

Brazil: political turbulence curbs the fiscal adjustment and fuels the uncertainty, undermining the economy

Main takeaways

- 1 Global growth continues to pick up, although less strongly, with weakness in emerging markets.** Uncertainty about Chinese long-term prospects remains (which effected an increase in market volatility in July-August) and the Fed's liftoff is pushed back to December, with a slower tightening path in 2016
- 2 Political turbulence curbs the fiscal adjustment and the uncertainty undermines the economy.** The fiscal adjustment ahead is likely to be too slow and too mild to prevent fiscal indicators to continue to worsen. That should prevent a recovery of confidence
- 3 Longer and deeper recession: GDP will contract significantly in 2015 and will drop again in 2016.** We expect GDP to drop 2.5% and 0.5%, respectively, in 2015 and 2016. Regarding inflation, it will peak around 10% at the end of 2015, and then will moderate
- 4 A more depreciated exchange rate will allow the current account deficit to decline significantly ahead.** The depreciation of the exchange rate will allow the current account deficit to adjust to the new environment, characterized by the lower 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

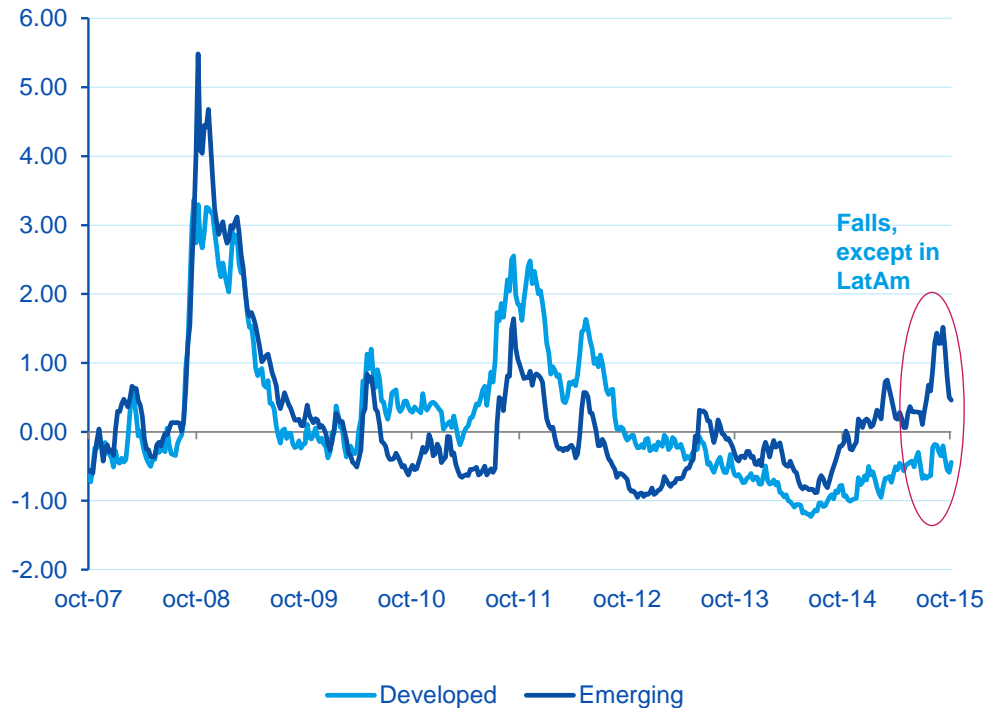
Outline

- 1 A more subdued global recovery, with less dynamic emerging markets
- 2 Brazil: political turbulence curbs the fiscal adjustment and the uncertainty undermines the economy

Financial markets reacted strongly in the previous quarter

BBVA Research Financial Stress Index

Source: BBVA Research



Possible overshooting in some markets

Strong FX depreciation and, in general, sharp correction of risky assets, such as those of emerging economies.

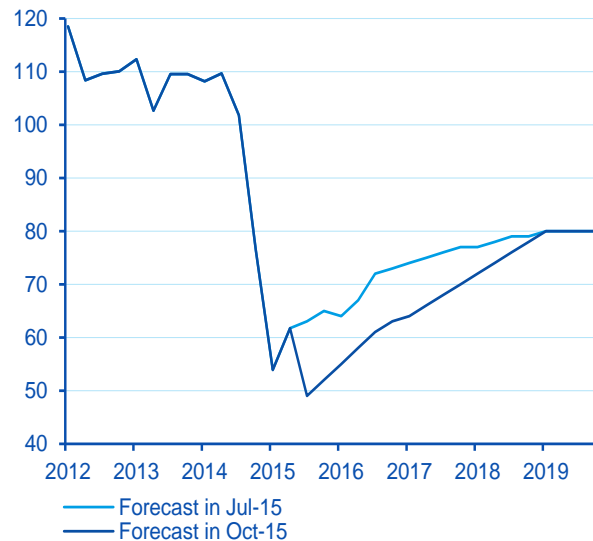
What's the source of this shock?

1. Commodity prices
2. Doubts about China
3. Waiting for the Fed's liftoff

Including a sharp fall in commodity prices

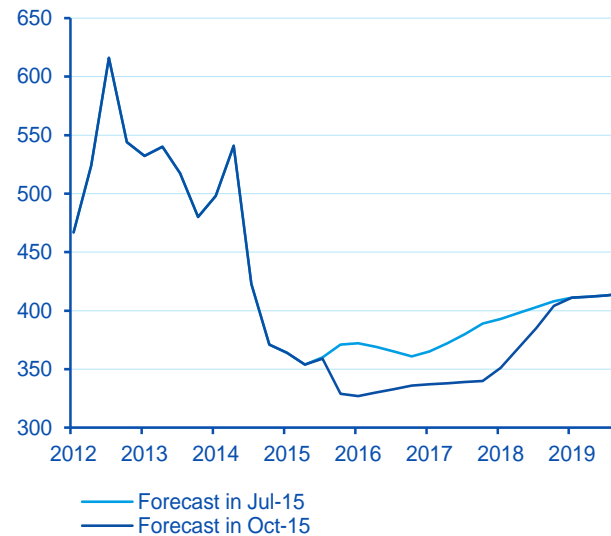
Brent oil: (USD/b)

Source: BBVA Research and Bloomberg



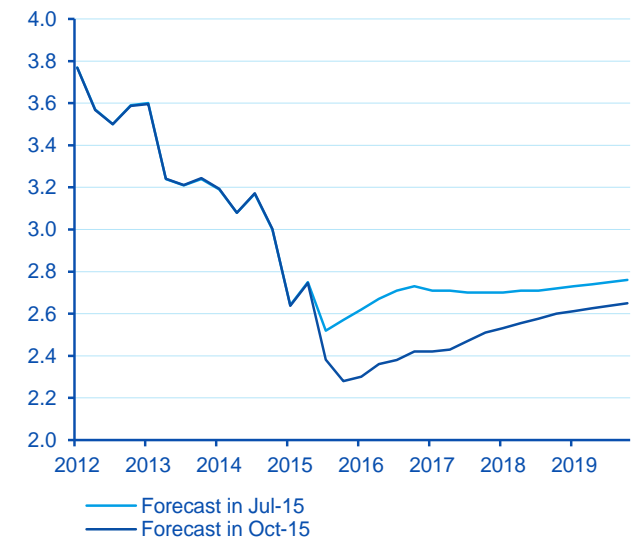
Soybeans: (USD/mt)

Source: BBVA Research and Bloomberg



Copper: (USD/lb)

Source: BBVA Research and Bloomberg



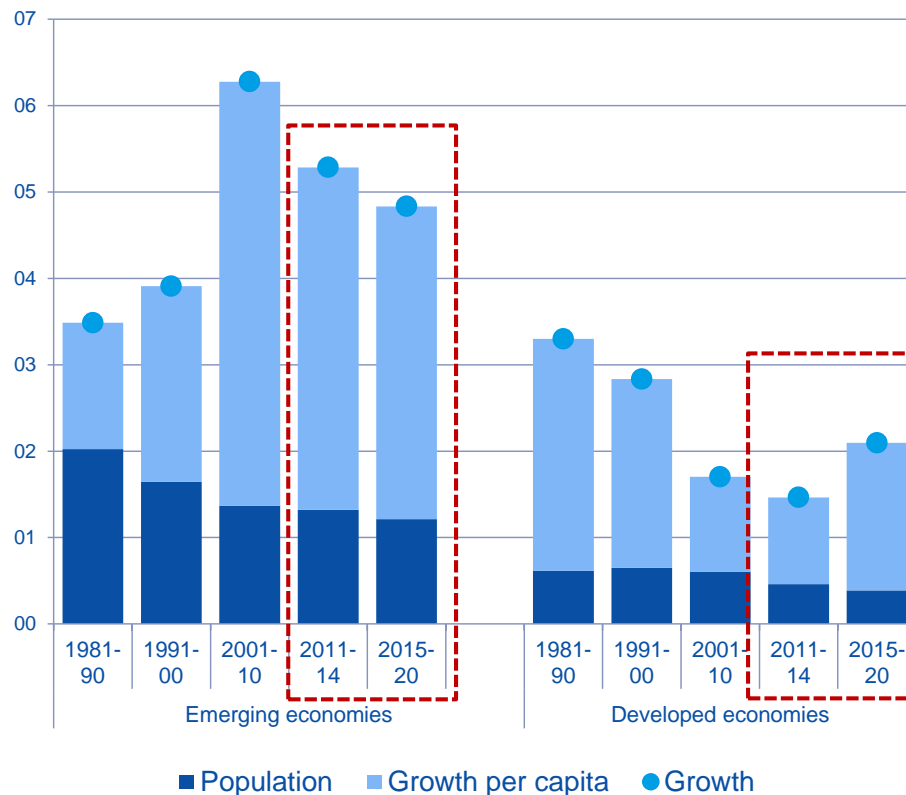
Oil prices reflected in part an unexpected resilience on the supply side...

... but also increasing doubts about Chinese growth, which hit other commodities as well.

Increase in global growth will be driven by developed economies

GDP Growth, population growth and per-capita GDP growth

Source: BBVA Research, IMF and World Bank



2011-14 has been the first 5-year period since the 80s in which both emerging and developed economies have slowed down simultaneously

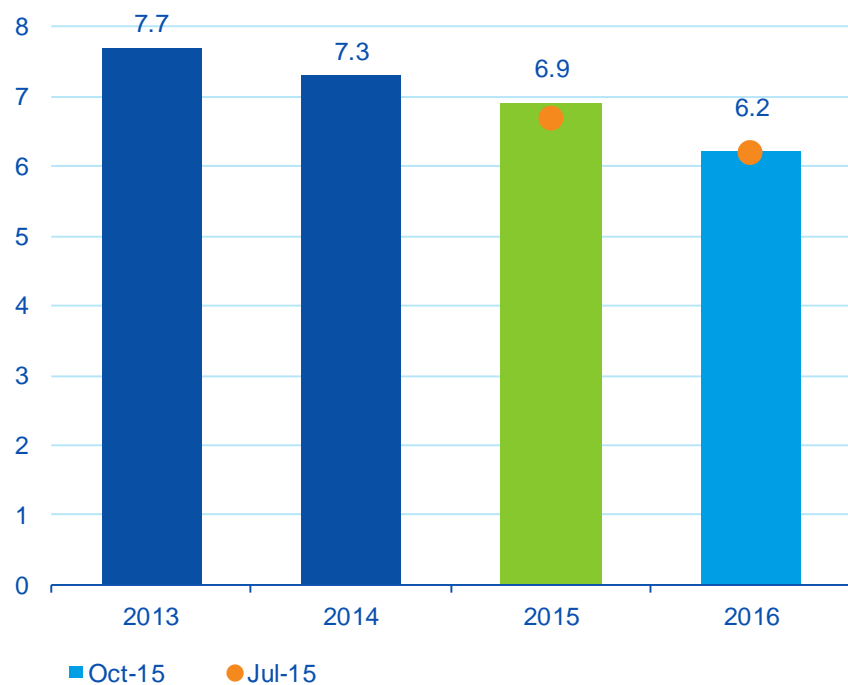
Rebalancing in China, slowdown in globalization and slower population growth drag down global growth

Stronger growth will come about from increase in per-capita growth and, thus, productivity, especially in developed countries

China: lingering doubts about medium-term prospects

China: GDP growth (%)

Source : BBVA Research



Alternative indicators of economic activity decelerate faster than official GDP figures ...

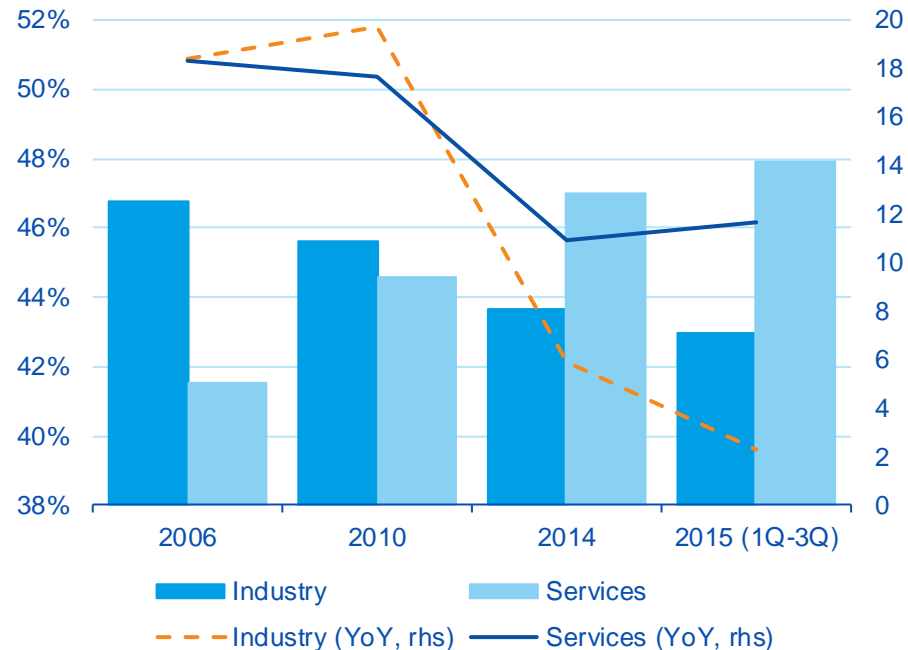
... but may be overestimating the importance of manufacturing, given growing importance of services

Greater support from fiscal and monetary policies. Financial sector reforms continue

China: Rebalancing towards services, consumption and urban employment continues

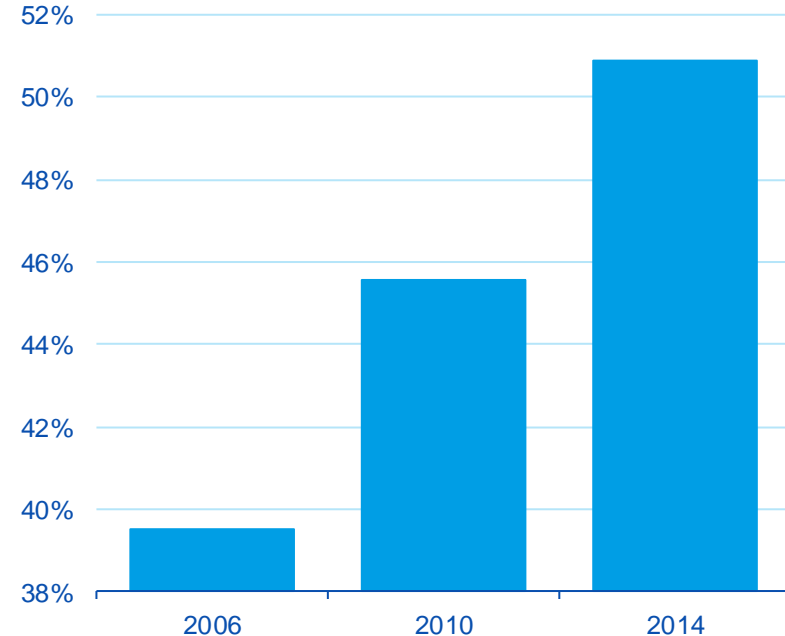
China: GDP by sectors (% of GDP and growth rate)

Source: BBVA Research



China: urban employment, % of total

Source: BBVA Research

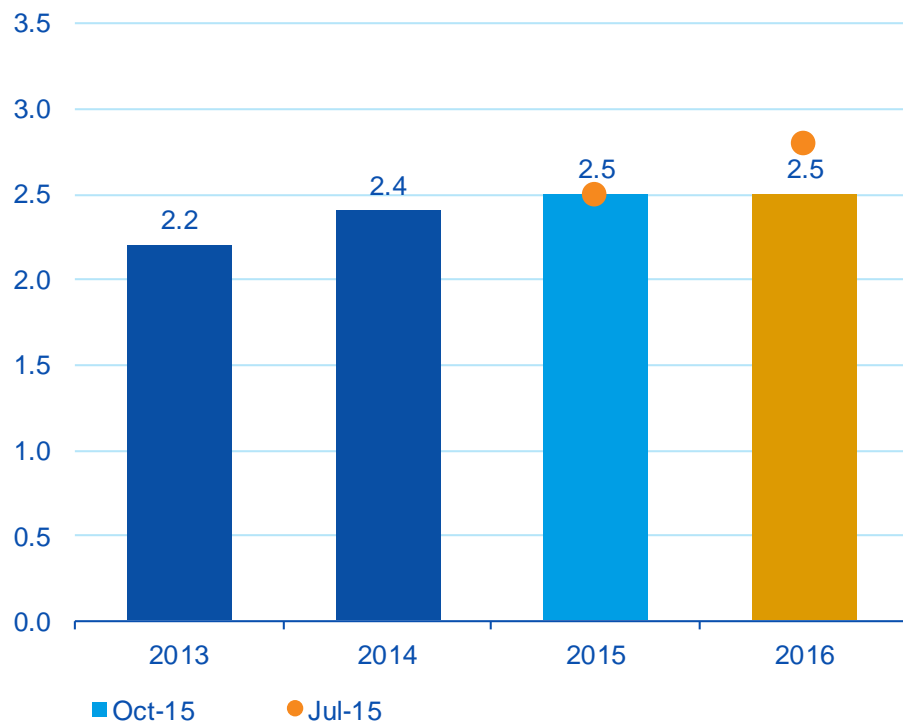


Risks are tilted to the downside as challenges are sizable: reduce indebtedness and ensure the efficiency of investment.

US: slightly less robust growth than anticipated, on weaker export and energy sector

US: GDP growth (%)

Source: BBVA Research, BEA



A strong US dollar, lower external demand and weak investment in energy sector have dragged GDP. Consumption is strong but cannot fully offset these two effects

Additional growth may come from a pick-up in credit after clean-up of banking sector and deleveraging of the private sector

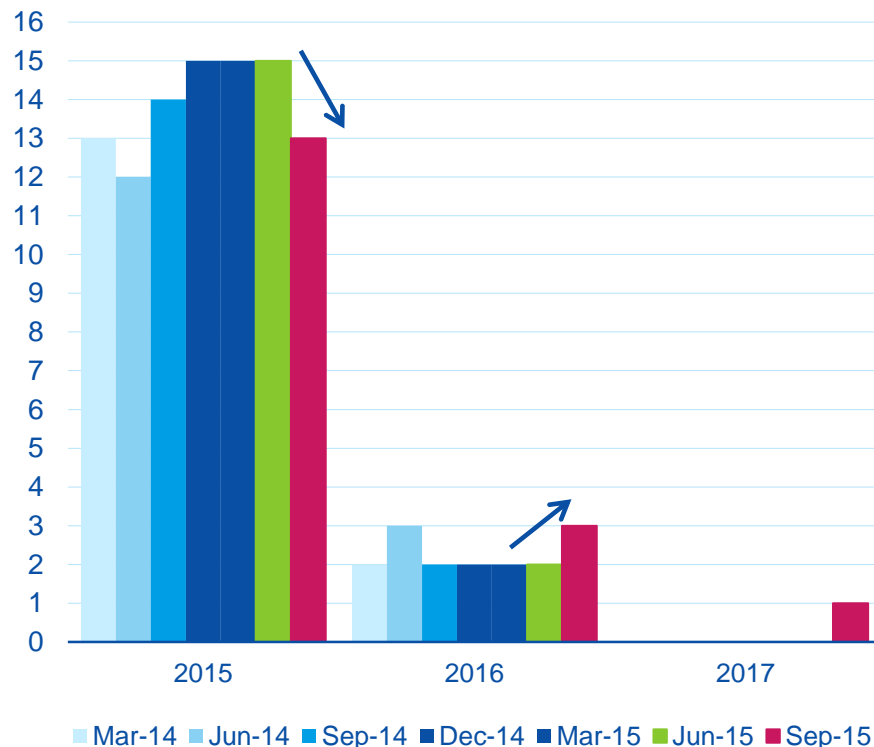
Fed rate rise in December is still uncertain and further rises would be slower than previously anticipated

Fed delays beginning of lift-off and points to a slower rate of increases in 2016

Fed: FOMC assesment of the best time to raise rates

Number of FOMC members

Source: Fed, BBVA Research



Fed delays lift-off on uncertainty about global economy and scant inflationary pressures

FOMC points that they may let unemployment fall below the stated target if spare capacity is to be reduced...

... and there are lingering doubts about the convergence of inflation to its target going forward

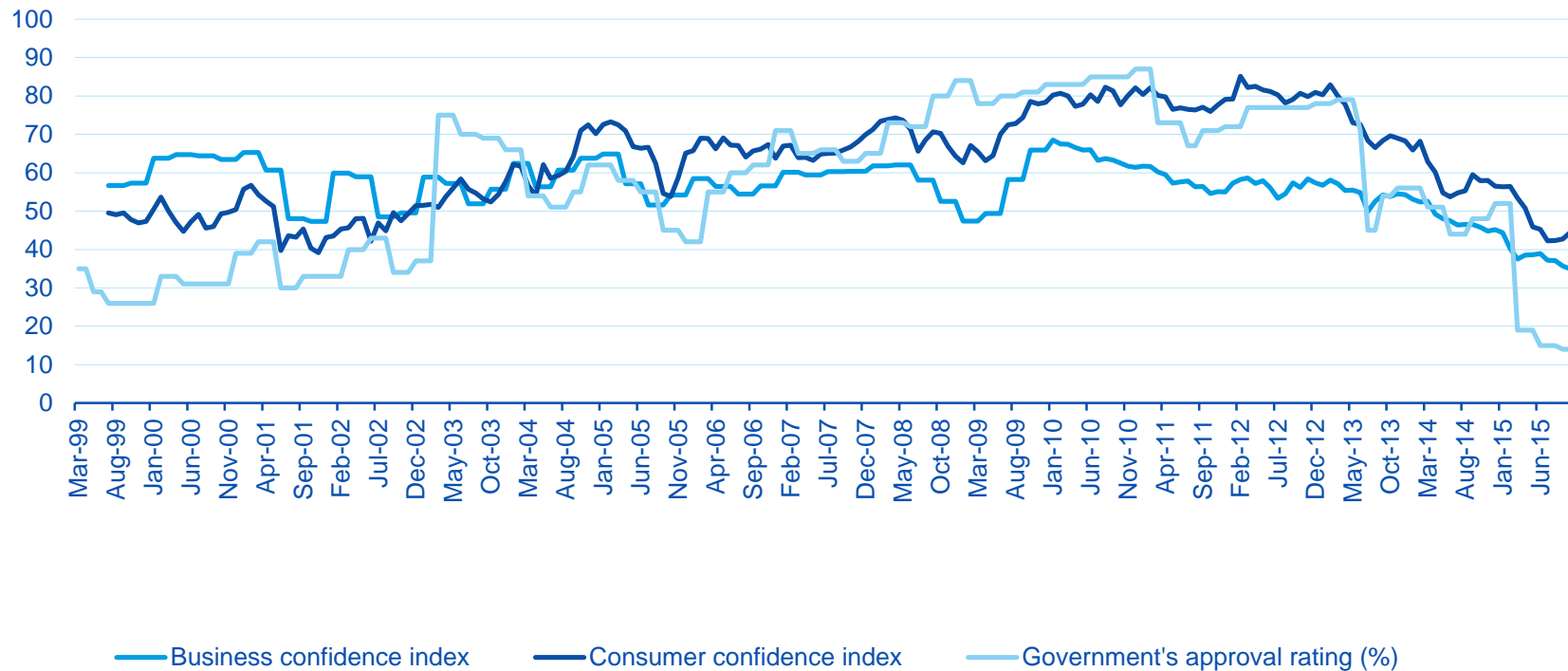
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Political turbulence and high uncertainty characterize the domestic environment

Government's approval rating (%) and confidence indices

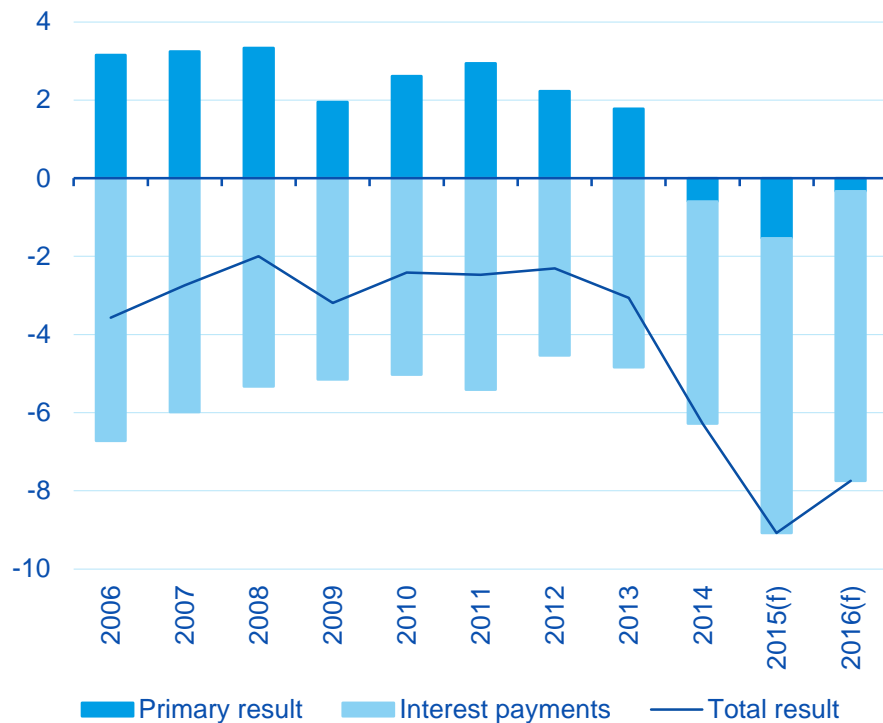
Source: CNI, IPEADATA and BBVA Research



Without political support, the fiscal adjustment will be implemented slowly, public accounts will deteriorate

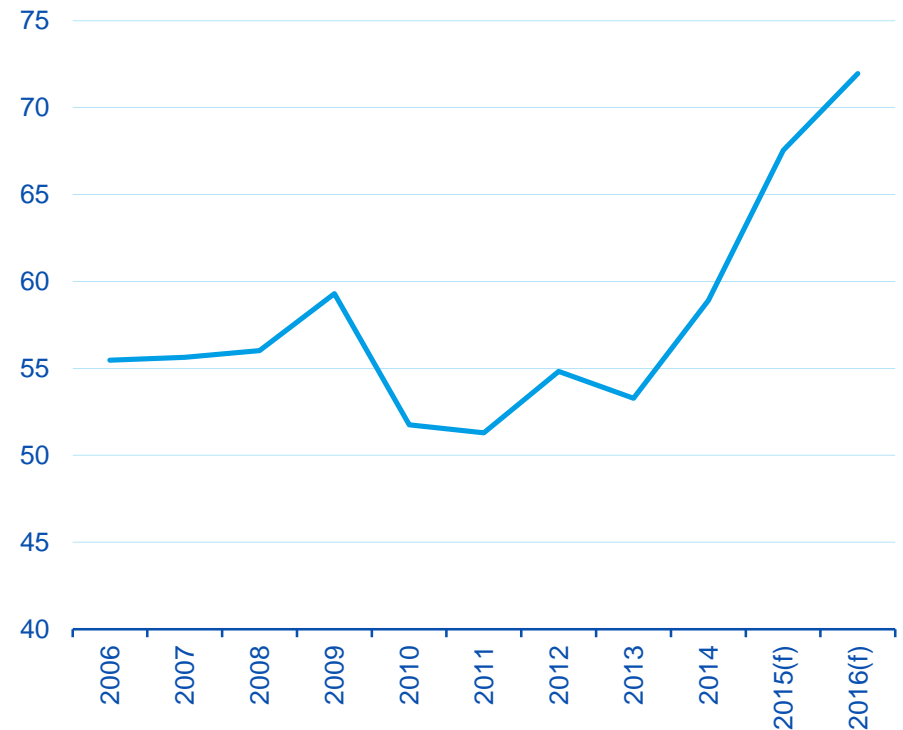
Public sector's fiscal accounts: primary and total results (% of GDP)

Source: BCB and BBVA Research



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

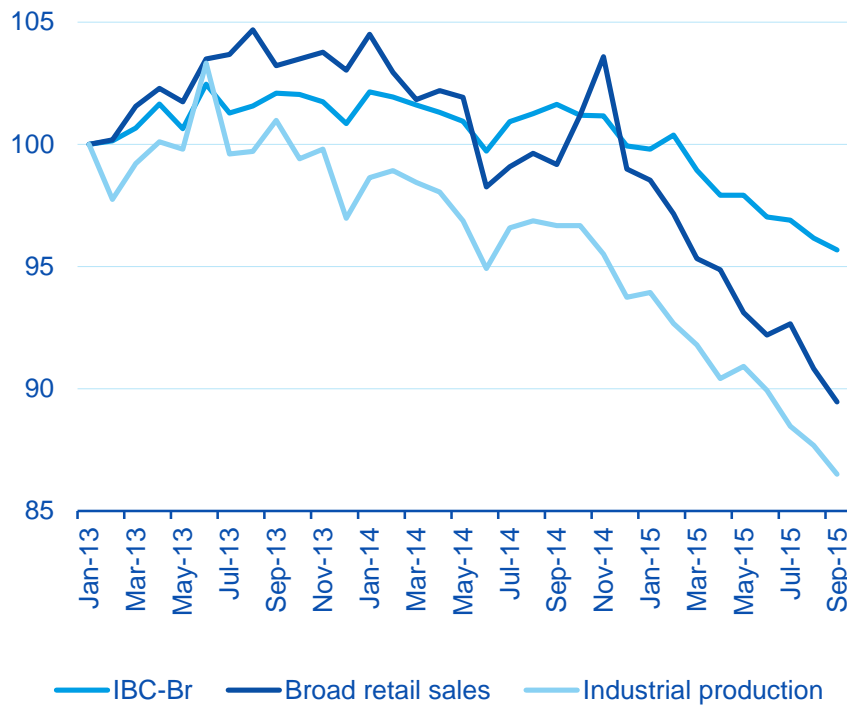
Source: BCB and BBVA Research



Economic activity: still in free-fall

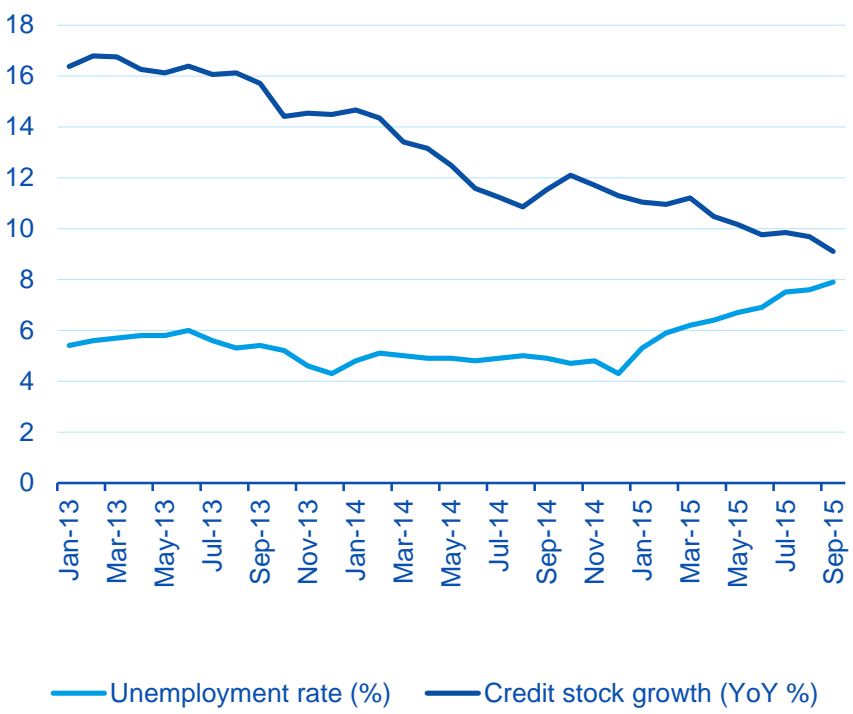
Economic activity indicators: BCB's activity indicator (IBC-Br), retail sales and industrial productions (seasonally adjusted series; index Jan 2013 = 100)

Source: BCB, IBGE and BBVA Research



Labor and credit markets: unemployment rate and credit stock growth

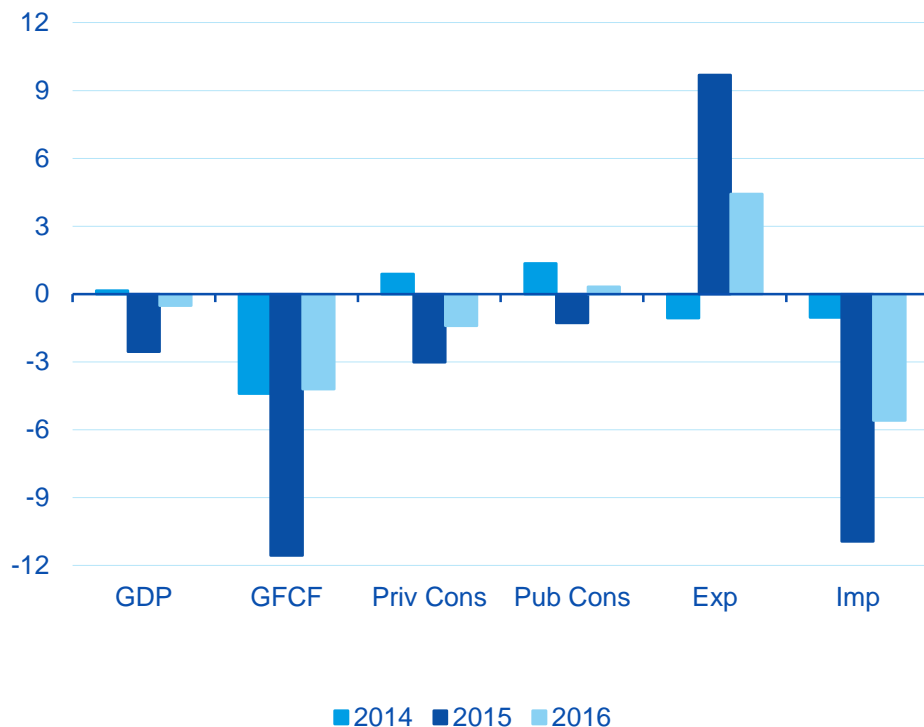
Source: BCB, IBGE and BBVA Research



We expect GDP to contract by 2.5% in 2015 and 0.5% in 2016; risks are tilted to the downside

GDP and components (%)

Source: BCB, IBGE and BBVA Research



The main drivers of the ongoing recession are:
 i) the drop in terms of trade; ii) political and fiscal turbulence; iii) tighter monetary and fiscal policy; iv) effects of Petrobras’s bribery scandal

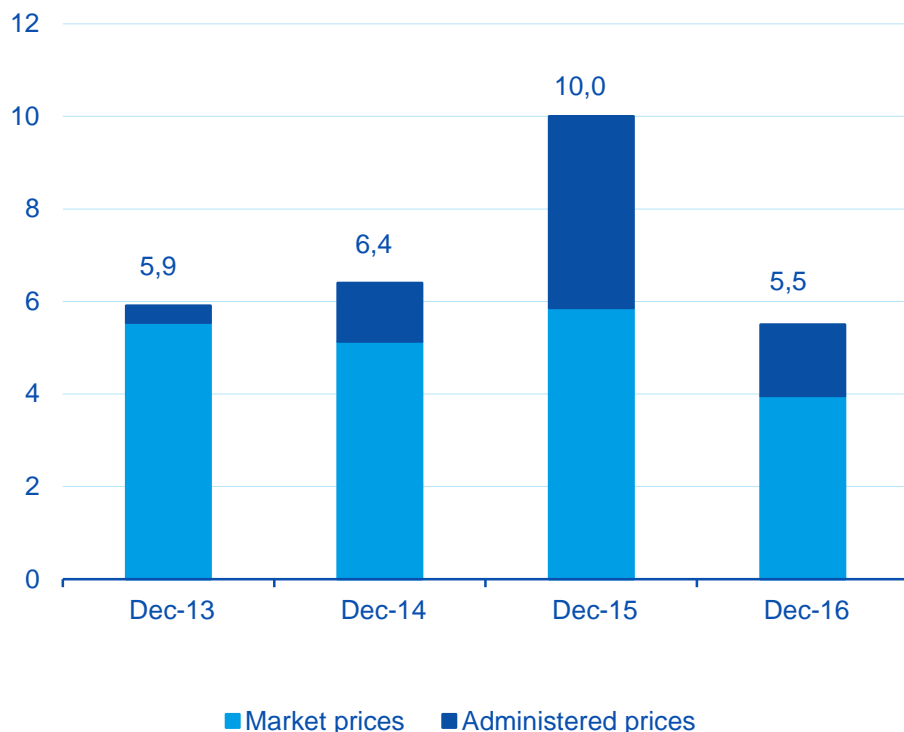
All these factors are likely to play a less negative role in 2016 than in 2015

Downside risks: external environment (further corrections in China, US monetary policy), larger deterioration of domestic labor markets, further politically or fiscally-driven tensions

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

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

Source: BCB, IBGE and BBVA Research



Inflation continued to trend upwards, fueled by larger-than-expected adjustments in regulated prices

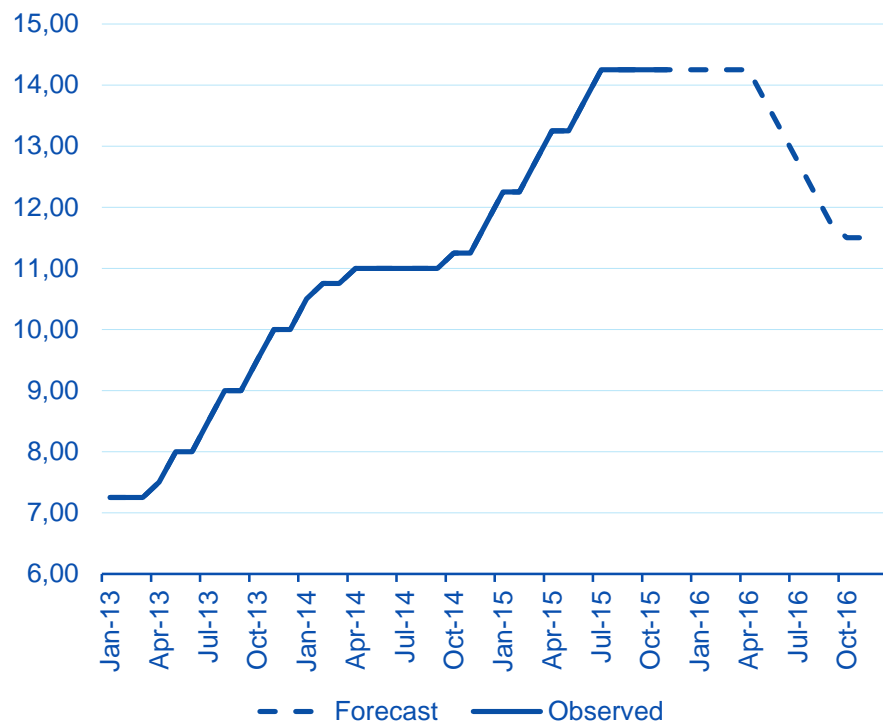
We now expect it to close the year at 10.0% and then moderate gradually next year, when the process of alignment of administered prices will be mostly over

Anyway, inertia and the effect of a weaker exchange rate should prevent inflation from converging to the 4.5% target next year

The monetary policy focus is already on 2017

Interest rate: Selic (%)

Source: BCB and BBVA Research



In spite of its deviations with respect to the target, we expect the BCB to also take into account the weakness of economic activity...

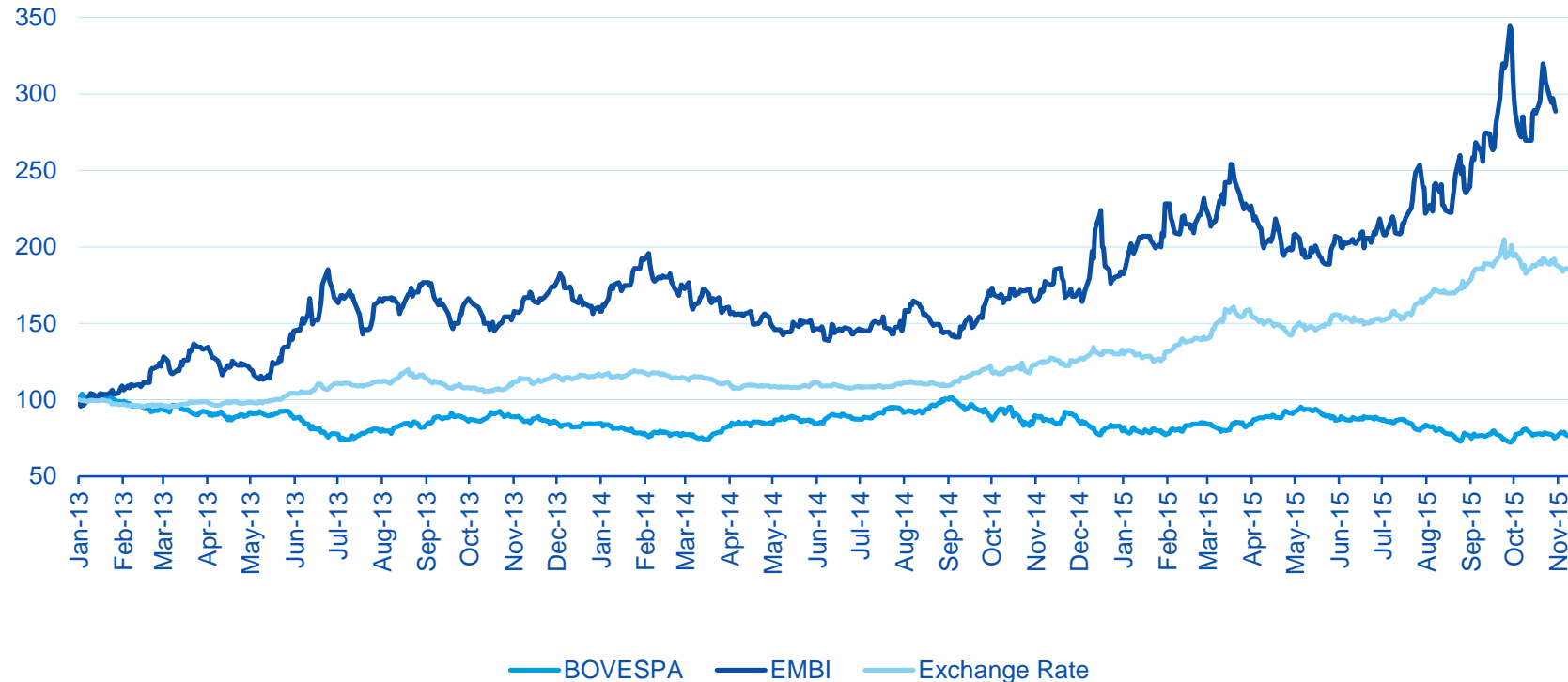
...and leave interest rates at 14.25% for some time

The recent change in the BCB communication, focusing on 2017 rather than on 2016 inflation, reinforces this view

Turbulences in financial markets due to external (mainly China) and local issues (fiscal deterioration)

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

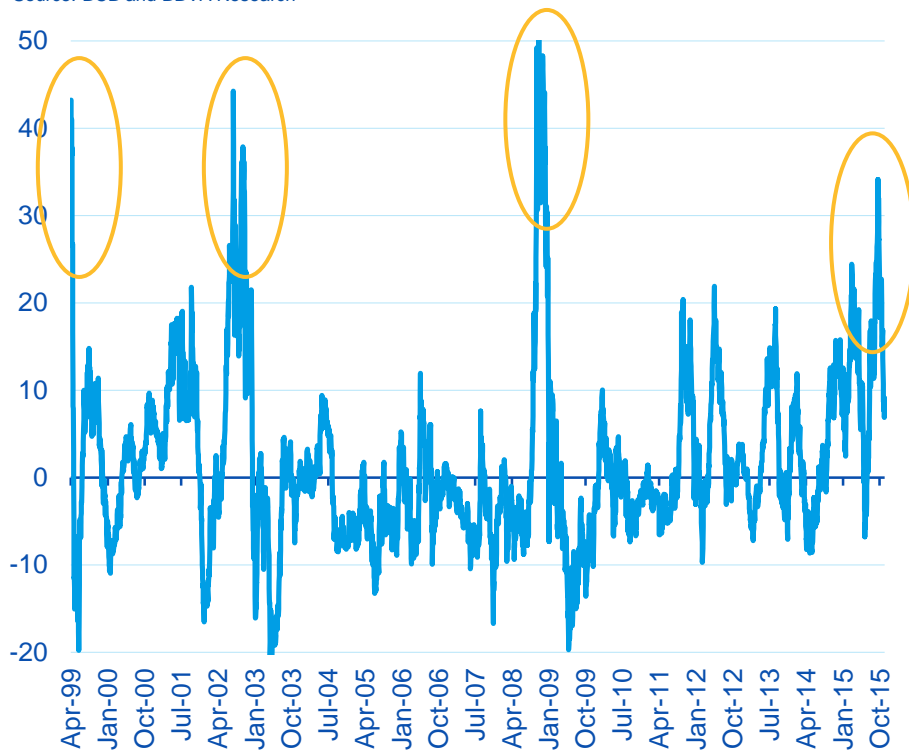
Source: Datastream and BBVA Research



Recently turbulences only comparable to the ones observed in 1999, 2002 and 2008

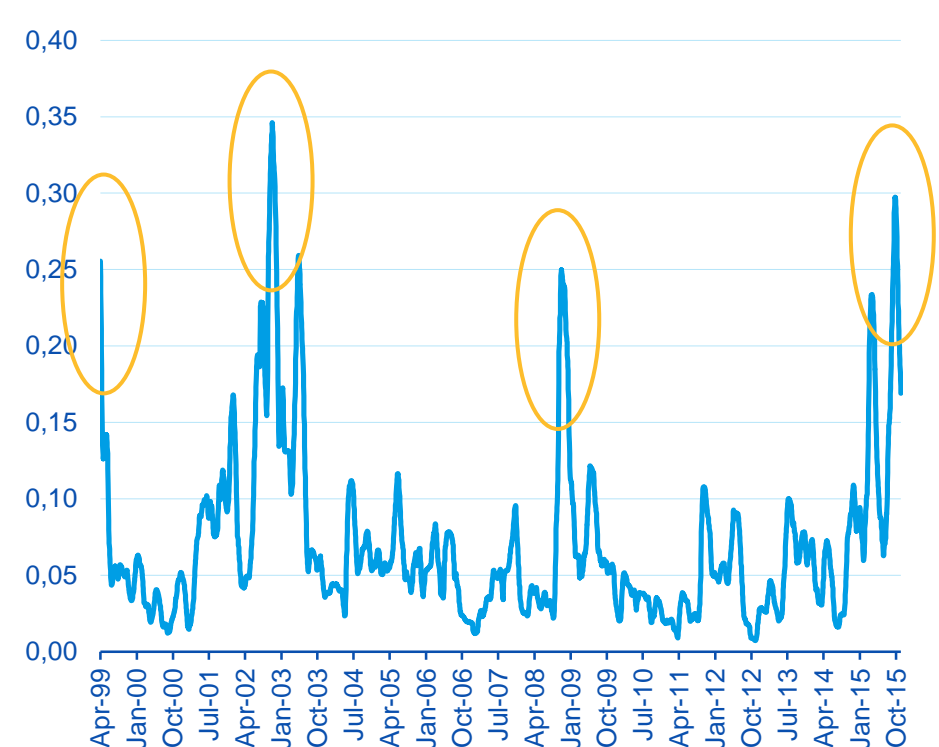
Exchange rate depreciation: 3-month rolling depreciation (%)

Source: BCB and BBVA Research



Exchange rate volatility: 3-month rolling standard deviation

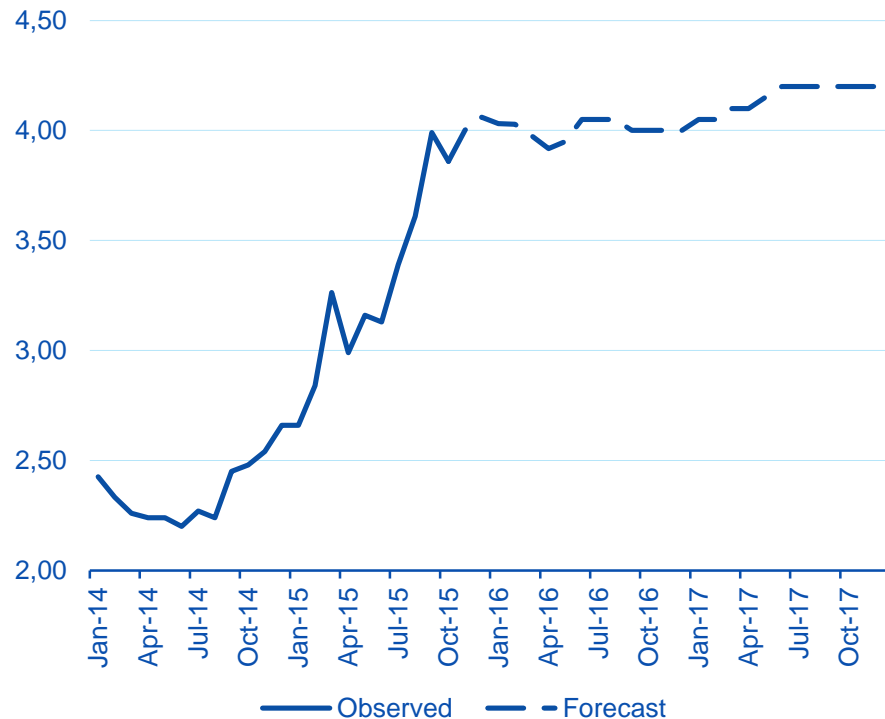
Source: BCB and BBVA Research



A weaker exchange rate will favor a relatively fast correction of the current account deficit

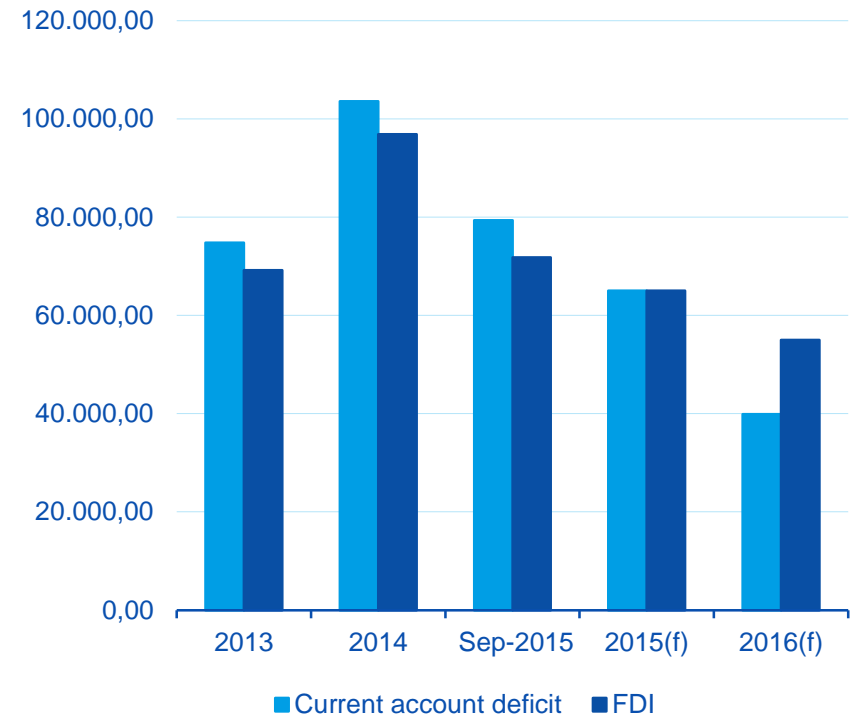
Exchange rate: Brazilian real (BRL) per US dollar (USD)

Source: BCB and BBVA Research



Current account deficit and foreign direct investment (FDI)*

Source: BCB and BBVA Research



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Brazil: BBVA Research 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