BBVA | RESEARCH

Brazil
Economic Outlook

2ND QUARTER 2016 | LATIN AMERICA UNIT

01
Economic activity will continue to weaken while the political environment should remain turbulent

02
GDP will fall around 3.0% in 2016, driven by a contraction of around 6% in the domestic demand

03
We expect positive GDP growth in 2017, but activity recovery will be slow, in line with our estimates showing potential growth of just 1%

04
Inflation slowdown and current account improvement will bring some relief, while fiscal concerns will continue

Index

Closing date: 12 May 2016

1 Overview

The political environment is expected to remain turbulent. The Senate has accepted the impeachment case for analysis, meaning that President Rousseff will have to step down and Vice-President Temer will assume presidential duties for 180 days. As it is most likely that during this period the Senate will favor the permanent dismissal of President Rousseff, the Vice-President will probably govern the country until the end of 2018. Once the doubts about who will govern the country have been mostly cleared up, we see some room for domestic uncertainty to fall. However, we expect political tensions to remain high, preventing a sharp turnaround of activity.

Economic activity will decrease around 3.0% in 2016 and rebound 0.9% in 2017. We expect GDP to contract in quarterly terms during the first half of the year (although not as much as in the second half of 2015), practically stabilize in the second half of 2016 and then be back into positive territory next year. The expected gradual improvement of economic activity over the forecast horizon is related to our view that both global growth and commodity prices will be progressively more supportive. Moreover, the economy will increasingly benefit from a mild decline in domestic uncertainty, a slowdown in inflation, a less contractive monetary policy, etc. Our prospects for the economy remain broadly unchanged in comparison to three months ago. We continue to forecast GDP to grow -3.0% in 2016 and have revised down our forecast for 2017 by 0.3 p.p. to 0.9%. Nevertheless, GDP growth will remain low, among other things, because the fiscal situation will continue to weigh negatively. This view is backed by our estimates showing that potential GDP has fallen to just 1.0% (Box 1).

Recent inflation moderation reinforces our forecasts that inflation will fall to 6.8% in 2016 and 4.5% in 2017. After having peaked at 10.7% in January, inflation has been falling lately. In April it reached 9.3% and we continue to expect it to converge to 6.8% at the end of this year and 4.5% at the end of 2017. The main drivers of this deceleration will continue to be the smaller adjustments in regulated prices (as most of the previous misalignment has already been corrected) and the contraction of domestic demand. Relatively high inertia (Box 2) will prevent a faster-than-expected convergence of inflation within the official targets.

The time for the beginning of a monetary easing cycle has not arrived yet. Although the recent slowdown of inflation has allowed the tone of monetary policy to become less hawkish, we think that the BCB will only start to cut the Selic rate at the beginning of next year, when inflation will finally be within the target range and expectations should be more anchored. A new BCB president could be appointed by the new government. Although that is likely to be a hawkish event, the possible changes in the monetary authority board increase uncertainty regarding monetary policy.

We remain skeptical about a short-term solution to the fiscal crisis. We think that the environment for the approval of the needed fiscal reforms will remain challenging. Even though the Temer administration seems willing to address fiscal matters, we are skeptical about its ability to approve a significant social security reform and to effectively reduce the degree of rigidity of public expenses. Therefore, we expect public accounts to continue to worse and fiscal risks (debt crisis, fiscal dominance, etc) to remain in place. The gross public debt is forecast to jump from 66% of GDP in 2015 to 72% in 2016 and 75% in 2017.

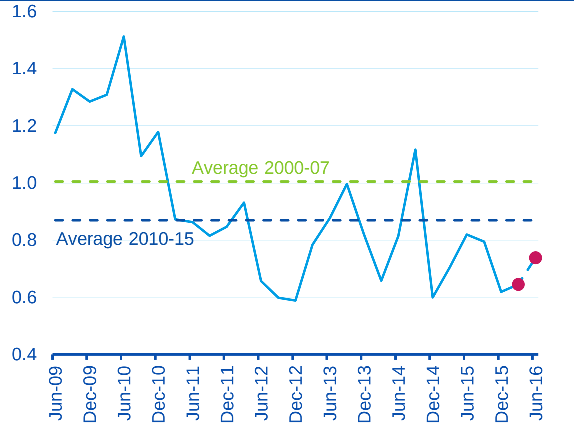
The exchange rate is likely to depreciate moving forward. The Brazilian real and other local financial assets prices appreciated recently, supported by lessening concerns with China and the US monetary policy. However, we expect both factors to continue to weigh in financial markets, which together with some local factors support the view that the exchange rate will depreciate moving forward. That will help the current account deficit to continue to decline until it reaches 1.0% of GDP in 2017 (vs. 4.3% in 2014), which will further reduce the risk of a balance-of-payments crisis.

2 Global environment: fragile and China-dependent growth

The information available for the first quarter of 2016 supports our view that global growth will stabilize at low levels, although not as low as at the end of 2015. Our BBVA-GAIN[1] indicator shows that quarterly global GDP reached 0.6% at the beginning of the year (2.6% at an annualized rate), much lower than recorded between 2010 and 2015 (Figure 2.1). This growth rate, which could slightly accelerate in the second quarter, if the evidence provided by recent indicators of production, trade and business confidence is reinforced, is still insufficient for the annual progress of the worldwide economy to reach approximately 3.2% (our estimate for the whole of 2016).

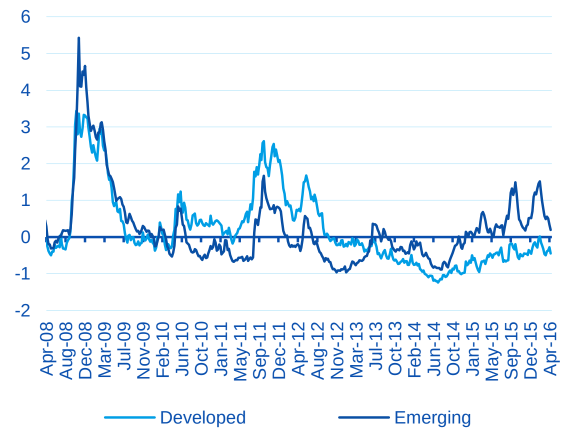
The significant increase in financial volatility observed between December 2015 and February 2016, in addition to responding to the downturn in global activity, threatens to be substantial if it continues with the same intensity and ends by being reflected in a tightening of spending decisions. The better than expected assessment for the economic indicators in China, together with the decreased downward pressure on the price of the Yuan, the recovery of prices for raw materials and the moderation of the expectations for a rise in interest rates by the Fed have been fundamental in the remission of financial stress from then onwards and in lessening, in turn, the probability of a stressful short-term scenario occurring on an international scale.

Figure 2.1
World GDP (QoQ%). Forecasts for 1Q16 and 2Q16 based on BBVA-GAIN



Source: BBVA Research

Figure 2.2
BBVA index of financial tensions (normalized values)



Source: BBVA Research and Haver

China: lower short-term risk, but more doubts in the long term

The reinforcement of incentive policies, both monetary and fiscal, by the Chinese authorities have contributed toward softening the effects of the manufacturing sector's readjustment to aggregate output and, therefore, to the trade flows of the country with the rest of the world. In the short term, the implementation of counter-cyclical measures may enable a more gradual than expected downturn in the economy. Nevertheless, if this similarly brings about a delay in the correction of fundamental imbalances, such as the increased leverage of the corporate sector or the oversupply in some areas of industry and construction, the financial vulnerability of China in the event of shocks like the one observed in summer 2015 would increase and, with it, its potential for destabilizing the rest of the world. Taken overall, these factors lead us to an upward revision of the growth estimates for China in 2016, up to 6.4% in 2016, and to sustained growth of 5.8% in 2017.

1: See https://www.bbvaresearch.com/en/publicaciones/global-gdp-growth-remains-stuck-at-2-6-yoy-in-q1-less-cloudy-outlook-but-the-same-risks/

The international context conditions the decisions of the Fed and contributes to alleviating the pressures on emerging blocks

The weight granted by the agents of the worsening international context on the reaction of the Fed explains the delay in the expectations for the next rise in interest rates. In the face of the two increases forecast by the members of the FOMC for 2016, the market has postponed the next increase to the beginning of 2017. The reaction of the dollar, depreciating despite the relatively good behaviour that domestic demand in the United States is continuing to display, and the relaxation of the long sections of the dollar curve have contributed to alleviating the financing restrictions on the emergent block, as reflected in: (i) the BBVA rate of financial stress for this region, which has corrected the entire upturn observed for the first months of 2016 (Graph 2.2), and (ii) the reactivation of foreign capital inflows, in which net capital inflows have been produced in the emerging countries since the middle of February due, in part, to the relocation of investment flows to instruments with greater profitability.

Furthermore, since the central banks in developed economies have maintained the same tone for their monetary policies as in recent months (reinforcement or maintenance of the stimulus in the case of the ECB and the Bank of Japan; caution in the normalization of interest rates in the case of the Fed), the emergent authorities will have a greater margin for manoeuvre when prioritizing, among other objectives, economic recovery. The expected gradualism of the FED (which is a factor supporting capital flows into the region) and the recent recovery of currencies (which restricts the possible increase in inflation due to increases in the price of imported goods) limit the need to undertake aggressive increases in interest rates.

All in all, the relative improvement in the global economic scenario over the last quarter continues to be fragile and conditioned, in the short term, by both the progress of the Chinese economy and the resolution of the points of geopolitical instability that are present in Europe. In any case, in a context of high uncertainty about the capacity of the emergent block to sidestep economic deceleration and the ability of the central banks in the developed countries to relaunch growth, the occurrence of new periods of financial volatility, like the one observed at the beginning of this year, is not unlikely.

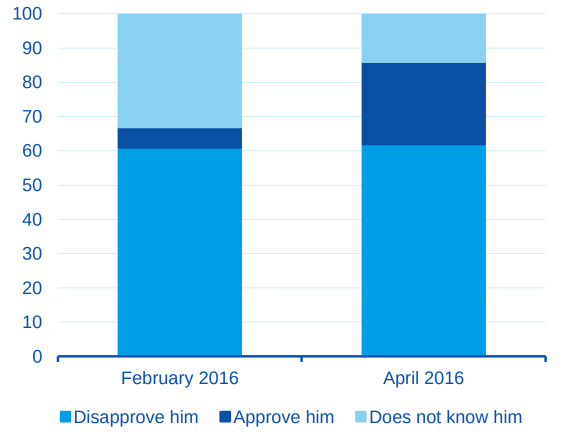
3 Brazil's political environment to remain turbulent

Political tensions should continue to weigh negatively on economic activity during the government of Michel Temer, although not as much as recently

On April 17th, 367 out of the 513 members of the Lower House voted in favor of impeaching President Dilma Rousseff and then, on May 12th, 55 out of the 81 members of the Upper House decided on to admit for analysis the impeachment case. As a consequence, she will be forced to step down and Vice-President Michel Temer will assume presidential duties for 180 days. During this period, the Upper House will trial President Dilma Rousseff and will take a final decision on her impeachment (two-thirds of the votes are needed to make the impeachment definitive). The most likely is that the Upper House will end up favoring her permanent dismissal. Therefore, Michel Temer is likely to govern the country until the end of 2018.

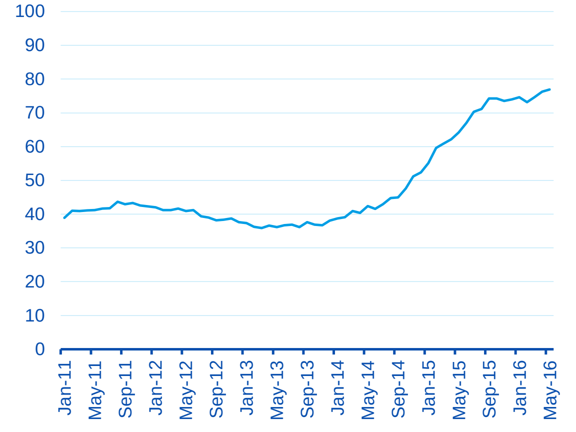
It is unclear whether Temer's government will have the needed support to govern the country. His party, the PMDB, holds only 18 of the 81 Senate seats and 67 of the 513 seats of the Chamber of Deputies. That is more than Rousseff's PT, which has 11 representatives in the Senate and 57 in the Chamber of Deputies, but still insufficient to govern without the support of other parties. In that regard, it is important to note that those who favored Rousseff's impeachment will not necessarily support Temer's government. On top of that, recent surveys show that the new government will begin with low popular support: Michel Temer's approval rating is around 25% (Figure 3.1), slightly higher than Rousseff's approval rating.

Figure 3.1
Michel Temer's approval rating



Source: Ipsos

Figure 3.2
Brazil's crisis index (based on web searches)*



* Seasonally-adjusted index built on the interest about the term "crise" (crisis in Portuguese) in Brazil.
Source: Google Trends and BBVA Research

Apart from the difficulties to govern a country facing a severe crisis (Figure 3.2), the next administration will also have to cope with the emergence of more news about the investigations on the corruption scandals at Petrobras and a fierce political opposition.

Thus, there are many reasons to think that the political environment will remain turbulent from now onwards, preventing the adoption of a proper solution to Brazil's fiscal problems and inhibiting a significant recovery of the confidence and therefore of economic activity. However, as we pointed out some months ago, once a decision about the impeachment was taken, the degree of uncertainty about the country could reduce somewhat. Anyway, the magnitude of this reduction will depend on the actions of the new government.

4 GDP will contract sharply in 2016, helping to drive inflation down; activity to recover slowly in 2017

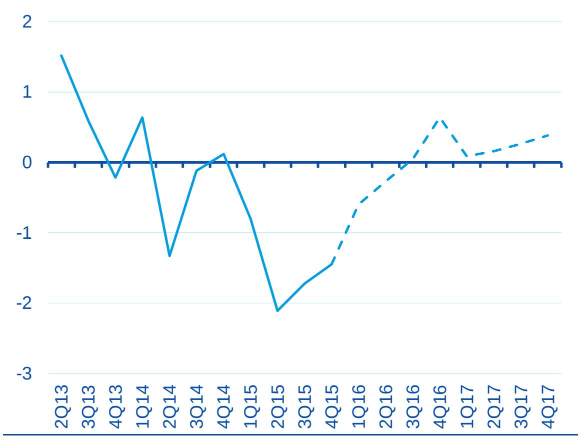
We forecast economic activity to decrease by 3.0% in 2016 and then to grow by 0.9% in 2017

Economic activity contracted for the fourth consecutive time in the last quarter of 2015 and it will likely decrease further in the next few ones. However, the economy has been decreasing at a declining pace in the last few quarters, a trend we expect to continue moving forward. More precisely, GDP dropped by 2.1% QoQ in the second quarter of 2015, 1.7% QoQ in the third, and 1.5% QoQ in the fourth one. We forecast it to decrease around 0.6% QoQ in the first quarter of 2016, somewhat less in the second quarter of the year and then to practically stabilize in the second half, before starting to grow at a positive, although low, rate in 2017 (Figure 4.1).

The expected dynamics of quarterly GDP is consistent with an annual GDP contraction of 3.0% in 2016, which would follow a 3.8% decrease in 2015, and a timid 0.9% rebound of growth in 2017.

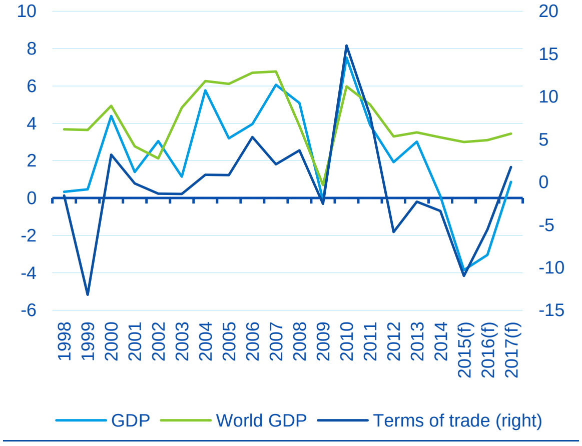
It is important to note that statistical carry-over effects play an important role in the determination of annual growth figures. More precisely, if GDP remained unchanged throughout 2016 at the same level as in the last quarter of 2015, growth would thus decrease around 3.0% in annual terms in 2016[2]. Similarly, if GDP remained stable during 2017 at the level expected for the end of 2016, then 2017 GDP would grow by 0.4%. That means that the contraction of GDP in 2016 will be mostly due to statistical issues and that part of the expected rebound in 2017 is also related to carry-over effects.

Figure 4.1
GDP growth (QoQ)*



* BBVA forecasts from 1Q16 to 4Q17.
Source: IBGE and BBVA Research

Figure 4.2
Brazil's GDP, terms of trade and world's GDP (% growth)*



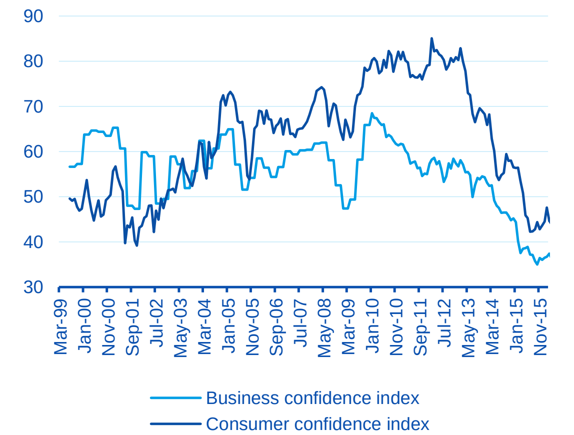
Source: IMF and BBVA Research

2: That is due to the fact that 4Q15 GDP was significantly below the levels observed in the previous quarters in 2015.

On the one hand, the performance of domestic GDP growth has been and will continue broadly synchronized with the evolution of the global economy: after decelerating in 2015, world GDP growth will likely be stable at around 3.2% in 2016 and will then accelerate somewhat in 2017. In addition, the domestic GDP path will continue to be shaped by the dynamics of commodity prices in global markets, which are expected to cause a 5% fall in Brazil's terms of trade in 2016 -somewhat less than in 2015 when the contraction was of 11%- and then to grow by 2% in 2017 (Figure 4.2)[3].

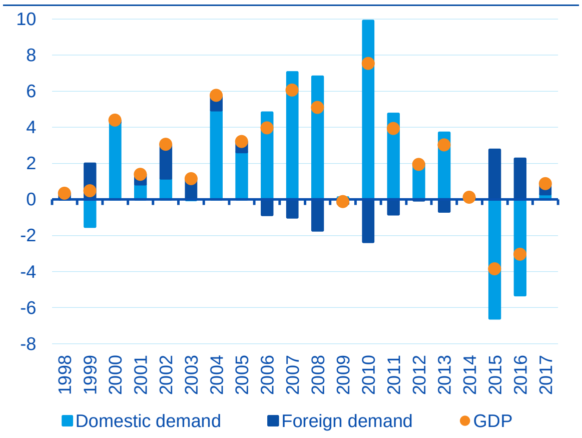
On the other hand, the evolution of domestic GDP will obviously continue to be linked to local factors. Firstly, after a sharp deterioration in 2015, confidence has been relatively stable at low levels in the last few months (Figure 5.3).We see some room for a small and gradual improvement going forward, which is line with our view that the decision on the impeachment of President Dilma Rousseff, whatever it was, would reduce –not eliminate- uncertainty regarding the domestic outlook. On top of that, the inflation slowdown and the improvement of the current account will take some pressure off economic policies, especially in 2017, when we expect monetary policy to become gradually less restrictive. Moreover, the reduction in manufacturing inventories as well the more depreciated exchange rate level should contribute to some improvement in the dynamics of exports and fixed capital investment during the next few quarters.

Figure 4.3
Confidence indices



Source: CNI, Fecomercio and BBVA Research

Figure 4.4
GDP growth: contributions of domestic and foreign demand



Source: IBGE and BBVA Research

Our prospects for the economy remain broadly unchanged in comparison to three months ago. Even though incoming activity data is somewhat worse than expected and the degree of political turbulence continues to surprise us negatively, their impact on activity is expected to be offset by the fact that commodity prices are performing better than we anticipated, which will likely imply that terms of trade will fall around 5% in 2016, less than we forecast before (8%). That is the main reason why our GDP forecast remains unchanged at -3.0% in 2016. With respect to 2017, we have revised our GDP forecast 0.3 p.p. down to 0.9%. This revision is mostly due to the fact that we now expect Brazil's terms of trade to increase only 2% next year rather than 5% as the rebound in commodity prices, expected to occur in 2017, ended up taking place in 2016.

From a different perspective, we expect the GDP contraction in 2016 to be mostly driven by a significant decrease in domestic demand. More precisely, we forecast it to fall by 5.8% in 2016, contributing with -5.3 p.p. to GDP growth this year, while last year it decreased by 6.4% and contributed with -6.6% p.p. to GDP

3: After a severe contraction at the beginning of the year, commodity prices rebounded more than we expected recently due to lessened concerns over China. Even though we see some room for a downward correction in the short-term, we expect commodity prices to remain broadly stable and even increase somewhat over the forecast horizon. For more details about our view on commodity markets, see our 2Q16 Latin America Economic Outlook.

growth. With respect to 2017, we forecast domestic demand to expand by 0.3%, contributing positively to GDP growth in the period (Figure 4.4).

We forecast both gross fixed capital formation (GFCF) and consumption to decrease significantly in 2016, although not as much as in 2015. However, in 2017 we are counting on a rebound in the former and expect consumption to remain broadly stable. The forecast of stability of consumption in 2017 is in line with our view that credit and mainly labor markets will continue to deteriorate until the beginning of next year.

Regarding the performance of foreign demand, we expect the slowdown in imports and a positive contribution from exports to jointly contribute with 2.3 p.p. to GDP growth in 2016. In 2017 the contribution of net external demand should be smaller, around 0.6 p.p., as imports should stabilize after having fallen significantly in 2015 and 2016 (see our forecasts table in Section 7).

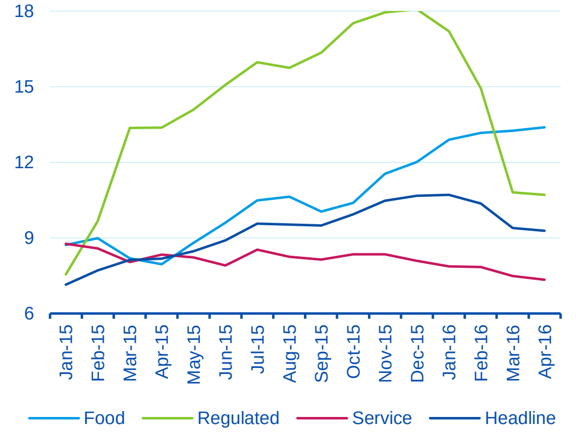
Finally, it is worth emphasizing that, even though the recession will likely lose intensity in the next few quarters and a recovery is expected to start at the end of this year, GDP growth will remain weak moving forward, due to the impact of the ongoing fiscal deterioration and of political turbulence, among other things. This view is supported by our estimates showing that potential GDP has deteriorated significantly and is now around 1.0% (see Box 1).

Domestic demand deceleration is finally affecting inflation more significantly

After peaking at 10.7% in January, annual inflation has been trending downward lately. In April it reached 9.3%, the lowest figure since June 2015. As we expected, smaller adjustments in regulated prices and the impact of the domestic demand slowdown are finally paving the way for a slowdown in inflation (Figure 4.5).

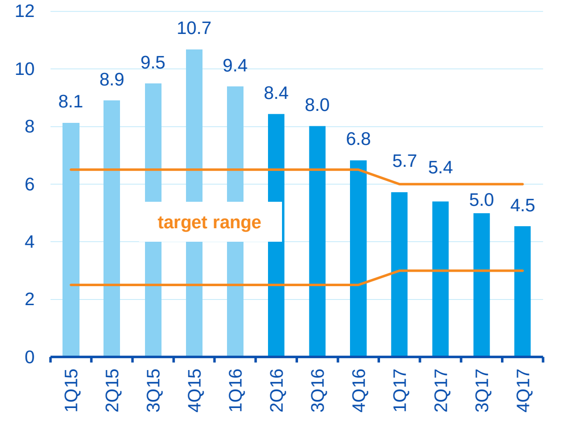
Inflation of regulated prices is now at 10.7% in annual terms, still high, but below the levels observed last year (18.1% in December 2015, for example). After the very sharp corrections implemented last year, the process of alignment of regulated prices is now nearing its end. In any case, it is worth noting that the reduction in administered-price inflation has benefitted from the recent moderation of oil prices in global markets, which reduced the need of further increases in fuel prices, and also from the more favorable dynamics of electricity tariffs. They increased only 1.7% in annual terms in April in comparison to 51% in December 2015 thanks to a more favorable rainfall regime this year and the reduction of the demand for electricity.

Figure 4.5
Inflation: headline, food, regulated, service and 12-month market expectation (YoY %)



Source: BCB and BBVA Research

Figure 4.6
Headline inflation: observed and forecasts (YoY %, end of quarter)



Source: IBGE and BBVA Research

With respect to the contraction in domestic demand, this has finally been driving down domestic prices more significantly. It has, for example, allowed service inflation to ease more significantly in the last months (Figure 4.5). More precisely, after remaining practically steady above the 8.0% mark last year, service inflation declined to 7.3% in April, the lowest level since 2010. Another symptom of the more important effect of the ongoing recession on internal prices is the recent moderation of wages. After growing by around 9% in 2014 and 6% in the first half of 2015, nominal wages have been increasing around 3% in annual terms in the last few months (and an additional slowdown in the next few months should not be ruled out).

In spite of the recent deceleration, inflation is still well-above the target range and we forecast it to only converge to the BCB goals by the beginning of next year (as announced in 2015, the target range will be narrowed to 3.0%-6.0% in 2017 from the 2.5%-6.5% in the previous years). Among the factors that will likely prevent a faster convergence of inflation within the targets we highlight i) the pressure from food prices, mostly due to supply issues (Figure 4.5); ii) the existence of significant mechanisms of indexation (the Box 2 shows that inflation persistence is relatively high in Brazil); iii) still high inflation expectations (Figure 5.1); and iv) the prospects that the exchange rate will remain at more depreciate levels over 2016 and 2017, in spite of the appreciation observed in the last few months (Section 6).

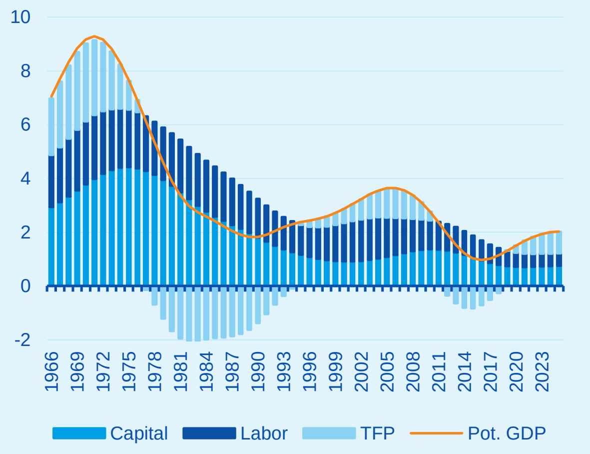
The recent inflation moderation caused markets' inflation expectations to decrease lately (Figure 5.1) and reinforced our below-consensus forecasts, which continue at 6.8% for the end of 2016 and 4.5% for the end of 2017 (Figure 4.6).

Box 1. Brazil's potential GDP falls to around 1%

The overall deterioration of the Brazilian economy in the last years has produced a significant reduction in the country's capacity to grow without generating distortions. The slowdown of the Chinese economy, the consequent fall in commodity prices, the mismanagement of local economic policies (in particular of the fiscal policy, which has contributed to the emergence of a fiscal crisis), the lack of reforms to spur domestic productivity, among other factors, have all contributed to a fall in Brazil's potential GDP. In fact, these factors have negatively affected each one of the components of potential GDP, namely capital, labor and overall productivity (also known as total factor productivity or TFP).

Some examples provide a quick illustration of the deterioration Brazil went through recently: i) investment in fixed capital decreased around 25% from 2013 until 2015, reducing the contribution of physical capital to growth; ii) unemployment jumped from slightly less than 5.0% in the second half of 2014 to more than 8.0% at the beginning of 2016, making less relevant the labor contribution to domestic growth; and iii) Brazil lost five positions in the World Bank's Ease of Doing Business Rankings, which is in line with the view that overall productivity has fallen in recent years.

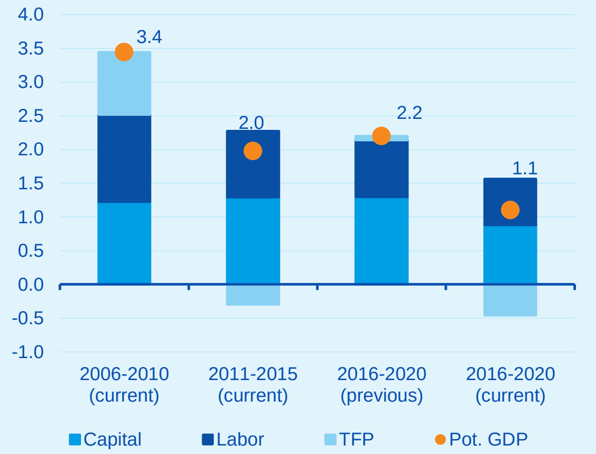
Figure B.1.1
Potential output by contributors



Source: BBVA Research

Our updated estimations show that Brazil's potential GDP is currently around 1.0% and that it will remain close to that level in the next few years (1.1% on average between 2016 and 2020). Looking beyond 2020, some improvement is likely and potential GDP could then converge to 2.0% (Figure B.1.1).

Figure B.1.1
Current potential GDP estimates for 2006-2010, 2011-2015 and 2016-2020 and previous (2015) estimates for the 2016-2020 period



Source: BBVA Research

The potential GDP estimate for the 2016-2020 period is significantly lower than we estimated in 2015 (2.2%), which reflects not only the deterioration recorded in the last few years but also less positive prospects for the future. Moreover, our estimations show that potential GDP will be in the next five years well-below the levels observed in the previous decades (Figure B.1.2).

A faster convergence to a higher potential growth level could be achieved by an early adoption of relevant economic reforms (of the political system, of the social security system, of labor markets, of the tax system, etc), which now we regard as unlikely.

Box 2. The persistence of inflation in Brazil: a comparative analysis

After peaking at the beginning of the year, inflation in Brazil has been decelerating in the last few months. Even though it is expected to moderate further due to the contraction of domestic demand and smaller adjustments in regulated prices, it is not clear when exactly it will converge to the targets established by the central bank.

To address that particular issue and, more generally, to analyze the domestic price dynamic we need to understand just how persistent inflation is in Brazil.

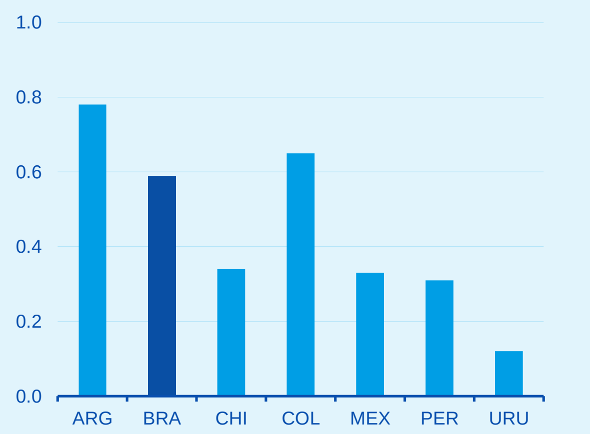
With this in mind, we present in this study three measures of inflation persistence and compare the results we obtain for Brazil with those for other Latin American countries (Argentina, Chile, Colombia, Mexico, Peru and Uruguay). We use monthly data, generally from January 2004 to March 2016, and take as a measure of inflation the annualized and deseasonalized monthly inflation rate.

Firstly, we estimate an auto-regressive model of order one (i.e. an AR(1)), in which current inflation depends solely on the inflation for the immediately preceding period[4]. The estimated value of the parameter that relates current to past inflation can be taken as a simple measure of persistence. The higher it is, the greater the impact of past inflation on current levels, suggesting greater inertia.

Figure B.2.1 shows that the persistence of inflation based on the AR(1) is around 0.6 in Brazil, lower than in Argentina and Colombia, but higher than in the other countries analyzed.

This initial measurement is in part determined by factors such as economic activity, the exchange rate and external inflation, among others. In order to exclude such extrinsic effects and have a measure of persistence that actually reflects the impact of intrinsically inertial factors on inflationary forces, related to the existence of price index mechanisms, we use the generalized method of moments (GMM) to estimate a Phillips curve for each economy, in which current inflation depends on the product gap, past inflation, inflation expectations, the exchange rate and the price of raw materials on global markets[5].

Figure B.2.1
Persistence of headline inflation: based on the estimation of an AR(1) model (Jan/04-Mar/16)*



* Results are significant at 5% level, with the exception of Uruguay.
Source: BBVA Research

In this case, the parameter that relates current to past inflation is an indicator of intrinsic persistence, free from the effect of the other variables included in the estimate.

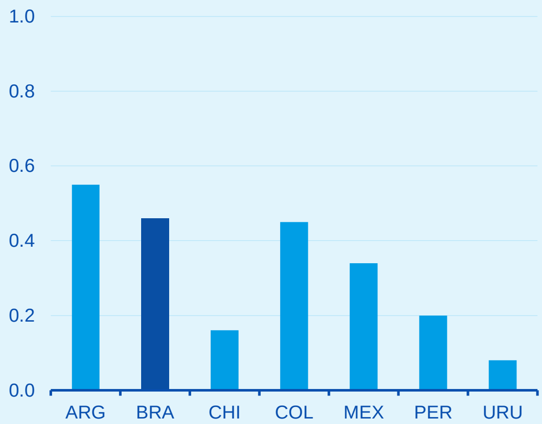
Despite the fact that in this case, the level of persistence for Brazil is around 0.5, slightly lower than in the previous measure, it is once again higher than in most countries in the region (Figure B.2.2)[6].

We re-estimate the previous Phillips curve model using core inflation, rather than headline inflation, as dependent variable as some items, such as food and regulated goods/services, show a price dynamic which differs sharply from the general. In this case, the estimated persistence for Brazil is lower than previously, which means that the inertia of non-core components of inflation is

4: In none of the countries the inflation series exhibit a unit root, according to standard tests. In all cases, therefore, these are stationary series.
5: The independent variables enter with only one lag, apart from inflation expectations, which enter contemporaneously (and have to be instrumented for).
6: The introduction in the model of the independent variables with additional lags does not significantly change the results.

higher than the persistence of core components. Anyway, the results continue to shows that persistence is relatively higher in Brazil than in other countries. In fact, in this case only in Argentina is the degree of inflation inertia higher than in Brazil (Figure B.2.3).

Figure B.2.2
Persistence of headline inflation: based on the estimation of a Phillips curve (Jan/04-Mar/16)*

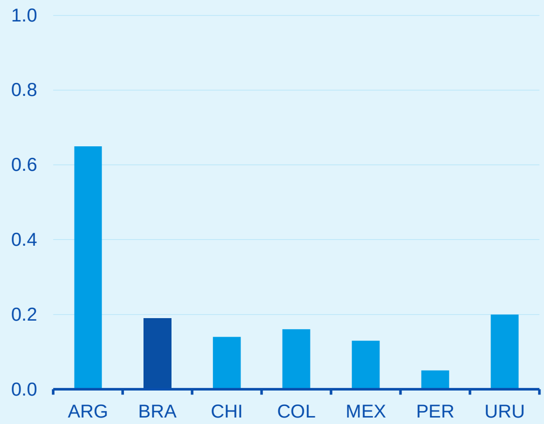


* Due to data issues, the sample for Argentina starts in August 2006. The results are significant at a 5% level for Argentina, Brazil, Colombia, Peru and Mexico and at 10% for Chile.
Source: BBVA Research

In general, the results support the idea that inflationary inertia is lower in countries where central banks have been less tolerant of inflation and higher in countries, such as Brazil, where inflation is usually higher[78].

Finally, in order to analyze whether the degree of inflation persistence has changed during recent years, we estimate the two previous Phillips curve models for the past three years (April 2013 to March 2016) and for earlier periods of the same duration. The results suggest that inflationary inertia increased over the past three years in Colombia, Peru and Uruguay. However, in the case of Brazil, as well as the other countries, the results are not conclusive, which is not totally surprising given the small size of the samples considered.

Figure B.2.3
Persistence of core inflation: based on the estimation of a Phillips curve (Jan/04-Mar/16)*



* Due to data issues, the samples for Argentina and Uruguay start in April 2008 and January 2011, respectively. The results are significant at a 5% level for Argentina, Brazil, Colombia and Mexico and at a 10% level for Peru and Uruguay.
Source: BBVA Research

All in all, our analysis suggests that indexing mechanisms play a relatively more important role in Brazil than in other similar countries. It reinforces our view that inflation deceleration in Brazil will be slow, and that inflation will only converge to within the target range at the beginning of 2017.

7: In the period analyzed, average inflation stood at 19.8% in Argentina, 6.0% in Brazil, 3.4% in Chile, 4.3% in Colombia, 4.0% in Mexico, 3.0% in Peru and 7.7% in Uruguay.
8: The results do no change significantly with the inclusion of additional independent variables with more lags.

5 Inflation fall brings some relief, but fiscal problems will continue to put pressure on economic policies

The time for a monetary easing has not arrived yet

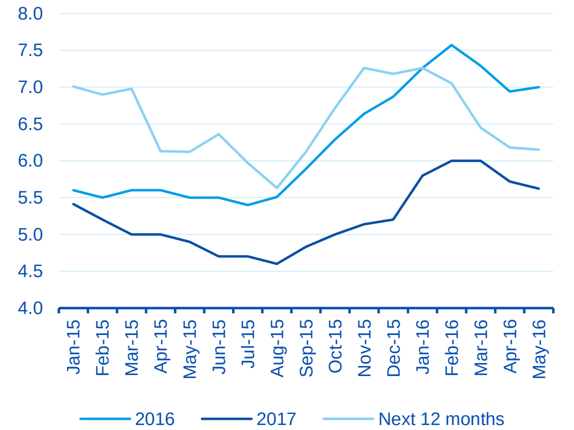
In line with our expectations, the Central Bank of Brazil (BCB) has kept the Selic rate unchanged at 14.25% in the last monetary policy meetings. On the one hand, the economic and political consequences of further tightening monetary policy during a recession closed the door on any further monetary tightening. On the other hand, the persisting high inflation did not leave room for the beginning of a monetary easing cycle.

Anyway, the recent moderation of inflation, in particular of market expectations (Figure 5.1), has allowed the monetary authority to adopt a less hawkish tone recently. In fact, while an additional dose of monetary tightening has been practically ruled out, a reduction of the Selic rate is now on the radar. Nonetheless, we continue to expect the BCB to cut interest rates only when inflation converges within the target range and market expectations near the 4.5% mark, something we think will only occur at the beginning of 2017. That view was reinforced by the minutes of the last monetary policy meeting in which the monetary authority stated that "…high annual inflation and inflation expectations distant from targets do not offer room for the easing of monetary policy".

Therefore, as three months ago, we expect the Selic rate to remain unchanged until the end of 2016 and then to be cut gradually over 2017 until it reaches 11.50% (Figure 5.2).

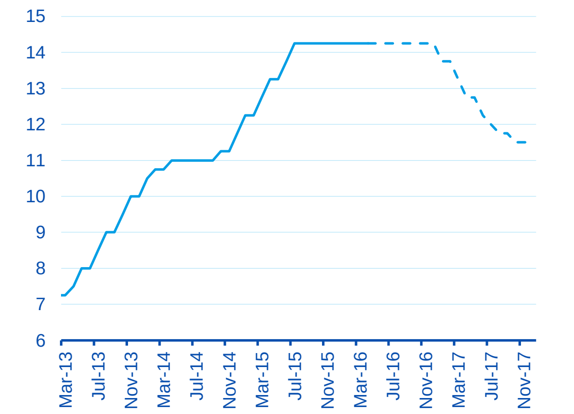
Anyway, as the Vice-President Michel Temer has assumed presidential duties, a new president for the BCB could be appointed soon. That would probably be a hawkish event as it is most likely that the new head of the institution would try to show a stronger commitment to low inflation than that the exhibited by the previous administration, which would then make a monetary easing less likely. However, the adoption of a more hawkish name for commanding the BCB, as well as any move towards formally conceding independence to the BCB, could drive inflation expectations down, creating some room for the beginning of a monetary easing cycle already in 2016. All in all, the possibility of changes in the BCB board heightens uncertainty regarding the monetary policy path over the next few months.

Figure 5.1
Inflation expectations: market consensus for next 12 months, end of 2016 and end of 2017 (YoY %)



Source: BCB and BBVA Research

Figure 5.2
Selic interest rate (YoY %)



Source: BCB and BBVA Research

We remain skeptical about a short-term solution to the fiscal crisis

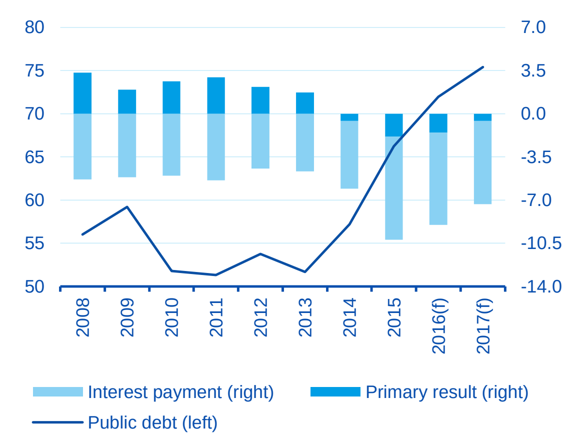
The political turmoil of the last few months has prevented the adoption of significant measures to reduce the concerns about Brazil's public accounts. As a consequence, not only have the main fiscal indicators continued to deteriorate, but also the prospects for the evolution of public accounts have further worsened.

The primary fiscal result accumulated in the last 12 months reached -2.3% of GDP in March, the worst result ever. Such a high primary deficit is related to the payment last year of around 1.0% of GDP in expenses of previous years, the deceleration in public revenues due to the contraction in domestic demand (federal government's tax revenues declined 9% in real terms in the first quarter of the year in comparison to the same period last year) and relatively high public expenditure (at federal level it expanded around 5% in the first quarter).

The total fiscal result, which adds interest payments to the primary result, improved somewhat very recently as the exchange rate appreciation reduced the expenses generated by the stock of exchange rate swaps of around USD67bn maintained by the BCB[9]. In spite of that improvement, the total fiscal result remained close to -10.0% of GDP (more precisely, -9.7% of GDP in March, in comparison to -10.4% of GDP in December 2015).

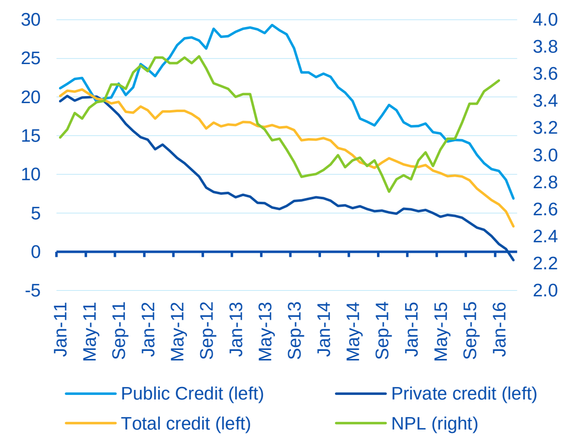
The gross public debt reached 67.3% of GDP in March, somewhat higher than in December 2015 when it was equal to 66.5% of GDP.

Figure 5.3
Fiscal indicators: primary balance, interest payment and gross public debt* (% of GDP)



* Primary result + interest payment = total fiscal result. Primary result and interest payment refer to the consolidated public sector while the gross public debt refers to the general government, which excludes the BCB and stated-owned companies.
Source: BCB and BBVA Research

Figure 5.4
Credit stock nominal growth (YoY %) and non-performing loans (NPL, %)



Source: BCB and BBVA Research

9: By providing exchange rate swaps, the BCB reduces the private sector's exposure to an exchange rate depreciation but increases its own. Even though these swaps are referred in USD dollars, they are paid in Brazilian reais. It is worth noting that if on the one hand the government gains with an exchange rate depreciation by maintaining these swaps, on the other hand it loses from a currency appreciation because its international reserves, amounting to almost USD370bn, make the government an external creditor. However, these losses do not impact the public sector's annual result (they do impact the public sector's debt).

We think that the environment for the approval of the needed fiscal reforms will remain challenging (see Section 3). Even though Michel Temer's administration seems willing to address the country's main fiscal problems and in spite of the fact that some positive steps will likely be adopted, we are skeptical about its ability to approve a significant social security reform and to effectively reduce the degree of rigidity of public expenses, which are essential to solve the fiscal crisis (for more details about these issues, see our 1Q16 Brazil Economic Outlook).

Based on these prospects for fiscal policy, we expect the primary result to close 2016 around -1.5% of GDP and 2017 around -0.6% of GDP: The relative improvement in 2017 is in line with our view that by then the tone of economic activity will be more positive than in 2016. Accordingly, the total fiscal deficit should remain very high, around 9.0% of GDP, this year and then fall to 7.3% of GDP next year thanks to the lower primary deficit expected for the period and the likely reduction in interest rate payments (the reference interest rate is forecast to fall from the beginning of 2017). Finally, we expect the gross public debt to reach 72.0% of GDP in December 2016 and 75.4% of GDP in December 2017.

In general, our current forecasts show a somewhat gloomier outlook for Brazil's public accounts. The expected additional deterioration in fiscal results should prevent a sharp turnaround of the confidence in the country, which is in line with our view that growth will remain low in the forthcoming years. Moreover, it will maintain the concerns about the building up of a solvency crisis and the emergence of a "fiscal dominance" scenario, for example.

Finally, it is worth adding that an exaggerated increase of credit from public banks is less likely under Michel Temer's government, which reduces the risks for these banks and therefore for public accounts due to a credit expansion during a recessionary period. Therefore, while there is more uncertainty about the stance of fiscal policy moving forward, the most likely is that credit markets will continue to exhibit a more contractive tone (Figure 5.4).

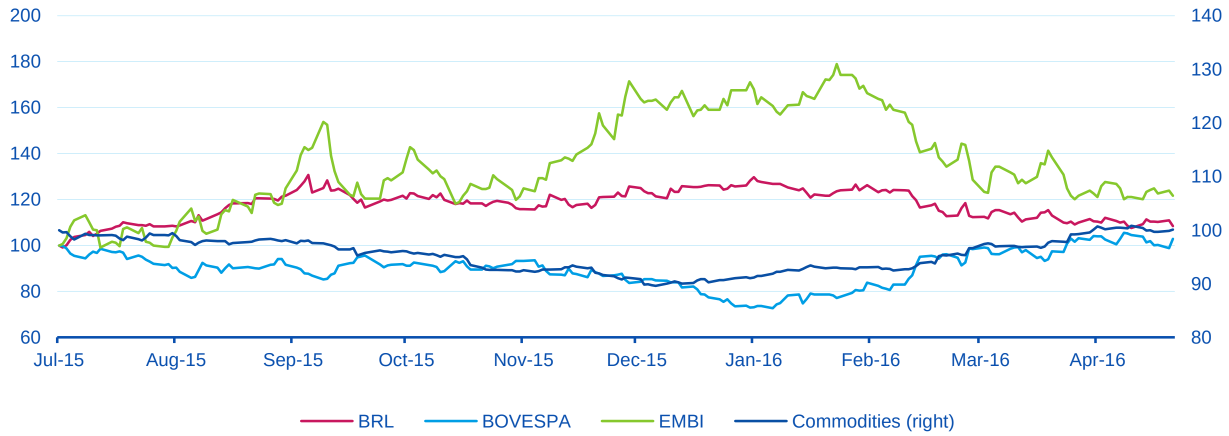
6 Financial markets: after the storm comes the calm; and then another storm?

Local financial assets recovered in the last months the losses recorded during the second half of 2015. We expect financial turbulence to remain high.

Lessening concerns about a hard-landin" of the Chinese economy and, secondarily, the consolidation of the perception that the process of normalization of monetary policy in the US will be gradual helped to reduce global financial tensions (Figure 2.2) and to drive up commodity prices in the last few months. The CRB commodity price index, for example, increased 11% since the beginning of the year (8% in the last three months). These recent increases offset the losses accumulated from the middle of July until the end of 2015, leaving commodity prices around the same levels observed around ten months ago (Figure 6.1). Since that moment at the beginning of the second half of 2015, the prices of oil, iron ore and soybeans, which are especially important for the Brazilian economy, varied -20%, +10% and +7%.

Interestingly, the prices of the main Brazilian financial assets exhibited a dynamic similar to the one showed by commodity prices and now are also close to the levels observed in the middle of July 2015 (Figure 6.1). The Sao Paulo stock exchange index (IBOVESPA) is now only 3% higher now than then. The Brazilian real is currently around 3,50, 8% weaker in nominal terms and broadly unchanged in real terms. Brazil's sovereign spread, measured by the EMBI+, is not so close to the levels observed at the beginning of the second half of 2015: it is around 20% higher now.

Figure 6.1
Commodity prices (CRB index), equity markets (BOVESPA), sovereign spreads (EMBI +) and exchange rate (USD/BRL). Indexes: figures as of July 20, 2015 =100.



* Higher values represent a weaker Brazilian real, a higher BOVESPA index and a higher sovereign spread. Data until May.
Source: Datastream, CRB and BBVA Research

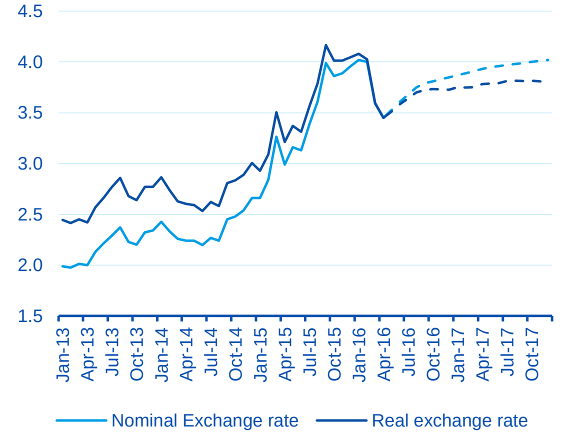
Therefore, in general, the recent dynamics of Brazilian financial assets are to a large extent explained by global factors, mainly commodity prices. Local factors are obviously also impacting financial asset prices. For example, the fact that Brazil's sovereign spreads are higher now than around 10 months ago is probably related to the sharp economic deterioration observed in the period, in particular of the public accounts (all the main credit rating agencies withdrew Brazil's investment grade since then). While the overall deterioration in the period also impacted negatively other local financial assets, the market's optimism with respect to the government of Michel Temer, which we do not completely share as commented in Section 3, have in general contributed to the gains exhibited in the last few months (the BRL, the IBOVESPA, and Brazil's sovereign spread gained 12%, 31% and 30% in the last three months).

We expect the process of moderation of the growth in China as well as the process of normalization of monetary conditions in the US to continue to weigh on global financial markets and on commodity prices, and therefore on Brazilian financial markets. The most likely is that both processes continue to create volatility even if Chinese authorities are able to avoid a hard-landing scenario and the US economy strengthens steadily.

Even though we see some room for a downward correction in the short-term, commodity prices should not be as low as at the beginning of the year moving forward. We forecast the oil price to converge to around USD40 per barrel at the end of this year and then to around USD50 at the end of 2017 and similar paths for other commodity prices (for more details, see our 2Q16 Latin America Outlook).

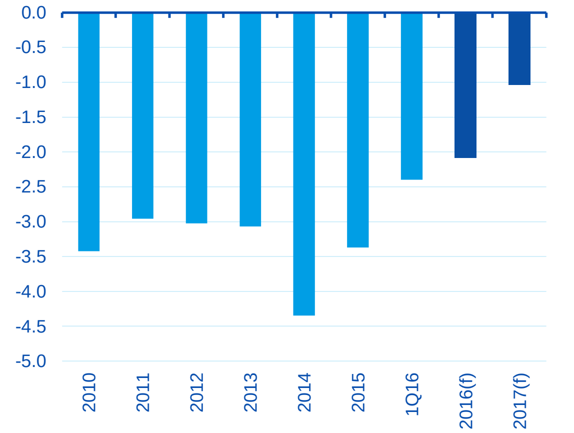
Taking that into account, as well as our view that the political environment will remain turbulent and that addressing fiscal problems will remain challenging, we expect the BRL to weaken somewhat over the forecast horizon and to close 2016 and 2017 around 3.85 and 4.02, respectively (Figure 6.2).

Figure 6.2
Exchange rate: Brazilian real per USD dollar (nominal and real rates)



Source: BCB and BBVA Research

Figure 6.3
Current account (% of GDP,)



Source: BCB and BBVA Research

The current account will continue to improve moving forward

The exchange rate weakening and mainly the sharp decrease of the domestic demand have been determining a steady reduction of the current account deficit lately. After closing 2014 at 4.3% of GDP, the current account deficit reached 3.4% of GDP in December 2015 and 2.4% of GDP more recently, in March. By components, the main contributor to the reduction in the current account deficit has been the improvement of the trade balance: -0.3% of GDP in 2014, 1.0% of GDP in 2015 and 1.8% of GDP at the end of the first quarter of 2016. Although exports have remained relatively weak, imports have been decreasing significantly.

We forecast the current account deficit to ease to 2.1% of GDP at the end of 2016 and 1.0% of GDP at the end of 2017. The trade balance is projected to inch up to 2.2% of GDP this year and 2.8% of GDP in the next one.

The fall of the current account deficit averts the risk of the country facing a balance of payments crisis. External funding needs will remain limited, not only because foreign direct investment (FDI) has been holding up well (4.6% of GDP in March 2016, in comparison to 4.3% of GDP in 2015 and 4.0% in 2014) and will likely slowdown at a slower pace than the current account deficit, but also because most of the public debt is denominated in local rather than in foreign currency and the country is a net external creditor (international reserves represent 22% of GDP and the gross external debt is equal to 19% of GDP).

7 Forecast table

Table 7.1
Macroeconomic forecasts

	2014	2015	2016	2017
GDP (% growth)	0.1	-3.8	-3.0	0.9
Inflation (% YoY, end of period)	6.4	10.7	6.8	4.5
Exchange rate (BRL/ USD,end of period)	2.66	3.96	3.85	4.02
Interest rate, SELIC (%, end of period)	11.75	14.25	14.25	11.50
Private consumption (% growth)	1.3	-4.0	-3.3	-0.1
Public consumption (% growth)	1.2	-1.2	-1.0	-1.6
Fixed capital investment (% growth)	-4.5	-14.1	-12.6	1.6
Exports (% growth)	-1.1	6.1	3.2	4.8
Imports (% growth)	-1.0	-14.3	-14.2	0.7
Fiscal result (% GDP)	-6.1	-10.2	-9.0	-7.3
Current account (% GDP)	-4.3	-3.4	-2.1	-1.0

Source: BBVA Research

DISCLAIMER

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

Julián Cubero
juan.cubero@bbva.com

Lorena Lechuga
lorena.lechuga.cuesta@bbva.com

BBVA Research

Contact details:

BBVA Research
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