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Brazil: a year of low growth and high inflation ahead

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Key takeaways

1 **World growth will continue to move upwards albeit slowly and very unevenly.** Global growth should increase from 3.3% in 2014 to 3.6% in 2015 and 3.8% in 2016. The developed economies, led by the US will increase their input into global expansion, whereas the controlled slowdown in China will persist.

2 **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.

3 **The shift in economic policy and exchange rate weakening are pre-requisites 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.

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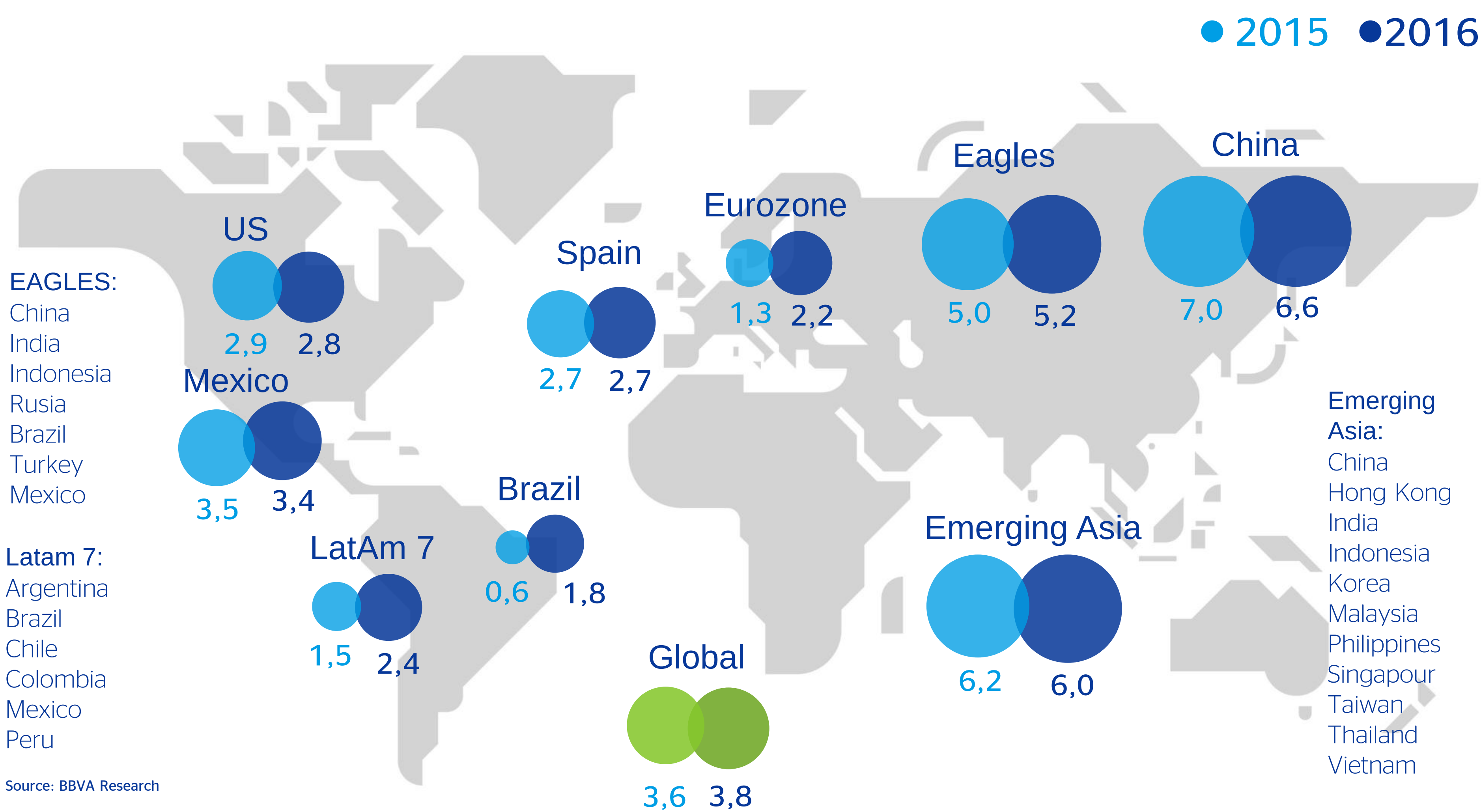
Global growth: Moderate and uneven accelaration

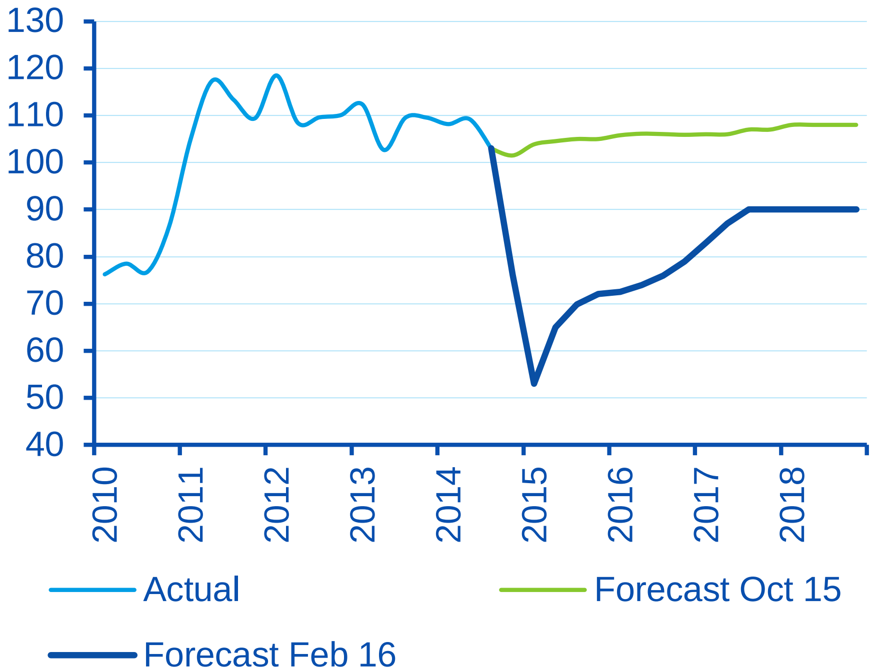


Source: BBVA Research

The fall in oil prices is positive for the world economy

BBVA Research price forecasts for Brent oil (USD/bbl, quarterly averages)

Source: BBVA Research



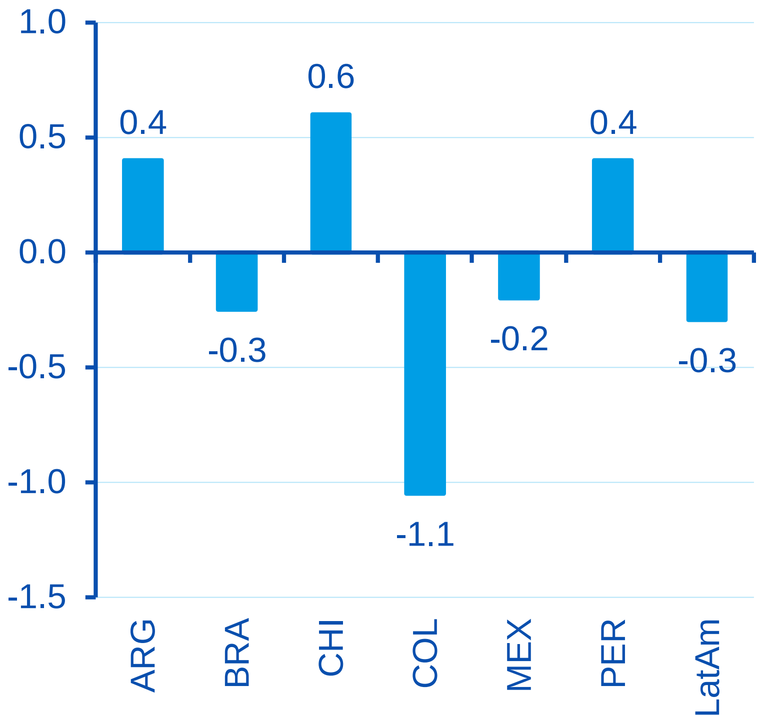
Uneven impact depending on countries

Direct impact on the overall drop in inflation

Although the lower oil prices has an uneven impact in LatAam [Box 1]

Impact on growth of the revised course of oil prices: forecasts in February 2015 versus October 2014 (pp, 2015-16 average)

Source: BBVA Research

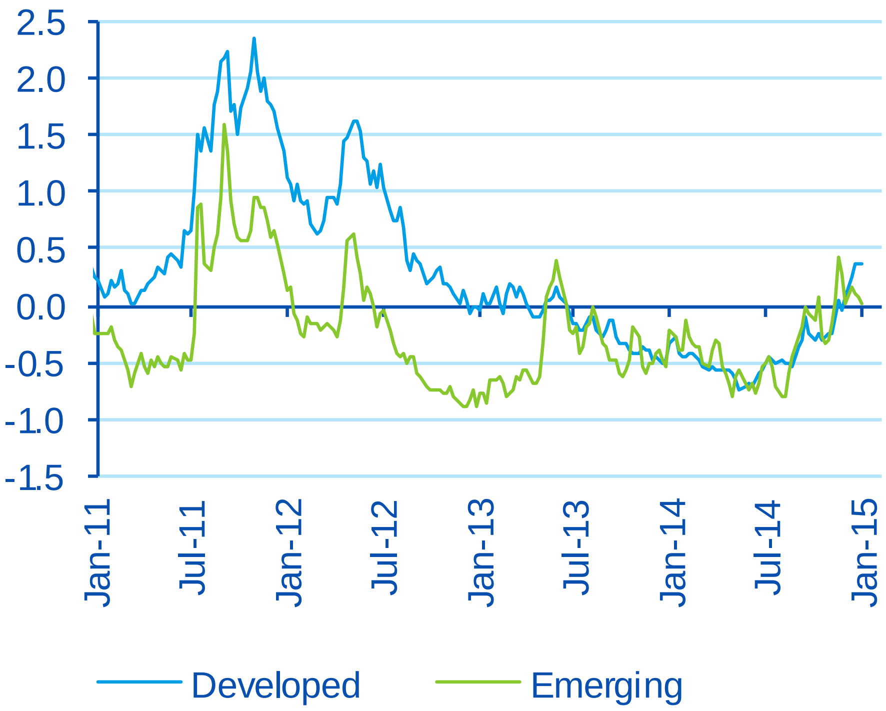


Positive impact in importing countries and overall drop inflation

Negative effect in Mexico, partially offset by the greater growth in US

MP divergency between the Fed and the ECB increase financial tensions

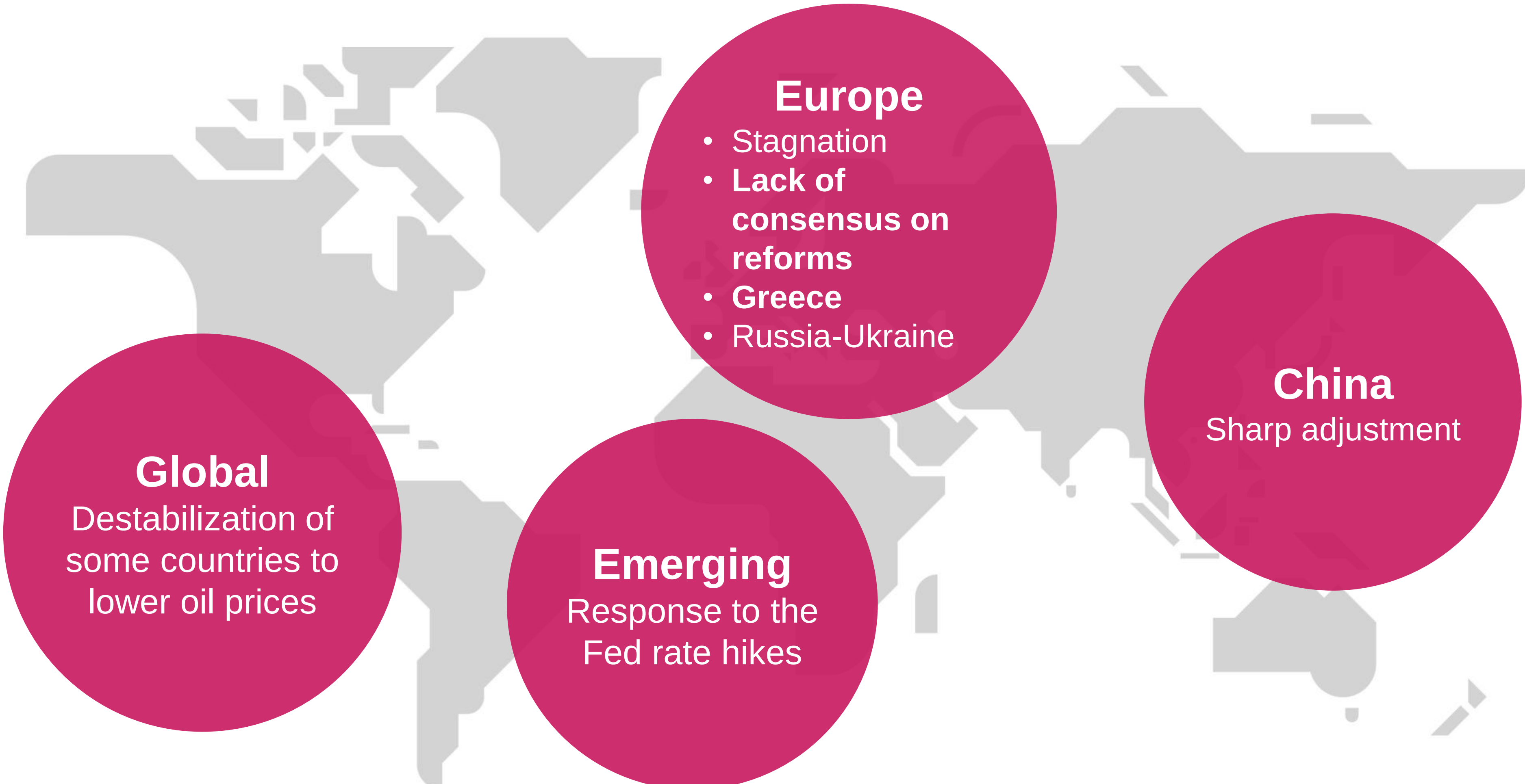
BBVA Research Financial Tensions Index
Source BBVA Research



Increasing financial tensions in a context of divergency between the Fed and the ECB monetary policy

Emerging economies will test their strengths to the normalization of monetary policy in the US

What are the risks of the global scenario?



Source: BBVA Research

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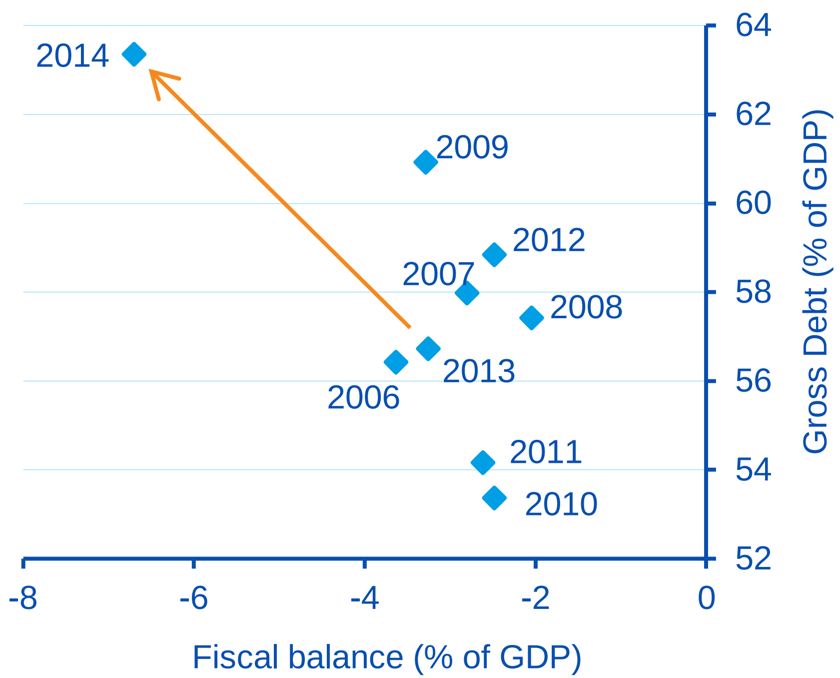
The orthodox adjustment of economic policy is now afoot

Fiscal accounts: gross debt and fiscal balance (% of GDP)*
Source: BBVA Research and BCB



After increasing distortions and loss of credibility in recent years, the government has initiated a process of adjustment of economic policy

Recent announcements show that the adjustment will focus on fiscal and quasi-fiscal policy, but it will also include changes in monetary policy

Despite recent positive signs, there remains the risk that the adjustment does not count on sufficient political support

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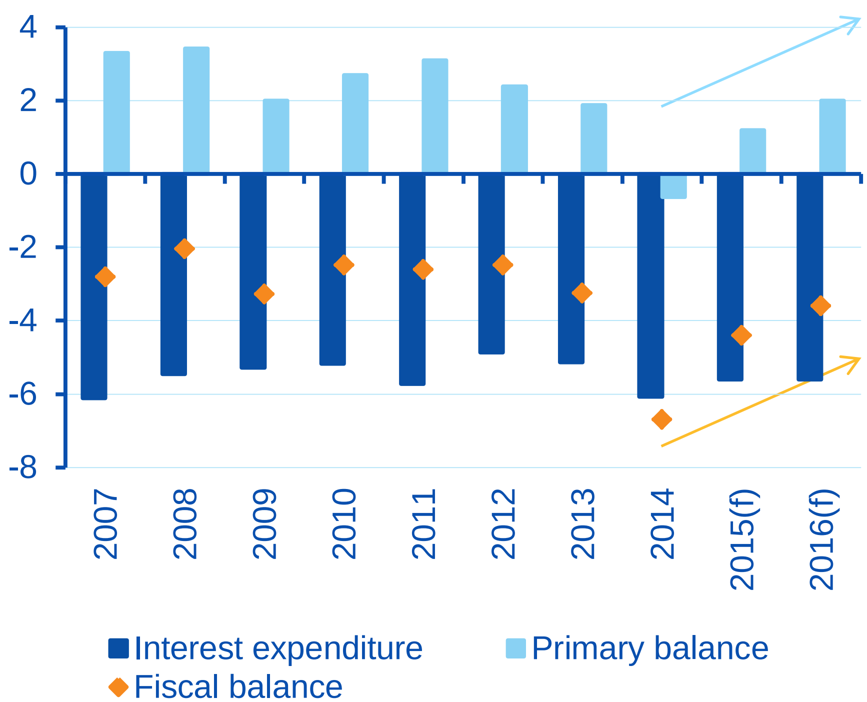
Tax hikes and cost-cutting will steadily reverse the sharp deterioration in the public finances in 2014

Public sector fiscal balance: primary and total balances, and interest expenditure (% of GDP)
Source: BBVA Research and BCB



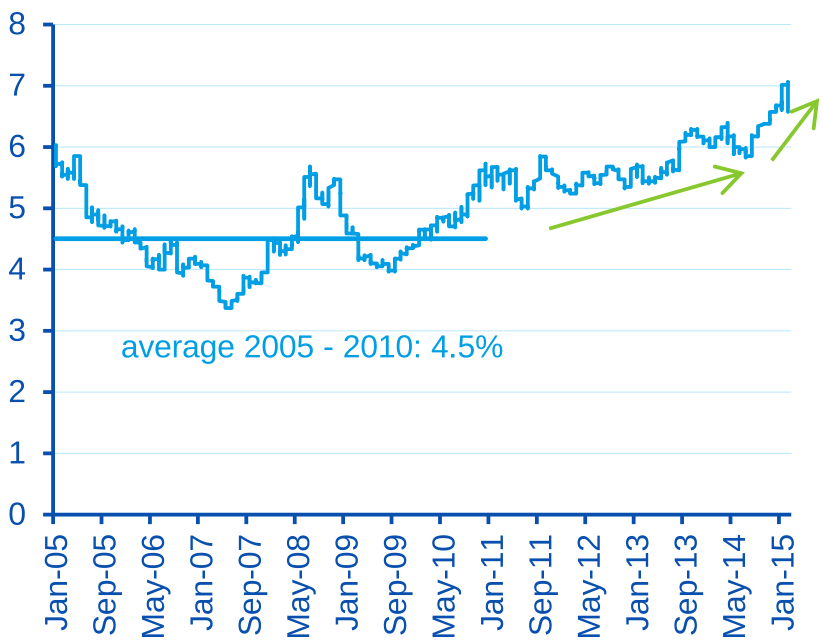
The use of fiscal policy in support of economic activity proved a body-blow to the public finances in 2014

Thus the correction required to meet the newly announced target primary surplus (1.2% and 2.0% of GDP in 2015 and 2016) will be greater

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

Inflation expectations over 12 months of analysts polled by the central bank (% YoY)
Source: BBVA Research and BCB



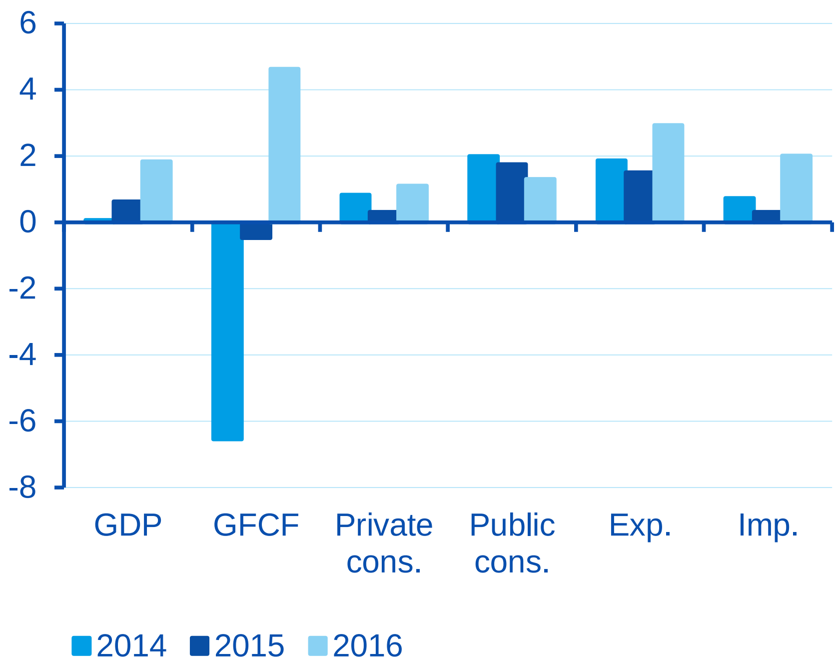
The new cycle of monetary tightening has begun early and will lead to higher-than-expected interest rates

The Selic rate ended 2014 at 11.75% and should soon rise to at least 12.50%.

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

GDP and components (% annual var.)
Source: BBVA Research and IBGE



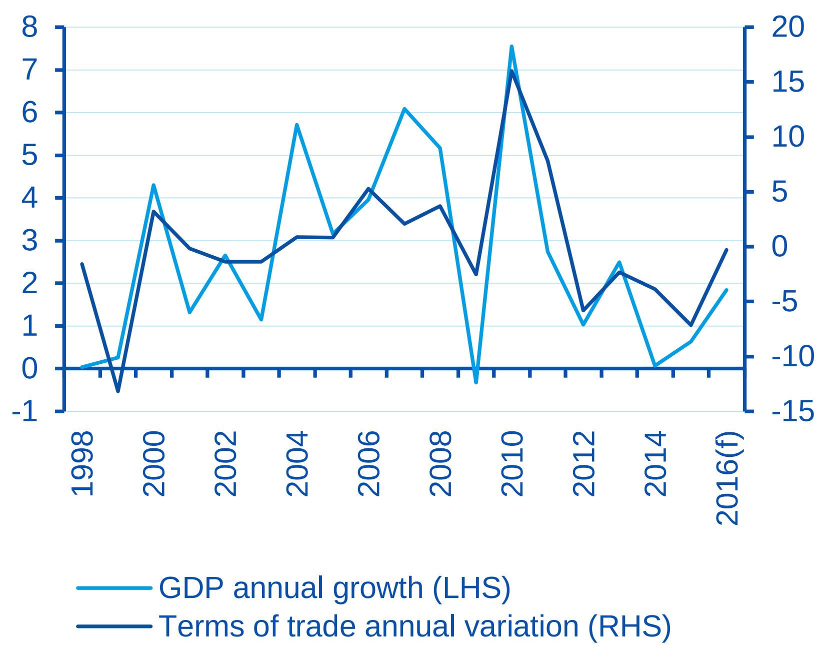
We expect a growth of just 0.6% this year, and the impact of adjustment due to: i) a further contraction of the terms of trade, ii) moderation in external demand; iii) the fallout from the Petrobras crisis, iv) the obstruction caused by the water and electricity shortage

larger-than-expected impact from any of these factors could tip the economy into recession.

Determinants of the stagnation of activity: the deterioration of terms of trade.

GDP and terms of trade (% var. YoY)

Source: BBVA Research and IBGE



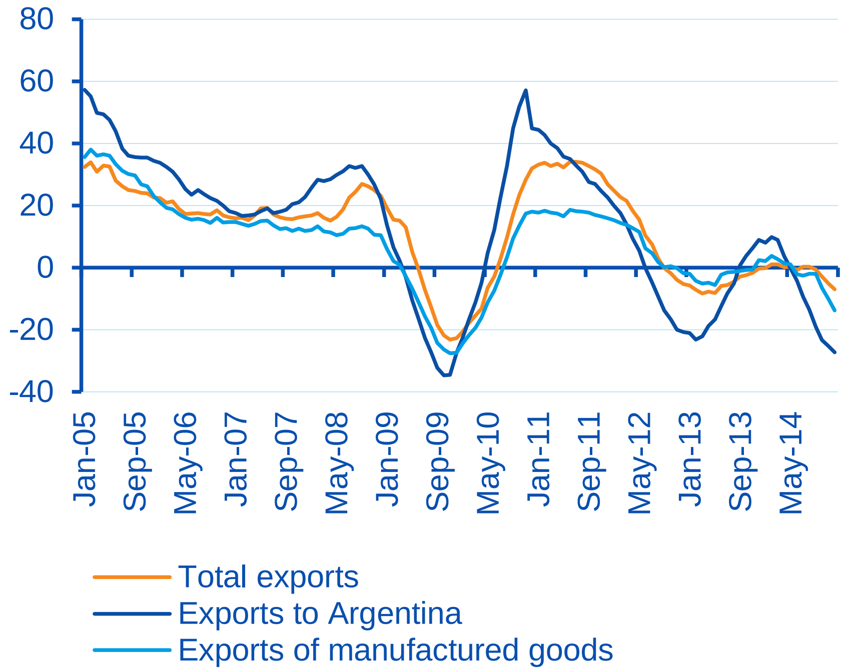
The falling price of commodities has been determining a deterioration of terms of trade.

We expect another downward revision of the terms of trade in 2015

Determinants of the stagnation of activity: barriers to the increase in exports

Exports (12-month export accumulation, % YoY)

Source: BBVA Research and MDIC



the slowdown in activity in the economies of major trading partners (China and Argentina) will impact the Brazilian economy

In addition, the country still has a problem of lack of competitiveness

Determinants of the stagnation of activity: the Petrobras crisis

Petrobras share-price on the São Paulo exchange
Source: BBVA Research and Bloomberg

The Petrobras crisis is the result of several factors: i) corruption scandal; ii) management problems; iii) falling oil prices

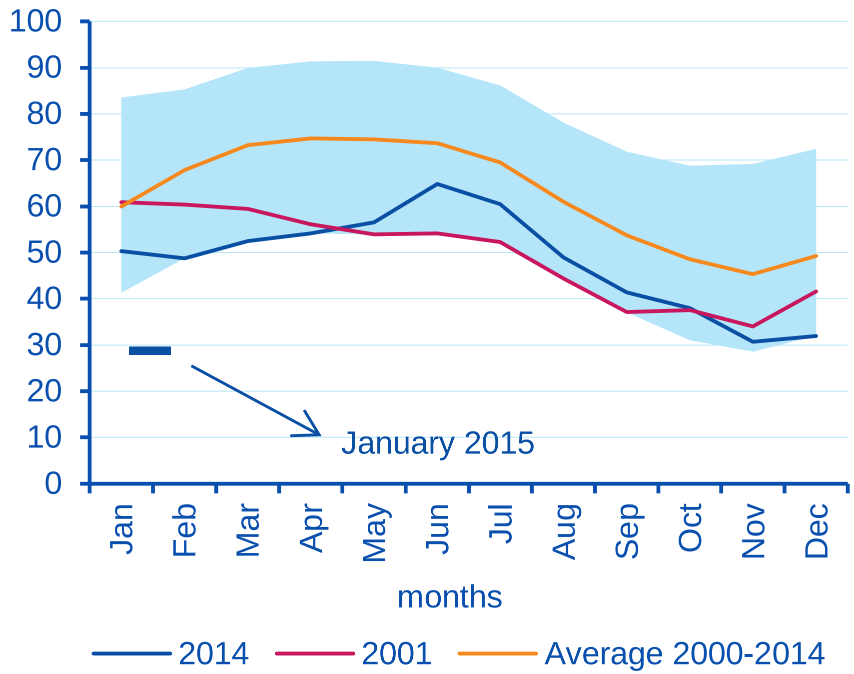
The impact on investment will be important

The loss of investment grade could have a contagion effect on other assets. At last, the political effects are uncertain but potentially high

Determinants of the stagnation of activity: water shortage and energy crisis

Reservoir levels (% of overall storage capacity)

Siource: BBVA Research and ONS

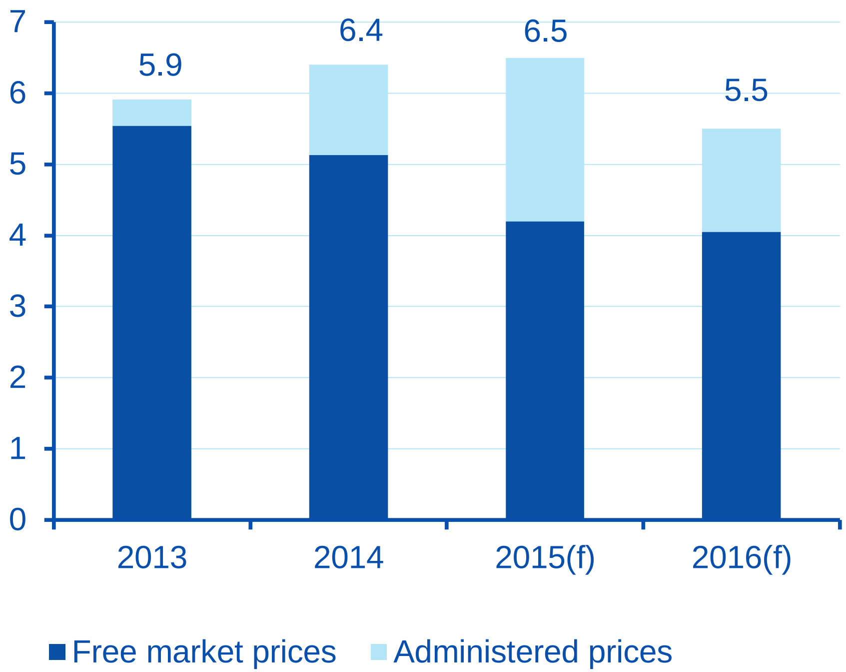


The country's reservoirs are at worryingly low levels, resulting from a system of unfavorable rainfall and delayed investments to increase generating capacity

If the country is forced to adopt a rationing of electricity, GDP growth would be about 1 pp lower than estimated

The increase in administered prices will keep up inflationary pressure

Contributions of free market and administered prices to annual inflation (pp)
Source: BBVA Research and IBGE



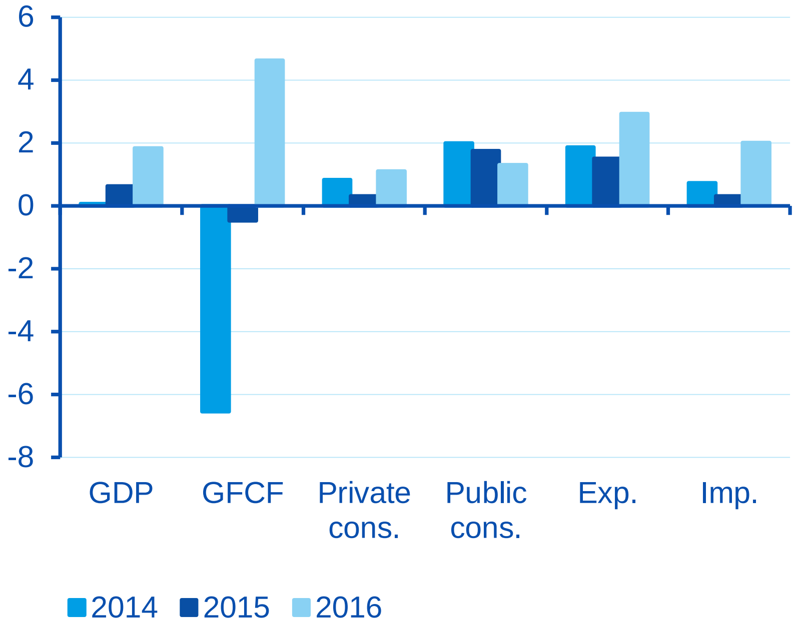
There is no fiscal space to continue keeping administered prices at artificially low levels

In addition, inflation will be impacted by increased taxes and the depreciation

The macroeconomic environment will brighten in 2016

GDP and components (% annual var.)

Source: BBVA Research and IBGE



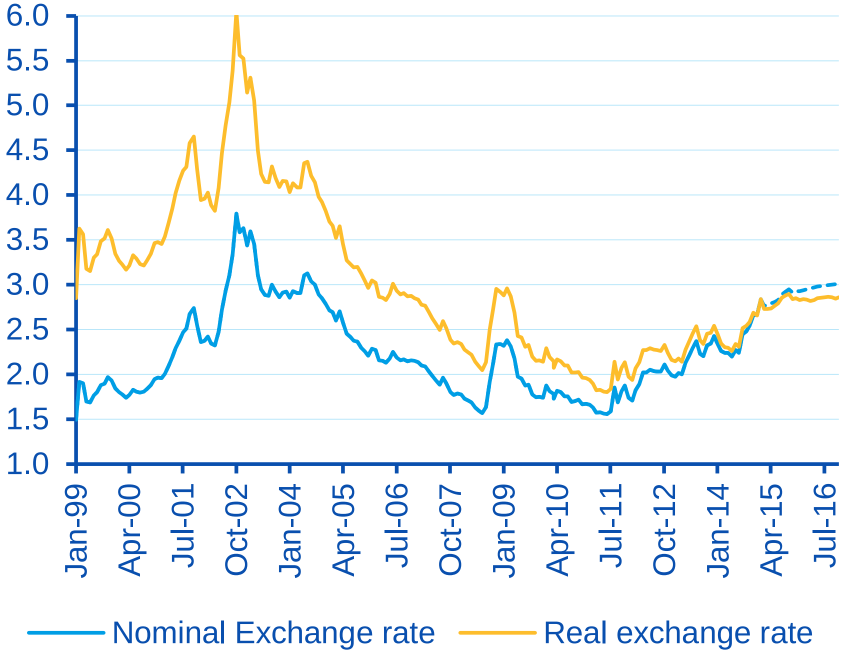
The contractionary effect of the economic policy adjustment and the shocks currently cramping activity show a tendency to focus on 2015 and slacken off in 2016

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 administered prices and the exchange rate will have kicked in by then.

All the factors suggest a weaker real

Exchange rate: nominal and real (current prices, USD/BRL)
Source: BBVA Research and Bloomberg



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

we see the USD/BRL rate ending 2015 and 2016 at around 2.93 and 3.03 respectively

Key takeaways

1 **World growth will continue to move upwards albeit slowly and very unevenly.** Global growth should increase from 3.3% in 2014 to 3.6% in 2015 and 3.8% in 2016. The developed economies, led by the US will increase their input into global expansion, whereas the controlled slowdown in China will persist.

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Appendix: Macroeconomic forecasts

Table 6.1
Macro Forecasts

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

Source: BBVA Research