Brazil Economic Outlook

4TH QUARTER 2015 | LATIN AMERICA UNIT

01
Political turbulence curbs the fiscal adjustment and fuels the uncertainty, undermining the economy

02
Longer and deeper recession: GDP will contract significantly in 2015 and will drop again in 2016

03
After peaking around 10% at the end of 2015, inflation will moderate in 2016 but will remain relatively high

04
A more depreciated exchange rate will allow the current account deficit to decline significantly

Index

Closing date: 25 November 2015

1 Overview

Global environment: slower growth in 2015 and limited improvement in 2016. Global growth continues to pick up, although less strongly, with weakness in emerging markets. Uncertainty about Chinese long-term prospects remains (which caused an increase in market volatility in July-August) and the Fed's lift-off is pushed back to December, with a slower tightening path in 2016.

Political turbulence curbs the fiscal adjustment and fuels the uncertainty. President Dilma Rousseff's approval rating declined to only 14% from 48% one year ago, helping to maintain political turbulence alive. The government has been facing significant hurdles in getting the Congress to approve most of its proposals, in particular those related to the necessary correction of the fiscal accounts. On top of that, both a worse-than-expected deterioration of fiscal accounts in 2014 and the impact of a sharper recession in public revenues are undermining the adjustment. Fiscal targets have been revised downwards, reinforcing the perception of fiscal deterioration and triggering a downgrade of Brazil's sovereign rating to high-yield by S&P. The fiscal adjustment ahead is likely to be too slow and too mild to prevent fiscal indicators from continuing to worse. We expect the fiscal deficit to reach 9.1% of GDP in 2015 and 7.7% of GDP in 2016, and the gross public debt is likely to increase to 68% of GDP this year and to 72% of GDP in the next one. In this environment, the most likely consequence is that, after being downgraded by S&P to high-yield in September, Brazil will have its investment grade withdrawn by a second credit rating firm in the coming months.

Longer and deeper recession: GDP will contract significantly in 2015 and will drop again in 2016. GDP declined in 1Q15 and 2Q15 and recent activity data suggest that growth will remain in non-positive territory in the second half of the year. In addition to the impact of political and fiscal turbulence, economic activity is being hit by other domestic factors such as the tighter tone of monetary and fiscal policies this year in comparison to 2014, the impact of the exchange rate depreciation and of the sharp adjustment in the administered prices, and the effect of the recent corruption scandals on Petrobras and the construction sector. Moreover, the sharp reduction in the terms of trade, mostly due to the moderation of economic activity in China, is also playing a significant role in the ongoing recession. We expect economic activity to contract by 2.5% and 0.5% in 2015 and 2016 respectively. A milder slowdown next year should be the consequence of a less negative joint effect of the factors highlighted before, especially of a much smaller reduction in Brazil's terms of trade. Anyway, risks to our forecasts are tilted to the downside as the evolution of domestic labour markets or of the Chinese economy, for example, could be worse than we are currently expecting.

Higher inflation; unchanged interest rates. Inflation continues to trend upwards, fueled by larger-than-expected adjustments in regulated prices. We expect it to close the year at 10.0% and then moderate gradually next year, when the process of alignment of administered prices will be mostly over. Anyway, inertia and the effect of a weaker exchange rate should prevent inflation from converging to the 4.5% target next year. In our view, inflation will close 2016 at 5.5%. In spite of its deviations from the target, we expect the BCB to also take into account the weakness of economic activity and leave interest rates at 14.25% for some time, at least until the middle of 2016.

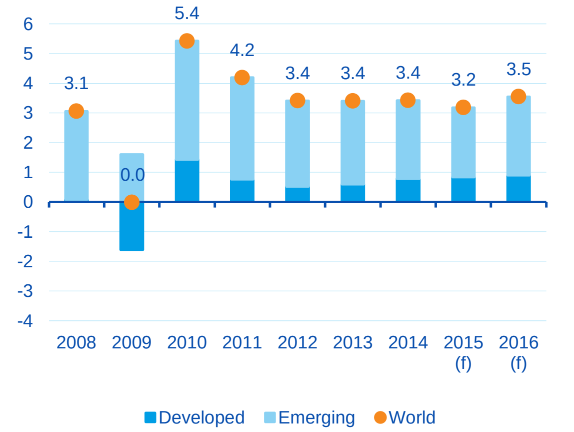
A more depreciated exchange rate will allow the current account deficit to decline significantly. Local financial markets recently went through turbulence only comparable to the episodes observed in 1999, 2002 and 2008, mainly due to concerns about the Chinese economy and the sharp fiscal deterioration. Even though financial markets have calmed down since the end of November, we are sceptical about the continuity of the recent upward trend in local asset prices. We expect the exchange rate to be close to 4 reais per dollar in the next few months and to be around 17% weaker in 2016 than in 2015. The depreciation of the exchange rate will allow the current account deficit to adjust to the new environment, characterised by the reduced availability of external funding. We forecast the current account deficit to decline to 3.8% of GDP and 2.6% of GDP, respectively, in 2015 and 2016.

2 Global environment: slower growth in 2015 and limited improvement in 2016

According to our estimates, global GDP has made four consecutive quarters of growth below the 2010-14 average. Mainly due to the ongoing deceleration in the principal emerging economies, in a context in which doubts over the strength of the economic cycle and the financial stability of China have triggered a significant spike in financial tensions and further corrections in commodity prices.

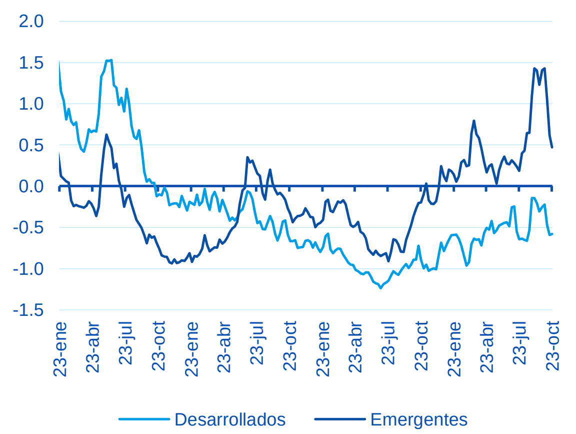
Global GDP growth could close 2015 at an annualised 3.2% (0.2% less than we forecast three months ago), the lowest since 2009 (see Figure 2.1). The gradual recovery of the developed block will not be sufficient to offset the moderation in the emerging, given that the latter will grow barely 4% compared with average growth in the five previous years of more than 5.5%. The outlook for 2016 is slightly more favourable (global growth could recover to 3.5%, 0.3% below our forecast three months ago), sustained by a better relative performance of both the developed and the emerging economies.

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



Source: BBVA Research

Figure 2.2
BBVA Financial Tensions Index



Source: BBVA Research

All in all, the stabilisation of commodity prices at low levels and the sustained rise in financial tensions in the emerging economies (Figure 2.2) - accompanied by heavy capital outflows, sharp currency depreciation and a widening of sovereign spreads - are evidence that the balance of global risks is still to the downside. Even when monetary policy could mitigate the impact of a scenario of slower growth on global financial conditions, the scope it has to kick-start the economic cycle is reduced, taking into account the low levels of interest rates and the high volume of liquidity already in existence. The combination of a financial shock in China, which takes the annual growth of that economy well below 6%, with an even slower recovery of the developed economies block than observed to date is a significant risk scenario, both because of its plausibility (limited, but not negligible) and its severity, given its potential impact on the world economy in general and on Latam in particular (see Box 1).

USA: downwards revision to GDP growth expected for 2016 due to the deterioration in the external environment

As regards the detailed analysis of the principal economies, note the stabilisation of economic growth in the US at lower rates than in other recovery episodes. Private consumption remains key to the healthy momentum of economic recovery; although not sufficient to offset the drops in both exports and investment in the energy sector (the fall in production and the erosion of oil companies' profitability anticipate a sharper correction in investment in the sector). GDP growth could reach 2.5% in 2015 and 2016.

The risks for the US economy in a more unfavourable global environment are determining the Fed's reaction function, and the start of the first interest rate hike, which would take place in December. In any case, the pace of rate increases is expected to be very gradual, probably reaching levels at end-2016 below those that we expected a quarter ago, and no higher than 1%.

China: upwards revision of GDP growth expected for 2015, although this will not dispel the uncertainties over the pace of future economic deceleration

China's cyclical position is obviously one of the principal variables to watch at a global level. The sharp stock market correction in August served as a warning of the risks posed by a financial shock in the country of a severity to compromise the growth in domestic spending. The magnitude of the capital outflows and the spike in financial volatility resulted in the introduction of a considerable battery of monetary policy measures directed at easing the deterioration in liquidity and its potential impact on the financing model of the corporate sector, which is heavily leveraged. The unexpected official announcement regarding the daily yuan exchange rate and the progressive cuts in reference rates fall into the same context, and are also characterised by a progressive deceleration of economic activity, which has taken GDP growth below 7% YoY in the third quarter.

It seems that the authorities will continue to employ monetary stimulus measures (further interest-rate cuts have not been ruled out, in spite of the fact that there have already been five such cuts in the year to date) and to exploit the central government's scope to use fiscal policy to ensure that economic growth does not fall below 6% YoY. Our forecasts suggest GDP growth of 6.9% for 2015 and 6.2% for 2016.

Eurozone: resilient domestic demand with the ECB ready to avoid further declines in inflation

In the Eurozone, the economic recovery continues although the pace has not intensified as we anticipated three months ago. The pace of Eurozone GDP growth could increase to 1.8% in 2016 (less than 10bp less than we expected last quarter). Italy and France should explain the improvement in the overall figure. The accentuation of the risks to the downside to inflation forecasts, largely due to cheaper imported goods, together with the recent appreciation of the euro, once again raises the question as to how much room for improvement there is in monetary conditions in the Eurozone. The ECB is extremely sensitive to this scenario, and this would justify the adoption of new stimulus measures in the short term.

3 Political turbulence curbs the fiscal adjustment

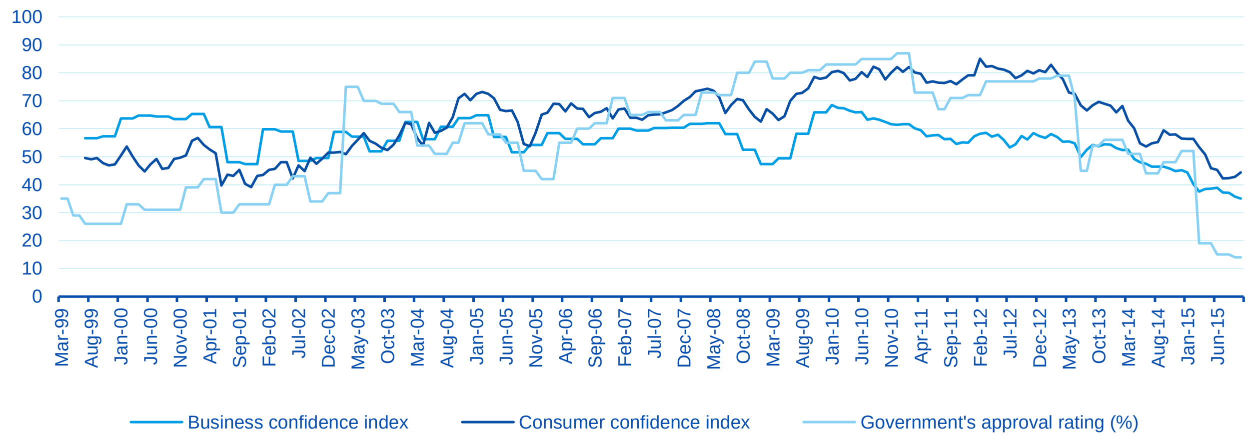
The political environment remains unstable

Surveys show that only around 14% of the population currently approves the government of President Dilma Rousseff. That is much smaller than one year ago, when the president was finishing her first four-year mandate and had just been elected to a new one. At that point, the government's approval rating was of 48%. And it was 71% exactly four years ago, in November of 2011, the first year of President Rousseff's first mandate (Figure 3.1).

In our view the three main factors behind this sharp deterioration in the approval rating of the Rousseff government are: i) the slowdown of economic activity; ii) the outbreak of some corruption scandals, mainly the Petrobras one, and iii) the relative contrast between the ideas defended by President Dilma Rousseff during last year's presidential campaign and the economic policies adopted following the elections.

The very low approval rating is one of the elements that is helping to undermine President Rousseff's government. It is not the only one, though. The problems of dealing with the Congress and also with the parties within the government coalition are also important. Moreover, the government –and the whole political environment- is being shaken by the Operation "Car Wash", the investigation being conducted by the Federal Police of Brazil on corruption at the state-controlled oil company Petrobras, which has already implied the arrestment of prominent political and private sector figures.

Figure 3.1
Government's approval rating (%) and confidence indices



Source: CNI, IPEADATA and BBVA Research

As a consequence of the turbulent political environment, the government has been facing significant hurdles in getting the Congress to approve most of its proposals, in particular those related to the necessary fiscal adjustment. Anyway, it is important to note that in spite of such hurdles, up to now many of the projects presented by the government have been approved by the legislative chambers. It is also important to highlight, though, that getting the Congress to approve the proposed measures generally took general much longer and required accepting more changes in the original projects than the government had expected. Having said that, it is not clear at this point whether and when the government will be able to get approval for some of the most important measures to continue implementing the fiscal adjustment, such as the recreation of the CMPF financial transactions tax.

Another consequence of the current political context was the emergence of talks to impeach President Rousseff. Even though that scenario cannot be ruled out, in our view the most likely scenario is that the current government will be able to survive until the end of its term, probably in a muddling-through mode.

Finally, it is worth emphasising the abnormally high degree of political uncertainty currently prevailing in Brazil. This helps to drive confidence levels down (Figure 3.1), having a negative impact on the economy and fueling a perverse feedback between economics and politics.

Without political support, the fiscal adjustment will be implemented at a slow pace and public accounts will continue to deteriorate rapidly

Since the aftermath of last year's elections, the government has been trying to adopt a fiscal adjustment to prevent a further deterioration in the public accounts. However, as commented before, the political turmoil has been an obstacle for the adjustment. Even though many measures to increase revenues and cut expenditure have been implemented, this has been happening at a relatively slow pace.

In addition to the difficulties in getting fiscal measures approved, at least two additional problems have been undermining the adjustment. The first is the fact that the fiscal deterioration in 2014 was larger than initially expected. The primary result last year ended up being equal to -0.6% of GDP, much higher than initially expected. Moreover, following a judicial decision, the government will have to pay this year - or over the forthcoming years if its request to do so is finally accepted by the audit office – an amount equivalent to BRL57bn –around 1.0% of GDP- related to the debt accumulated in 2014 with state banks and funds, which made upfront payments on some federal government's economic and social projects without being reimbursed (this has been referred locally as "pedaladas" or "backpedalling").

The second additional problem is that the ongoing recession has been much sharper than expected, which means that public revenues are declining more than initially forecast.

Considering all this, the government was forced to revise downward the primary surplus targets that the Minister of Finance, Joaquim Levy, announced at the end of last year right after being appointed by President Rousseff. In June, they were cut to 0.15% of GDP in 2015, 0.7% of GDP in 2016 and 1.3% in 2017 from 1.1% in 2015 and 2.0% in both 2016 and 2017. More recently, at the end of October, a new target for 2015 was established: the public sector committed to generate a primary result no worse than -0.85% of GDP, or -2.0% of GDP if the government is finally forced to pay this year the aforementioned "pedaladas" and if the government fails to raise around 0.15% of GDP in the hydroelectric sector auctions until the end of the year.

We suppose that at least a significant proportion of the "pedaladas" will be paid this year and, therefore, that the primary deficit will be around 1.5% of GDP this year. This will represent an additional worsening in comparison to last year's primary deficit of 0.6% of GDP, not to say to the surpluses of 3.0% of GDP produced some few years ago (Figure 3.2).

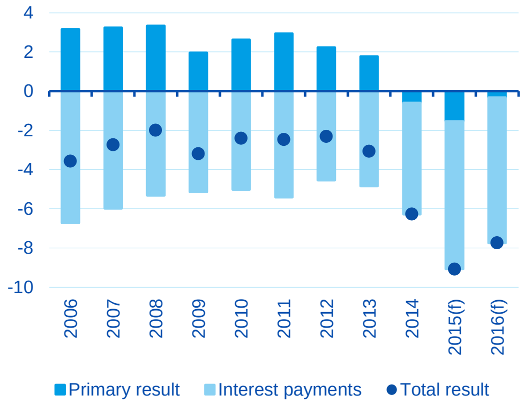
The same problems faced in 2015 – contracting economy, political turbulences, and the payment of part of the "pedaladas" – are likely to play a negative role on fiscal accounts in 2016. Regarding the government proposal of recreating the CPMF financial transaction tax, which would raise federal revenues by around 0.8% of GDP per year and is the main piece of its adjustment plan going forward, we remain sceptical about its approval by the Congress. Anyway, we think that other measures to increase revenues and cut expenditure will be gradually adopted. All in all, we expect the public sector to post a third consecutive primary deficit in 2016. More precisely, we expect the primary result to reach -0.3% of GDP next year.

In addition to the deterioration in the primary account, interest payments are expected to increase as a consequence of a higher Selic rate, higher risk premia and the cost of holding a stock of FX swaps of around

USD100bn while the exchange rate depreciates (the latter is around 1.7% of GDP in the year up to September). More precisely, we forecast interest payment to jump to around 7.5% in both 2015 and 2016, taking the total fiscal result to -9.1% of GDP in 2015 and -7.7% of GDP in 2016. In this context, the public sector gross debt is likely to increase to 68% of GDP this year and to 72% of GDP in the next one, from 66% in September and 59% in December 2014 (Figure 3.3).

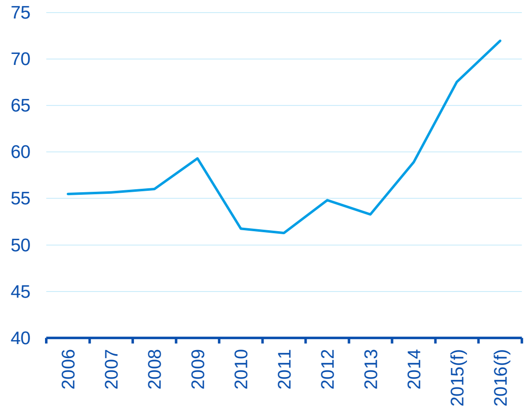
Therefore, in few words, the fiscal adjustment ahead is likely to be too slow and too mild to prevent fiscal indicators from continuing to worsen. In this environment, the most likely is that, after being downgrade by S&P to high-yield in September, Brazil will have its investment grade withdrawn by a second credit rating agency in the forthcoming months (for more details about this issue see BBVA Research's Latin America Economic Watch "Brazil: back to high-yield").

Figure 3.2
Public sector's fiscal accounts: primary and total results (% of GDP)



Source: BCB and BBVA Research

Figure 3.3
Central government's gross public debt (% of GDP)



Source: BCB and BBVA Research

4 Longer and deeper recession; higher inflation

Economic activity: still in free-fall

Most indicators show that, after remaining broadly stable in 2014, economic activity has been declining sharply this year. Brazil's GDP, which grew only 0.1% last year, contracted 0.7% QoQ and 1.9% QoQ in 1Q15 and 2Q15 respectively.

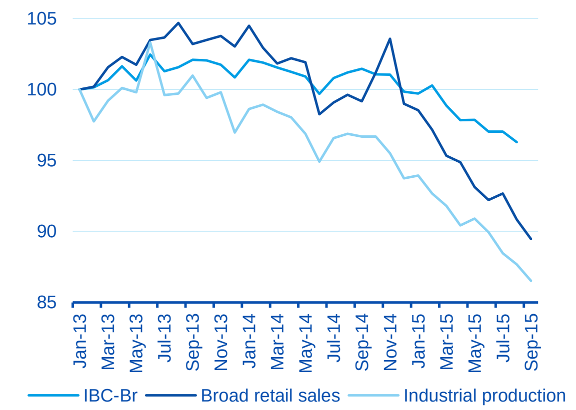
Recent data show that economic activity continued to decline in 3Q15. The BCB's activity indicator, the IBC-Br, contracted 1.4% QoQ in the quarter. The retail sales indicator, which works as a proxy for private consumption, dropped 2.6% QoQ in the period. Industrial production, a supply-side indicator, declined 3.2% QoQ (Figure 4.1).

There are clear signs of slowdown in credit and labour markets (Figure 4.2). Regarding the former, even though non-performing loans remain relatively stable around 3.0%, the credit stock is now contracting in real terms, as the nominal growth rate (9.1% YoY in September) is running below the inflation rate. Regarding the latter, after showing resilience in 2014, the unemployment rate started to increase sharply since the beginning of the year. In September it reached 7.9%, in comparison to 4.9% in the same month last year.

Therefore, taking all these indicators into account, the most likely result is that GDP will have contracted again in 3Q15. Even though most recent data show that there is a significant risk that our -0.5 QoQ GDP forecast proves to be too optimistic, they reinforce the view that the contraction will not be as large as in 2Q15.

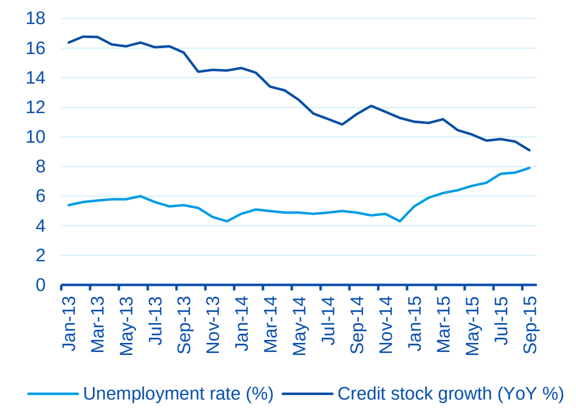
There are external and local factors behind the strong downward correction of economic activity in Brazil. With respect to the external environment, the main driver is the 11% decline in the country's terms of trade (i.e. the ratio between the price of Brazilian exports and the price of its imports). This is largely due to the contraction in the price of some commodities produced by Brazil, which is a consequence of the moderation of economic activity in China. As an example, the soybean and iron ore prices are now around 10% and 20% lower than twelve months ago.

Figure 4.1
Economic activity indicators: BCB's activity indicator (IBC-Br), retail sales and industrial productions (seasonally adjusted series; index Jan 2013 = 100)



Source: BCB, IBGE and BBVA Research

Figure 4.2
Labour and credit markets: unemployment rate and credit stock growth



Source: BCB, IBGE and BBVA Research

On top of the Chinese slowdown, the turbulence generated by the imminent normalisation of monetary policy in the US and the growth moderation faced by Latin American countries, especially by Argentina which is one of the main markets for Brazilian products, are also weighing negatively on Brazil's activity situation.

Regarding the domestic determinants of the ongoing deceleration of the Brazilian economy, we highlight the political and fiscal problems commented on in the previous sections, which are helping to drive confidence levels to historically low levels. Economic activity is also being hit by the tighter tone of both monetary and fiscal policies this year in comparison to 2014, the impact of the exchange rate depreciation and of the sharp adjustment in the prices of regulated products and services (mainly electricity tariffs) on the costs faced by consumers and producers, and the effect on the activities of Petrobras and some of the most important construction companies due to the ongoing bribery scandals involving them (the oil extraction and construction sectors together represent around 9% of GDP).

We expect GDP to contract 2.5% in 2015 and 0.5% in 2016

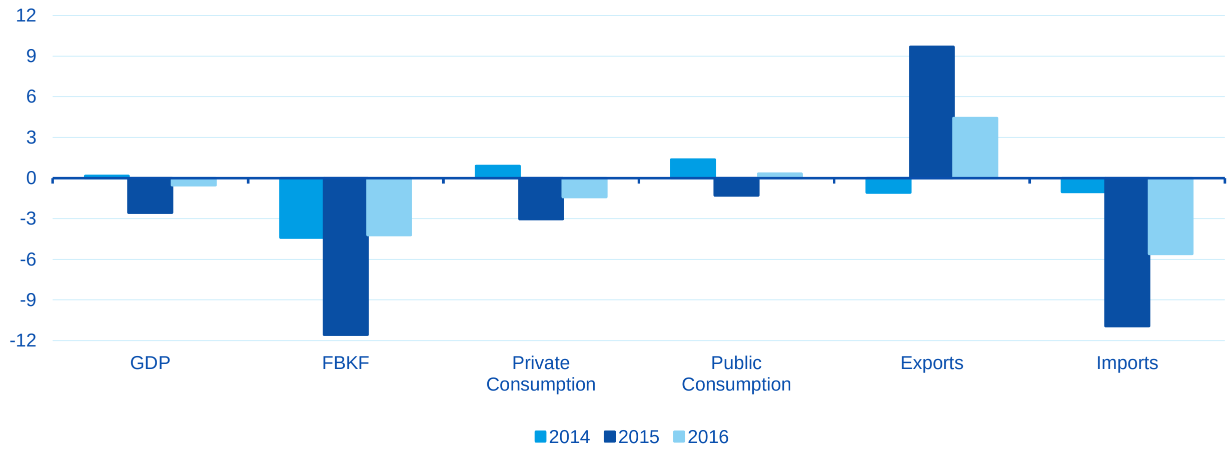
Based on the contraction of GDP in the first half of the year and on our view that growth will not be back into positive territory in the second part of the year, we expect economic activity to contract 2.5% in 2015. This means that the recession this year will be sharper than we anticipated three months ago, when our forecast for GDP growth this year was -1.5% (for details on our previous forecasts, see our 3Q15 Brazil Economic Outlook). Even though a less supportive global environment is also playing a role, the main determinants of the downward revision in our growth forecast for 2015 are domestic. Again, we highlight the negative impact on the economy of the intensification of the problems on the political and therefore the fiscal front. From a different perspective, most of the revision is related to the downward surprise in 2Q15 GDP (observed: -1.9% QoQ; forecast: -1.4% QoQ), although our perspectives about the evolution of the economy in the second half of the year are now more negative than before.

By components, the contraction of the economy this year will be driven by domestic demand. Its contribution to growth is estimated to be around -5.3pp. We forecast investment in fixed capital to contract by almost 11% this year, following a 4.4% decline in 2014, and consumption to reduce by 2.6%, which would be the first negative rate since 2003 when consumption declined 0.1%. Private consumption, which accounts for 78% of total consumption and two-thirds of GDP, is forecast to contract by 3.0% in 2015 after a growth of 1.0% in 2014 (Figure 4.3 and Table 6.1). Among the many factors behind the expected contraction of investment and private consumption, we highlight the impact on the former of the abnormally high uncertainty and the reduction of demand, and on the latter of the sharp deterioration of labour markets.

Regarding external demand, we expect it to contribute with +2.7pp to GDP growth in 2015. This is likely to be a consequence of both a growth in exports of goods and services and a significant contraction in imports (Figure 4.3 and Table 6.1), which are in line with a scenario of contracting domestic demand and weakening exchange rate.

As we do not expect political turbulence to lessen considerably going forward, and therefore do not see a solution to the fiscal imbroglio in the short-term, it is unlikely that confidence levels will rebound in the forthcoming months. Our view that labour markets will continue to worse, with the unemployment rate moving higher to 9.1% on average next year in comparison to 6.9% in 2015 and 4.8% in 2014 to a large extent due to the lagged impact of ongoing overall economic deterioration, contributes to the assessment that economic activity will remain very weak in 2016, especially in the first half of the year. Taking this into account, we expect GDP to contract by 0.5% next year, which is in contrast to our previous forecast of 0.5% growth. Domestic demand is set to contribute negatively to GDP again next year (-1.9pp), due to another contraction in both investment and consumption, while external demand should contribute positively to growth (+1.3pp), although less than in 2015 (Figure 4.3 and Table 6.1).

Figure 4.3
GDP and components (%)

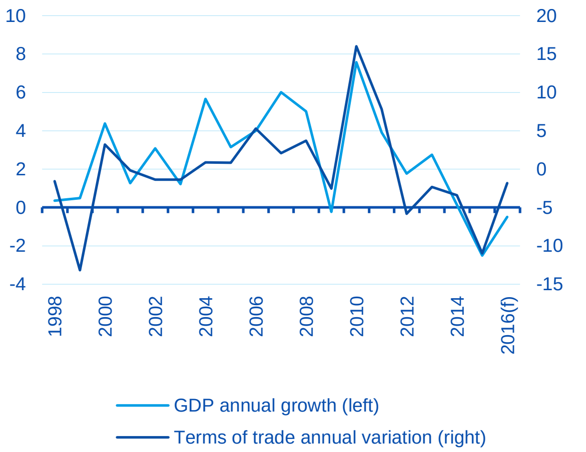


Source: IBGE and BBVA Research

Even though we acknowledge the downside risks, mainly due to the worse-than-expected performance of private consumption but also as a consequence of a further slowdown in China (see Box 1), our 2016 forecasts show that we do not expect the next year to be as bad in terms of GDP growth as the current one. This view builds on our evaluation about the evolution of the factors behind the current crisis. In general, we think that they will contribute less negatively to growth in 2016. On the one hand, we expect the global environment to be more supportive next year. After a contraction of around 11% in the terms of trade in 2015, we expect commodity prices to evolve in a way such that terms of trade decline "only" around 2.0% in 2016 (Figure 4.4). On the other hand, regarding domestic factors, even though we are not optimistic about the evolution of the political situation and the fiscal adjustment next year, we expect the deterioration in uncertainty and confidence levels to be not as marked as in 2015. Moreover, a moderation in inflation and a relatively stable exchange rate would imply that consumers and producers would face lower cost problems than in 2015. In addition, they would create some room for a less tight monetary policy, which would also be good news in terms of activity. On top of that, we think that Petrobras and the construction sector's companies, all involved in a bribery scandal, will contribute less negatively to activity in 2016. Finally, we expect the process of import substitution to gain momentum next year, following the recent depreciation of the exchange rate.

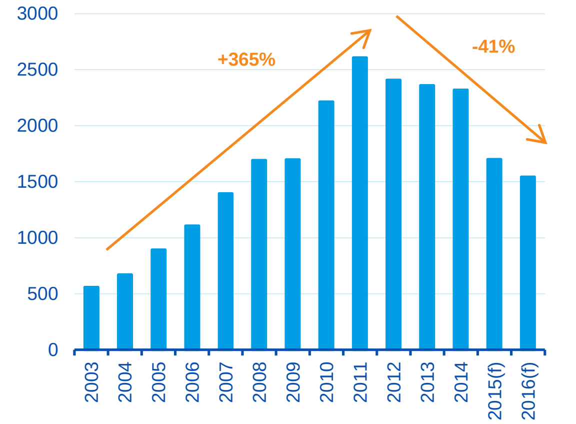
Anyway, Brazil is set to see its GDP contract two years in a row for the first time since 1930-31. Negative growth rates in 2015 and 2016, coupled with below-potential growth since 2011 and a sharp weakening of the domestic currency, imply that GDP measured in dollars is likely to drop by around 40% between 2011 and 2016, following a 365% expansion since 2003 (Figure 4.5). To be able to grow again at rates close to 3%-4% and recover relatively quickly the losses accumulated in the past years, the country should address its current political and fiscal problems and then adopt a series of structural reforms to increase domestic productivity.

Figure 4.4
GDP and terms of trade (% growth)



Source: IBGE and BBVA Research

Figure 4.5
GDP in USD (bn)



Source: IBGE and BBVA Research

After peaking around 10% at the end of 2015, inflation will moderate in 2016 but will remain relatively high

Inflation has been surprising to the upside in the last few months. As a consequence, it reached 9.9% YoY in October. The main driver of the recent surprises was - once more - administered prices, whose annual variation was 17.5% in October. Within this group of products, it is worth to highlight the sub-group of electricity tariffs, with an annual inflation of 52.3% YoY and whose weight on the Brazilian CPI (the IPCA) is 4%.

The electricity sector actually illustrates well some of the problems currently faced by the country. The costs of the sector skyrocketed this year following the scarcity of water (key to the working of the system as most of the energy generated within the country is hydroelectric) and insufficient investment in previous years. Without fiscal room to support the sector, this year the government was forced to authorise abnormally high tariff adjustments. This is somewhat in contrast with the solutions to help the sector in the past, which relied more than now on fiscal resources and less on tariff increases.

On top of the pressure from regulated prices, inflation has also been fueled by the effect of supply issues on food prices (+10.4% YoY in October) and by the impact of the exchange rate depreciation, even though the evidence suggests that the pass-through into domestic prices has not increased (for more on this issue, check our Brazil Economic Watch “Has the exchange rate pass-through in Brazil changed?”). Together, these factors are offsetting the impact of the contraction of domestic demand and the moderation in labour markets on domestic prices.

Looking ahead, we expect administered prices and food prices to drive inflation up to 10.2% YoY in November and 10.0% YoY in December (Figure 4.6). This will be the highest inflation since 2002, when it reached 12.5% YoY.

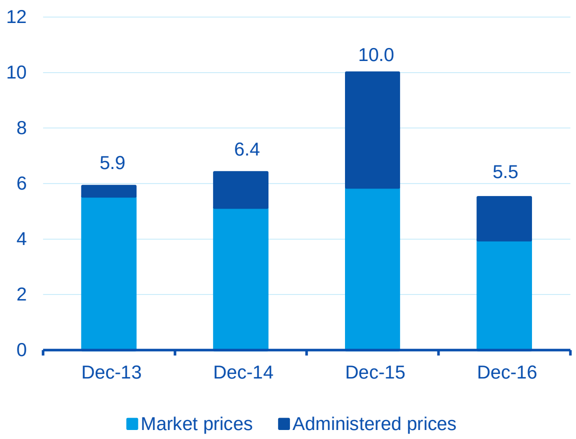
As we move into 2016, the adjustments in administered prices are likely to lose steam as most of its misalignment will be corrected by then. In particular, electricity tariffs are expected to grow much less, by around 6%, due to the downward impact on the sector’s costs deriving from the contraction in domestic demand and an eventual improvement in the rainfall regime. That will allow annual inflation to moderate since the very beginning of the year, a trend which will be reinforced by the slowdown of labour markets, including a moderation in wages which are likely to exhibit negative growth rates in real terms.

Anyway, the moderation of inflation in 2016 will be constrained by the impact of the exchange rate depreciation and by the existence of important inertial mechanisms (as in the determination of the minimum wage, for example, which is set by the variation of inflation in the previous year plus GDP growth two years ago).

We expect inflation to average 7.1% in 2016 (vs. 8.9% in 2015) and to close the year at 5.5%, somewhat higher than the 4.5% inflation target, but within the 2.5%-6.5% target range. In our view, inflation will only be able to converge to the 4.5% target in 2017, and only if further fiscal deterioration does not trigger more exchange rate depreciation.

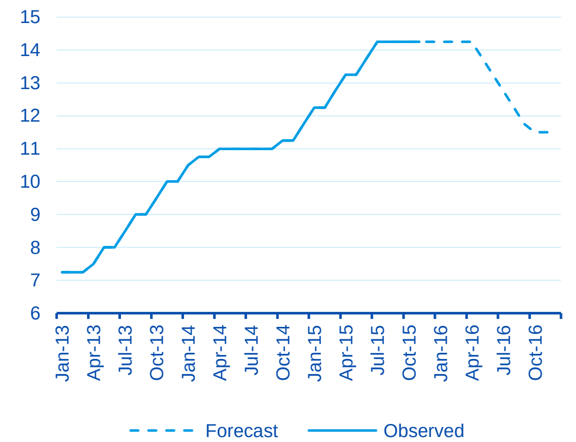
Finally, it is worth to note that there is a risk that regulated prices end up increasing more than expected in 2016, as happened in 2015, as a consequence of an adjustment in some taxes (such as the CIDE fuel tax, for example) within the context of the fiscal adjustment or of higher fuel prices, which could be announced to try to improve the financial situation of Petrobras. If this risk materialises, inflation would be closer to the 6.5% target ceiling than to the 4.5% main goal. Moreover, guaranteeing the convergence of inflation to the central target in 2017 would be more difficult.

Figure 4.6
Contribution from market and administered prices to annual inflation (pp)*



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

Figure 4.7
Interest rate: Selic (%)



Source: BCB and BBVA Research

The monetary policy focus is already on 2017

After hiking the Selic rate to 14.25%, from 7.25% at the beginning of 2013, monetary policy is now on hold. Adjusting the policy rate further up would represent a larger risk in terms of activity, while cutting it would send markets the wrong signal as inflation is now well above the target and expectations are not yet anchored.

To justify maintaining the Selic rate unchanged at 14.25% rather than having to increase it again, the Central Bank of Brazil (BCB) recently adjusted its communication. It now wants to ensure that inflation converges to the 4.5% target in "the relevant horizon for monetary policy" (i.e. 2017) rather than in 2016 as it previously affirmed. This means that the BCB will be more tolerant with respect to inflation in 2016 and that its focus is now on 2017.

Even though there is still a risk that an extra exchange rate depreciation, either due to further fiscal deterioration or to the normalisation of monetary policy in the US, triggers another dose of monetary tightening, the most likely event is that the Selic rate remains unchanged for some time, at least until the middle of 2016. By then, we expect inflation to have converged to around 6.5%-7.0% and expectations for 2017 to be close enough to 4.5%. In that environment, the most likely result is that the BCB decides to start a relatively small monetary easing cycle (Figure 4.7).

Box 1. What would be the impact on Brazil and other Latin American countries of a greater slowdown in China? [1]

Even though our central scenario assumes that Chinese authorities will continue to provide support for annual growth of at least 6%, doubts about this scenario make it useful to examine the effect of a sharp and long-lasting deceleration in China which leads to growth that is significantly below such a level.

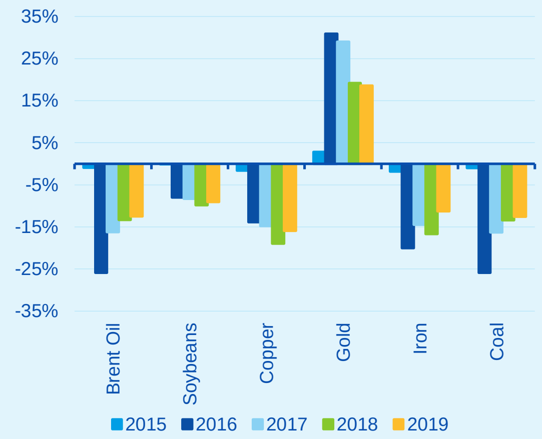
More precisely, we analyse in this Box the impact on Brazil and other Latin American countries of a scenario of enduring stagnation in China where growth rates approach 4%, while investment increases at under 7% YoY and industrial production at below 4%, instead of the rates of 11% and 7% respectively that are envisaged under the baseline scenario.

This risk scenario would affect Latin America mainly through two pivotal channels: i) a reduction in Latin America's external demand, though chiefly a drop in the price of key export commodities, and ii) increased global risk aversion.

Regarding the first channel, Figure B.1.1 shows the estimated impact on the prices of the region's key export commodities in relation to the baseline forecast scenario. Particularly notable is the strongly negative effect on the prices of the key industrial metals (copper, iron ore), especially owing to the drop in industrial demand and for real estate investment. Prices of energy commodities would be hard-hit too, especially oil and initially even more so than metals, since the shock of lower demand would come on top of lingering doubts over the capacity to soak up current excess supply. On the other hand, food prices would not suffer such a heavy fall, since they are more closely associated with consumption, which is less affected by this kind of shock.

With respect to the second channel, a severe slowdown in China would be highly likely to bring with it a rise in global risk aversion as doubts intensify over the ability to sustain world growth, the chances of financial turbulence in China, and asset quality, both there and among the emerging economies most closely linked to it. In China's case, there could be a rise in risk premiums beyond even those seen immediately following the Lehman Brothers failure, and the impact on Latin America would be substantial, with risk premiums approaching those observed in 2009. The increase in risk aversion would unleash a flight to the safety offered by assets of developed economies and put asset prices in Latin America under pressure, as well as exchange rates. Precisely such a flight to safer assets would underpin a rise in the gold price above the level forecast in the baseline scenario.

Figure B.1.1
Effect on the price of major commodities under the risk scenario in China (% price difference vs. the baseline scenario)



* Percentage impact on commodity prices one year after a 1pp decrease in fixed asset investment growth in China.
Source: BBVA Research

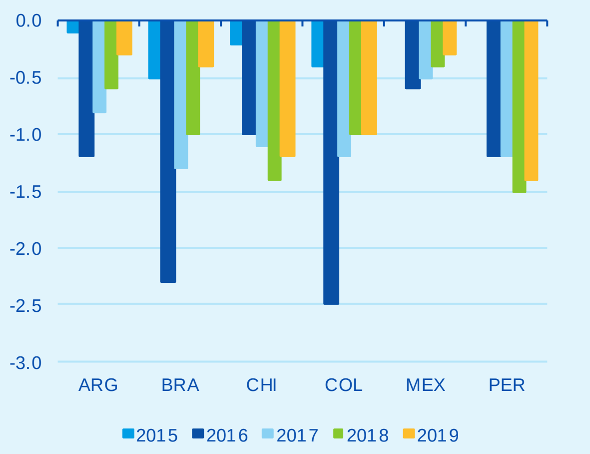
The two spillover channels would be augmented by the adverse impact on family and business confidence in the region. Specifically, we assume that the negative effect on family and business confidence would be of a degree akin to what was observed in the wake of the Lehman Brothers bankruptcy, and last for 4-6 quarters.

It should also be recalled that, unlike in 2009, the

1: This Box is a shortened version of the Box published in our 4Q15 Latin America Economic Outlook.

region has far less room to manoeuvre in terms of counter-cyclical economic policies that could deaden the impact of the shock. On the monetary side, the rise in inflation and the risk of unanchoring of expectations (except in Mexico and especially in Brazil) makes monetary easing highly unlikely. On the other hand, fiscal scope has been used up in certain countries, such as Brazil and Argentina (and has been much reduced in the others). The only exceptions would be Peru and Chile, where a lower base in their fiscal deficits and government borrowing in 2015 would give them some (but not too much) leeway. Thus policies in most countries would be clearly pro-cyclical and would leave exchange rate depreciation to absorb most of the shock.

Figure B.1.2
Impact on growth of the risk scenario in China (difference in pp vs. the baseline scenario)



Source: BBVA Research

Faced with a scenario of slowdown in China such as that described above, domestic demand in South America would be battered by the falls in both consumption and investment deriving from the drop in family and business confidence. Even though the countries with scope for counter-cyclical economic policies would implement some sort of initial fiscal stimulus, domestic demand would still be harmed, albeit less than in other countries where such a margin does not exist. Figure B.1.2 shows that specifically Brazil and Colombia would be among the worst-hit countries, owing to their high exposure to China; in Colombia's case due to suffering from the impact of the oil price collapse (which fell more dramatically than the price of other commodities), and in Brazil's case due to having to face the shock with very badly weakened fundamentals and a need to continue with its fiscal correction.

Meanwhile, Peru and Chile are highly exposed to a shock from China, but they have something of a shock-absorber in the shape of scope for counter-cyclical fiscal policies (at least initially) which would soften the initial impact. In Argentina, the impact would be smaller, largely because the shock affects the prices of food (its chief type of export good) far less than metals, while the fall in the price of imported oil actually counteracts part of the negative effect on its external accounts. Finally, the effect on Mexico would be only marginal, on account of its low exposure to China, although its public finances would suffer from the impact of a lower oil price.

Thus, under the risk scenario, Brazil would face a withering recession in 2016 (deeper than that already built into our baseline scenario) and stagnation in 2017, while growth in Argentina and Colombia would be practically nil in 2016, although with a recovery at rates of closer to 2.5% in 2017. Growth in Peru and Chile would be reduced to only around 1.5% in 2016, thereafter picking up to a pace of between 2.5% and 3% in subsequent years.

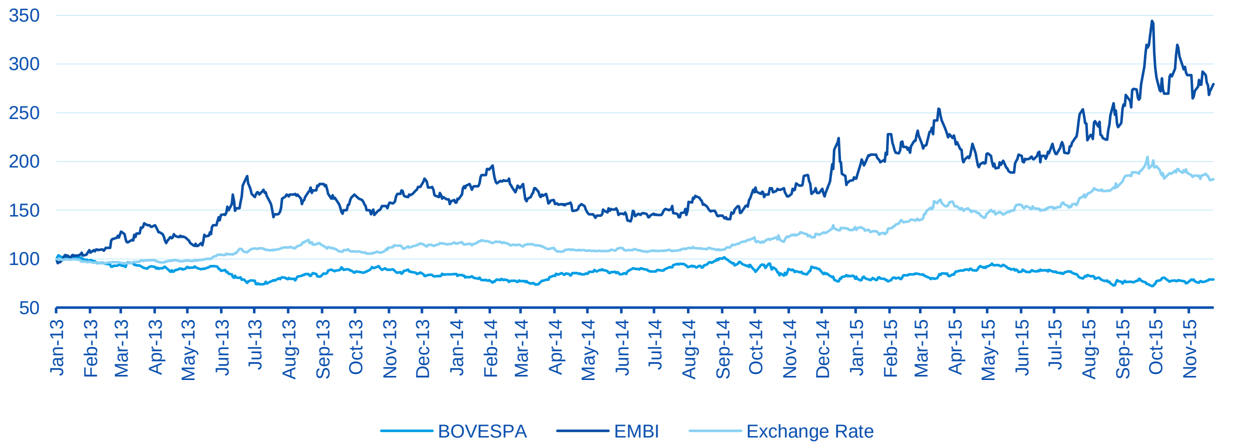
The results of this simulation exercise therefore show that certain countries in the region, such as Mexico, Peru and Chile, can withstand a shock from China relatively better, although their weak macroeconomic starting point means that for most countries, with the exception of Mexico, the effects are potentially quite pronounced. At the same time, the exercise underscores the importance of having some margin for counter-cyclical policies, while the stock of such scope has still not been replenished after being successfully used up to soften the impact of the 2008-09 global crisis.

5 A more depreciated exchange rate will allow the current account deficit to decline significantly

Financial markets exhibit some calm after a storm triggered by concerns about China and fiscal deterioration

Local financial markets have accumulated significant losses in the last months, especially from July to September (Figure 5.1). In that period the sovereign spread reached 489bp, the Sao Paulo Stock Exchange Index (IBOVESPA) traded at its lowest level since the Lehman Brothers crisis, 40% below its peak value in May 2008, and the exchange rate reached 4.2 reais per dollar.

Figure 5.1
Equity markets (BOVESPA), sovereign spreads (EMBI +) and exchange rate (USD/BRL). Indexes Jan-2013=100.

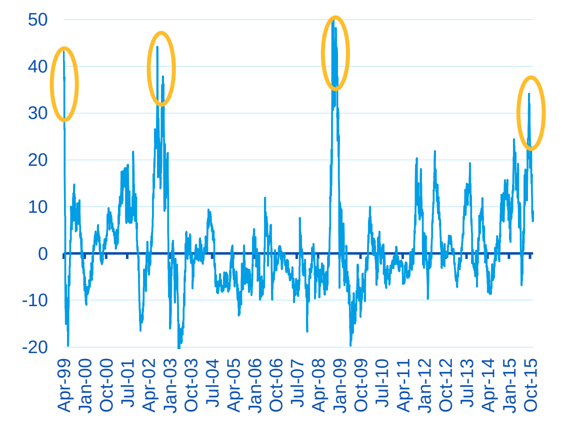


Source: Datastream and BBVA Research

These losses were to a large extent a consequence of the increasing concerns about the Chinese economy, which intensified especially between the middle of June and the end of August with important turbulences in its financial markets, and the sharp deterioration of the prospects for Brazil's fiscal situation. Markets reacted very negatively to the flexibilisation of fiscal targets and to further signs of political instability in the middle of the year, which showed that the fiscal worsening would be more severe and longer than previously expected. That triggered some negative announcements by rating agencies with a negative impact on local financial markets: in August Moody's downgraded Brazil's sovereign rating to Baa3, just one step above high-yield, with a stable outlook; in September S&P withdrew the country's investment grade; and in October Fitch also cut Brazil's grade to the lowest within the investment-grade range, although with a negative outlook.

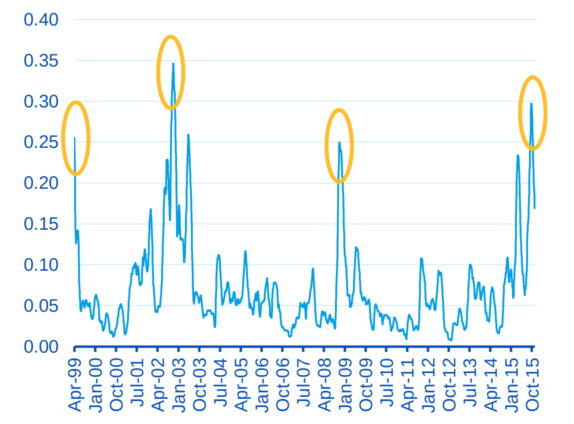
The exchange rate movements illustrate very well the storm that local financial markets went through from July until September. Within that period, at the end of September more precisely, the Brazilian real (BRL) accumulated a 34% depreciation in three months, a correction only comparable to those recorded right after the introduction of a flexible exchange rate system in 1999, in 2002 some months before President Lula was elected for his first term and in 2008 during the beginning of the Lehman Brothers crisis (Figure 5.2). Similarly, the recent volatility in exchange rate markets was only similar to those watched in the same three periods (Figure 5.3).

Figure 5.2
Exchange rate depreciation: 3-month rolling depreciation (%)



Source: BCB and BBVA Research

Figure 5.3
Exchange rate volatility: 3-month rolling standard deviation



Source: BCB and BBVA Research

After the storm, financial markets have been exhibiting some calm. Part of the previous losses was recovered in October and November. The sovereign spread receded to around 390bp (almost 100bp lower than the recent peak), the IBOVESPA increased 10% since of September and the exchange rate appreciated somewhat and neared the 3.70 mark.

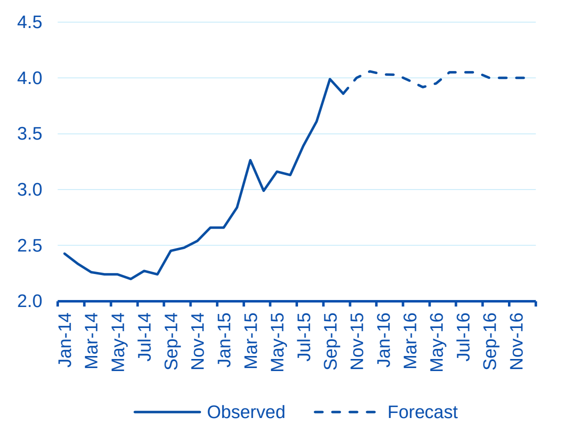
Even though many financial assets are currently trading below their equilibrium levels, we are sceptical about the continuity of the recent upward trend in local asset prices. With the imminent beginning of the process of normalisation of monetary policy by the Fed in the US, and taking into account that the recession in Brazil will continue, the fiscal problems are still far from being addressed, a second downgrade to high-yield is very likely, and the political environment is likely to remain turbulent, the most likely consequence is that financial markets turbulence remains.

We continue to see limited room for the exchange to appreciate; we expect it to be around 4 reais per dollar next year

After weakening almost 60% from the beginning of the year until the end of September, the BRL strengthened 11% and is now trading around 3.70 per dollar, not far away from its equilibrium level. However, in our view the most likely result is that external and internal factors will constrain any further appreciation. In fact, we expect the BRL to lose value going forward, mainly after the Fed starts to tighten monetary conditions – something we expect to happen in December – and the fiscal deterioration progresses, which among other consequences should trigger a second downgrade of Brazil's sovereign rating to high-yield by the middle of 2016. A likely monetary easing by the BCB sometime next year should also favor a further weakening of the BRL. Therefore, we expect the BRL to get closer to 4.00 per dollar in the next few months and to fluctuate around this level next year (Figure 5.4). That would mean an average exchange rate around 17% and 70% weaker than in 2015 and 2014 respectively.

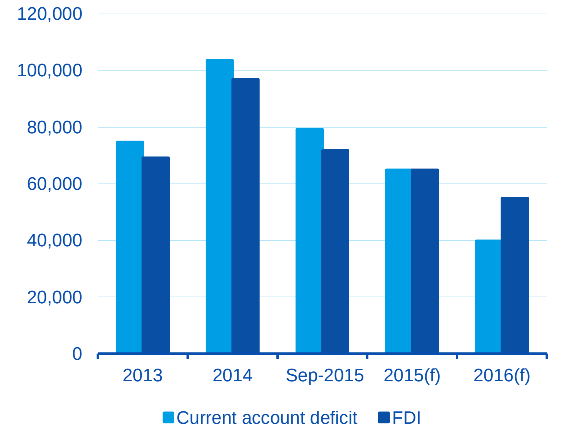
As commented before, a weaker BRL would put pressure on domestic inflation. Moreover, it would represent a problem to the part of the corporate sector which has a significant share of its liabilities denominated in the dollar or another foreign currency, mainly to the companies that do not have foreign assets or are not properly hedged. Anyway, even though the corporate sector's external debt is relatively high – at around 6.0% of GDP or 17% of GDP if we consider intercompany loans - most of it is not due in the short-term.

Figure 5.4
Exchange rate: Brazilian real (BRL) per US dollar (USD)



Source: BCB and BBVA Research

Figure 5.5
Current account deficit and foreign direct investment (FDI)*



* A positive figure represents a current account deficit.
Source: BCB and BBVA Research

Current account deficit to decline from 4.5% of GDP in 2014 to 3.8% of GDP in 2015 and 2.6% of GDP in 2016

In spite of its negative consequences, a weaker exchange rate will allow the current account deficit to adjust to a new environment, characterised by the reduced availability of external funding due to the changes in the global environment, mainly on the Fed's monetary stance, as well as to domestic issues, which are making the country in general less attractive than before.

In the year up to September, net external inflows reached USD48bn, 32% less than in the same period in 2014. Gross foreign direct investment (FDI) also accumulated to USD48bn, 34% less than last year.

In the face of this new funding situation, the current account deficit has been adjusting. In the first nine months of 2015 it accumulated to USD49bn, a value around one-third lower than that recorded in the same period in 2014. Therefore, as in the previous years, FDI continues to fund most of the current account deficit.

The downward adjustment of the current account deficit observed in the last few months has, up to now, basically been due to a contraction of imports and other external expenses (-21%), driven by the slowdown in domestic demand and the exchange rate depreciation. Exports and other external revenues declined 16% in the year to September. Regarding the exports of goods, the main contraction is in the exports of basic products (-22%), which is largely due to the sharp contraction in their prices. Exports of manufacturing products, which represent around 50% of total exports, contracted less, by around 10%.

We expect a gradual improvement of exports, in particular of the manufacturing ones, and subdued imports to generate trade surpluses of USD15bn and USD29bn, respectively, in 2015 and 2016, in comparison to last year's USD6bn deficit. That would allow the current account deficit to decline from USD104bn (4.5% of GDP) in 2014 to USD65bn (3.8% of GDP) in 2015 and USD40bn (2.6% of GDP) in 2016. It is interesting to note that the nominal adjustment of the current account deficit will be sharper than the adjustment of the current account-to-GDP ratio. The latter will decline more mildly, as GDP measured in dollars will also decline in the period.

The expected adjustment of the current account deficit should avoid an external funding problem, even though the most likely consequence is that FDI and other capital inflows will continue losing steam in the forthcoming years (Figure 5.5).

6 Forecast table

Table 6.1
Macroeconomic forecasts

	2013	2014	2015	2016
GDP (% growth)	3.0	0.1	-2.5	-0.5
Inflation (% YoY, end of period)	5.9	6.4	10.0	5.5
Exchange rate (BRL/ USD,end of period)	2.34	2.66	4.06	4.00
Interest rate, SELIC (%, end of period)	10.00	11.75	14.25	11.50
Private consumption (% growth)	2.9	0.9	-3.0	-1.4
Public consumption (% growth)	2.2	1.3	-1.3	0.3
Investment (% growth)	6.1	-4.4	-11.6	-4.2
Exports (% growth)	2.1	-1.1	9.7	4.4
Imports (% growth)	7.6	1-.0	-10.9	-5.6
Fiscal result (% GDP)	-3.1	-6.2	-9.1	-7.7
Current account (% GDP)	-3.2	-4.5	-3.8	-2.6

Source: BBVA Research

DISCLAIMER

This document has been prepared by BBVA Research Department. it is provided for information purposes only and expresses data. opinions or estimations regarding the date of issue of the report. prepared by BBVA or obtained from or based on sources we consider to be reliable. and have not been independently verified by BBVA. Therefore. BBVA offers no warranty. either express or implicit. regarding its accuracy. integrity or correctness.

Estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past. either positive or negative. are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss. direct or indirect. that may result from the use of this document or its contents.

This document and its contents do not constitute an offer. invitation or solicitation to purchase. divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract. commitment or decision of any kind.

In regard to investment in financial assets related to economic variables this document may cover. readers should be aware that under no circumstances should they base their investment decisions in the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

The content of this document is protected by intellectual property laws. It is forbidden its reproduction. transformation. distribution. public communication. making available. extraction. reuse. forwarding or use of any nature by any means or process. except in cases where it is legally permitted or expressly authorized by BBVA.

This report has been produced by the Latin America Unit:

Enestor Dos Santos
enestor.dossantos@bbva.com

With the contribution of:

Cecilia Posadas
c.posadas@bbva.com

Marina Conesa
marina.conesa@bbva.com

Julián Cubero
juan.cubero@bbva.com

BBVA Research

Contact details:

Azul Street, 4
La Vela Building - 4 and 5 floor
28050 Madrid (Spain)
Tel.: +34 91 374 60 00 and +34 91 537 70 00
Fax: +34 91 374 30 25
bbvaresearch@bbva.com
www.bbvaresearch.com