

Brazil: the adjustment continues, GDP is contracting and inflation is taking off

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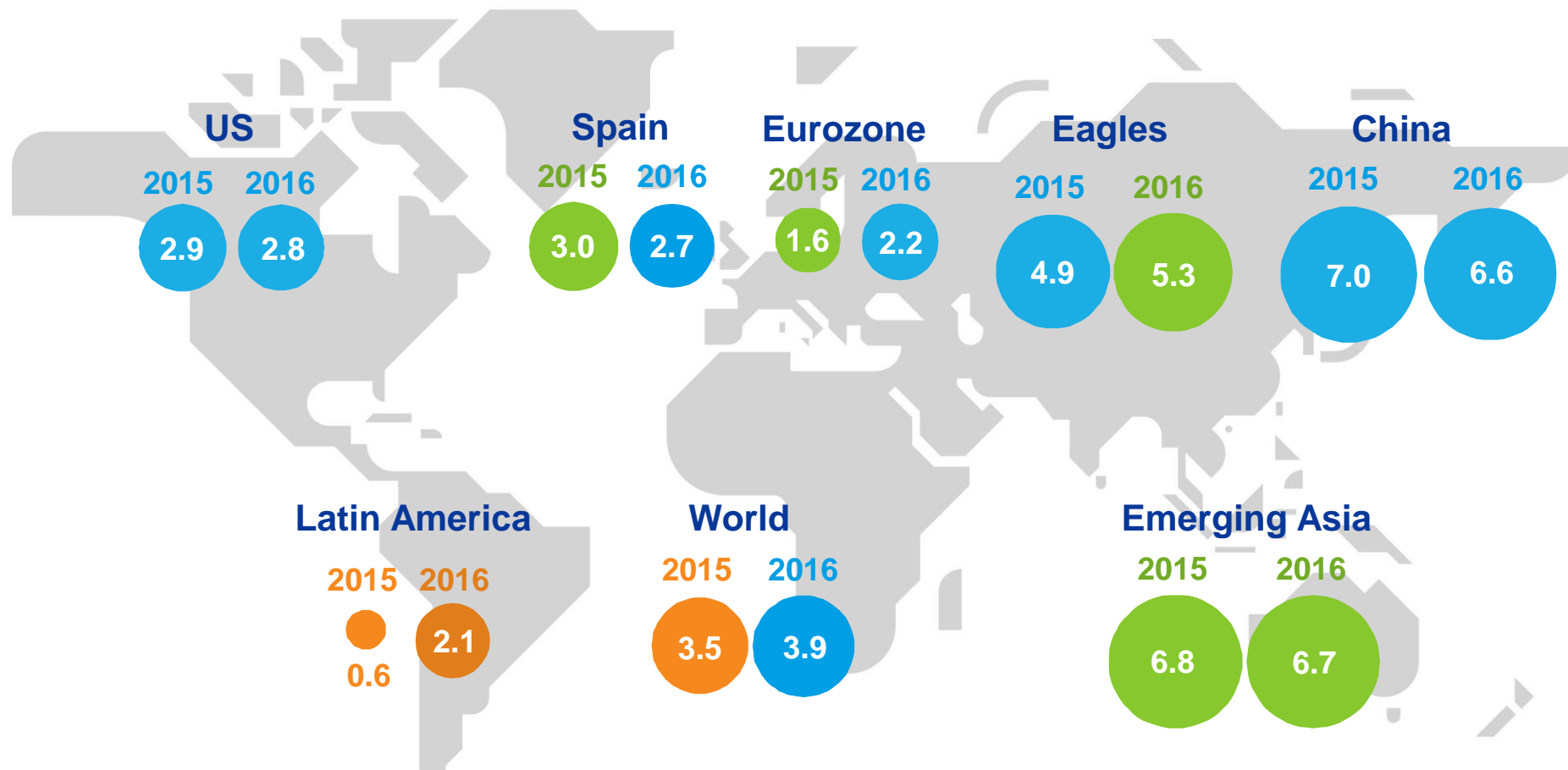
Key messages

- 1 The growth in the global economy continues, but growth is weaker and more uneven.** China continues to decelerate in a controlled manner, and US economic policy is preparing for a hike in interest rates, which will increase market volatility.
- 2 Brazil's GDP is contracting and inflation is shooting up.** We expect negative economic growth this year of 0.7%, due to both external and internal factors, and that inflation will remain at around 8.0% in the second half of 2015 as a reflection of the sharp correction in administered prices.
- 3 Economic adjustment continues, in spite of the upheavals. The expansive tone of fiscal and monetary policy has been reversed.** In spite of the negative impact on growth in the short term and the political turbulence, additional measures need to be announced to increase confidence in Brazil and set the bases for economic recovery.

Outline

- 1 Global economy: weaker and more uneven world growth
- 2 Brazil: the adjustment continues, GDP is contracting and inflation is shooting up

A less convincing and more uneven global recovery



See: <https://www.bbvarsearch.com/public-compuesta/situacion-global-segundo-trimestre-2015//>

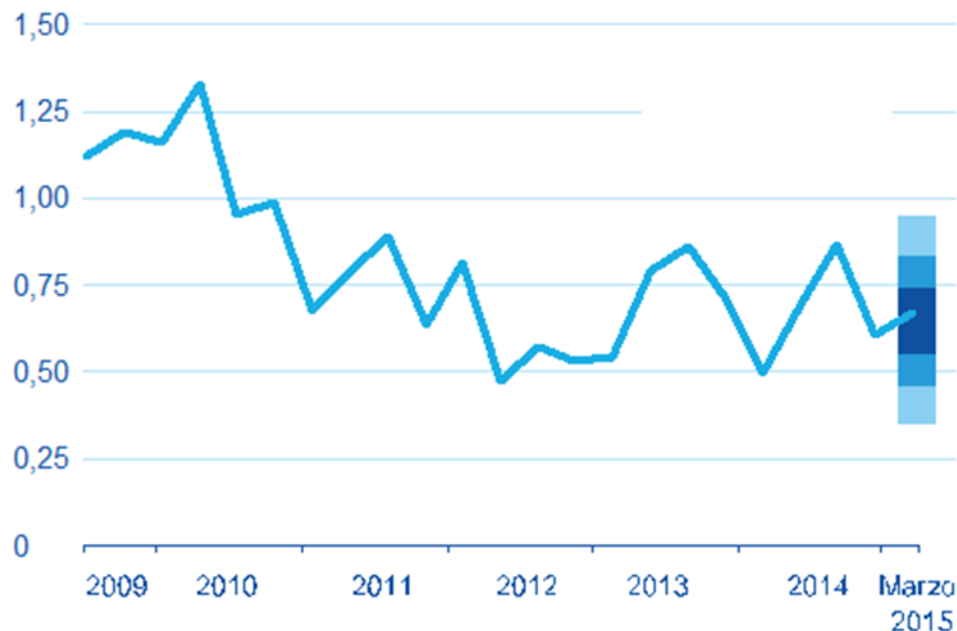
Source: BBVA Research

● Down
 ● Steady
 ● UP

A less convincing and more uneven global recovery

BBVA-GAIN world growth indicator (% by quarter)

Source: BBVA Research



■ IC al 20% ■ IC al 40% ■ IC al 60% — GDP (% QoQ)

In Europe the improvement in activity intensifies

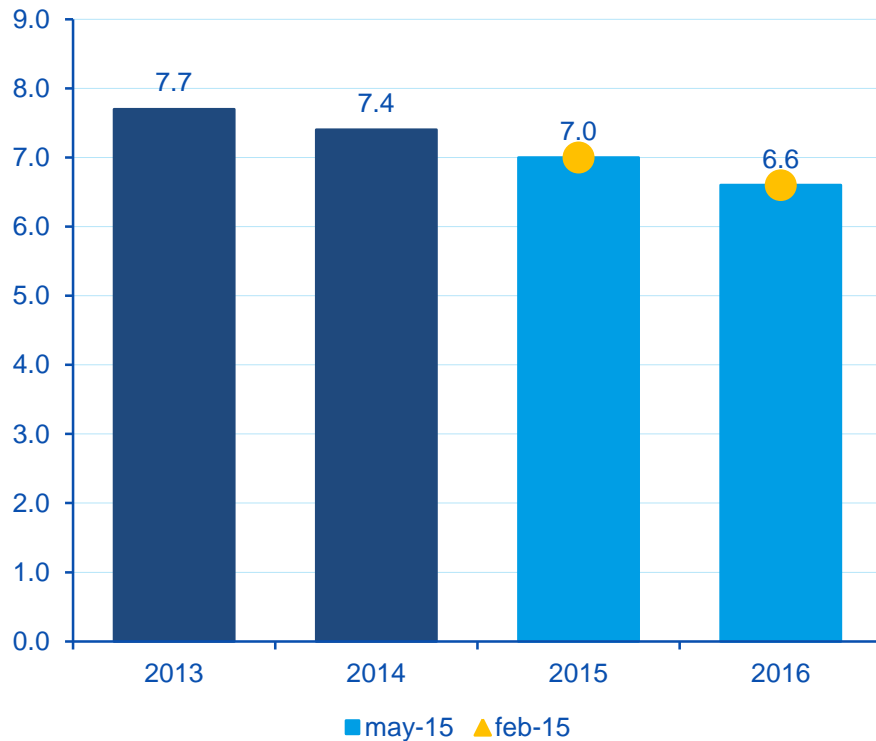
Growth loses momentum in EMs

The deceleration in the US will be transitory

China: the gradually decelerating trend in activity continues

China: GDP growth (%)

Forecast 2015-16
Source: BBVA Research



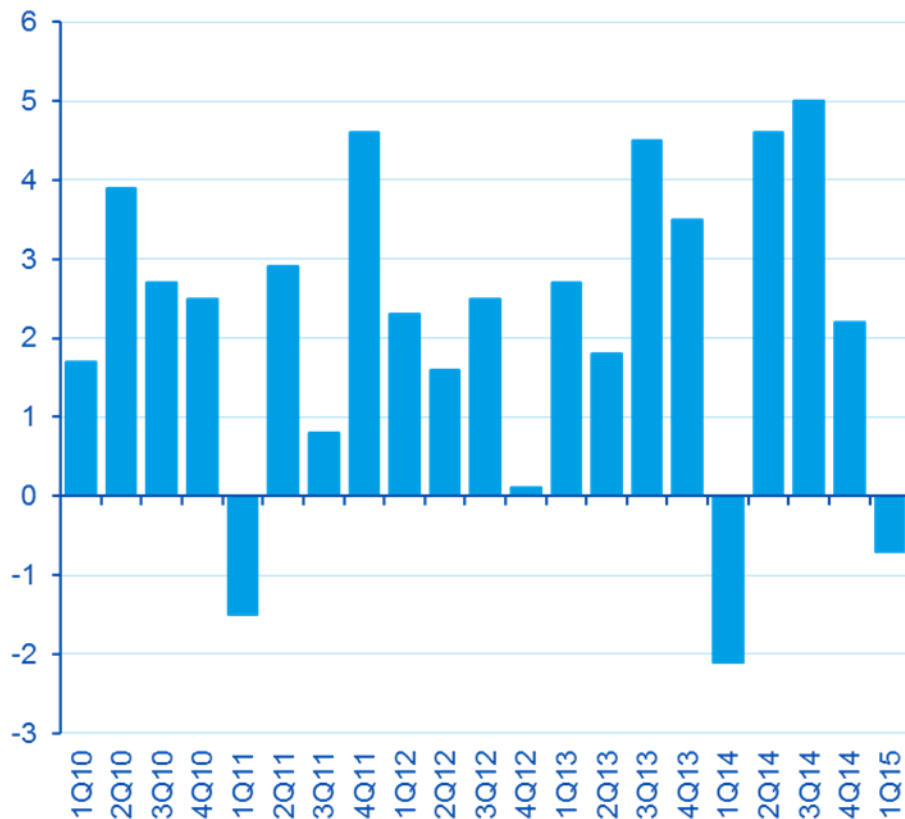
Deceleration as a reflection of the real estate correction and fiscal consolidation in local government

Objective of 7% growth in 2015 will set in motion new fiscal and monetary stimulus measures

US: a transitory deceleration in the first quarter

US: GDP growth (quarterly annualized rate)

Source: BBVA Research y Haver



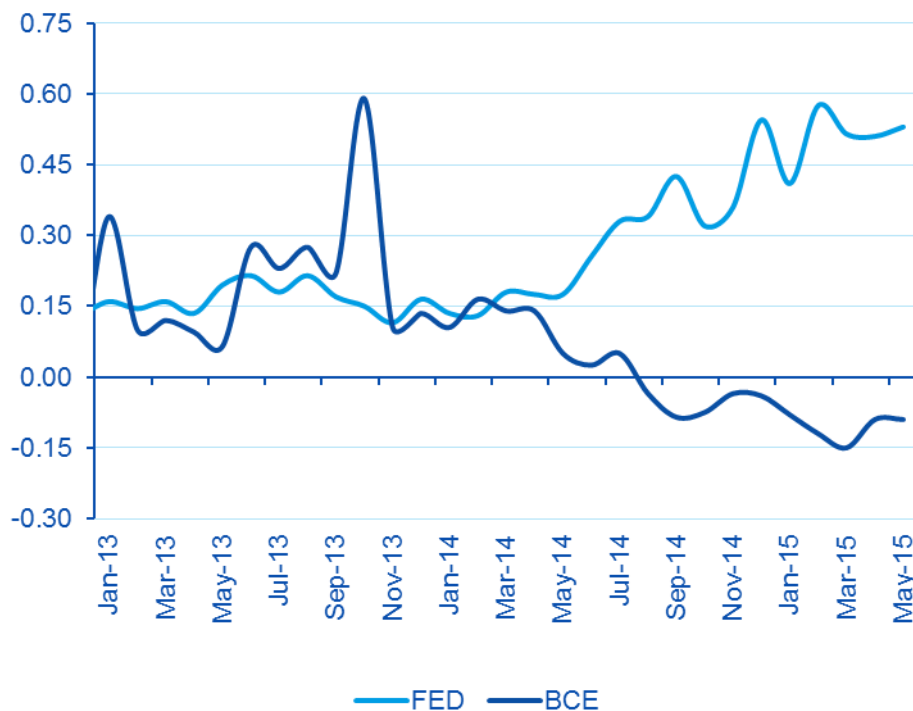
Employment rising and inflation falling support household income and consumption

This will offset dollar appreciation and the weakness in external demand

Monetary policy differentiation between the US and the rest of the world

Interest rate expectations (%, one year forward FED and ECB interest rates)

Source: BBVA Research, Haver Analytics



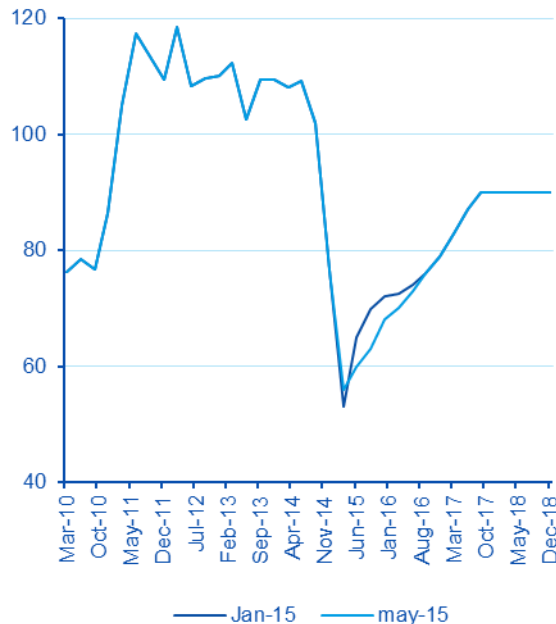
Since January 2015, central banks have taken 27 decisions to lower interest rates and only two to raise them

Recent volatility associated with the change in the likely timing for the Fed's hike cycle

Commodity prices are recovering slightly, but remain subdued

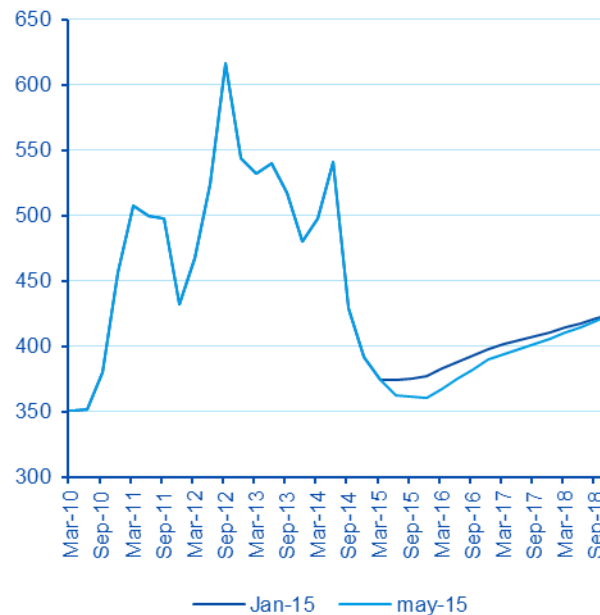
Brent: (USD/b)

Source: BBVA Research and Bloomberg



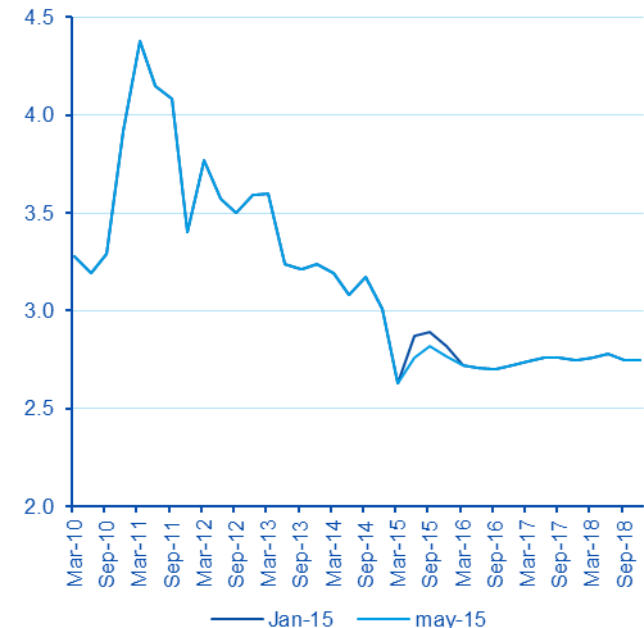
Soy: (USD/tm)

Source: BBVA Research and Bloomberg



Copper: (USD/lb)

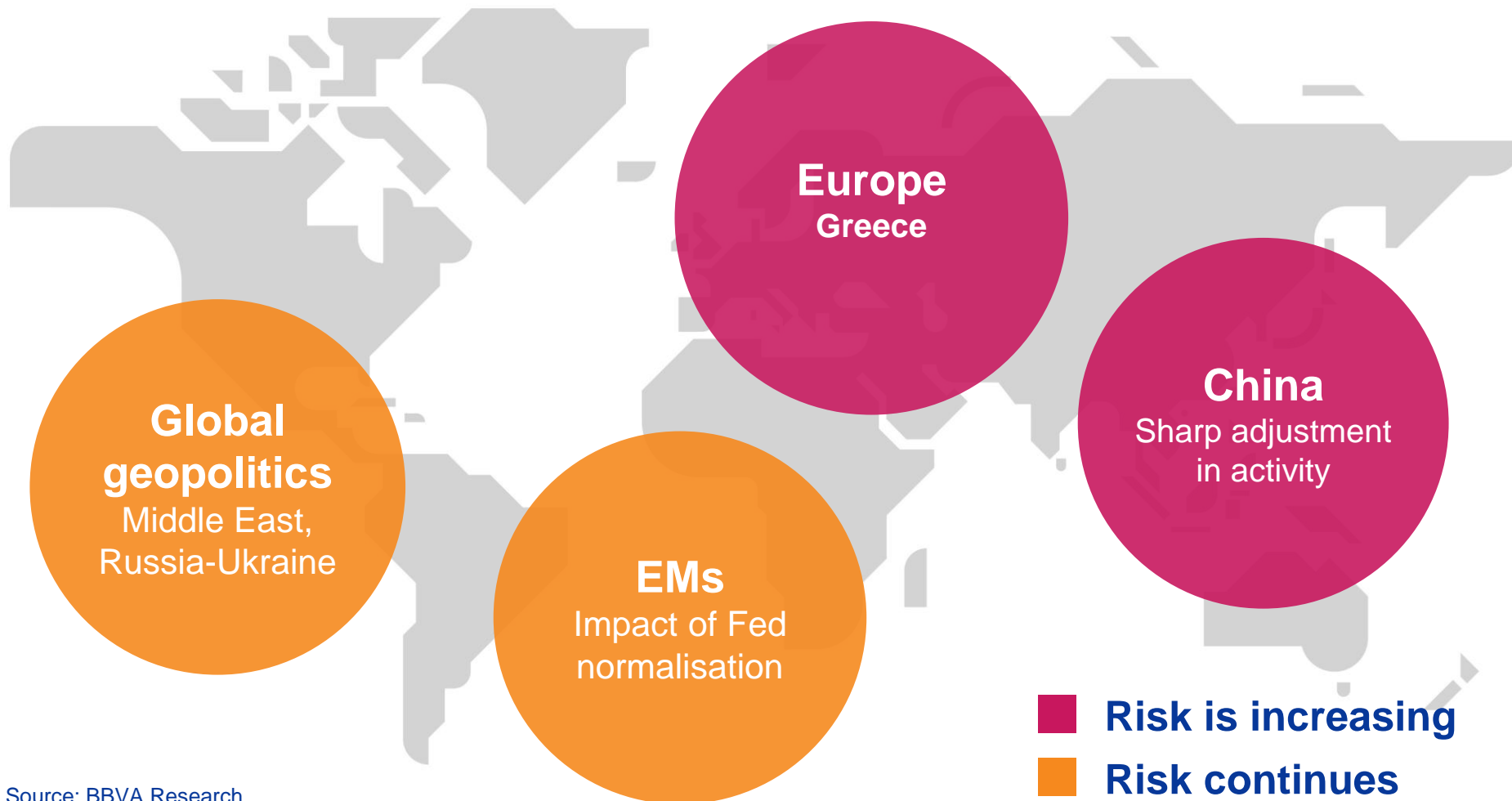
Source: BBVA Research and Bloomberg



Oil and copper prices increased slightly in the last quarter ...

... for fundamental supply reasons, as well as dollar weakness in recent weeks

What are the global risks?



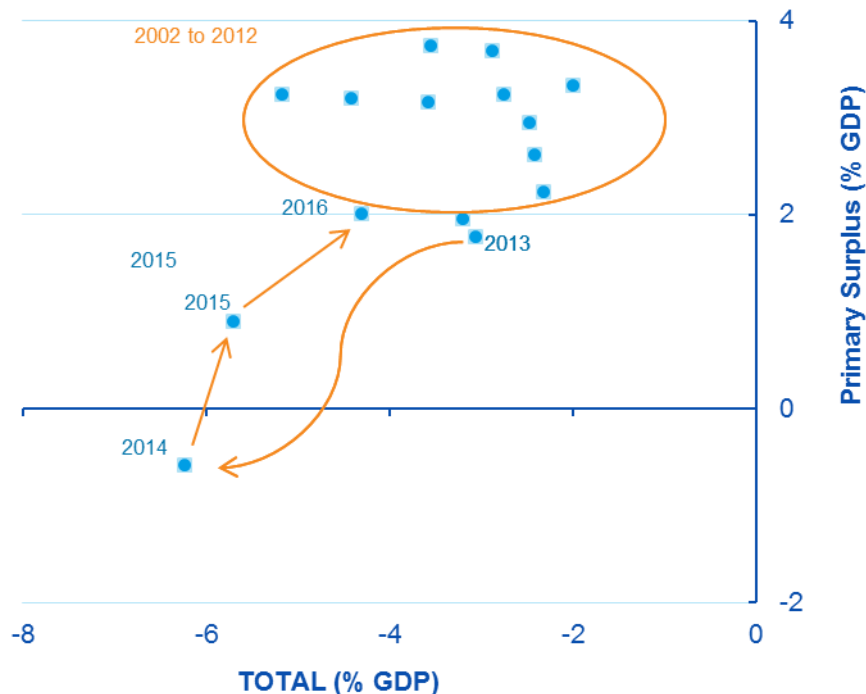
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The fiscal adjustment will be considerable, but Brazil will not reach its target of a primary surplus

Public sector fiscal results: primary and total (% GDP)

Source: BBVA Research y BCB



The tightening of economic policy has continued in recent months, with fresh monetary and fiscal action

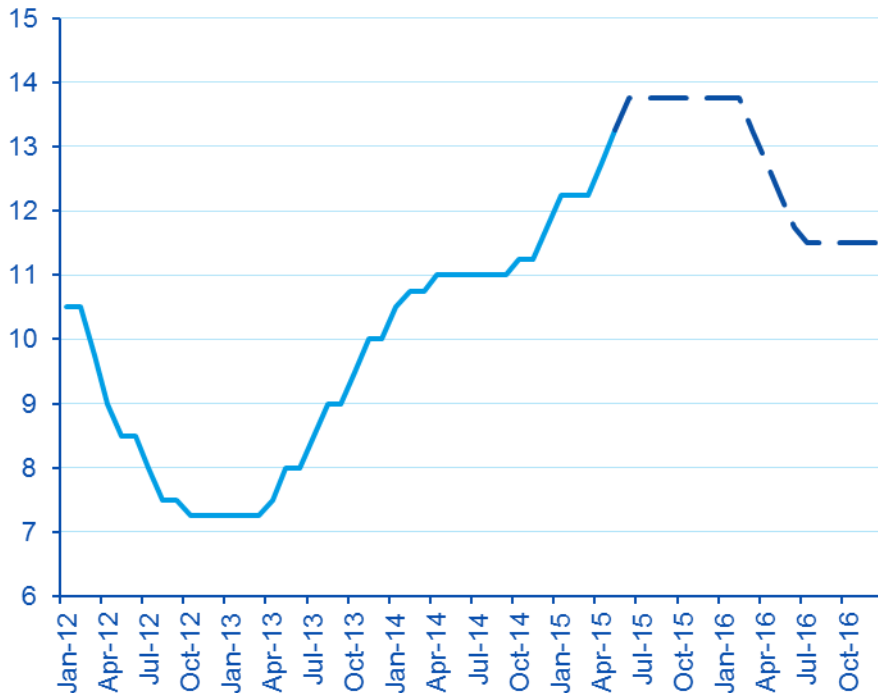
In spite of the unstable political situation, this process should continue in the coming months. The adjustment is fundamental for a recovery in confidence and activity

Additional measures will enable the public sector to generate a primary surplus of 0.9% of GDP in 2015, below the target (1.1%), but much better than in 2014 (-0.6%)

A sharper monetary adjustment than we expected, but with a limited impact on expectations

SELIC interest rate (%)

Source: BBVA Research and BCB



The BCB should continue to adjust the Selic rate upwards to at least 13.75%, and only start to lower rates in 2016

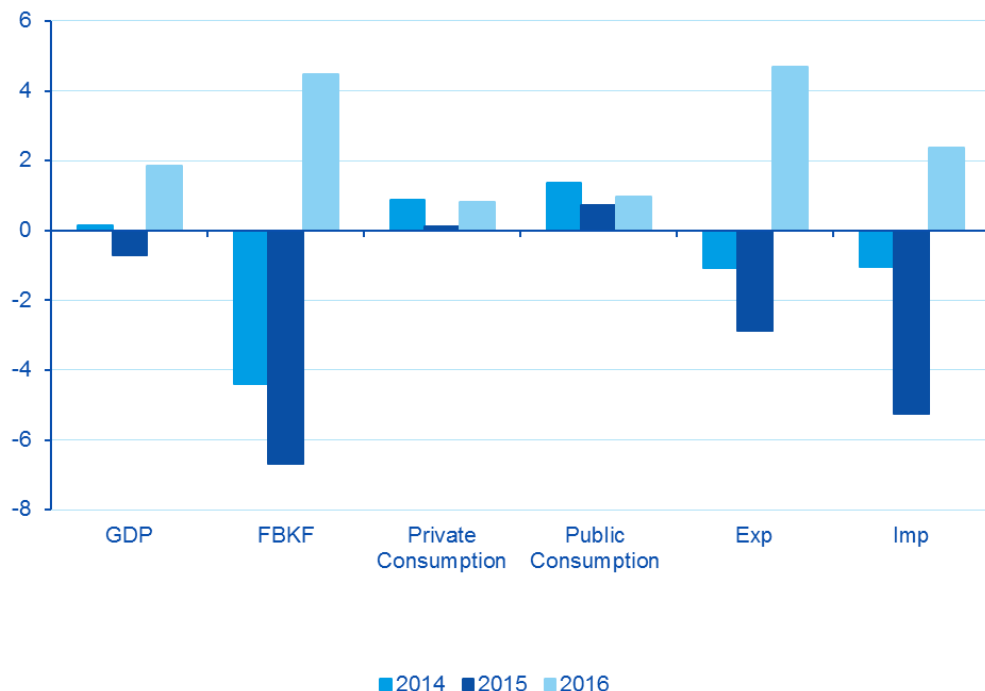
The objective is to recover the credibility lost in earlier years and make inflation converge on 4.5% at year-end 2016 (market expectations remain 5.5%)

Box 1: impact of the changes in the Selic on future interest rates is reduced, but the markets now give more weight to BCB communication

We forecast a 0.7% contraction in GDP in 2015 and a slight uptick in 2016

GDP and components annual growth (%)

Fuente: BBVA Research y BCB



In the first quarter, GDP contracted 0.2% QoQ and the recent indications point to a sharper deterioration in the second quarter

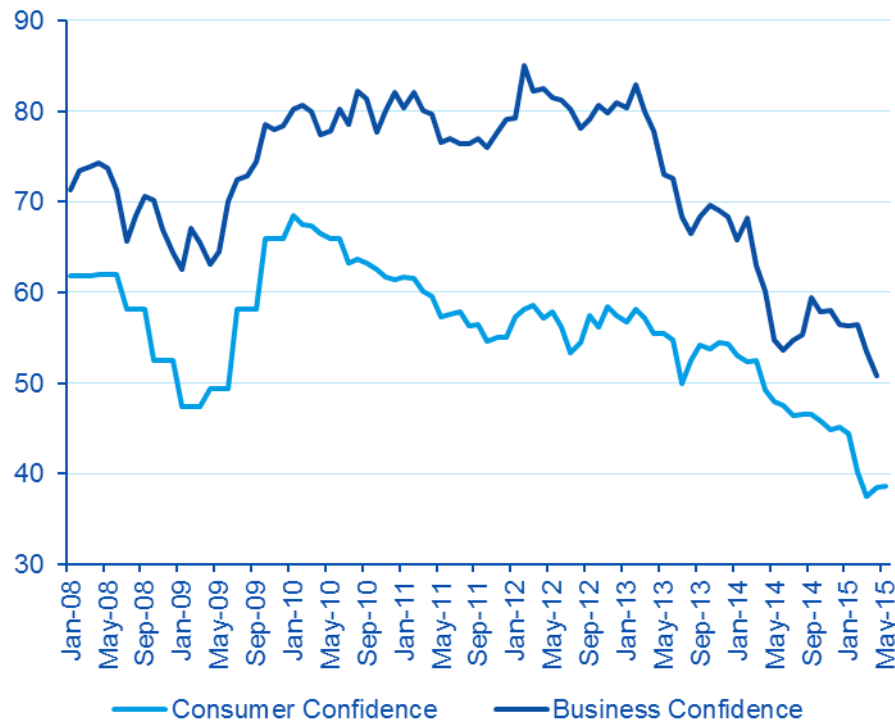
In spite of the downside risks, there should be a slight recovery in the second half

We expect GDP growth of 1.8% in 2016, in line with the expected recovery in confidence after the monetary, fiscal and exchange-rate adjustments in progress

The present environment is very unfavourable for economic activity ...

Confidence Indexes

* Consumer confidence index was adjusted, new range 0-100.
Source: Fecomercio, CNI y BBVA Research.



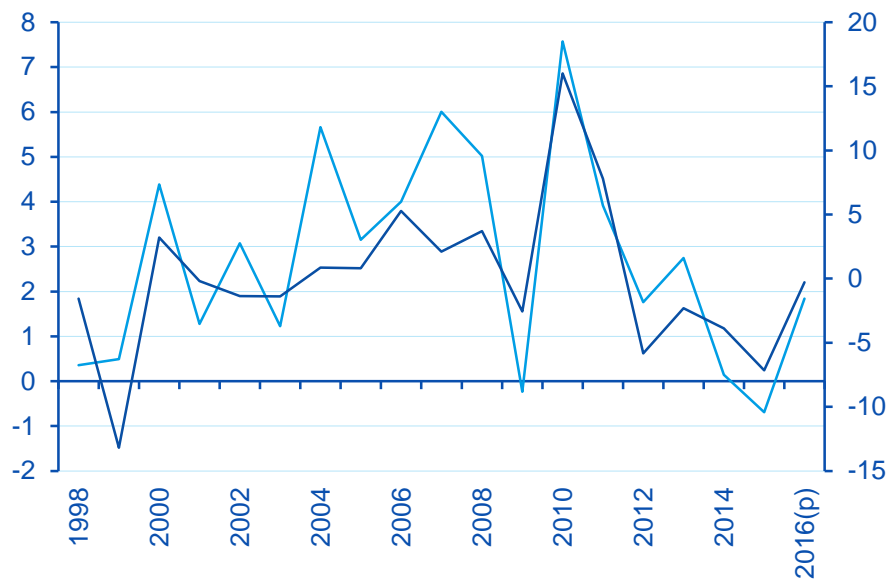
There are external and internal factors weighing on confidence and economic activity

The negative impact of these factors will be concentrated in the current year and, to a lesser extent, next year

...both due to external factors ...

GDP and terms of trade (% annual change)

Source: BBVA Research.



— GDP annual growth (LHS)
 — Terms of trade annual variation (RHS)

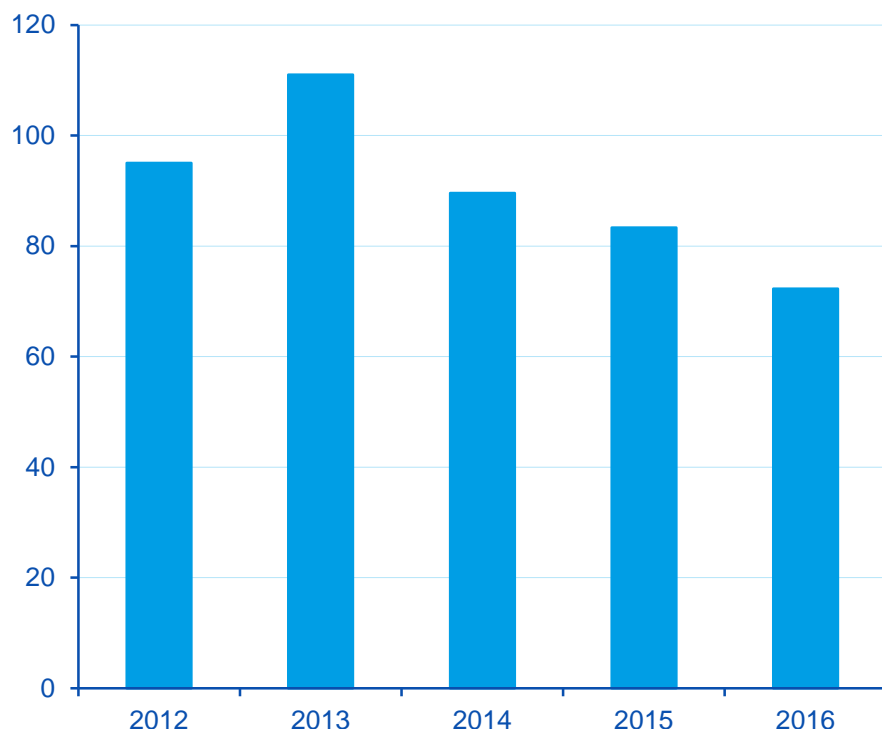
Note the impact of the downward adjustment of the terms of trade, as a consequence of the fall in commodity prices

The slowdown in some EMs which are important for Brazil (China and Argentina) also has a negative impact on internal activity

...and internal factors

Petrobras: total investment (at constant prices, BRL as of 2014)

Source: Petrobras.



The factors having a particularly negative impact on growth (especially in 2015) include:
i) the monetary and fiscal adjustments, including the moderation in public credit

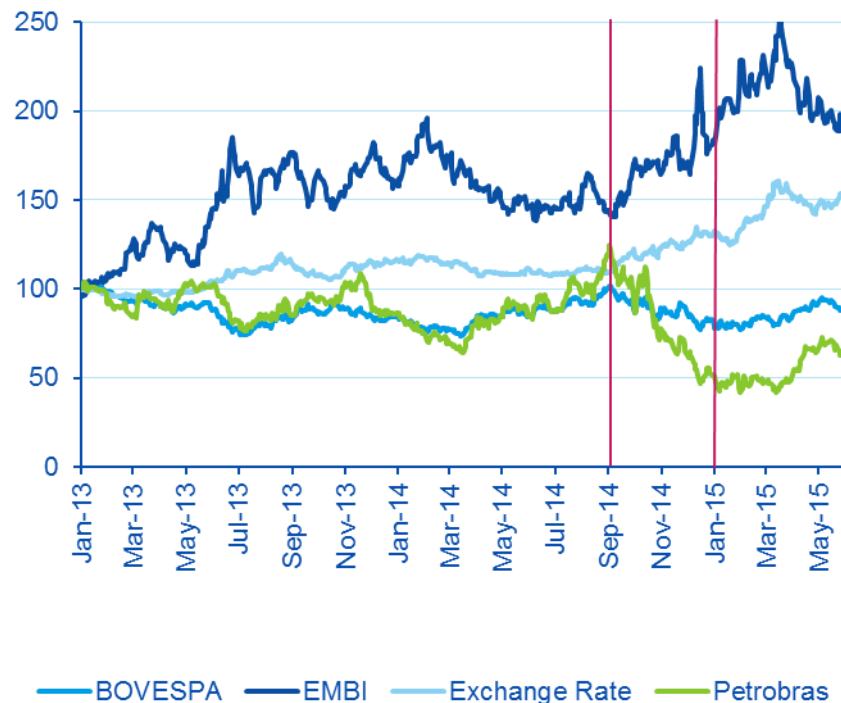
ii) the crisis at Petrobras, due to the effects on the economy and the already turbulent political environment.

iii) the rising costs faced by companies and households due to the realignment of state regulated prices and BRL depreciation

The financial markets have calmed down, but activity still hinges on the economic adjustment process and the Fed's normalisation

Stock exchange (BOVESPA), sovereign spread (EMBI+), exchange rate (BRL/USD) and Petrobras share at IBOVESPA (index Jan-2013=100)

Source: Datastream y BBVA Research



Domestic asset prices have recovered since March, reversing some of their earlier falls

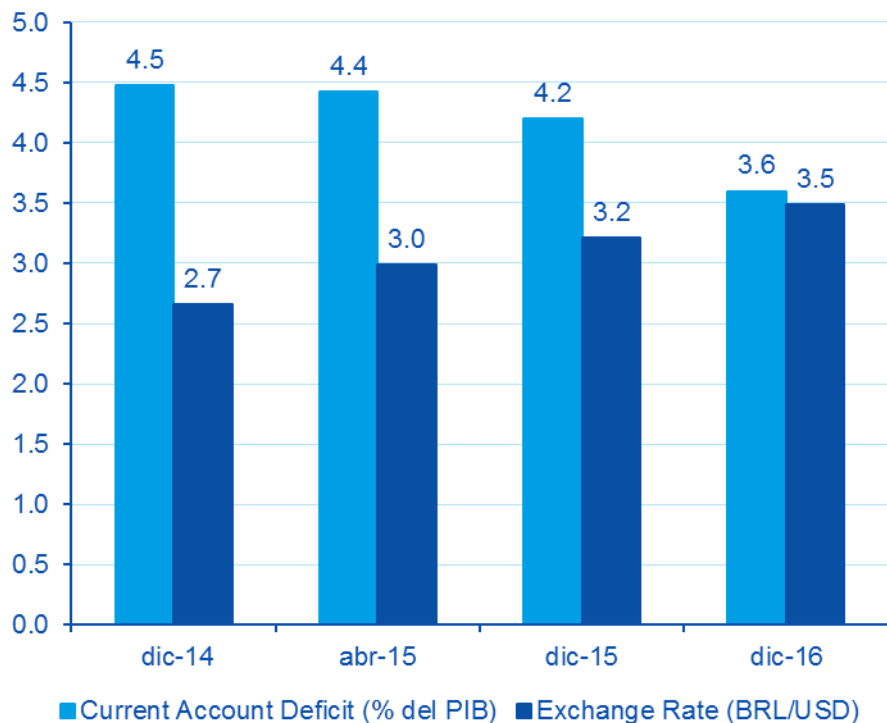
The recent correction was due to perceptions that US monetary normalisation will not be sharp, progress made in the economic adjustment process and the reduced risks related to Petrobras

In any case, the evolution of these factors is likely to continue to generate turbulence in the coming months

The currency has to continue to depreciate if Brazil is to recover its competitiveness and exports are to contribute more to growth

Exchange Rate (BRL/USD) and current account (%GDP)

Source: BCB y BBVA Research



The recent BRL appreciation against the dollar, from BRL3.30 at the beginning of March to 3.15 at the end of May will soon reverse

Further BRL depreciation is essential if Brazil is to recover competitiveness and growth

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Annex: Forecasts

Annual Macroeconomic Forecast

	2013	2014	2015	2016
GDP (% YoY)	2,7	0,1	-0,7	1,8
Inflation (% a/a, end of the period)	5,9	6,4	7,6	5,5
Exchange rate (vs USD, end of the period)	2,34	2,66	3,21	3,49
Interest rate (% end of the period)	10	11,75	13,75	11,50
Private consumption (% YoY)	2,9	0,9	0,1	0,8
Public consumption (% YoY)	2,2	1,3	0,7	1,0
Fixed Investment (%YoY)	6,1	-4,4	-6,7	4,5
Exports (%YoY)	2,1	-1,1	-2,9	4,7
Imports (%YoY)	7,6	1,-0	-5,3	2,4
Fiscal Result (% GDP)	-3,1	-6,2	-5,7	-4,3
Current Account (% GDP)*	N.D.	-4,5	-4,2	-3,6

* Current account series revised by BCB, available as of 2014

Source: BBVA Research