

# Brazil Economic Outlook

First quarter 2015

Emerging Economies Unit

- Brazil has a year of low growth and high inflation ahead. As in 2014, GDP growth will be around zero and inflation will be nudging the 6.5% ceiling of its target range in 2015.
- The shift in economic policy and exchange rate weakening are prerequisites for the country to return to growth. Nonetheless, together with the impact of the deterioration in the terms of trade, the Petrobras crisis and the shortage of water and electricity will exert a detrimental effect in the short term.

## Outlook

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**Closing date: 25 February 2015**

# 1 Overview

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**World growth will continue to rise in 2015 and 2016, albeit sluggishly and very unevenly.** Specifically, we expect world growth to climb from 3.3% in 2014 to 3.6% in 2015 and 3.8% in 2016. Led by the United States, the developed economies will increase their input into global expansion, whereas the controlled slowdown in China will persist.

**The shift in economic policy is now afoot.** Recent statements indicate that the adjustment will focus on fiscal and quasi-fiscal policy, but will also involve monetary policy changes. The switch to a more pragmatic, transparent and orthodox economic policy approach is vital to staving off a degeneration of external accounts, fiscal decline and the rise of inflation. If implemented properly, it should allow the country to grow in line with its potential rate of around 2.5% again, but in spite of the recent hopeful signs, the risk remains that the adjustment might lack the necessary political backing.

**Tax hikes and cost-cutting will steadily reverse the sharp deterioration in the public finances in 2014.** The use of fiscal policy in support of economic activity proved a body-blow to the public finances in 2014, meaning that the correction required if the country is to meet its recently announced primary surplus targets for the next three years is that much greater. What is more, in the next few months the government will have no option but to announce a further round of tax rises and spending cuts to meet its fiscal targets and drive back the mounting public debt.

**The central bank is using more restrictive language in a bid to anchor inflation expectations.** The new cycle of monetary tightening has begun early and will lead to higher-than-expected interest rates. The Selic rate ended 2014 at 11.75% and should soon rise to at least 12.50%. After these hikes in H1, the central bank will only be able to trim the Selic rate back again when inflation offers clearer signs of relenting, which we see happening in mid-2016.

**GDP will remain at a standstill in 2015.** We predict growth of only 0.6% this year on further terms of trade weakening, the ongoing economic policy correction, the fallout from the Petrobras crisis, and the obstruction caused by the water and electricity shortage, while any larger-than-expected impact from any of these factors could tip the economy into recession.

**The increase in regulated prices will keep up inflationary pressure.** After ending 2014 at 6.4%, inflation should hold within the 6.5-7.5% range throughout the year. The reason behind the apparent paradox of continuing inflation pressure while domestic demand is waning is that the key culprit in the recent rise of prices is inflation of regulated prices, as a direct consequence of the lack of fiscal leeway to hold them at artificially low levels.

**The macroeconomic environment will brighten in 2016.** The contractionary effect of the economic policy adjustment and the shocks currently cramping activity show a tendency to focus on 2015 and slacken off in 2016. On the other hand, there will be greater manifestation of the economic policy correction in confidence and of the currency depreciation in exports in 2016. We thus expect GDP growth to rise to 1.8% in 2016, while inflation will also let up, as a considerable part of the corrections to regulated prices and the exchange rate will have kicked in by then.

**There is still turmoil in financial and currency markets.** The real has lost 13% in the last three months, and 28% since August 2014. This is a product of the need to restore loss competitiveness, the wider current account deficit, the terms of trade deterioration, the greater sensation of risk, and dollar strength in world markets, where we see the USD/BRL rate ending 2015 and 2016 at around 2.93 and 3.03 respectively.

## 2 Global backdrop: increasing divergence between the key economic areas

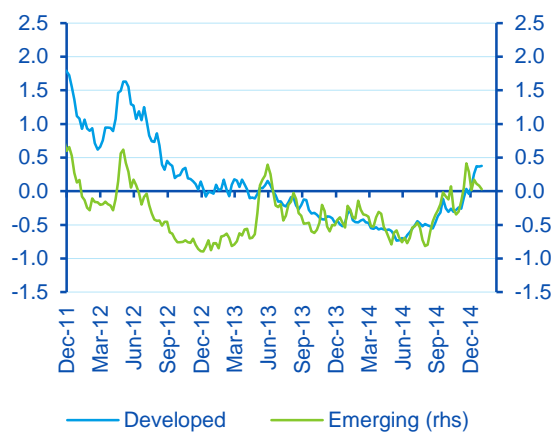
### Global growth should increase to 3.6% in 2015 and 3.8% in 2016

The world economy grew in the fourth quarter of 2014 at a similar pace to the third, close to 0.8% per quarter. A dynamic economic performance in the US has been offset by the weakness of the recovery in Japan and the eurozone, and the progressive deceleration of China and other emerging economies. Hence, we estimate that global GDP will have grown 3.3% in 2014, 10bp more than in 2013, with a slight increase in the DMs' contribution over the three previous years, and the EMs continuing to decelerate.

One of the biggest pieces of news in the global economic scenario in recent months is the very sharp fall in the oil price and its uneven impact on different countries, depending on whether they are net importers or exporters. Overall, we think the global impact of cheaper oil should be positive in terms of growth, inasmuch as the reduced burden on household and corporate income in oil-importing countries (such as the US, the eurozone and China) offsets the reduced activity in the principal producer countries. On the other hand, the correction in oil prices also increases the risk of inflation scenario too low in some developed regions, at least until the end of 2015.

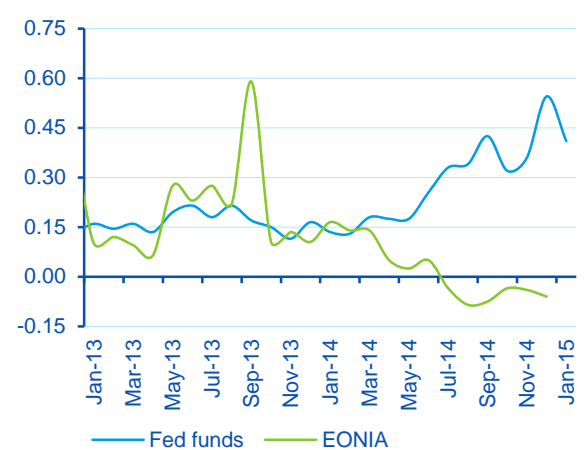
The increased volatility in financial markets, which has now reached the same level as in mid-2013, according to the BBVA Financial Tensions Index (Figure 2.1), is another of the highlights of the quarter, and one the EMs and the DMs have in common as a consequence of two factors: i) doubts about the economic development of many EMs, and ii) the uncertainty around the Fed's rate-hiking cycle.

Figure 2.1  
BBVA Research Financial Tensions Index



Source: BBVA Research and Bloomberg

Figure 2.2  
Monetary policy expectations: 12M fwd interest rates (%)



Source: BBVA Research and Bloomberg

In this context of low inflation and moderate economic growth, monetary policies remain accommodative in tone, although the biases differ, with the Fed and the Bank of England on the one side, and the ECB and the PBoC on the other (see Figure 2.2).

Thus, the improvement in global growth will continue in 2015 and 2016, by more than 3.5% on average, but there will be a significant differentiation between areas, given the asymmetric effect of falling commodity

prices and monetary policy divergence in the development bloc, with these being the two effects that mark *a priori* the prospects for the global economic scenario.

All in all, and in spite of the support offered by economic policies and lower oil prices, the risks to world growth in 2015 remain to the downside. The risks presented by geopolitical tensions have been exacerbated by those associated with the effectiveness of the monetary policies introduced to increase inflation expectations and – in the case of the Fed in particular - to establish a strategy for withdrawing stimulus that does not erode the EMs' financing conditions to such an extent that this restricts their growth.

### The US consolidates its recovery and the Fed is ready to raise interest rates

Momentum in the US recovered over the course of 2014, based on the strength of domestic demand and also lower oil prices. Looking forward, US growth could reach 2.9% in 2015 which, together with low inflation, will accentuate the Fed's dilemma when it comes to start its monetary normalisation process. In this context, our forecast date for the first increase in the Fed funds rate remains 3Q15.

### The controlled slowdown in China continues

In China, the slow deceleration in activity continued, with an estimated growth of 7.2% in the fourth quarter, the slowest since 2009 due to the loss of momentum in fixed capital investment, the deterioration in external competitiveness which was driving the yuan's appreciation and the correction in the real estate sector.

Although we have left our forecast for growth in 2015 unchanged at 7%, the risks are clearly biased to the downside as a reflection of the magnitude of accumulated financial imbalances, the uncertainty over the evolution of the real estate market and the doubts about the capacity of policies to achieve a correction in the present imbalances with economic liberalisation underway. It is important to remember that the authorities have started to show more tolerance towards economic deceleration, provided that job-creation moves in line with the active population.

### Finally, the downward pressures on inflation in Europe continue

Of the large economic areas, the eurozone is the most likely to have to deal with a scenario of inflation that is too low for too long. In addition to the negative surprises on consumer prices, the area has only a moderate economic growth profile, in line with expectations. In particular, an increase of 0.8% in 2014 is anticipated, which could increase up to 1.3% in 2015, supported by the fall in the price of oil, the accumulated depreciation of the euro in recent months and the relaxation of monetary conditions thanks to the ECB's actions.

Among the main focus-points of downside risks is the increased tension in Russia's sphere of influence. A second risk factor is the uncertainty generated by the divergences between some national authorities and the EU institutions as to the most appropriate supply-side reform, the pace of fiscal consolidation and the ECB's support in fostering growth. Finally, another risk is that medium-term inflation expectations will continue to fall, discouraging consumption in the short term, and leading to a negative feedback loop.

### 3 Brazil: adjusting economic policy

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#### The orthodox and all-pervasive adjustment of economic policy is designed to reduce distortions and regain lost credibility

After the elections of 26 October 2014 and even before the official start of her second term, president Dilma Rousseff embarked on an overhaul of Brazil's economic policy by generally adopting a more orthodox, pragmatic and less interventionist approach.

The escalation of the distortions brought about by the previous economic policy and the evident loss of credibility in recent years, as well as the dismal macroeconomic performance, have motivated, and even forced, a shift in economic policy.

The correction being implemented is personified by Joaquim Levy, the new finance minister who is in the technical and orthodox mould. The measures announced thus far suggest that the adjustment will focus on fiscal and quasi-fiscal policy, though it will also feature changes to monetary policy management, which is still coordinated by Alexandre Tombini, the governor at the central bank.

The switch to a more pragmatic economic policy is fundamentally to trouble-shoot the deterioration in external accounts, the decline in the fiscal situation and rising inflation. We think that if it is well implemented the adjustment could enable the country to return to growth in line with its potential rate of around 2.5% in the next few years. More robust growth calls for a package of economic reforms which we view as unlikely to emerge in the current political and economic climate.

Come what may, despite the benefits in the medium and long term, this change of tack will bridle economic activity in the short term, as it will mean tighter economic policy this year.

So, because of the legacy of mistakes and distortions that have accumulated in recent years, the country is being forced into applying restrictive economic policy at a time when domestic activity is being buffeted by a raft of major unwelcome shocks (about which more below). The tone of economic policy will contrast, for example, with that of other countries in the region where, like Brazil, they have been hit by the fall in commodity prices, but counter-cyclical policy is being employed.

Finally, although the necessary economic policy fix is being applied in line with our expectations and even surprising a wide section of analysts in a positive sense, the risk still looms of political support being withdrawn from it as its impact on activity bites more noticeably over the course of the year.

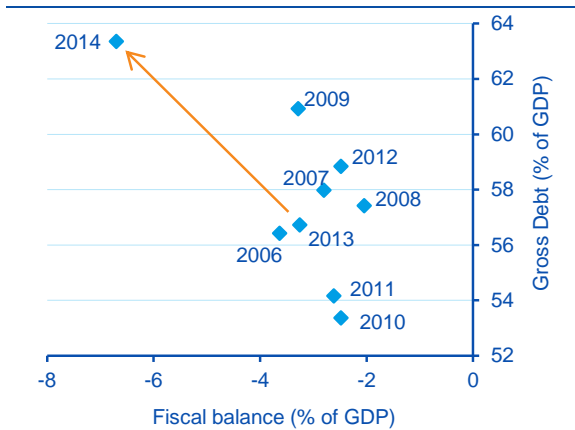
#### Fiscal policy: higher taxes and cost-cutting aimed at gradually neutralising the sharp deterioration noted in 2014

The public sector showed a primary deficit of 0.6% of GDP in 2014. The balance was a long way short of the comparable figures for previous years (surplus of 1.9% in 2014 and of c.3% in the 10 years before that) as well as the target primary surplus of 1.9% for the year, which had been initially set by the government only to be officially abandoned later. The figure also caught analysts wrong-footed, who, having learned the figures to November, were counting on a consensus estimate close to 0% or fractionally negative.

The decline in 2014 came from lower government revenues and, most significantly, a rise in spending (the available data for general government give a 4% fall in revenues and a 6% increase in spending, in real terms). In an environment marked by a decrease in tax receipts, the attempt to boost economic activity in an election year through greater spending and tax incentives has played havoc with the public finances.

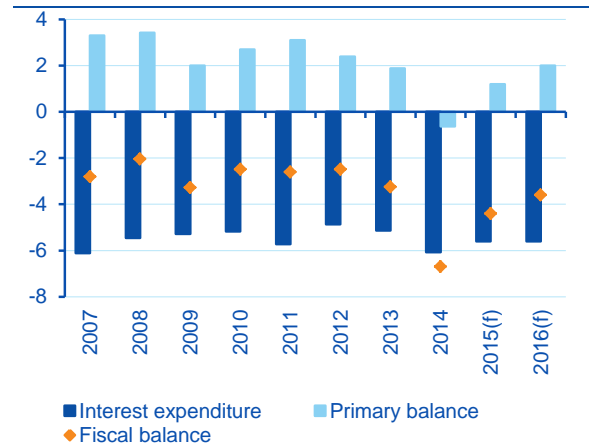
The slashing of the primary surplus contributed to the nominal deficit swelling to 6.7% of GDP, which was also encouraged by the upturn in interest payment costs (6.1% of GDP), and instrumental in gross general government debt arriving at 63.7% of GDP at the close of 2014, up by almost 7pp on the previous year (figure 3.1).

Figure 3.1  
**Fiscal accounts: gross debt and fiscal balance (% of GDP)\***



\* Gross debt of general government, methodology used from 2008. Overall fiscal balance (primary balance + interest payments) for the consolidated public sector. Source: central bank and BBVA Research

Figure 3.2  
**Public sector fiscal balance: primary and total balances, and interest expenditure (% of GDP)**



Source: central bank and BBVA Research

The public sector accounts thus reveal that fiscal policy was more expansive than was supposed in 2014. Among other consequences, this implies that a bigger correction will be required for the country to meet the primary surplus targets which were announced in December, and are necessary to stabilise the government borrowing to GDP ratio at 1.2% in 2015 and 2.0% in 2016 and 2017. Specifically, a fiscal effort of 1.8% of GDP is needed to hit the primary surplus target this year (raising the primary balance from -0.6% in 2014 to 1.2% this year).

In the first few weeks of the year, the government announced precise measures to boost the fiscal surplus via increased taxation and spending cuts. Tax-wise, the CIDE levy on fuels was reduced again, the rate of financial tax was lifted for loans to families, and the IPI tax on manufactures was standardised. In terms of cuts, the government has already announced its intention to cut spending in connection with certain welfare benefits, such as unemployment cover and widows' pensions. The government has also placed a ceiling on fiscal expenditure until the final budget for the year has been approved. Lastly, it has scaled down subsidies to the electricity sector and on loans from public banks. This set of measures should have an effect amounting to roughly 1% of GDP this year (0.4% on the revenues side and 0.6% on spending).

More measures still are therefore required to reach the figure of 1.8% of GDP and to achieve the primary surplus target of 1.2%. Besides a potential contribution to the fiscal effort from regional governments (around 0.2%), we expect the government to announce further tax rises and more public spending cuts in the coming months.

Our baseline scenario for the Brazilian economy factors in meeting the fiscal target this year, as well as in the coming ones. Taking this into account, we estimate that the total public sector deficit should come down to 4.4% of GDP in 2015 and 3.6% in 2016 (figure 3.2). Such results do not preclude a small blip in government borrowing in the short term, though it should allow it to stabilise from 2016. Were such a scenario to materialise, it should stop the rating agencies from withdrawing Brazil's investment grade status.

The ongoing correction of fiscal policy will also have an additional impact beyond reducing the available income of families and companies through tax hikes and decreasing transfers to the private sector. The current rise in interest rates charged by the public banks, and the subsequent reduction of the underlying subsidies in the loans arranged by such financial institutions, will cause an additional slowdown in the credit markets. Furthermore, the scaling down of subsidies to the energy sector and other segments will give rise to a surge in regulated prices (for details see Section 4).

Whatever the case, we should make the point again that there is a risk of the fiscal targets not being met due to a lack of political backing in a scenario marked by the flatness of economic activity, the difficulties the government is facing in its negotiations with the national congress and the waning of popular support (Dilma Rousseff’s approval rating dropped from 42% in December 2014 to 23% in January, according to a poll conducted by Datafolha).

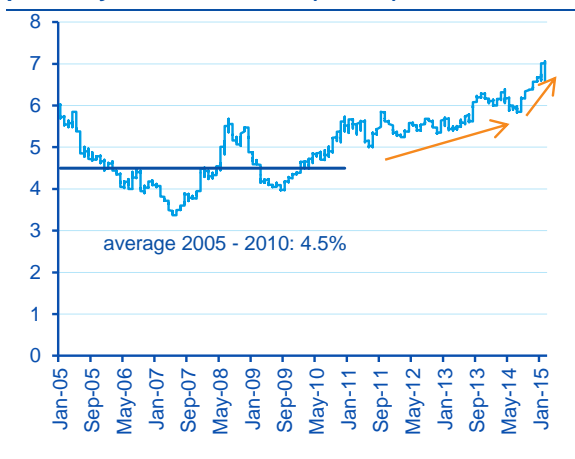
### Monetary policy: a more restrictive tone to try to anchor inflation expectations

Only a few days after the elections confirming another term for president Dilma Rousseff in October 2014, the central bank sprang a surprise by tightening again, hiking rates after holding them at 11% for six months. The Selic rate thus closed 2014 at 11.75% and, following the hikes announced coming into the year, it now stands at 12.25%.

We forecast that the Selic will be raised one last time, by 25bp to 12.50% in early March. Our thinking is that the monetary authority will wait to gauge the delayed impact on prices of the 525bp rise in the Selic rate in recent years and the ongoing fiscal adjustment. Fear of miring the economy in a deeper recession lends weight to the view that the rate-rise cycle will draw to a close in March.

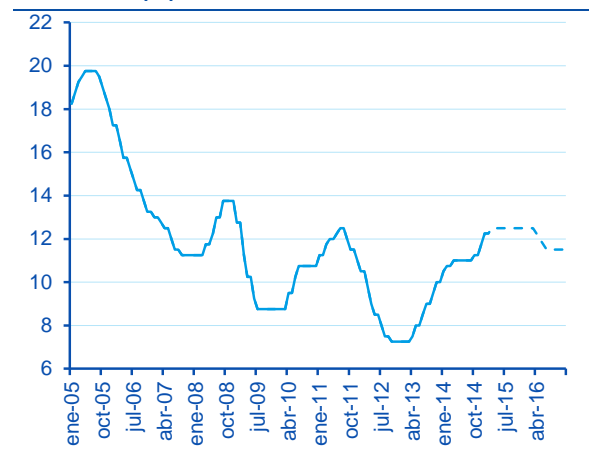
Having said this, one cannot rule out the central bank deciding to lift the Selic past the 12.50% level, to try to bed down expectations more decisively (figure 3.3) and to make inflation converge towards 4.5% in 2016, for the first time since 2009, which is the target that it has pinpointed in its recent statements and which still seems a long way off. The upturn in inflation in the short term supports the likelihood of such further monetary tightening (see inflation section below).

Figure 3.3  
Inflation expectations over 12 months of analysts polled by the central bank (% YoY)



Source: Central bank and BBVA Research

Figure 3.4  
Selic rates (%)



Source: Central bank and BBVA Research.



Monetary tightening will, whatever the case, not only have begun early, but it will also have been more powerful than predicted a few months ago, as the overhaul of economic policy being implemented also embraces a turnaround of expansive fiscal policy as well as the more restrictive monetary policy. There is notably tighter coordination between fiscal and monetary policy at the moment than there was last year (or at other times in recent years), when the accommodative fiscal policy blunted the effect of restrictive monetary policy moves.

Our models suggest that the spin given to monetary policy in the United States has a significant impact on its domestic counterpart. We therefore expect that the Fed's normalisation of monetary policy will add to the challenge faced by the central bank of keeping expectations under control and coaxing inflation towards 4.5% in 2016, and will make any cutting of interest rates in the short term problematic. Thus we predict that, after the hikes announced at the beginning of the year, the Selic will hold steady for a while.

As we see it, the central bank will only be able to trim rates when inflationary pressures give clearer signs of fading, which we think will happen in mid-2016 (figure 3.4 and forecast table at the end of this report).

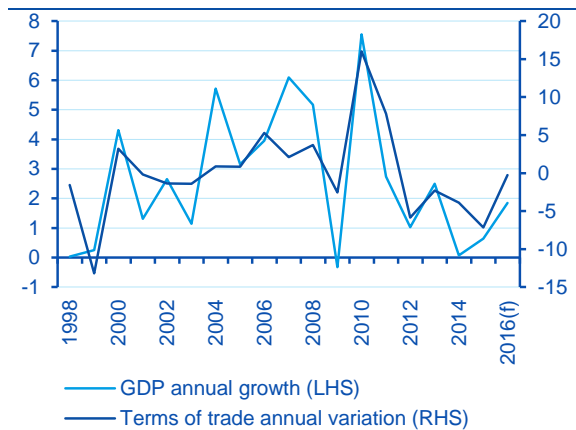
## 4 2015: another year of low growth and high inflation

GDP will remain at a standstill in 2015. Besides a less kindly global environment and the correction of economic policy, activity will be affected by the crises surrounding Petrobras and the water and electricity shortage.

Since 2009, when GDP reduced by 0.3% on the global crisis, economic activity had never presented as much weakness as it did last year. Our forecast for 2014 GDP growth is 0.1%, which takes into account a small upturn in activity in Q4 (0.3% QoQ) that marked just a shade over the level observed in Q3 (0.1% QoQ). More recent figures, however, show weaker-than-expected activity in Q4, which lays bare the fact that we cannot rule out that GDP has grown less (and even shrunk back), both in Q4 and in 2014 as a whole. Come what may, the figure for 2014 GDP growth will not be even lower, as it will be helped up by a statistical carry-over effect, to the tune of 0.6pp to be exact.<sup>1</sup>

In our opinion the weakness of the economy in 2014 relates to external factors, such as the deterioration in the terms of trade, the slowdown in activity in the economies of major trading partners (China and Argentina) and disturbances associated with monetary policy normalisation in the United States, and also domestic aspects. As regards the latter, there are more cyclical factors, such as the uncertainty attaching to economic policy, the dramatic fall in confidence and the upward course of interest rates over the year, as well as others of a more structural nature, such as the country's lack of competitiveness.

Figure 4.1  
GDP and terms of trade (% var. YoY)



Source: IBGE and BBVA Research

Figure 4.2  
Exports (12-month export accumulation, % YoY)



Source: MDIC and BBVA Research

The environment for economic growth will be no better in 2015 than it was in 2014. The main factors behind the stagnation of activity last year, which have already been discussed, will generally continue to stand in the way this year. There are additionally new, idiosyncratic factors which will contribute to activity remaining at a standstill (in the best-case scenario).

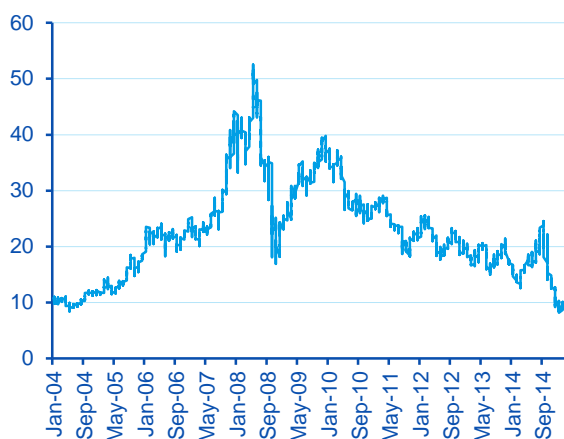
Our take on 2015 therefore factors in the negative impact of the following variables: i) further deterioration of the terms of trade (figure 4.1); ii) another year of weak demand from major trading partners (figure 4.2); iii) the series of Fed rate hikes; iv) the correction of economic policy underway, especially in the first quarters of

1: Statistical carry-over measures how much a country would grow in a certain year if quarterly growth were 0.0% QoQ in the four quarters of the year, where its magnitude is determined by the quarterly growth profile the previous year.

the year; v) the corruption scandal involving Petrobras and several of the country's biggest construction companies, and vi) the water shortage and the energy crisis.

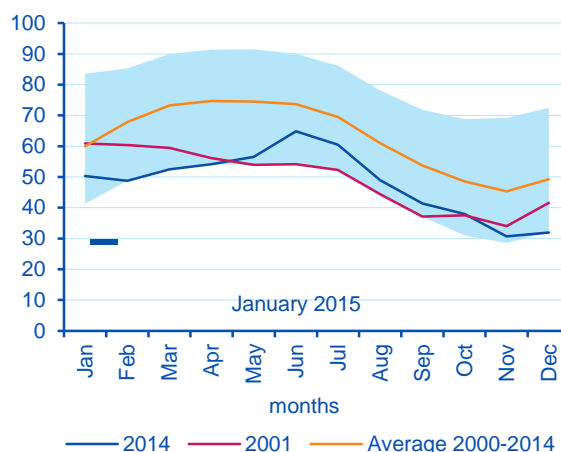
With respect to Petrobras, the problems arising from the suspected payment of bribes by the country's major construction companies to the oil production company come on top of those concerning how the company is run and the oil price slide, all of which makes for a highly ominous situation for the company, especially considering the recent withdrawal of its investment grade status by Moody's (figure 4.3). In our macroeconomic scenario for the country, we basically build in the impact of the Petrobras crisis on Brazil's fixed capital investment and oil production in the medium and long terms. Concerning the FCI impact, it should be noted that Petrobras is one of the country's major investment players and that the construction companies being accused of bribery are the very ones that execute a very substantial proportion of its infrastructure investments. Our baseline scenario for Brazil does not take into account any political aftermath effect from the recent scandal (such as might, for example, undermine the position of the present government and put paid to the passing of the measures required to see the fiscal adjustment through), and neither does it give consideration to a scenario (which we see as unlikely) where the government, as majority shareholder, has to inject capital into the company. At the same time, the risk of a greater-than-estimated impact on economic activity confers a certain downside bias on our growth forecasts.

Figure 4.3  
**Petrobras share-price on the São Paulo exchange (BRL)**



Source: Bloomberg and BBVA Research

Figure 4.4  
**Reservoir levels (% of overall storage capacity)**



Source: ONS and BBVA Research.

Another of the idiosyncratic factors which will hamper economic activity is the current water shortage, and consequently a lack of electricity (75% of the country's energy comes from hydroelectric power generation). Brazil's reservoirs are at worryingly low levels (figure 4.4) as a result of poor rainfall and a delay in investing in generating capacity. The water level in reservoirs is currently as low as in 2001, when Brazil was forced into rationing electricity, even though there is now closer integration of the regional systems (and therefore greater capacity to transfer energy from one region to another) and increased thermoelectric power generating capacity (which makes the power supply somewhat less dependent on hydroelectric energy). Given this context, in our macroeconomic scenario for Brazil we are taking into account the impact of: i) water supply restrictions in the country's South-east region (which takes in the states of São Paulo and Rio de Janeiro, for example); ii) the rise of over 30% in electricity rates; iii) measures to rationalise electricity consumption focusing on households and business. Notwithstanding this, even though we do not consider it in our baseline scenario, there is still a chance that Brazil will be forced into applying compulsory across-the-

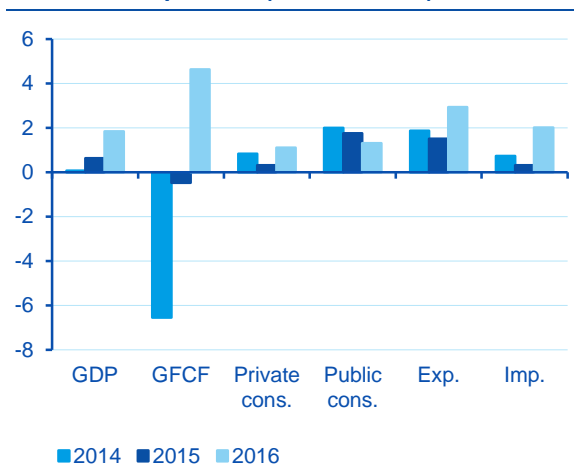
board electricity rationing. This is another of the risks facing the country and which, if it came about, could bring down our current GDP estimate by around 1pp this year.

Among the factors which will support economic activity this year we would pick out the gradual dispelling of uncertainty and misgivings concerning the economy as the adjustment of economic policy takes hold (see our Brazil Economic Watch “2003 and 2015: similar adjustments, different times” for a comparison of the current adjustment with that undertaken in the first year of president Lula’s administration in 2003) and the impact of the recent exchange rate depreciation on net exports (we estimate that the rate this year will average 20% weaker than in 2014 and 70% down on 2011). Private consumption also, which accounts for around two-thirds of GDP, will be boosted by the 2.5% minimum wage increase, which could help shake this component of GDP out of its customary sloth.

Bearing these factors in mind, we estimate that GDP will grow by only 0.6% this year, thus performing on a par with 2014 (figure 4.1 and forecast table in Section 6). In quarterly terms, we expect growth of around 0.0% QoQ in the first two and a gentle pick-up in H2 as the adjustment of economic policy manages to allay uncertainty and the weaker exchange rate lifts net exports.

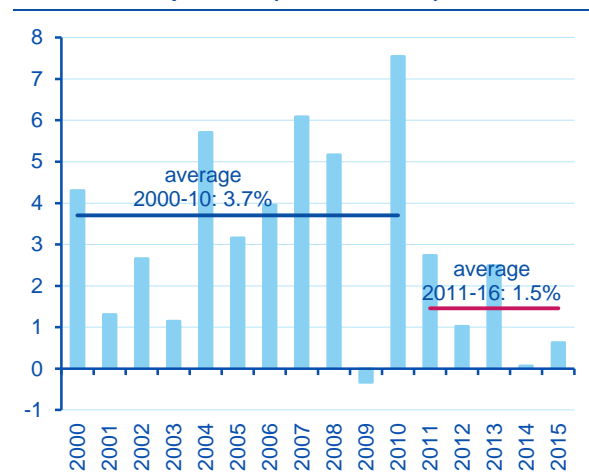
This growth forecast of 0.6% in 2015 does, however, face a series of downside risks. Instead of remaining at a virtual standstill, the country’s GDP could contract sharply this year, among other reasons, if the Petrobras scandal ends up representing a larger-than-expected bombshell for activity, if the government is forced to order electricity rationing, or if the perception prevails that the adjustment of economic policy underway cannot count on sufficient political support.

Figure 4.5  
GDP and components (% annual var.)



Source: IBGE and BBVA Research

Figure 4.6  
GDP and components (% annual var.)



Source: IBGE and BBVA Research.

### The rise in regulated prices will keep up inflationary pressure

In spite of the persistent gingerliness of domestic demand, inflation remains at a high level. It closed 2014 at 6.4% YoY and in January broke through the ceiling of the target range of 6.5%, reaching 7.1% YoY (figure 4.7). This upward trajectory should continue in the short term, and we expect inflation to have arrived at 7.5% YoY in February, marking an almost ten-year high, and then to ease back without falling below 6.5%, where it should close 2015 (figure 4.8).

What explains the apparent paradox of still strong inflationary pressure while domestic demand is ebbing at the same time is that the key factor in the recent price rises is inflation across regulated prices, i.e. those of goods and services controlled by the government.

The upsurge in regulated price inflation is a direct consequence of the lack of fiscal scope to go on holding them down at artificially low levels. This situation has become even more obvious in recent months as the new finance minister, Joaquim Levy, has begun to reverse the expansive accent on fiscal policy and to champion a model of less intervention by the government in terms of setting the prices of regulated goods.

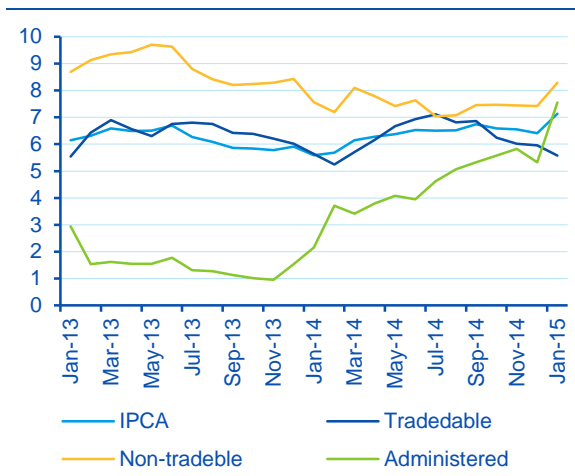
The adjustment in electricity rates of approximately 30% this year is a case in point, as it shows that the ballooning costs faced by the sector in a situation marked by a water shortage crisis will be passed on to end consumers this year rather than the government, which contrasts with events last year, and in particular with the 17% price cut made by the government in 2013.

Inflation will also be fuelled in 2015 (chiefly in the initial months of the year) by the impact of tax hikes on prices (see the earlier section on fiscal policy for further details on this subject).

Taking stock of all of these elements we therefore forecast that inflation for regulated prices will hit 10% this year, which is a long way above 2014 (5.5%), as well as 2013 (1.5%) in particular. On the other hand we expect inflation of free market prices to continue to subside gradually this year. Specifically, we see it reaching 5.5% at the end of 2015, which compares to 7.3% and 6.7% at the close of 2013 and 2014 respectively.

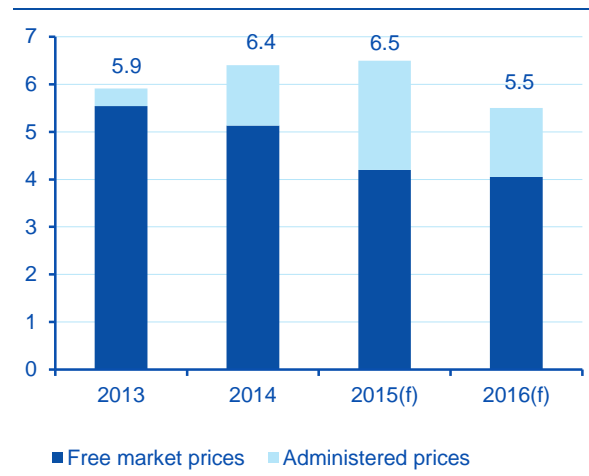
It should be noted that the slowing down of free market price inflation in line with domestic demand will be very gradual, among other reasons because of the impact of the weaker exchange rate on domestic prices, especially those of tradable goods.

Figure 4.7  
**Inflation and components (% YoY)**



Source: IBGE and BBVA Research

Figure 4.8  
**Contributions of free market and regulated prices to annual inflation (pp)**



Source: IBGE and BBVA Research.

## The domestic macroeconomic environment will improve in 2016

In our opinion the macroeconomic environment will not be as unfriendly in 2016 as in 2015 or 2014. The international landscape should be kinder, given that, after four years of big falls, the terms of trade ought to hold relatively stable in 2016 (figure 4.1) and economic growth both worldwide and for certain major trading partners should outstrip levels seen in 2015 and the recent past. The harmful effects on activity, both from the Petrobras crisis and the water and electricity shortage, are also likely to focus on 2015, although how big this will be and how long these problems will last is hard to predict (among other things, in the case of Petrobras, because of the unknown quantity of the political impact and, as regards the energy crisis, due to the fact that rainfall levels over 2015 will play a key role). In addition to this, fiscal consolidation should

continue in 2016, though its impact on economic activity is unlikely to be as large as in 2015, while monetary policy should be less contractionary than in 2015 (figure 3.4). Lastly, the encouraging effect of both a steady restoration of credibility via the change of tack in economic policy and the exchange rate depreciation on net exports should weigh more heavily in 2016.

We therefore predict GDP growth of 1.8% in 2016, which is still short of its potential rate (around 2.5%) but a long way above levels in 2014 or 2015 (figures 4.5 and 4.6 and the forecast table in Section 6).

Turning to inflation, we also expect 2016 to be a better year than those previously, since a sizeable portion of the corrections to regulated prices and the exchange rate will have already worked through. We forecast that inflation of regulated prices will come down to 6.3% over the next year, while its counterpart for free market prices will come in at 5.3%, which would imply inflation of 5.5% at the end of this time. We therefore estimate that, despite the anticipated slowdown, the central bank will not manage to meet its target of bringing inflation down to 4.5% in 2016. Doing this would mean raising interest rates some way above the expected 12.50%, which we do not see happening in the present circumstances.

## 5 Continued upheaval in domestic financial markets

### All the factors suggest a weaker real

Although uncertainty over the political scenario and economic policy in the coming years has diminished after the October 2014 elections, volatility persists on the financial markets and there are still downward corrections in Brazilian asset prices. These falls in value on Brazil's financial markets are linked to the disruption caused by the process of Fed rate rises, commodity price corrections, and the decline in the country's economic and political environment. With regard to this last aspect, special mention should be made of the ravages inflicted on Brazil's financial assets by the corruption scandal in which Petrobras is embroiled, which has also involved the withdrawal of the company's investment grade status by Moody's.

In the past three months the São Paulo stock market has dropped 7% and the sovereign spread has risen by 31bp, meaning that these have built up respective losses of 16% and 57bp since the end of August 2014 (figure 5.1).

The Brazilian real has depreciated by 13% in the last three months and 28% since August 2014. In real terms the current level is similar to those recorded in 2006 (figure 5.2). This weakness is generally very much associated with the deterioration in the Brazilian economy, yet it is specifically a consequence of the need to regain lost competitiveness, the widening current account deficit, the deterioration in the terms of trade and the greater sensation of country risk. Overlaying these factors are the prospects of US monetary policy normalisation and a stronger dollar on global markets.

In the short term, both the Selic rate hikes and the central bank's currency swap selling programme will to a certain extent underpin the real. We nonetheless think that the impending end to the Selic's upward cycle and the non-renewal of the swap programme from Q2 (or another scaling down of the value involved in intervention activity) should add to the aforementioned pressure on the exchange rate to weaken.

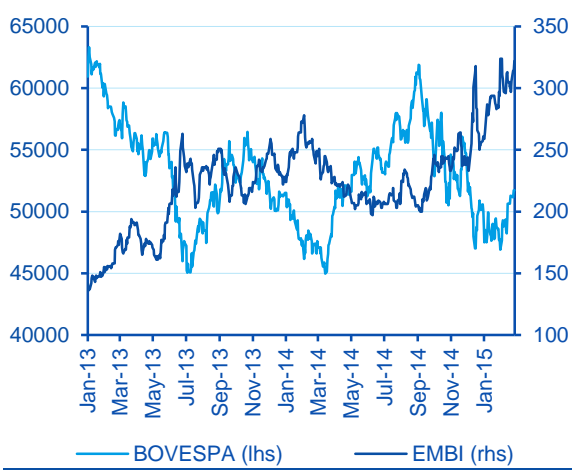
We thus expect the dollar exchange rate to close 2015 and 2016 respectively in the region of 2.93 and 3.03 reals, although we do see upside bias linked to these forecasts. Since practically all the key variables are acting in the same direction, and ought to continue to do so, there is very little basis for claiming to make out signs of a substantial appreciation of the real while there are several variables which could cause an even stronger-than-expected depreciation. The recent depreciation, which was more pronounced than we were anticipating, underlines this upside bias.

In spite of the effect which the currency depreciation will have on inflation and on the corporate sector, we consider the real's depreciation as a necessary correction for the country to be able to grow again<sup>2</sup>. Since a set of structural factors will not permit consumption to grow as it did in the past, both investments and exports will have to have more input for the economy to be able to grow at close to its potential rate of 2.5%.

Finally, together with the slowdown in domestic demand, the currency depreciation should enable a reduction of the current account deficit from 4.2% of GDP in 2014 to 4.0% this year and 3.4% in 2016.

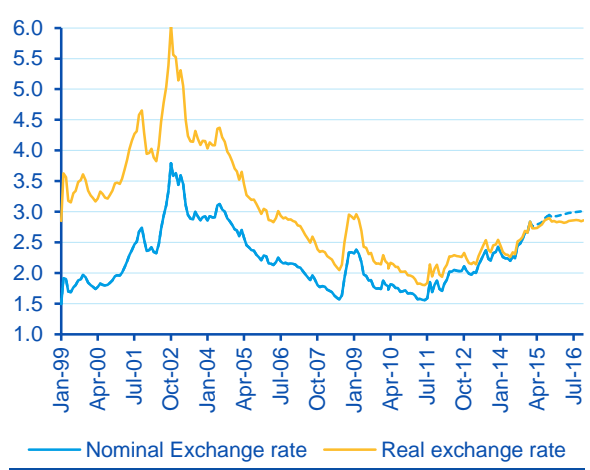
2: For further details on the impact of exchange rate depreciation on the corporate sector see Box 3 of [our Latin America Outlook, First Quarter 2015](#).

Figure 5.1  
**São Paulo stock exchange index (IBOVESPA) and sovereign spread (EMBI +)**



Source: Datastream and BBVA Research

Figure 5.2  
**Exchange rate: nominal and real (current prices, USD/BRL)**



Source: central bank and BBVA Research.



## 6 Forecast table

Table 6.1

### Macro Forecasts

	2013	2014	2015	2016
<b>GDP (% YoY)</b>	2.5	0.1	0.6	1.8
<b>Inflation (% YoY, eop)</b>	5.9	6.4	6.5	5.5
<b>Exchange rate (vs. USD, eop)</b>	2.34	2.66	2.93	3.03
<b>Interest rates (% eop)</b>	10	11.75	12.50	11.50
<b>Private consumption (% YoY)</b>	2.6	0.8	0.3	1.1
<b>Government consumption (% YoY)</b>	2.0	2.0	1.8	1.3
<b>Fixed investment (% YoY)</b>	-5.1	-6.5	-0.5	4.6
<b>Exports (% YoY)</b>	2.5	1.9	1.5	2.9
<b>Imports (% YoY)</b>	8.3	0.7	0.3	2.0
<b>Fiscal balance (% GDP)</b>	-3.3	-6.7	-4.4	-3.6
<b>Current account (% GDP)</b>	-3.6	-4.2	-4.0	-3.4

Source: BBVA Research

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