

Brazil Economic Outlook

Third quarter 2015
Latin America Unit

- **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.
- **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.
- **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.

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Closing date: 11 August 2015

1 Overview

Global growth is revised downwards in 2015, to 3.4%. The global economy would then recover in 2016, with a 3.8% expansion. Developed economies continue to exhibit favourable growth expectations, helping to limit the impact of the slowdown in emerging countries.

Brazilian financial markets were hit by political turmoil, economic deterioration and external factors. Turbulence resulted in a 14% depreciation of the exchange rate, a 12% contraction of equity markets and a 36bp increase in sovereign spreads in the last three months. Among the drivers of this correction are the sharp economic deterioration and mainly the political upheaval, characterised by the spillovers of the Petrobras bribery scandal, the deterioration of the relationship between the executive and legislative branches and the sharp decline in President Dilma Rousseff's approval ratings. In this context, S&P revised the country's rating outlook from "stable" to "negative" and Moody's cut Brazil's rating to Baa3, which means that the country could soon find its investment grade withdrawn. Regarding the external drivers, we highlight the imminence of the beginning of US monetary tightening, the concerns about the Chinese economy and the fall in commodity prices.

The Brazilian economy will contract sharply in 2015 and stagnate in 2016. The sharp deterioration of confidence indicators and labour markets are some of the signs that suggest that GDP will contract sharply – by around 1.4% QoQ – in 2Q15, following a decline of 0.2% QoQ in 1Q15. The most likely result is that the economy will continue in recession, at least during the third quarter, and that GDP will fall to 1.5% in 2015. 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 worsening of the fiscal prospects. Even though we do not expect a sharp turnaround by the economy next year, there are some factors (better external environment, inflation moderation, end of the monetary tightening and the lagged impact of the exchange rate depreciation on net exports) that support the emergence of a less negative scenario, in which GDP would grow 0.5%. Given the poor macroeconomic performance in the last few years, the lack of an agenda to increase productivity and investment and the gradual aging of the population, long-term potential growth is now estimated to be only 2.2%.

Inflation is expected to remain under pressure. The effect of the contraction in domestic demand will be offset by the upward adjustment in regulated prices (in 2015) and inertial factors (mainly in 2016). The significant currency depreciation will also put pressure on inflation (in both 2015 and 2016), even though there is no evidence of a higher exchange rate pass-through into prices. We forecast inflation to close 2015 at 8.9%, that it will start to decelerate during the first half of 2016 when the effect of the adjustment in regulated prices implemented at the beginning of 2015 will start to fade away, and will then close 2016 at 5.3%.

The larger-than-expected monetary tightening is over. The next easing cycle is still far away –second quarter of 2016– and will not be as aggressive as the previous ones.

Economic and political headwinds induce a more gradual adoption of the fiscal adjustment, hindering the recovery in confidence and leaving the country on the verge of losing its investment grade. Due to the impact of the contraction of domestic demand on public revenues and of the problems in getting some fiscal measures approved by the Congress, the government cut its primary targets to 0.15% of GDP in 2015, 0.7% in 2016, 1.3% in 2017 and 2.0% in 2018 (vs. 1.1% in 2015 and 2.0% from 2016 onwards previously). We think that the 2015 and 2016 targets will be reached, but that will not prevent the fiscal accounts from deteriorating. It will be difficult for the government to avoid losing its investment grade.

The exchange rate will remain more depreciated in the future than it was in the past years. We expect it to average 3.2 reals to the US dollar in 2015 and 3.4 in 2016, compared to 2.4 in 2014. The currency depreciation and the contraction of domestic demand should reduce the current account deficit from 4.5% in 2014 to 3.9% this year and 3.1% in 2016.

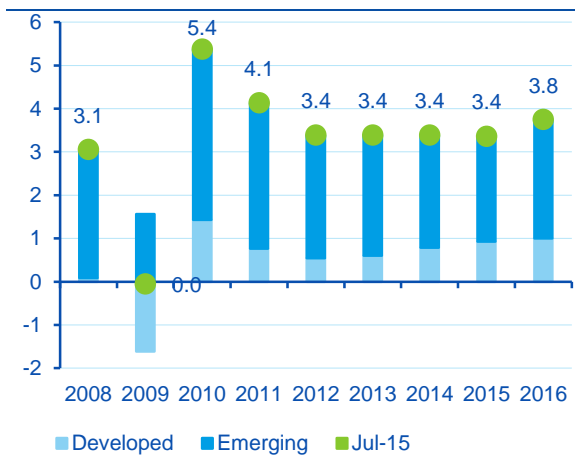
2 Global environment: moderation in world growth and a marked deceleration in the emerging economies

We have revised our forecast for 2015 world growth downwards, to 3.4%. This will recover to 3.8% in 2016

After a poor first quarter, world growth appears to be more dynamic in 2Q15, on the back of the recovery in the US (after the stagnation in GDP observed in the first few months of the year), euro area strength and GDP growth in China of 7% YoY, the same reading as in the first quarter. Despite this, world GDP is likely to have grown at under 3% YoY in the first half of the year, thus justifying our downward revision of growth for 2015 as a whole (to 3.4%, which is 0.1pp below what we were predicting in April). Looking to 2016, the world economy could pick up pace and attain growth of 3.8%.

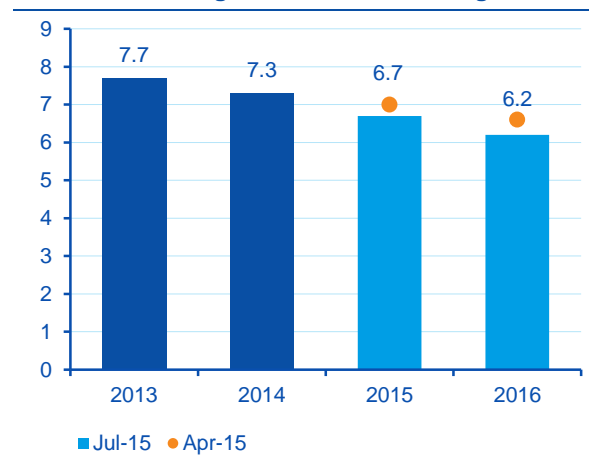
The developed economies continue to share encouraging growth prospects, which will contribute to mitigate the impact on world activity and trade of the current slowdown among the key emerging economies. Specifically, while in 2015 the developed nations have the potential to grow at their fastest pace since 2010, at a shade over 2% YoY, the major emerging markets could see weaker growth again for the fifth year in succession.

Figure 2.1
World growth: annual growth (%). 2015-16 forecasts



Source: BBVA Research

Figure 2.2
China: economic growth, % annual change



Source: BBVA Research

Besides the downward revision of growth forecasts for the world economy, a hallmark of the global context in the last quarter has been the manifestation of some of the risk events that we singled out three months ago and, if they take a turn for the worse, this could bring the global economic recovery to a halt. The first of these involves the bout of financial instability in China. This was brought about by the sharp correction of its stock market, within a situation of trend deceleration in growth, which has drawn on substantial borrowing, and a process of financial liberalisation still underway. The second, which is equally significant, is the Greek crisis, and the constraints to reach an agreement that ensures that the country will face its financial commitments in the short term, as well as the sustainability of its debt via reforms to enhance the economy's capacity to grow in the long term.

The combination of these two risk events, together with the approach of the Fed's first rate, has heightened financial disruption the world over, particularly in the form of greater volatility in stock and currency markets, with a heavier impact on the euro area and Asia.

The disappointing growth in the first half of the year justifies our downward revision for growth in the US in 2015 ...

In the US, GDP growth contracted in the first quarter, followed by modest growth in the second, judging by the available indicator readings for activity and confidence. This justifies our downward revision for growth for 2015 as a whole, which we think could reach 2.5%, or some 0.4pp below the level we forecast in April. The uncertainty over how the economic cycle will perform in the coming quarters has now been heightened bearing in mind the impact of the persistent dollar appreciation on exports, the weakness of private investment and the deterioration in the global situation. Even so, US GDP could grow by 2.8% in 2016.

... while the financial volatility in China has also led us to revise our growth forecasts for 2015 and 2016

In China, the pace of economic growth is likely to slow owing to the impact of the recent bout of financial tensions. Besides the negative effect on the confidence of the private sector, there might also potentially be some reversal of consumption decisions as a result of the drop in households' financial wealth. More than anything though, there is likely to be a deterioration in financing conditions for corporates, which is associated with both the suspension of new placements and the loss of value of collateral backing bank loans. These are the factors responsible for the downward revision in the growth forecast for China in 2015 and 2016 to 6.7% and 6.2% respectively (0.3pp and 0.4pp lower than in our April scenario, see Figure 2.2). The battery of stimulus measures implemented by the country's authorities to stave off the possibility of even worse contagion to the economic activity cycle is the reason why we do not expect a more intense correction to the rate of economic growth.

Economic growth in the euro area continues to recover despite the Greek crisis

The pattern in the euro area is still one of sustained recovery, with quarterly GDP growth rates in the order of 0.4% in the first two quarters of the year. The improved dynamics in France and Italy are combining with the strength of Germany and Spanish GDP growth, which is advancing at a quarterly pace of close to 1%. The emergence of certain risk hotspots with differing impacts on the region could slightly reduce estimated growth for 2015 and 2016 but, even so, the forecasts are still positive (+1.4% in 2015 and +1.9% in 2016, 0.1pp and 0.3pp below those we forecast in April). Altogether, without a doubt the most significant challenge is to try and dispel any scepticism about the irreversibility of the monetary union project.

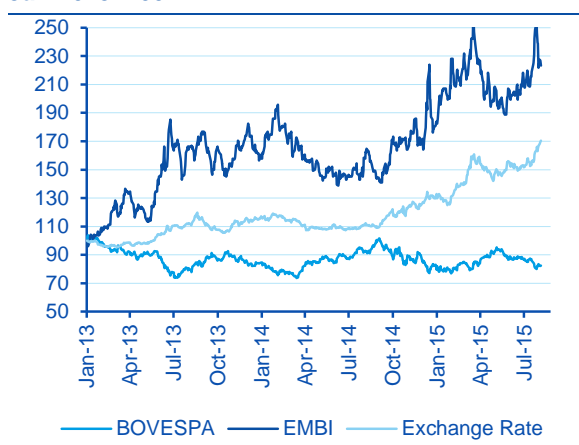
3 Brazilian financial markets are hit by political turmoil, economic deterioration and external factors

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

A set of factors caused a new bout of turbulence in Brazilian financial markets in the last few months. Local assets went through important downward corrections: i) the exchange rate, which was among the most affected markets, depreciated and reached more than 3.5 reals per dollar at the beginning of August, in comparison to around 3.05 three months ago and to 2.3 in August 2015; ii) the BOVESPA equity index lost 12% in the last three months and also 12% in comparison to the beginning of 2014, and iii) the EMBI+ sovereign spread jumped 36 points in the last three months, and now stands at 317bp, in comparison to 230bp one year ago (Figure 3.1).

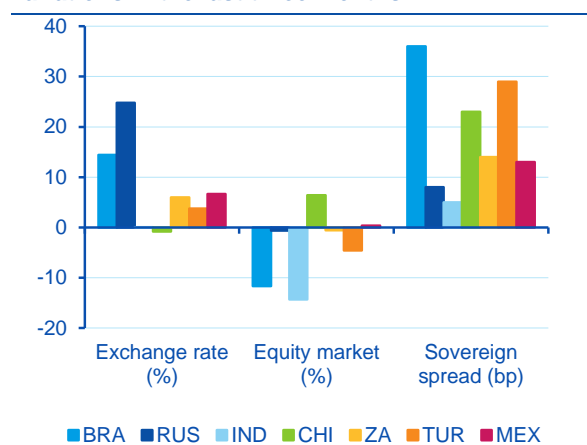
The fact that other emerging markets went through some significant corrections in the last three months suggests that the turbulence in Brazilian financial markets were determined, at least to some extent, by external factors such as the imminence of the beginning of the US monetary tightening, the concerns over a sharper moderation of the Chinese economy as well as the recent volatility in its equity markets, and the downward corrections in commodity prices in the last quarter (oil: -19%; iron ore: -2%; soybeans: -1%)¹.

Figure 3.1
Equity markets (BOVESPA), sovereign spreads (EMBI +) and exchange rate (USD/BRL). Indexes Jan-2013=100.



Source: Datastream and BBVA Research

Figure 3.2
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

However, the recent losses observed in Brazilian financial markets were larger than those in other emerging economies (see the Figure 3.2 and, for a comparison with other Latin American countries, our [3Q15 Latin America Economic Outlook](#)): in the last three months the Brazilian sovereign spreads grew the most among the countries analysed (Russia, India, China, South Africa, Turkey and Mexico), the Brazilian real depreciated more than most of other emerging currencies (only the Russian ruble depreciated more) and the BOVESPA index declined more than all but the Indian stock exchange index. This reinforces the generalised

1: For more details on the recent evolution of commodity markets, see our [3Q15 Latin America Economic Outlook](#).

view that local turbulence was also a consequence of idiosyncratic issues, mainly political instability and a sharp economic deterioration, which have been feeding each other since at least the beginning of the year.

With respect to the political environment, it is important to highlight that the spillovers of the Petrobras bribery scandal to important leaders from both the public and private sectors are one of the main drivers of the heightened political uncertainty and instability. To some extent due to the evolution of the police investigations about the reported corruption episodes, there has been some weakening of the government's capacity to deal with the Congress, which has been jeopardising the efforts by President Dilma Roussef and Finance Minister Joaquim Levy to implement a fiscal adjustment (more on this issue below). Moreover, recent corruption scandals have been also helping to erode the government's approval ratings, which are at this moment at historically low levels (Figure 4.1). In this environment, speculation about an impeachment of the President Dilma Rousseff, a scenario that we still see as unlikely, has been gaining momentum.

Regarding the economic deterioration, which we describe in details below, it is relevant to highlight the sharp deceleration in domestic demand, the rapid deterioration of labour markets and the negative impact that these trends are having on fiscal revenues.

All in all, political and economic environments have thus increased the uncertainty and fueled the downward correction in Brazilian markets. This negative trend was reinforced by S&P's revision from "stable" to "negative" of the Brazil's rating outlook and by Moody's decision to cut the country's rating from Baa2 to Baa3 (although with a "stable" rather than a "negative" outlook). In practice, it means that Brazil, which now stands only one notch above speculative grades according to the two rating agencies, could soon lose the investment grade it obtained in 2008.

In spite of the abnormally high uncertainty surrounding the Brazilian environment, it is likely that pernicious economic and political dynamics will continue to introduce volatility to the local financial markets. Among other reasons to support this view, we highlight the fact that the the police "Car Wash" operation will continue to investigate the Petrobras-related bribery scandals for the immediately foreseeable future. On top of that, and shifting back to the external environment, we expect interest rates in the US to start to be adjusted up as soon as September, which should also generate some turbulence in emerging economies such as Brazil's.

4 The Brazilian economy will contract sharply in 2015 and stagnate in 2016; inflation will remain under pressure

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

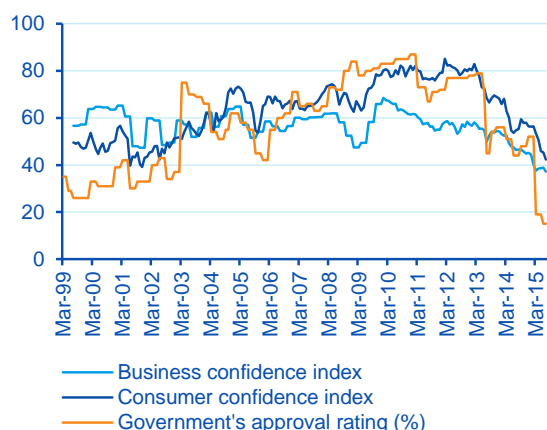
The economy contracted sharply in the second quarter of 2015, following a moderate decline in the first quarter, according to most indicators.

The confidence indices, which were already at very low levels at the beginning of the year, deteriorated further in the last months, especially since March. Both business and consumer confidence are now at the lowest levels in more than ten years. To some extent, the worsening of confidence is related to the negative political dynamics (corruption scandals spilling over the public and private sectors, government’s increasing problems in dealing with the Congress, etc.) described in the previous section, especially in the last few months. The government’s approval rating has dropped from 40% at the end of 2014 to only 9% in June, by far the worst in many years (Figure 4.1).

The negative trends exhibited by confidence and the government’s approval indicators are certainly linked to the performance of economic activity. In this sense, it is worth noting that after displaying an impressive resilience in the past years, labour markets have started to deteriorate significantly in the last few months (Figure 4.2). If the former strength was a sign of optimism regarding the future of the economy, the recent worsening can be used to support the opposite view, i.e. that the optimism regarding the country has waned.

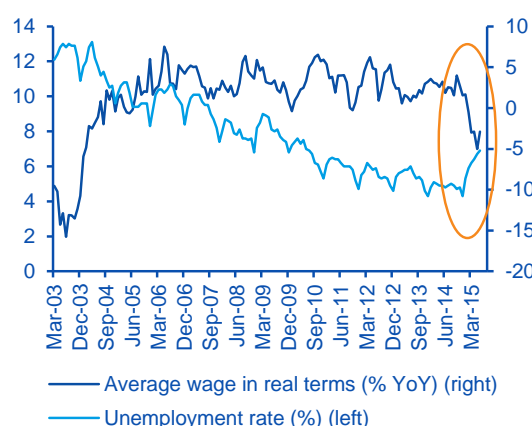
The unemployment rate, which averaged 4.8% in 2014, jumped to 6.9% in June. Average wages, which expanded around 2.7% in real terms in 2014 (and even more in previous years), started to grow at negative rates in real terms in February (Figure 4.2).

Figure 4.1
Confidence indices and government’s approval rating



Source: CNI, IPEADATA and BBVA Research

Figure 4.2
Labour markets: unemployment rate and real wages



Source: IBGE and BBVA Research

With respect to credit markets, where the moderation trend started some years ago (due to private credit deceleration which was only seen in public banks from the middle of 2014), the recent evolution also supports the view that economic activity is deteriorating. Not only is the stock of credit’s growth pace now running below the inflation rate, but also lending rates are increasing, among other reasons due to the aggressive monetary tightening that the Brazilian central bank has been implementing (Figure 4.3).

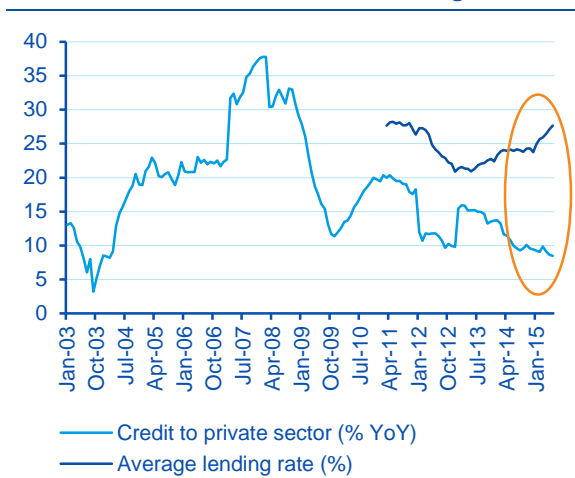
Even though the government is currently being forced to adopt a tightening of both monetary and fiscal policy (see Section 5), which is certainly one of the main factors behind the current slowdown of the economy, it announced in the last few months a couple of measures to try to provide some partial relief to labour and credit markets. At the beginning of July the government announced [a measure to try to reduce lay-offs by increasing the flexibility in the number of hours worked](#), and a few days later it raised to 35% from 30% the cap of payroll loans as a share of personal income.

Still regarding domestic factors that are currently driving growth down, we note that the rising inflation and the exchange rate depreciation have been representing a costs shock for both consumers and producers. On the positive side, there are the reduced risks of an energy blackout, due to increased rainfall and a contraction of consumption.

Even though the domestic environment is playing a very significant role in the ongoing deceleration of the Brazilian economy, we have to note that the external environment is not being supportive either, mainly because of the negative impact of the moderation of the Chinese economy and, consequently, of commodity markets.

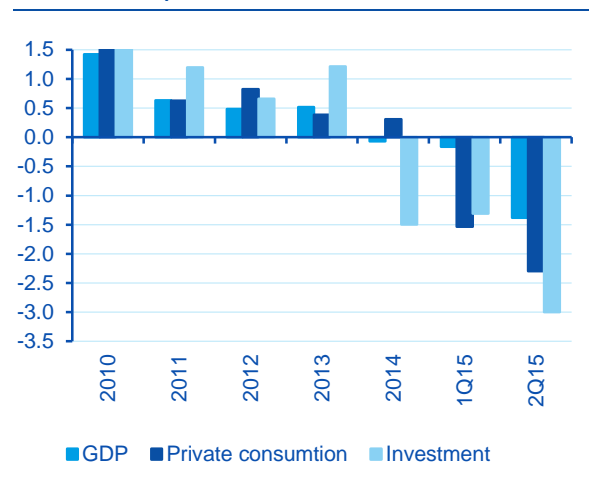
Considering all these factors, we expect the economy to contract by 1.4% QoQ in the second quarter, in comparison to a 0.2% QoQ contraction in the first. A second consecutive quarter of negative quarterly growth would mean that the country is technically in recession.

Figure 4.3
Credit markets: credit stock and lending rate



Source: BCB and BBVA Research

Figure 4.4
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

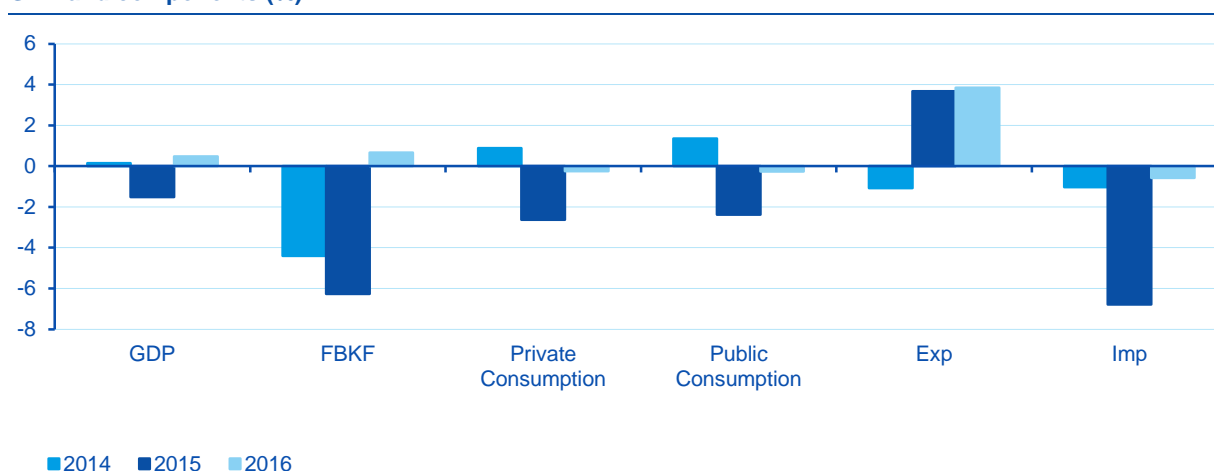
In terms of GDP components, the main drivers of the contraction in the first two quarters of the year were investment and private consumption (Figure 4.4). The latter, which actually accounts for two-thirds of GDP, declined 1.5% QoQ in the first quarter and our forecasts point to a more significant drop in the second quarter, mainly reflecting the deterioration in the labour market. If our estimate proves to be correct, this will be the most significant contraction in private consumption since 1995. Regarding investment, it is expected to contract for the eighth consecutive time in the second quarter. Among other reasons, the expected contraction of investment is due to the impact of low confidence and heightened uncertainty, as well as of the reduction in investments by Petrobras following the recent financial problems faced by the company on private investment; and the impact of the ongoing fiscal adjustment on public investment. In contrast with the very negative contribution of domestic demand components to GDP growth, we expect external demand to contribute positively in the second quarter, as it did in the first, mainly due to a contraction in imports.

GDP is expected to drop 1.5% in 2015, and to grow only 0.5% in 2016

Up to now, there are still neither clear signs nor strong reasons to think that the economy will recover in the second half of 2015 after the sharp deceleration in the first part of the year. Therefore, the most likely outcome is that the economy will continue in recession, at least during the third quarter. The turbulence observed in both the political and financial arenas at the beginning of the second half of the year and the leading indicators (such as confidence) for the period reinforce the view that the economy will deteriorate further in the remainder of the year. Nonetheless, we do not expect GDP to contract as sharply in any of the two following quarters as it probably did in the second.

Based on these prospects, we estimate that GDP will contract 1.5% in 2015 (Figure 4.5). Therefore, we now expect the economy to go through a more significant correction than we did three months ago when we held a -0.7% forecast, even though growth surprised to the upside in the first quarter (observed: -0.2% QoQ; forecast: -0.6% QoQ), and in spite of the perspectives of a less intense fiscal adjustment this year (see Section 5 for more on fiscal policy). The main factor behind this downward revision is a larger-than-expected fall in domestic demand – mainly due to the worsening of confidence and the sharp deterioration of the labour market – although a less positive evolution of the world economy, especially in China, also contributed to it.

Figure 4.5
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 worsening of the fiscal prospects (more negative political or fiscal dynamics are the main downward risks to our baseline scenario). 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, in which confidence stops worsening. Among them, we highlight: i) the fall in inflation, that we expect to occur from the beginning of next year; ii) the likely end of the monetary tightening cycle in July of 2015 and an eventual easing cycle next year; iii) the lagged impact of the ongoing exchange rate depreciation on net exports; iv) the increase of world growth to 3.8% in 2016 from 3.4% in 2015 (Section 2); and v) the expected stabilisation of commodity prices and, consequently, of Brazil's terms of trade (Figure 4.6).

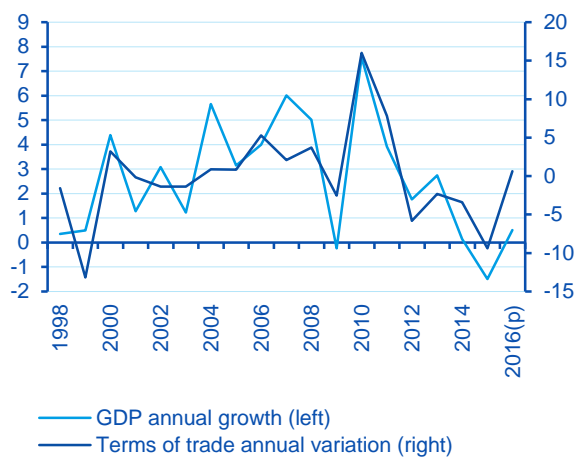
We have revised our forecast for growth in 2016 down to 0.5% from 1.8% previously, as we expect the aforementioned factors to be less supportive than we had expected and as the fiscal adjustment will be more gradual than forecasted, which means that part of the expenditure control and revenue increase will be done

in 2016 rather than in 2015, and mainly because it will make the government’s task of recovering the credibility of economic policy more difficult (see Section 5 for more details). Finally, it is important to highlight that carry-over statistical effects will be negative in 2016: taking into account our 2015 forecasts, GDP will contract by 0.5% in 2016 if GDP remains stable (0.0% QoQ) in every quarter of the next year.

We expect private consumption to decline by around 0.3% in 2016, as the ongoing labour market slowdown should continue next year, as it usually reacts with some lags to the economic cycle (we forecast an increase of the average unemployment rate from 4.8% in 2014 to 6.7% in 2015 and 8.2% in 2016). However, this contraction would be not as significant as the one expected to happen this year (-2.6%). We expect public consumption to exhibit a similar growth pattern (Figure 4.5) and investment to remain broadly unchanged after a sharp contraction in 2015 (around -6.0%). Therefore, after contributing very negatively to growth in 2015 (-2.7pp), domestic demand will contribute slightly negatively (-0.1pp) to growth in 2016. Regarding net exports, they will contribute significantly (+1.2pp) to growth this year, mostly due to the contraction in imports, and to a lesser extent in 2016 (+0.6pp) due to a smaller contraction in imports, and in spite of the better performance of exports.

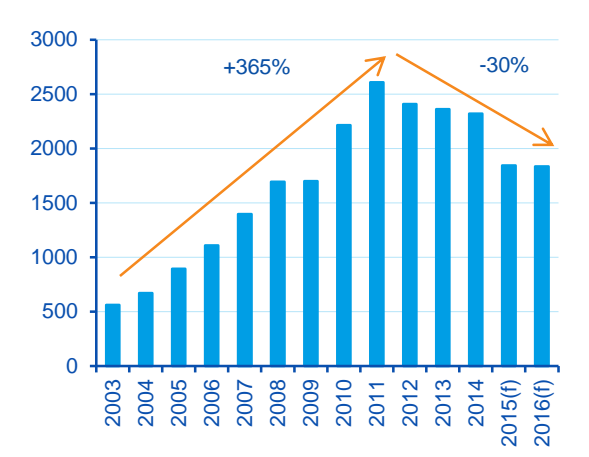
At the end of 2016, according to our estimates, the Brazilian GDP measured in dollars will be around USD1,834bn, 30% lower than in 2011 when it peaked at USD2,607bn thanks to five years of poor growth and a weakening currency (Figure 4.7). Not surprisingly, given the macroeconomic performance in recent years, the lack of a national agenda to increase productivity and investment and the gradual aging of the Brazilian population, long-term potential growth is around 2.2%, lower than in the previous years and than expected some time ago (see Box 1 for more on potential GDP estimates for Brazil and other Latin American countries).

Figure 4.6
GDP and terms of trade (% growth)



Source: IBGE and BBVA Research

Figure 4.7
GDP (USD bn)



Source: IBGE and BBVA Research

Inflation is expected to remain under pressure, at around 9.0% in 2015 and 6.0% in 2016, in spite of the contraction in domestic demand

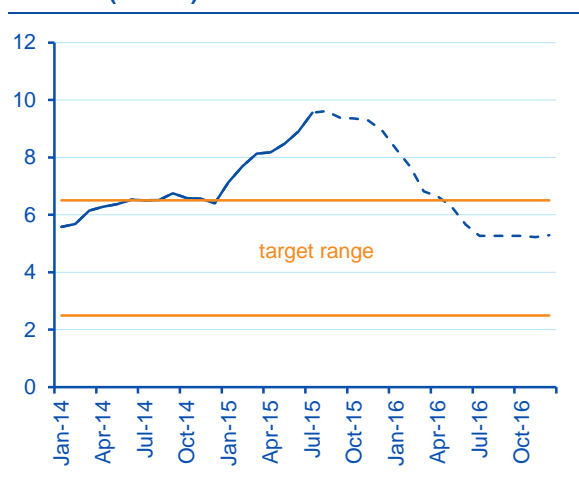
In spite of the benign impact on prices of the slowdown in domestic demand, overall inflation has clearly been trending upwards (Figure 4.8). In July it increased for the seventh consecutive month and reached 9.6%, the highest rate since 2003, 3.2pp above the level observed at the end of 2014.

The main factor behind the vertiginous rise of inflation in the last few months is the upward adjustment in administered prices, i.e. in the prices of those services and goods regulated by the government, which represent around 24% of the consumption basket. After remaining for some time at artificially low levels, administered prices started to be adjusted at the beginning of the year, given the lack of fiscal room to manoeuvre. Other factors, such as the cost pressures on energy companies due to climate shocks in the first months of the year, also contributed to the upward revision in regulated prices. Therefore, administered-price inflation jumped to 15.9% in July from 5.5% at the end of 2014 (and 1.5% in December 2013).

Although the main culprit of the recent inflationary skyrocketing is administered-price inflation, tax increases implemented at the beginning of the year, the impact of higher costs (mainly water and electricity tariffs) on food markets and the effects of a weaker exchange rate have also contributed (for more on the latter, including a discussion about the degree of exchange rate pass-through into domestic prices, see Box 2). According to our calculations, more than 80% of inflationary deviations from what we expected a year ago are due to larger-than-expected adjustments in administered prices.

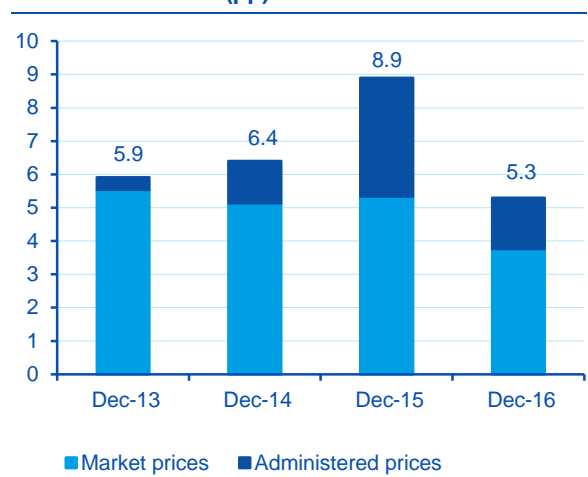
With respect to non-administered prices, they have remained broadly stable lately (7.7% in July, compared to 7.1% and 7.9% in July 2014 and July 2013 respectively), in spite of the sharp deceleration of domestic demand and the recent deterioration of domestic labour markets.

Figure 4.8
Inflation (% YoY)*



* BBVA Research forecasts from August 2015 onwards.
Source: IBGE and BBVA Research

Figure 4.9
Contribution from market and administered prices to annual inflation (pp)



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

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%. The inflation rate should then decelerate more significantly during the first half of 2016, when the effect of the adjustment in regulated prices implemented at the beginning of 2015 will start to fade away. Moreover, the contraction of domestic demand and the sharp slowdown in labour markets should drive down market inflation to 5.3% at the end of 2016. However, the effects of the sharp exchange rate depreciation and the strength of inertial factors should play against the moderation of inflation next year. Regarding the latter, it is worth reminding that the minimum wage, which is still an important reference for local labour markets, will be revised around 9% up at the beginning of 2016². Taking all these factors into account, we expect inflation to reach 5.3% at the end of 2016, much lower than 2015 inflation, but still above the 4.5% inflation target (Figure 4.9).

2: The law establishes that minimum wage adjustment in a given year is equal to inflation in the previous year plus GDP growth two years ago. With inflation expected to reach 8.9% in 2015 and taking into account that GDP grew 0.1% in 2014, one arrives at the 9.0% figure.

Box 1: Brazil’s long-term potential GDP is estimated at 2.2%

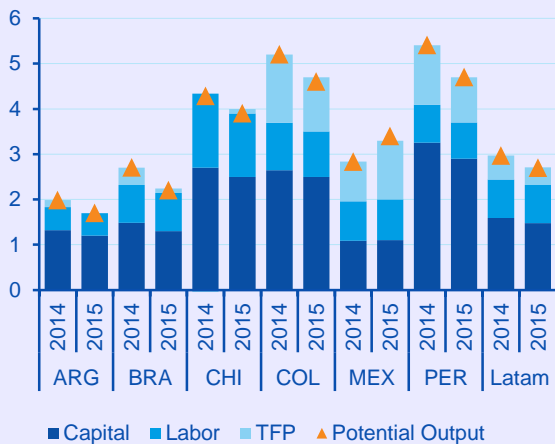
We have revised our estimates of potential output and the contributions of its various elements, i.e. capital, labour and total factor productivity (TFP), for Brazil and other economies in Latin America^{3 4}. The results suggest a long-term potential GDP, defined here as the average of potential GDP for the period 2016-20, of 2.7% for Latin America, below the estimate of 3.0% made a year ago (B.1.1). We are revising down our estimate of long-term potential GDP in all the South America countries considered: Argentina, Brazil, Chile, Colombia and Peru, in contrast to Mexico, where we have revised our estimates upwards. Highlights include downward revisions in Peru (-0.7pp), Colombia (-0.6pp) and Brazil (-0.5pp), and, in contrast, an upward revision in the case of Mexico (0.6pp).

during the boom years. We also note that, in terms of potential GDP components, the main determinant of the downward revision of potential GDP in South American countries has been the worsening perspective on the evolution of TFP and, secondly, the lower expected contribution of capital.

In the case of Brazil, long-term potential growth is estimated at 2.2% (Figure B.1.2.), 0.5pp lower than the estimation we obtained one year ago (-0.3pp is due to lower estimates for TFP and -0.2pp to a downward revision of the contribution of capital).

Our estimates show that the annual potential growth will remain relatively stable in Brazil in future (Figure B.2.2), below the levels in the recent past. Our current estimate of potential GDP reflects the structural problems that have undermined the economy in recent years and our view that most of them will not be addressed in the near future.

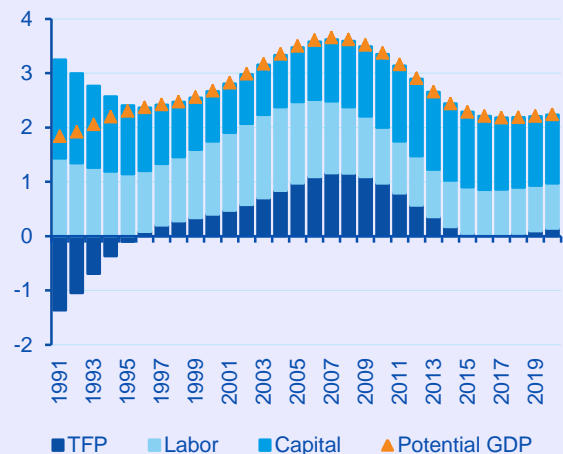
Graph B.1.1
Potential long-term growth (% annual average from 2016 to 2020; 2015 vs. 2014 estimate)



Source: BBVA Research

In general, the potential output is now lower than previously estimated for reasons including the less favourable external environment and the inability to implement reforms and other measures to raise capital accumulation and productivity

Graph B.1.2
Brazil: potential output and contributions



Source: BBVA Research

3: For previous revisions, see our reports: 3Q13 Latam Economic Outlook and 3Q14 Latam Economic Outlook.

4: To assess the potential for long-term growth, that is, potential GDP, we estimated a production function in which potential output of each economy depends on the stock of accumulated capital, available labour, the Non-Accelerating Inflation Rate of Unemployment (NAIRU) and total factor productivity (TFP), which can be understood as the efficiency with which capital and labour factors are combined.

Box 2: Changes in the exchange rate pass-through in Brazil?

While, on the one hand, inflation has been surprising to the upside in Brazil in recent months, on the other the exchange rate has been depreciating significantly lately. The simultaneity of these two phenomena raises the question whether they are related or not. In particular, it could be the case that upside surprises in inflation are, to some extent, due to a higher exchange rate pass-through into prices⁵. In order to analyse the contribution of exchange rate variations to the recent inflation surprises in Brazil and contrast empirically whether there has been a recent increase in the rate of pass-through, we conducted two empirical exercises: the first was an estimation of a Phillips curve using the two steps least squares method (2SLS) and the second was a VAR with time varying coefficients (TVC-VAR).

In the first case⁶, market inflation (which excludes from the general CPI those products and services whose prices are regulated by the government) is assumed to be determined by past market inflation, inflation expectations, the output gap, commodity prices, variables to control for supply shocks and exchange rate (USD/BRL). Using quarterly data from 1Q99 to 2Q15, we found virtually identical results in the response of inflation to exchange rate moves to that found in the estimates with data up to 1Q14, suggesting that there has been no change in the coefficient of pass-through in the last year and, therefore, it continues to be no higher than 5%.

In the second model, we used monthly data from Jan-00. Estimates using data up to May 2015 were compared against those obtained with data up to May 2014⁷. We included the following

variables as endogenous: an index of economic activity (the BCB's IBC-Br), the Selic rate, the exchange rate against the dollar and the price index (general or market prices). As exogenous variables we included US industrial production, the Fed funds rate, the index of US consumer prices and an index of commodity prices. The results indicate that the response of annual depreciation on market-price inflation has remained virtually unchanged over the last year (Figure B.2.1), and is between 3% and 5% (the May-15 impact is within May-14 confidence range as exhibited in Figure B.2.2). When using the general index (including government-administered goods), rather than market inflation, the pass-through decline slightly, from 5% to 2% over the last year (Figure B.2.2). Anyway, we attach less importance to this latter finding, as we interpret this decline as a consequence of the increasing pressure from administered prices over inflation in the last months⁸ (i.e. the pass-through has a lower explanatory power because administered prices have a more important role explaining general inflation movements).

Interestingly, we found no evidence of asymmetric response in the exchange rate pass-through: the response appears to be no greater in moments of depreciation than in moments of appreciation.

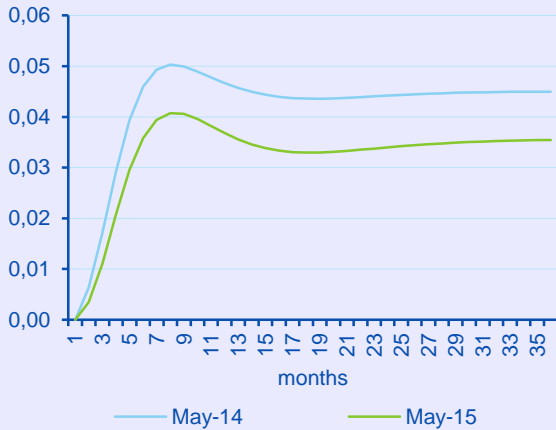
5: Simultaneous upward inflationary surprises and exchange rate depreciations have also been observed in other Latin American countries, which has deserved an analysis in the Box 2 of our [3Q15 Latin America Economic Outlook](#).

6: In this case we follow the model introduced by the BCB in its 2Q15 Inflation Report.

7: The reason for making the estimation by a TVC-VAR is that with this method we obtain the estimation at each point in time rather than sample average as in a traditional VAR. The TVC-VAR allows the estimated coefficients to change over time; to take account of the changes affecting the relationship between the variables. The effect of the exchange rate pass-through is calculated as the cumulative response over the first year of inflation to a 1% variation in the exchange rate.

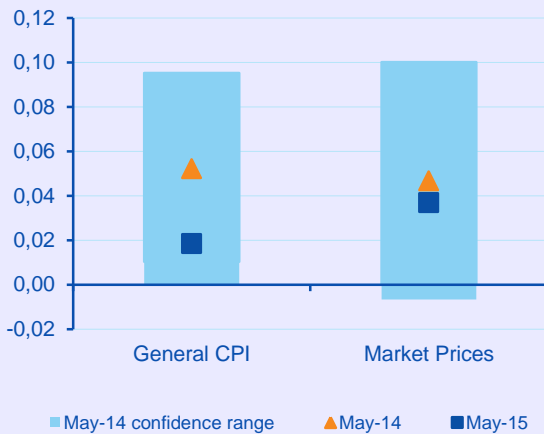
8: See Section 4 for more details.

Figure B.2.1
Accumulated impulse response from exchange rate to market prices



Source: BBVA Research

Figure B.2.2
Accumulated exchange rate pass-through in one year: sample until May-14 vs. sample until May-15



Source: BBVA Research

Conclusions

In line with our two empirical exercises, we conclude that the pass-through of exchange rates to domestic prices in Brazil is between 3% and 5%. Moreover, we found almost no evidence of a significant change in the pass-through coefficient in the last year, meaning that recent inflationary surprises are probably related to other factors (such as larger-than-expected administered-price inflation).

While there are some factors that may lately be driving the pass-through coefficient downwards (in its Inflation Report 1Q15, and the Brazilian central bank quoted some of them: economic activity weakness, the restrictive stance of monetary policy and a lower depreciation of the effective – multilateral - exchange rate compared to the bilateral exchange rate USD/BRL), the relative stability of the pass-through coefficient found in our models implies that there are other factors working in the opposite direction (such as the magnitude of the ongoing exchange rate depreciation and the perception that the depreciation is a permanent rather than a temporary phenomenon).

5 The monetary tightening is over, but the fiscal adjustment still has a long and uncertain way to go

The larger-than-expected monetary tightening is over. The next easing cycle is still far away and will not be as aggressive as the previous ones.

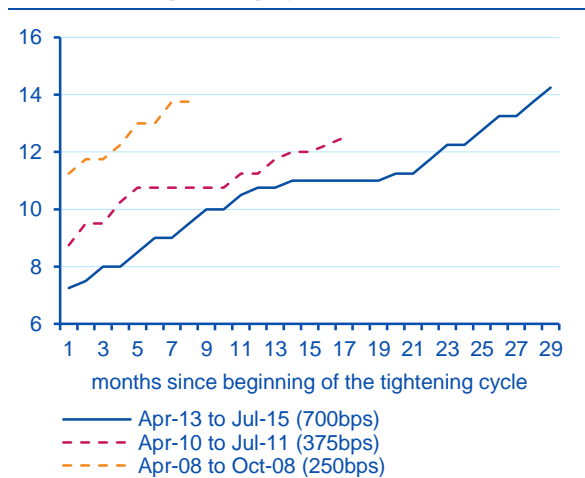
After adjusting reference interest rates up in each monetary policy meeting since April 2013, with the exception of the three meetings that preceded the presidential elections in October 2014, and taking the Selic rate to 14.25%, the Central Bank of Brazil (BCB) signalled in July that the tightening cycle is now over. Even though the monetary authority suggested that it could further tighten monetary conditions in the case of further fiscal policy softening or of additional exchange rate depreciation, in our view the Selic rate will now remain stable for some time.

The recent monetary policy tightening was not only longer than the previous ones. It was also larger (Figure 5.1). The adjustment process of the Selic rate, that we think ended in July, lasted for 28 months and implied a 700bp increase in the policy rate. The two previous cycles, from April 2010 to July 2011 and from April 2008 to October 2008, were shorter (16 and 7 months respectively) and smaller (375bp and 250bp respectively).

In our opinion, the main reasons for the BCB having adopted a more aggressive monetary policy since the beginning of 2013, and especially in the year up to date, are the higher inflationary pressures than in the past, the need to compensate for the sharp fiscal deterioration and the desire to recover the credibility lost during the last easing cycle, which lasted until September 2012, when it was perceived to be more tolerant with respect to inflation.

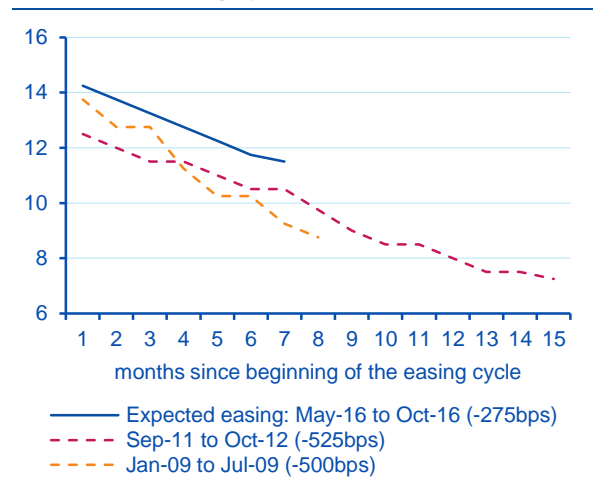
Looking forward, we expect the Selic rate to remain at the current 14.25% level, which is the highest in ten years and which leaves monetary policy in a restrictive stance, until the second quarter of 2016. By then we expect inflation to be once again within the 2.5-6.5% range and expectations regarding 2017 inflation to be close to 4.5%.

Figure 5.1
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

Figure 5.2
Selic rate in easing cycles (%)*



* Includes the easing cycle that we expect to start next year and the previous two.
Source: BCB and BBVA Research

Following a more aggressive tightening cycle, we expect the BCB to start in 2016 an easing cycle. In our view, the forthcoming cycle of downward adjustments of the Selic rate will be softer than the previous ones (Figure 5.2), not only because credibility will continue to be an issue, but also because the tightening of the monetary policy by the Fed in the USA, the exchange rate depreciation and the risks related to a more gradual fiscal adjustment – including the risk that the country will lose its investment grade – will continue to weigh on it.

Finally, it is worth noting that the 2017 inflation target range was narrowed to 3.0-6.0% from 3.5-6.5%. In our view, this was a welcome step to increase the BCB's commitment to reach the 4.5% central target. It is important that the BCB continues to be focused on recovering/maintaining its reputation for fighting inflation and that the Brazilian inflation targeting system continues to be adjusted to allow for a reduction of the 4.5% target, which is much higher than in other similar countries, sometime in the future.

Economic and political headwinds induce a more gradual adoption of the fiscal adjustment, hindering the recovery of confidence and leaving the country on the verge of losing its investment grade

In addition to reinforcing a moderation in the growth of credit from public banks and adopting a necessary correction in administered prices, a set of measures was implemented during the first half of the year to reduce public expenditure and increase fiscal revenues (see our [2Q15 Brazil Economic Outlook](#) for a review of such measures). As a consequence, the government was able to put an end to the primary result's negative trend. After a continuous deterioration since the end of 2011, when the primary surplus was around 3.0% of GDP, until the end of 2014, when the primary result reached -0.6% of GDP deficit, the primary fiscal result stabilised at around -0.7% of GDP during the first half of 2015 (Figure 5.3).

However, more than stabilising the primary result at negative levels, the government had committed at the end of 2014 to deliver primary surpluses of 1.1% of GDP in 2015 and 2.0% in 2016 and 2017, to address the concerns about the sharp increase in the public sector's gross debt, which had jumped from 53.3% of GDP at the end of 2013 to 58.9% at the end of 2014, to re-establish the credibility in fiscal policy and to pave the way for a recovery of economic activity.

In practice, however, the government faced two major obstacles in delivering the fiscal targets. On the one hand, the sharper-than-expected deceleration of economic activity generated lower-than-expected fiscal revenues. On the other hand, the process of getting the Congress to approve the fiscal measures to increase revenues and cut expenditure was tougher than the government had anticipated, due to the worsening of the relationship between the presidency and the legislative body in an environment characterised by the rapid decline in President Dilma Rousseff's approval ratings and the spillovers of the Petrobras bribery scandal.

As a consequence, the government announced a reduction of the primary surplus targets to only 0.15% of GDP in 2015, 0.7% in 2016, 1.3% in 2017 and 2.0% in 2018. In fact, it was also announced that the 2015 target could be reduced further and a deficit could emerge again this year if the Congress refuses to approve some pending measures.

Even though the fulfilment of the reduced targets would still represent a tightening of fiscal policy, it would imply that the public gross debt will increase more and for a longer time (it would only stabilise after 2018 above 70% of GDP).

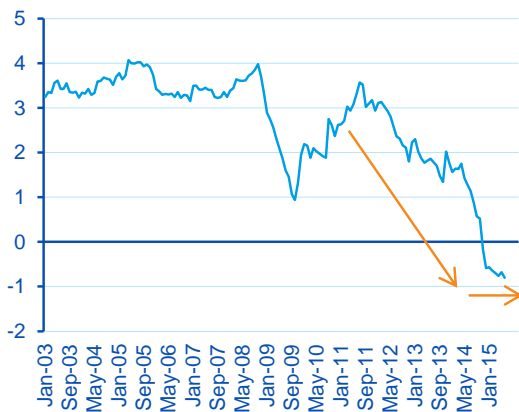
With the adoption of a more gradual fiscal adjustment, the government puts more pressure on monetary policy, refrains from addressing the concerns on the evolution of its debt and fails to re-establish the credibility of its fiscal policy, which, in turn, makes the recovery of confidence – and therefore of economic activity – more difficult.

Following the announcement of the reduction in fiscal targets, the rating agency S&P revised the outlook attached to its BB- ratings to “negative” from “stable” and Moody’s downgraded the country’s sovereign rating to Baa3 from Baa2, which attaching a “stable” rating outlook to it.

We expect the new 2015 and 2016 primary surplus targets to be reached. However, interest payments should increase to 6.8% of GDP in 2015 from 5.7% in 2014, due to higher Selic levels and the costs of carrying exchange rate swaps of around USD100bn during a period of currency depreciation, and then to decline to reach 6.6% in 2016. Taking that into account, the total fiscal deficit should increase from 6.2% of GDP in 2014 to 6.8% in 2015 and then decline to 5.7% of GDP in 2016, which would still be higher than the total deficits between 2002 and 2013 (Figure 5.4).

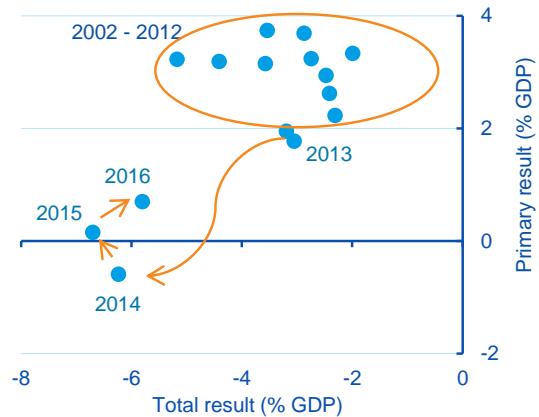
In our view, it will be very difficult for the government to avoid losing its investment grade in the future. Not only there is no clear and solid improvement in the fiscal accounts at sight, as there are economic and mainly political associated risks that could end up by determining a larger-than-expected deterioration of fiscal accounts in the future.

Figure 5.3
Primary surplus (% of GDP; accumulated in the last 12 months)



Source: BCB and BBVA Research

Figure 5.4
Fiscal result: primary and total (% of GDP)



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

6 The domestic environment favours a current account adjustment going forward

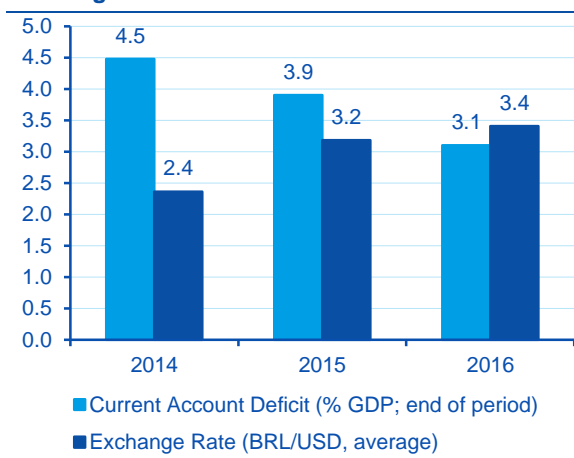
The exchange rate will remain more depreciated in the future than it was in past years. That, and the contraction of domestic demand, will trigger a reduction of the current account deficit

The exchange rate could go appreciate somewhat in the remainder of the year, following the vertiginous depreciation observed in the last few months (see Section 3 for recent financial market movements). In spite of that, the Brazilian real (BRL) should remain at much weaker level going forward than it was in the past: we forecast it to average 3.2 reals per dollar in 2015 and 3.4 in 2016, compared to 2.4 in 2014, 2.2 in 2013 and 2.0 in 2012.

Both external and internal factors support this view. Regarding the former, the US monetary tightening, which we expect to start in September, will contribute to a moderation in capital flows into Brazil in the next few years (our estimate is that flows into Latin America will decline by around 2% of its GDP in the next two years) and drive the BRL further down. Another external factor that should also favour a weaker exchange rate is the moderation of the Chinese economy mainly due to its impact on commodity prices. Even though we do not expect them to continue to decline further, they are likely to remain at much weaker levels than observed a few years ago (see our [3Q15 Latin America Economic Outlook](#) for more details on our views on commodity markets).

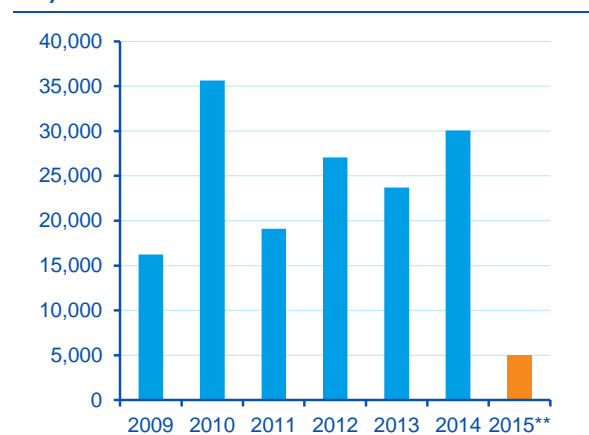
Regarding the internal factors that favour the weakening of the BRL, we highlight, in addition to economic deceleration and negative political dynamics, the apparent unwillingness of local authorities to prevent exchange rate depreciation (the costs of carrying USD100bn exchange rate swaps, accumulated by the BCB from the end of 2013 until the beginning of 2015, during a period of exchange rate depreciation should to some extent inhibit additional BCB interventions on exchange rate markets). More importantly, the country faces the necessity of addressing the manufacturing sector’s competitiveness problem, to increase the external sector’s contribution to GDP growth and to reduce the current account deficit.

Figure 6.1
Exchange rate and current account



Source: BCB and BBVA Research

Figure 6.2
Brazilian debt issued in foreign markets (USD mn)*



* Debt issued in foreign currencies by the sovereign and by corporates. ** Until 7 August.
Source: Bloomberg and BBVA Research

Some of the latter adjustments have already started to happen. In fact, the current account deficit declined 23% in the first half of 2015 in comparison to the same period last year. Even though the exchange rate has been contributing to this correction, its main driver has been the impact of the ongoing domestic demand contraction on goods imports (-18% in 1H15). With respect to exports, they dropped 15% in the first half by comparison with the first six months of 2014, which reveals that the support from a weaker BRL is still insufficient, especially if we take into account that Brazil's terms of trade (i.e. the ratio between its export and import prices) continue to decline.

Looking forward, we expect both the exchange rate depreciation and the sharp slowdown of domestic demand to continue to determine a moderation of the current account deficit. More precisely, we forecast it to decline from 4.5% of GDP in 2014 and 4.4% in June of 2015 to 3.9% at the end of 2015 and 3.1% in December 2016 (Figure 6.1). This year, most of the correction is expected to be due to a contraction of imports, while in 2016 a more positive performance by exports should also play an important role.

A smaller current account deficit will be more in line with an expected reduction of the external funding in the forthcoming years, in an environment in which international liquidity will not be as in the past. In fact, this has already been happening. During the first half of the year, the overall external funding (according to the balance of payments data published by the BCB) dropped by 21%, highlighting a 32% reduction in the foreign direct investment (FDI) into the country, which stood at 3.8% of GDP in June. With respect to capital flows, they declined 17% in the first half of the year, in spite of the significant increase in domestic interest rates. The lower availability of external funding is also evidenced by the volumes of debt issuance in foreign markets: only USD5.0bn in this year up to the beginning of August, which represents 17% of the total issued last year (Figure 6.2).

7 Forecast tables

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

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