts, which would additionally include a reduction in transfers to the state-owned banks.

Our scenario implies the overall fiscal balance, which takes in not only the primary balance but also interest servicing expenses, reaching a deficit of 5.1% of GDP this year, the highest since 2003, when the total fiscal balance was -5.2%. In line with the expected increase in the primary surplus, the fiscal deficit should move down from 2015, when it should come in at 4.7%.

In summary, we forecast that the government will steadily reverse the expansive tone of fiscal policy and also make it more transparent than it has been in recent years, so as to nip any emergent solvency problems in the bud, avoid a loss of investment grade status and foster a more benign macroeconomic picture. There are also serious risks involved in announcing and carrying out the fiscal adjustment, such as, for example, that it might be seen as insufficient and temporary, or that it could produce a more powerful effect than intended on the labour market and economic activity.

The current account deficit is holding at 3.7% of GDP and we do not expect it to subside until the end of 2015

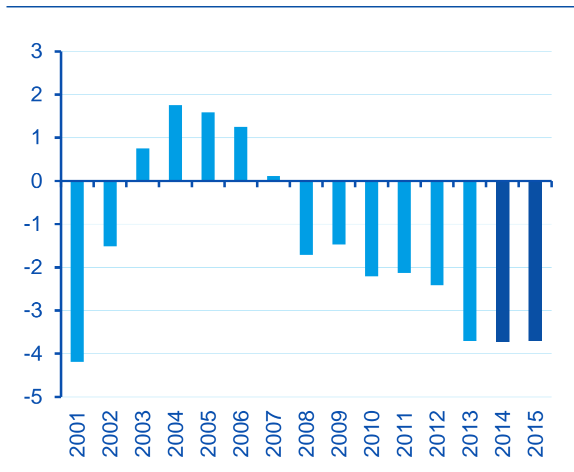
The deficit on the current account touched 3.7% of GDP in September, and we predict that it will hover around this figure, not just until the end of the year, but also in 2015.

A sizeable portion of the worsening overall current account situation from the end of 2012, when the deficit was 2.4% of GDP, until now owes itself to the increasingly unhealthy trade balance, although the widening deficit within the revenues and services accounts has also been influential.

In 2015 we expect the depreciation of the Brazilian real and the weakness of domestic demand to offset the adverse effect of the reduction of roughly 5% in the terms of trade, and that the deficit will thus remain practically stable.

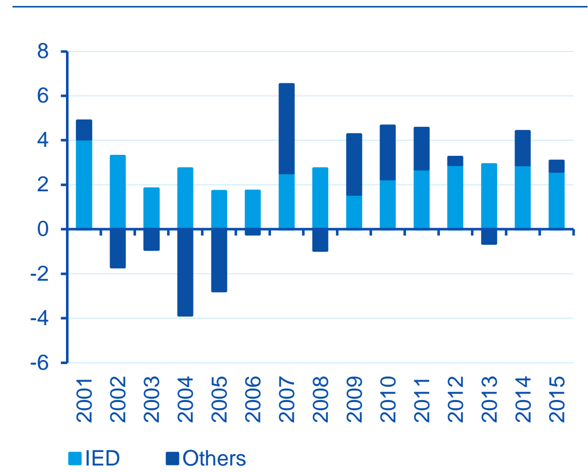
9: Brazil's current ratings are BBB-, BBB and Baa2 from S&P, Fitch and Moody's respectively, which implies that the country is just one notch away from losing investment grade status according to S&P, and two according to the other two credit rating agencies.

Figure 5.8
Current account (% of GDP)



Source: BCB and BBVA Research

Figure 5.9
Capital and financial account (% of GDP)



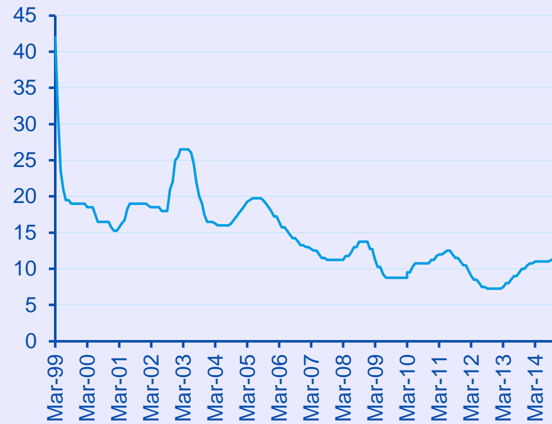
Source: BCB and BBVA Research

Foreign Direct Investment (FDI) is likely to dwindle slightly next year, although it should remain relatively high (around 2.7% of GDP) and finance a large part of the current account deficit. The global situation will also be less conducive to attracting portfolio investment, given the expected rate hikes in the United States and the reduction of global liquidity, which means that a balance of payments deficit would come as no surprise. Even though the high level of international reserves (37% of GDP) offers a cushion against stressful circumstances, the lower levels of international financing in a climate where the corporate sector has historically high external debt (14% of GDP in June 2014, compared to 7% in June 2008) suggest that it is not the case that risks are non-existent.

Box 1: Taylor rules and short term equilibrium interest rates

Since the end of the 1990s, monetary policy in Brazil has converged towards one of "inflation targeting", typically involving the setting of medium- and long-term inflation targets. This system has come far enough to be able to try and describe the current behaviour of monetary authorities given various types of pressures on an empirical basis (Figure B.1.1).

Figure B.1.1
Reference rates in Brazil (%)



Source: BCB

Empirical estimation of Taylor rules for Brazil

In an extension of the traditional framework for Taylor rules (Clarida et al., 1998[10]), we construct a linear rule to explain the official interest rate in Brazil. In this rule interest rates respond to three macroeconomic variables: the activity gap (relative to long term output), the inflation expectations gap (relative to target inflation) and the US dollar exchange rate gap (relative to the long-term equilibrium exchange rate). Following the standard methodology for this type of exercise, we add in a lag in the official interest rate. In other words, we assume that the monetary authorities do not automatically adjust the interest rate as dictated by these gaps, but instead do so only partially, taking into account the rate level currently obtaining. This gradual approach to monetary policy therefore produces two key values: a short term equilibrium interest rate, on which we shall focus our attention, and an "effective" or "partially adjusted" interest rate.

The model supports the contention that the central bank attaches great relative importance to economic activity

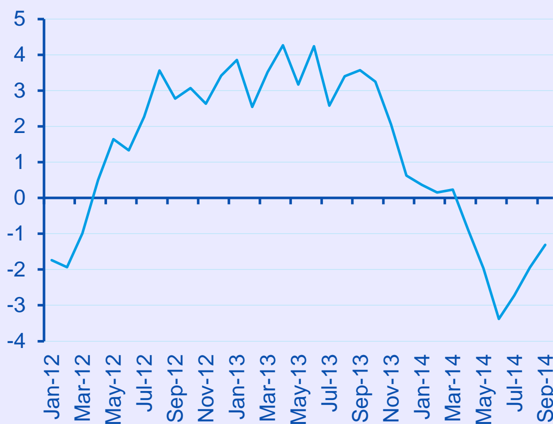
Figure B.1.2 shows a monetary policy index showing the gap between the estimated short term interest rate and the effective interest rate for each country. A positive sign indicates pressures on raising interest rates, whereas a negative sign shows pressures on lowering them. It is clear from our model that Brazil faces downward pressures, although these are letting up.

10: Clarida, Richard, Jordi Gali, & Mark Gertler. 1998. "Monetary Policy Rules in Practice: Some International Evidence." European Economic Review 42:1033–67.

This downside bias is in part due to low growth in activity, which offsets the upward pressure imposed by high inflation. The model thus supports the view that the central bank is (directly and significantly) taking account of the impact of activity in reaching its decisions on monetary policy. We have also found evidence that activity has become a relatively more important factor in decisions by the monetary authorities in recent years.

Nevertheless, the recent decision to begin raising interest rates suggests that the central bank might be starting to attach greater importance to inflation compared to both the weight given to this in the last few years and what the model indicates.

Figure B.1.2
Index of pressure on monetary policy rates



Source: BBVA Research

Empirical evidence suggests that Fed rate hikes will put upward pressure on interest rates in Brazil

Given the imminence of an upward rate adjustment in the United States, we use our model to try to capture the impact on local interest rates of a Fed rate hike[11]. Taylor rules in Brazil appear to respond to US monetary policy as regards the "shadow" rates controlled by its monetary policy committee (the FOMC)[12]. In general terms, our model therefore offers evidence that the impact of US monetary policy is direct, that is to say that a restrictive Fed policy leads to rises in the local interest rate[13]. These findings support the view that the normalisation of monetary policy by the Fed in 2015 will contribute to upward pressure on interest rates.

11: In the period reviewed for most countries, from 2004 to 2014, there has only been a single monetary cycle in the United States (see Figure B.3.1), which means we should be cautious in analysing the findings from the models.
12: Given that for some years Fed rates have been limited by the impossibility of having negative rates, "shadow" measures exist which seek to determine the negative interest rate which would be equivalent to the extraordinary monetary policies that have been implemented in their stead (see Wu & Xi, "Measuring the Macroeconomic Impact of Monetary Policy at the Zero Lower Bound", Wworking Ppaper, 2014).
13: This effect could relate to financial stability considerations in the medium term (outflows of capital in a more risk-averse global environment which could give rise to vicious circles with even larger currency depreciations that cause/are caused by an imbalance and impairment of the balance sheets of banks and companies).

6 Forecast table

Table 6.1
Macro Forecasts

	2012	2013	2014	2015
GDP (% YoY)	1.0	2.5	0.2	1.3
Inflation (% YoY, eop)	5.8	5.9	6.2	5.8
Exchange rate (vs. USD, eop)	2.04	2.34	2.52	2.70
Interest rates (%, eop)	7.25	10.00	11.50	12.25
Private consumption (% YoY)	3.2	2.6	1.4	1.1
Government consumption (% YoY)	3.3	2.0	1.4	1.2
Fixed investment (% YoY)	-4.0	5.1	-7.9	2.0
Exports (% YoY)	0.5	2.5	2.3	3.2
Imports (% YoY)	0.3	8.3	-0.5	1.9
Fiscal balance (% GDP)	-2.5	-3.3	-5.1	-4.7
Current account (% GDP)	-2.4	-3.6	-3.7	-3.7

Source: BBVA Research

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This report has been produced by the LatAm Co-ordination unit

Enestor Dos Santos
enestor.dossantos@bbva.com

With the contribution of:

Cecilia Posadas
c.posadas@bbva.com

Jorge Redondo
jorge.redondo.caballero@bbva.com

Alejandro Neut
robertoalejandro.neut@bbva.com

BBVA Research

BBVA Group Chief Economist
Jorge Sicilia Serrano

Developed Economies Area
Rafael Doménech Vilariño
r.domenech@bbva.com

Spain
Miguel Cardoso Lecourtois
miguel.cardoso@bbva.com

Europe
Miguel Jiménez González-Anleo
mjimenezg@bbva.com

United States
Nathaniel Karp
Nathaniel.Karp@bbva.com

Emerging Markets Area
Alicia García-Herrero
alicia.garcia-herrero@bbva.com

Cross-Country Emerging Markets Analysis
Álvaro Ortiz Vidal-Abarca
alvaro.ortiz@bbva.com

Asia
Le Xia
le.xia@bbva.com

Mexico
Carlos Serrano Herrera
carlos.serranoh@bbva.com

LATAM Coordination
Juan Manuel Ruiz Pérez
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive Carrasco
jselaive@bbva.com

Colombia
Juana Téllez Corredor
juana.tellez@bbva.com

Peru
Hugo Perea Flores
hperea@bbva.com

Venezuela
Oswaldo López Meza
oswaldo.lopez@bbva.com

Financial Systems and Regulation Area
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy
María Abascal
maria.abascal@bbva.com

Recovery and Resolution Strategy
José Carlos Pardo
josecarlos.pardo@bbva.com

Global Coordination
Matías Viola
matias.viola@bbva.com

Global Areas

Economic Scenarios
Julián Cubero Calvo
juan.cubero@bbva.com

Financial Scenarios
Sonsoles Castillo Delgado
s.castillo@bbva.com

Innovation & Processes
Oscar de las Peñas Sánchez-Caro
oscar.delaspenas@bbva.com

Contact details:

BBVA Research
Paseo Castellana, 81 – 7th floor
28046 Madrid
Tel.: +34 91 374 60 00 and +34 91 537 70 00
Fax: +34 91 374 30 25
bbvaresearch@bbva.com
www.bbvaresearch.com