BBVA | RESEARCH

# Brazil: recession in 2015; stagnation in 2016

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Brazil Economic Outlook – 3Q15 | Madrid, 12 August 2015

# Key messages

1. **The world economy continues to grow but more weakly, especially in the emerging countries.** Growth forecasts for China and the US were adjusted, while the Fed is preparing for an imminent raise in interest rates, probably in September.

2. **Economic activity will contract sharply in 2015 and then stagnate in 2016.** We forecast GDP to drop 1.5% this year and to expand only 0.5% next year. The long-term potential growth of the Brazilian economy is around 2.2%, lower than previously estimated.

3. **Inflation will remain under pressure.** The effect of the contraction in domestic demand will be offset by the upward adjustment in regulated prices and inertial factors. The significant currency depreciation will also put pressure on inflation, even though there is no evidence of a higher exchange rate pass-through into prices.

4. **The monetary tightening is over, but the fiscal adjustment still has a long way to go.** The remaining uncertainty about the latter, largely due to the political turmoil, undermines the prospects of a recovery in activity and leaves Brazil on the verge of losing its investment grade.

# Outline

1 **Softer global recovery, with less dynamism in emerging economies**

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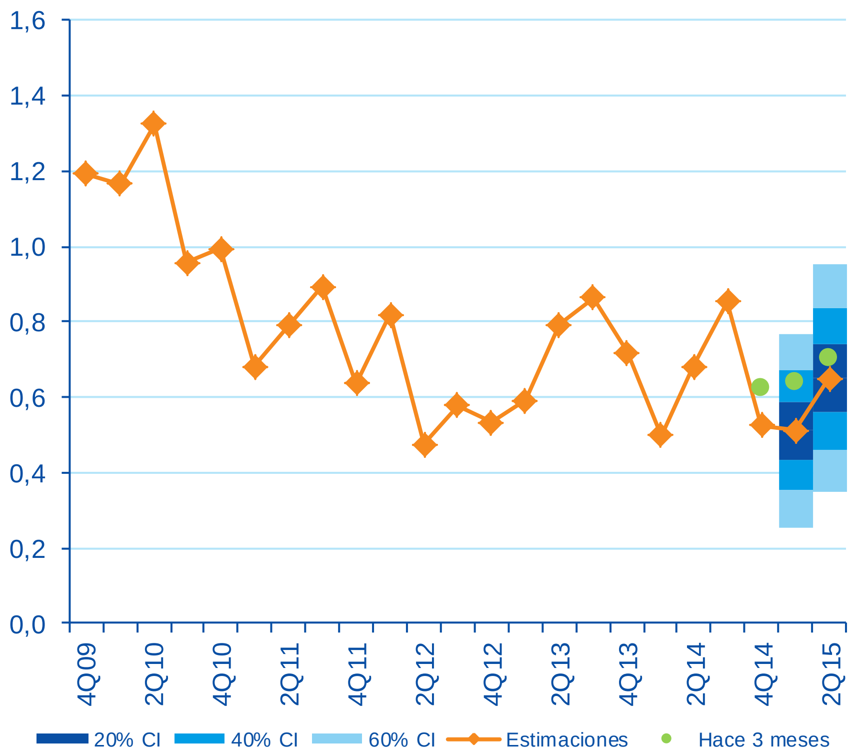
# The improvement in global growth slows down: emerging economies slow more

**BBVA-GAIN indicator of global growth (% quarterly)**
Source: BBVA Research



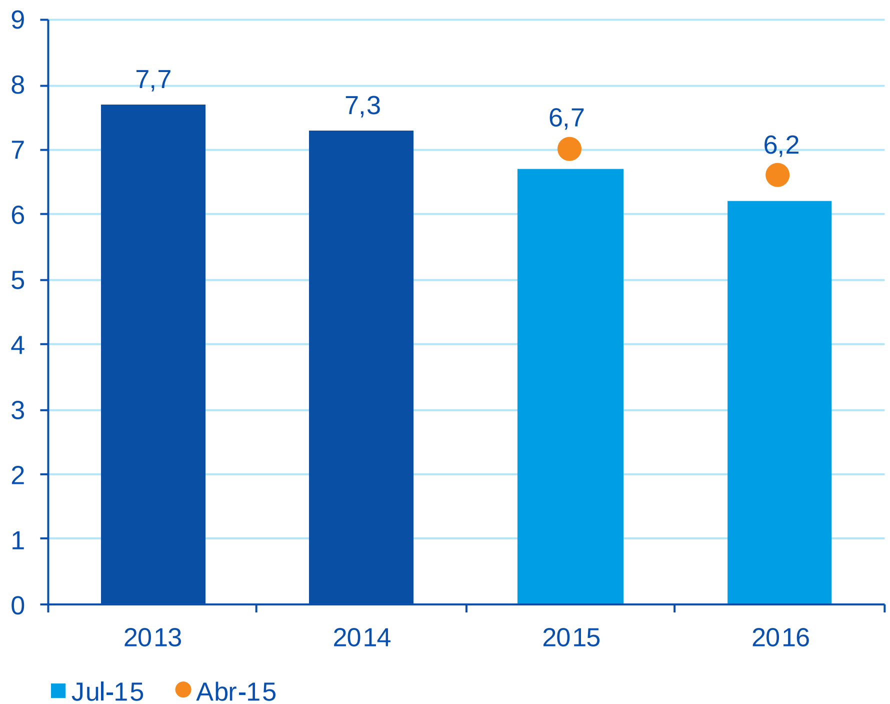

The recovery slowed in the first half of 2015 due to the temporary adjustment in the US and a lingering slowdown in China

Emerging economies face a more uncertain outlook due to the imminent rate hike by the Fed and the adjustment of raw material prices

The risk balance remains bearish: normalisation of the Fed's monetary policy; consequences of the Greek crisis and the slowdown in China

# China: lower growth and higher risks with the bursting of the bubble

**China: GDP growth** (%).
Forecast 2015-16
Source: BBVA Research



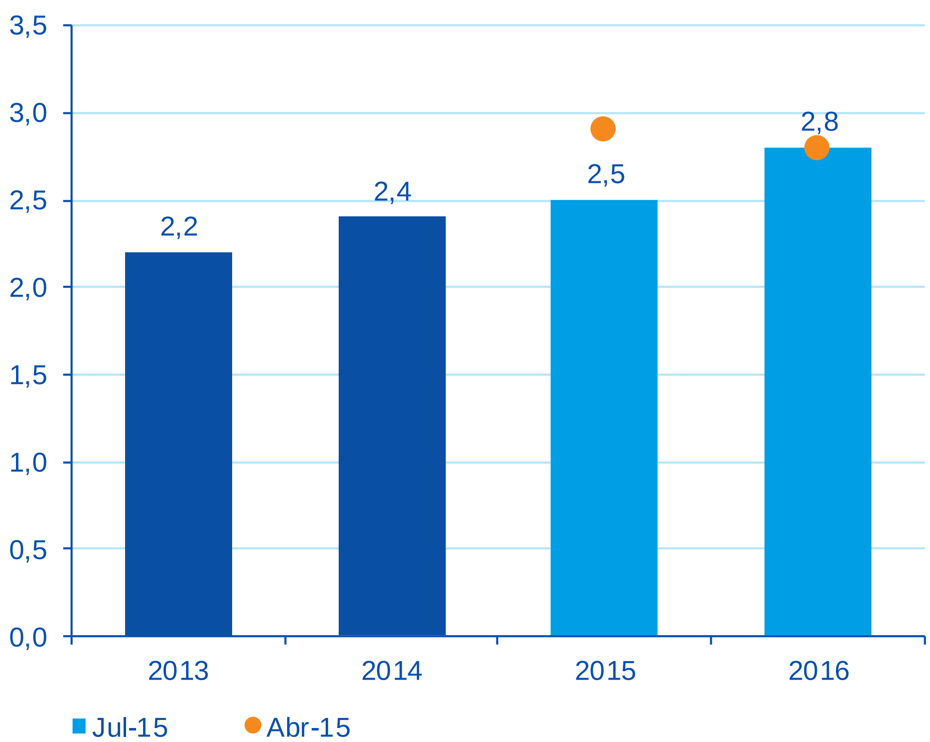

The model of debt-intensive growth is reaching its limits

The stock market shock is unlikely to have a big impact on Chinese wealth, although financing conditions and business confidence deteriorate

All in all, we revise our growth forecasts downwards in 2015 and 2016, to 6.7% and 6.2%

# USA: improving outlook in the second half of 2015

**US: GDP growth (%)**
Source: BBVA Research y Haver



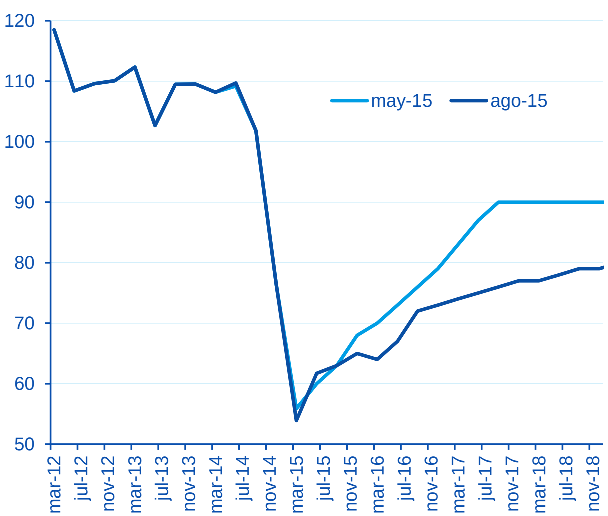

Strong recovery, but the revisions of published data can be significant; Inflation remains low

Labour market strengthens. The equilibrium unemployment rate is not far from current records

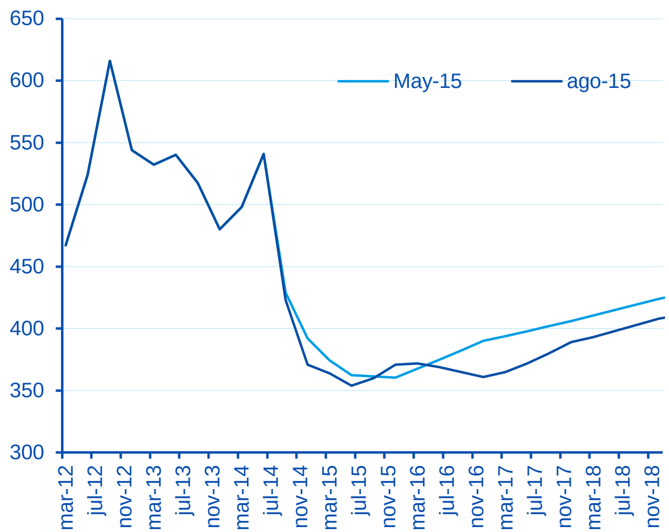
Fed raising rates from near-zero levels gains momentum (probably in September)

# Oil and copper price adjustments driven by China, but mainly by supply shocks

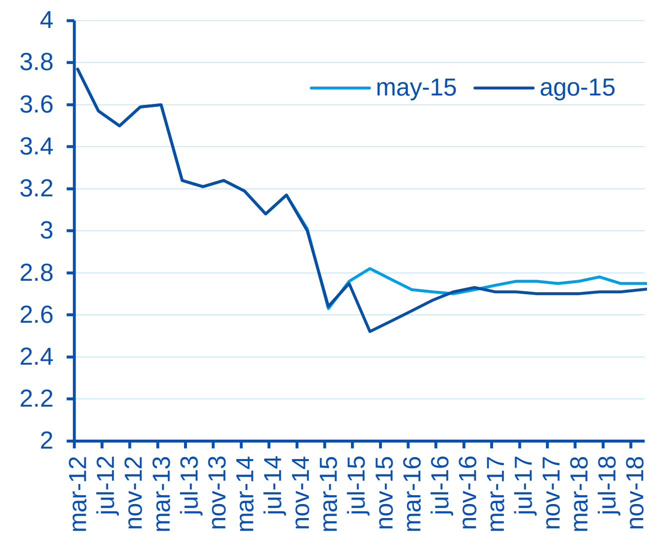
**Brent: (USD/bbl)**
Source: BBVA Research y Bloomberg




**Soybean: (USD/mtn)**
Source: BBVA Research y Bloomberg




**Copper: (USD/lb)**
Source: BBVA Research y Bloomberg




Move in oil prices was driven by an increase in the observed and expected supply …

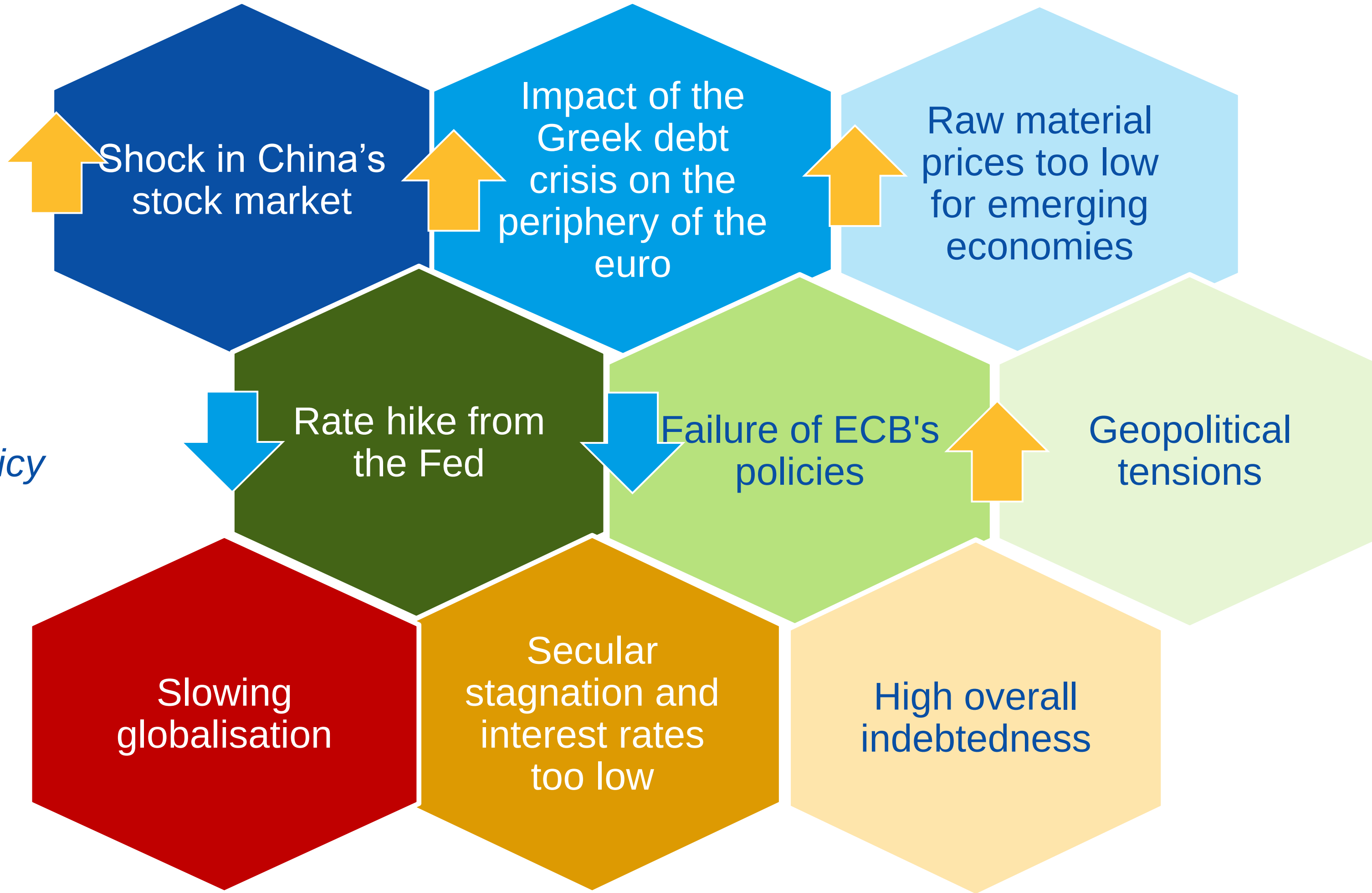
… as well as by slower growth in China, which also hit the copper price

# Global risk factors

*Risks of global reach*

*Economic and geopolitical policy*

*Pending challenges*




Upside risks

Downside risks

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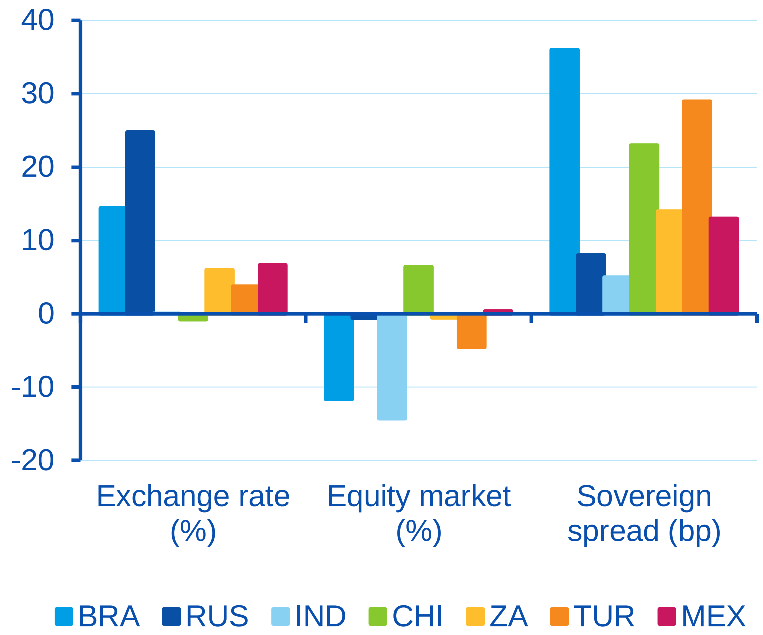
# Brazilian financial markets are hit by political turmoil, economic deterioration and external factors

**Financial markets in selected emerging countries: variations in the last three months***

* BRA: Brazil; RUS: Russia; IND: India; CHI: China; ZA: South Africa; TUR: Turkey; MEX: Mexico.
Source: IBGE and BBVA Research




Turbulence imposed a 14% depreciation in the exchange rate, a 12% contraction of equity markets and a 36bp increase in sovereign spreads in the last three months

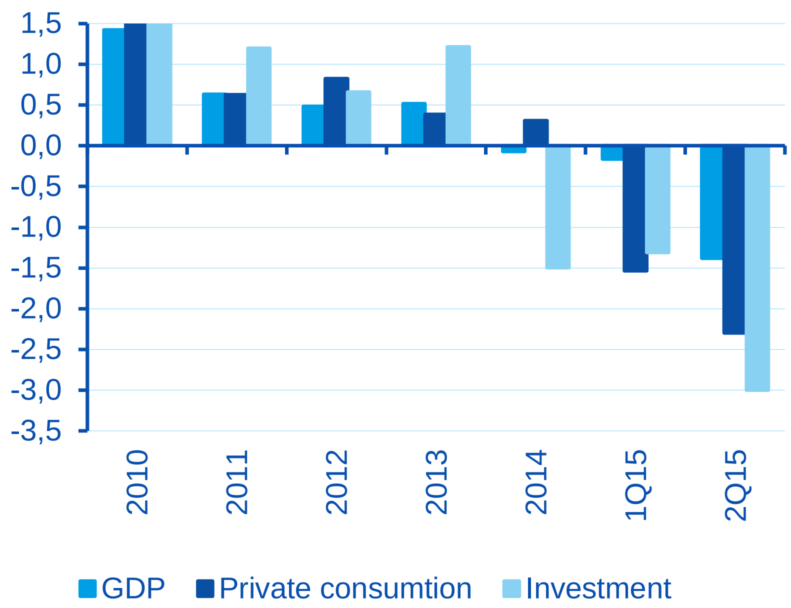
Internal drivers: negative political and economic dynamics; risk of losing investment grade (S&P changed rating outlook to “negative”; Moody’s cut the rating to Baa3)

External drivers of the recent correction in financial markets: the imminence of the US monetary tightening, the concerns over the moderation of China, fall in commodity prices

# A sharp contraction in domestic demand pushes the country into a recession

**GDP, private consumption and investment (average quarterly growth for 2010-14, 1Q15 and 2Q15, % QoQ)***

* BBVA Research forecast for 2Q15. Source: IBGE and BBVA Research




The economy contracted sharply in 2Q15 (BBVAe: -1.4% QoQ), after a 0.2% QoQ decline in 1Q15, according to most indicators.

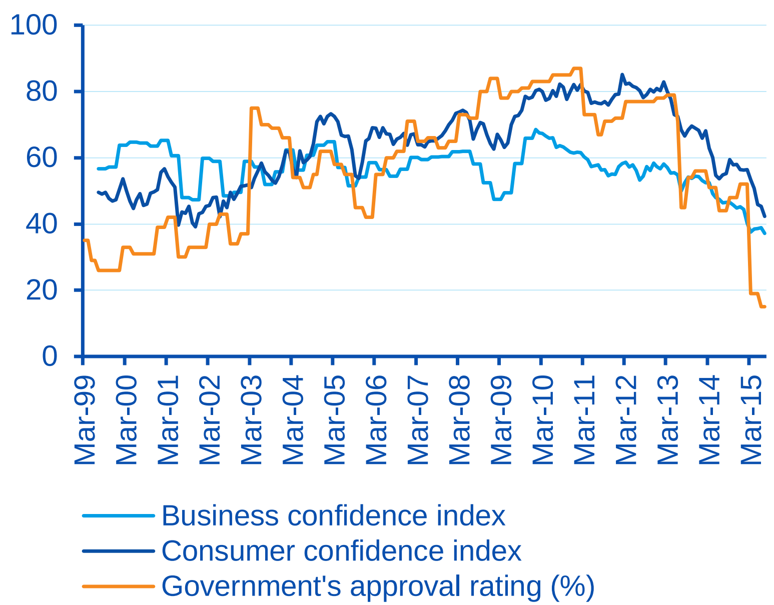
Labour markets have started to deteriorate significantly in the last few months: the unemployment, which averaged 4.8% in 2014, jumped to 6.9% in June.

In terms of GDP components, the main drivers of the contraction in 1H15 were investment (8º drop in a row in 2Q15)and private consumption (-1.5% QoQ in 1Q; around -2.3% in 2Q)

# GDP is expected to drop 1.5% in 2015

**Confidence indices and government's approval rating**

Source: CNI, IPEADATA and BBVA Research



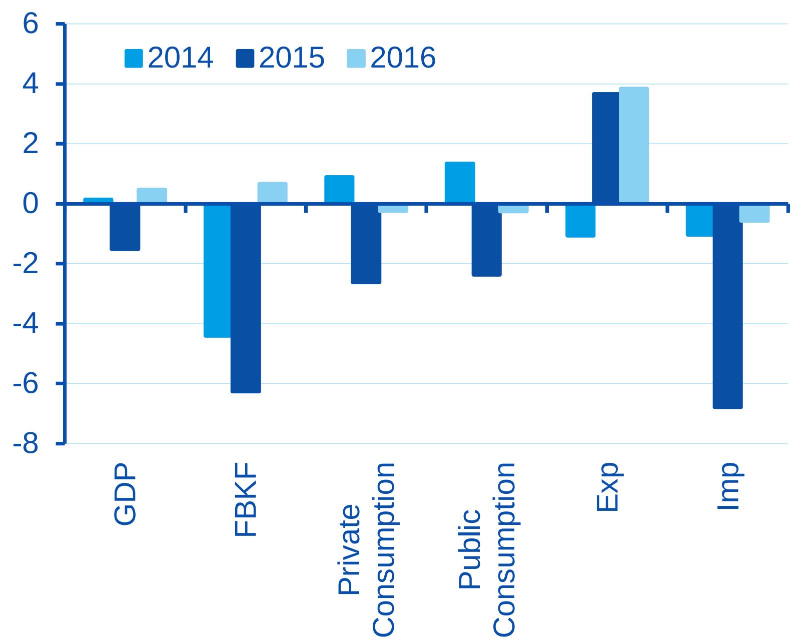

The turbulence in both the political and financial arenas at the beginning and leading indicators (such as confidence) suggest that the economy will deteriorate further in 2H15.

Nonetheless, we do not expect GDP to contract as sharply in any of the two following quarters as it probably did in the second.

Domestic demand is expected to contribute very negative to growth in 2015 (-2.7pp). Net exports (mainly imports contraction) to provide some relief (+1.2pp).

# GDP is expected to grow only 0.5% in 2016

**GDP and components (%)**
Source: IBGE and BBVA Research




The worst of the current crisis should be left behind in 2016, at least if the political situation stops deteriorating and if the government manages to prevent a further fiscal worsening.

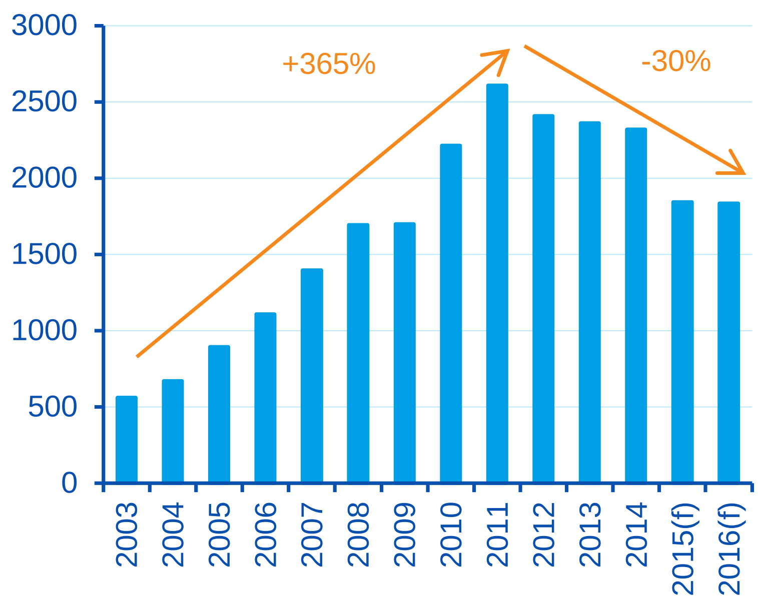
Even though we do not expect a sharp turnaround of the economy next year, there are some factors that support the emergence of a less negative scenario:

**i) better external environment, ii) inflation moderation, iii) end of the monetary tightening; iv) the lagged impact of the exchange rate depreciation on net exports**

# The “bust” that follows the “boom”…

**GDP (USD bn)**

Source: IBGE and BBVA Research




At the end of 2016 the Brazilian GDP measured in dollars will be 30% lower than in 2011 thanks to five years of poor growth and weakening currency.

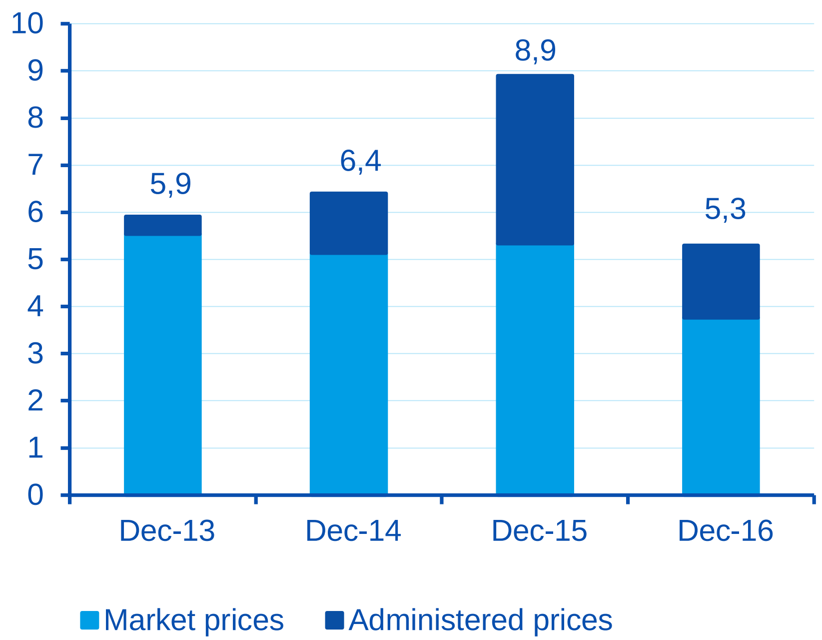
Long-term potential growth is estimated to be only 2.2%, lower than in the previous years (3.2% in the 2003-2011 period) and than expected some time ago (2.7% in 2014)…

**… which is not surprising given the recent macroeconomic performance, the lack of an agenda to increase productivity, investment and the gradual aging of the population**

# Inflation is expected to remain under pressure, in spite of the contraction in domestic demand

**Contribution from market and administered prices to annual inflation (pp)***

* BBVA Research forecasts for Dec-15 and Dec-16.
Source: IBGE and BBVA Research




The main factor behind the rise of inflation, from 6.2% in Dic-14 to 9.6% in Jun-15, is the upward adjustment in administered prices. Other factors: tax increases, food prices, FX…

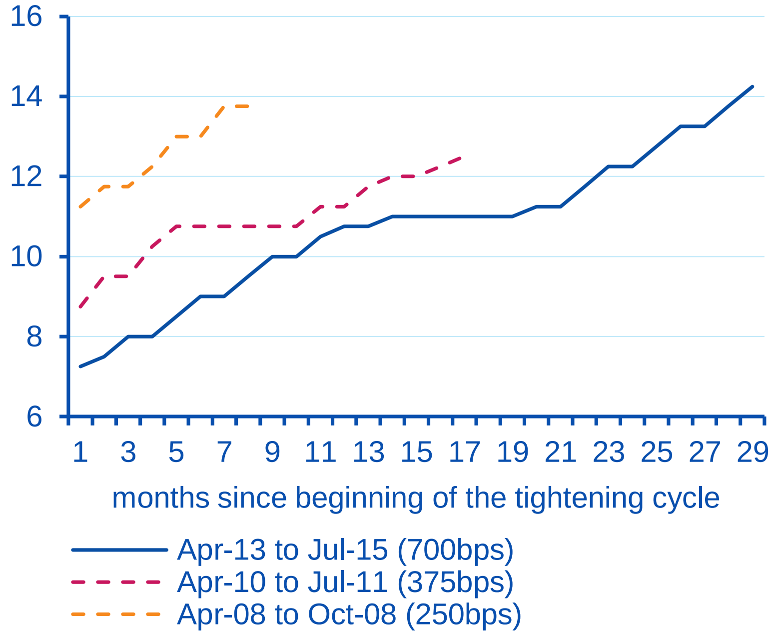
As most of the realignment process of regulated prices is now over, we expect inflation to lose some steam from September onwards and to close the year at 8.9%.

**Inflation to decelerate to 5.3% in 2016, due to the waning of the adjustment in regulated prices effect, domestic demand contraction and labour markets slowdown.**

# The monetary tightening is over. The next easing will not be as aggressive as the previous ones.

**Selic rate in tightening cycles (%)***

* Includes the last tightening cycle, that we expected to have ended in July 2015, and the previous two.
Source: BCB and BBVA Research




Even though the BCB suggested that it could further tighten monetary conditions in the case of further fiscal softening or additional exchange rate depreciation, the Selic rate will now remain stable for some time

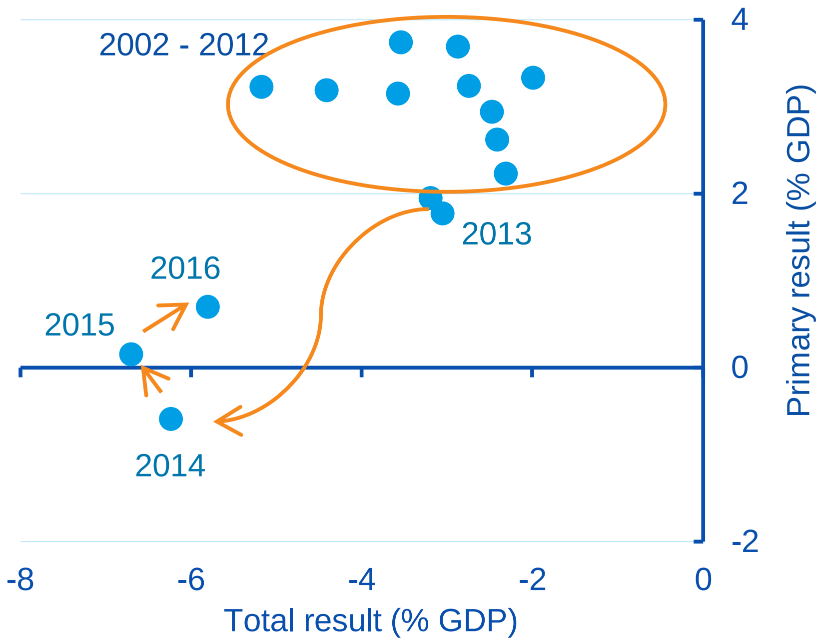
The recent monetary tightening was longer and larger than the previous due to: i) higher inflation; ii) to compensate for fiscal deterioration; iii) to recover credibility

**BCB to start in 2Q16 an easing cycle, which will be softer than the previous ones due to: i) (still) credibility issues; ii) fed tightening; iii) fiscal risks**

# Economic and political headwinds induce a more gradual adoption of the fiscal adjustment

**Fiscal result: primary and total (% of GDP)***

* BBVA Research forecasts for 2015 and 2016.
Source: BCB and BBVA Research




Due to economic and political headwinds, the government reduced primary targets to only 0.15% of GDP in 2015, 0.7% in 2016, 1.3% in 2017 and 2.0% in 2018

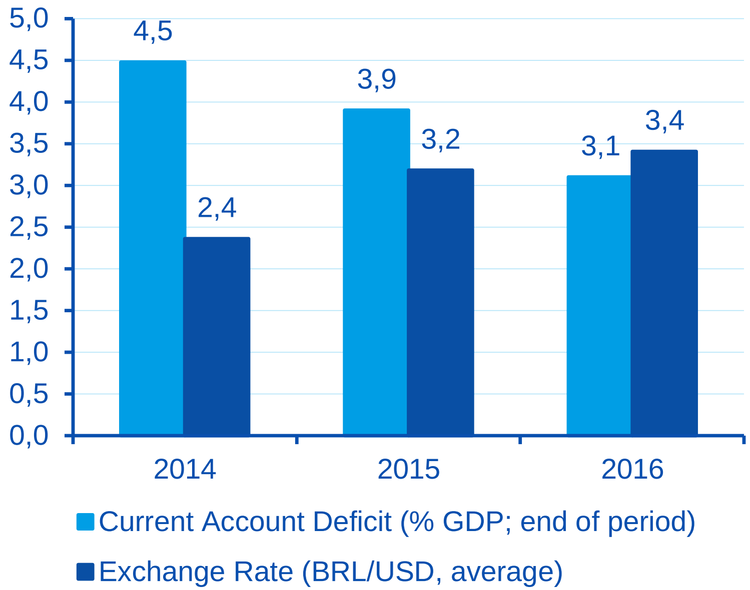
Even if these targets are reached, fiscal indicators will continue to deteriorate (gross debt would only stabilise after 2018 above 70% of GDP).

**All in all, a more gradual fiscal tightening hinders the recovery of confidence and leaves the country on the verge of losing its investment grade**

# The domestic environment favours a current account adjustment going forward

## Exchange rate and current account*

* BBVA Research forecasts for 2015 and 2016.
Source: BCB and BBVA Research




A weaker BRL going forward due to external factors (Fed, China, commodities, etc.) and internal drivers (economic deceleration, negative political dynamics, need to recover competitiveness, etc.)

A weaker BRL and the domestic demand contraction will drive the CA deficit down (in fact, this has already been happening: CA declined 23% in 1H15)

**Smaller CA deficit will be more in line with a reduction in external funding (FDI declined 32% in 1H15, debt emissions abroad only USD5bn in 1H15 vs. USD30bn in 2016)**

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# Annex: Annual macroeconomic forecasts

## Macroeconomic forecasts

| | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|
| **GDP (% growth)** | 2.7 | 0.1 | -1.5 | 0.5 |
| **Inflation (% YoY, end of period)** | 5.9 | 6.4 | 8.9 | 5.3 |
| **Exchange rate (BRL/ USD,end of period)** | 2.34 | 2.66 | 3.34 | 3.49 |
| **Interest rate, SELIC (%,end of period)** | 10.00 | 11.75 | 14.25 | 11.50 |
| | | | | |
| **Private consumption (% growth)** | 2.9 | 0.9 | -2.6 | -0.2 |
| **Public consumption (% growth)** | 2.2 | 1.3 | -2.4 | -0.3 |
| **Investment (% growth)** | 6.1 | -4.4 | -6.3 | 0.7 |
| **Exports (% growth)** | 2.1 | -1.1 | 3.7 | 3.9 |
| **Imports (% growth)** | 7.6 | 1-.0 | -6.8 | -0.6 |
| | | | | |
| **Fiscal result (% GDP)** | -3.1 | -6.2 | -6.8 | -5.7 |
| **Current account (% GDP)*** | N.D. | -4.5 | -3.9 | -3.1 |

* Current account series updated by the BCB, available from 2014.

Source: BBVA Research