

Brazil Economic Outlook

3rd QUARTER 2017



Brazil: political tensions threaten the economic recovery

- 1. We revised down our GDP forecasts to 0.6% in 2017 and 1.5% in 2018, in both cases 0.3 p.p. below our previous forecasts.** This revision is largely due to the upsurge of political tensions, in an environment marked by the increasing uncertainty about the continuity in power of President Temer. The higher level of political uncertainty will postpone the recovery of investment and should prevent the approval of the indispensable social security reform in the short term.
- 2. Nevertheless, the economy will likely continue recovering in a timid way, leaving behind the recession.** Among other factors, the economy will be stimulated by the reduction of interest rates, allowed by the sharp deceleration of inflation, which should close 2017 at 3.7% and 2018 at 4.3%.
- 3. The expansive tone of monetary policy will contrast with the contractionary tone of fiscal policy.** In spite of the already implemented fiscal adjustments, public debt will continue to increase, likely reaching 87% in four years from now. And an additional deterioration will occur if an ambitious social security reform is not approved over the next few years.



GLOBAL

Stable growth, with risks still tilted to the downside



Positive global momentum

Global growth driven by China

Signals of stabilization of global growth

Some rebalancing from US towards Europe

Both in the macro as well as policy fronts

Low inflation in developed countries

Wage moderation as well as some correction in commodity prices

Central banks in developed countries lean towards policy normalization

Mopping up liquidity and increasing policy rates

Complacent financial markets

Low volatility supports lower risk aversion

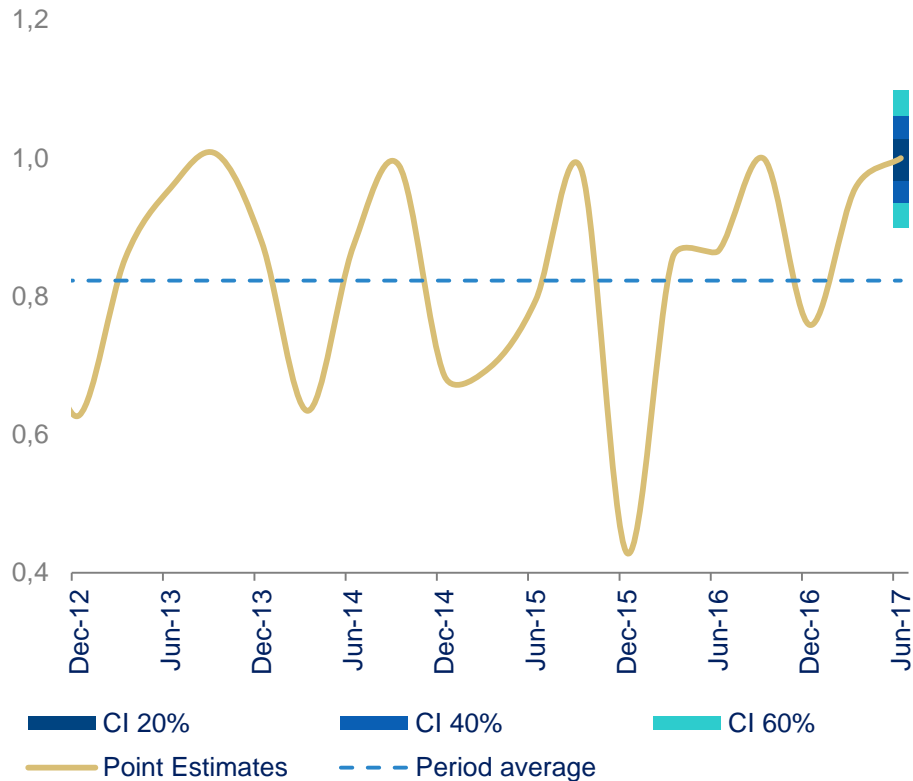
Risks

Decreased in Europe, but scaling up in China

Global growth tends to stabilize

Global GDP growth

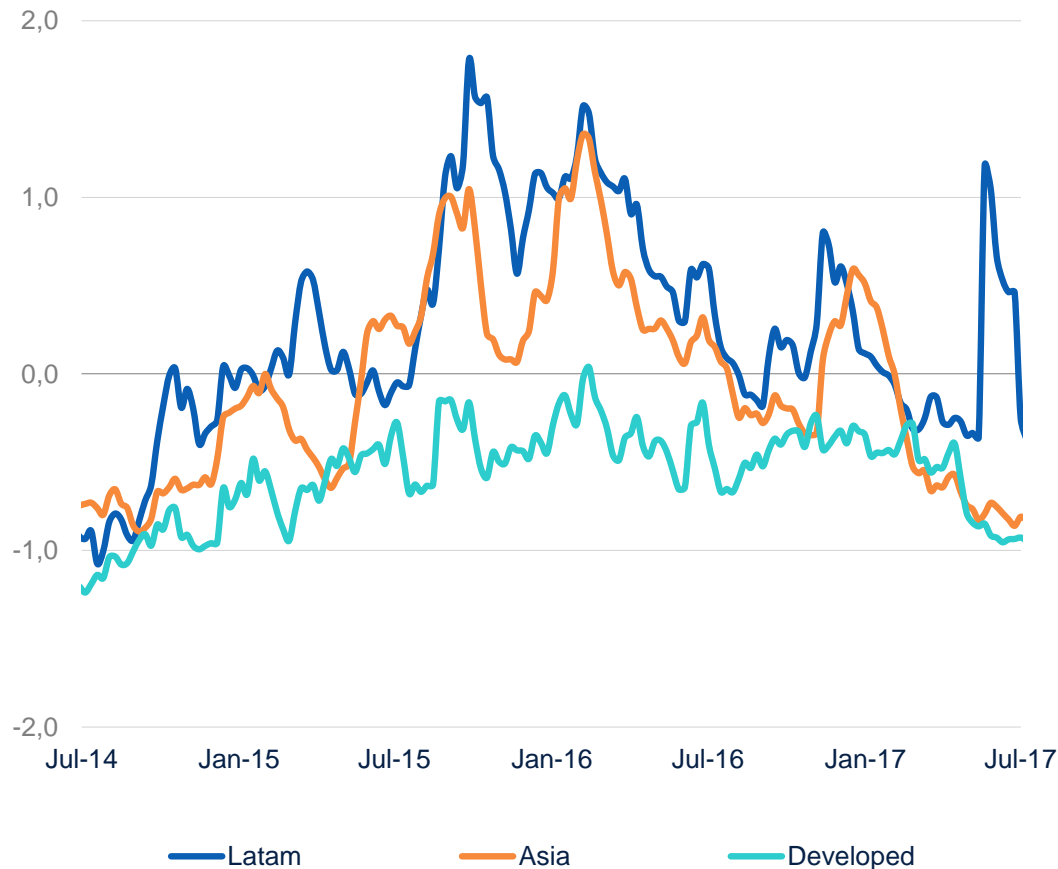
Forecasts based on BBVA-GAIN model (% , qoq)



- ◆ Confidence indicators remain very high, stronger than actual hard data
- ◆ China and emerging Asia show strong growth, pushed by expansionary policies...
- ◆ ... have supported stronger trade and investment in the last quarters

Financial stress remains low

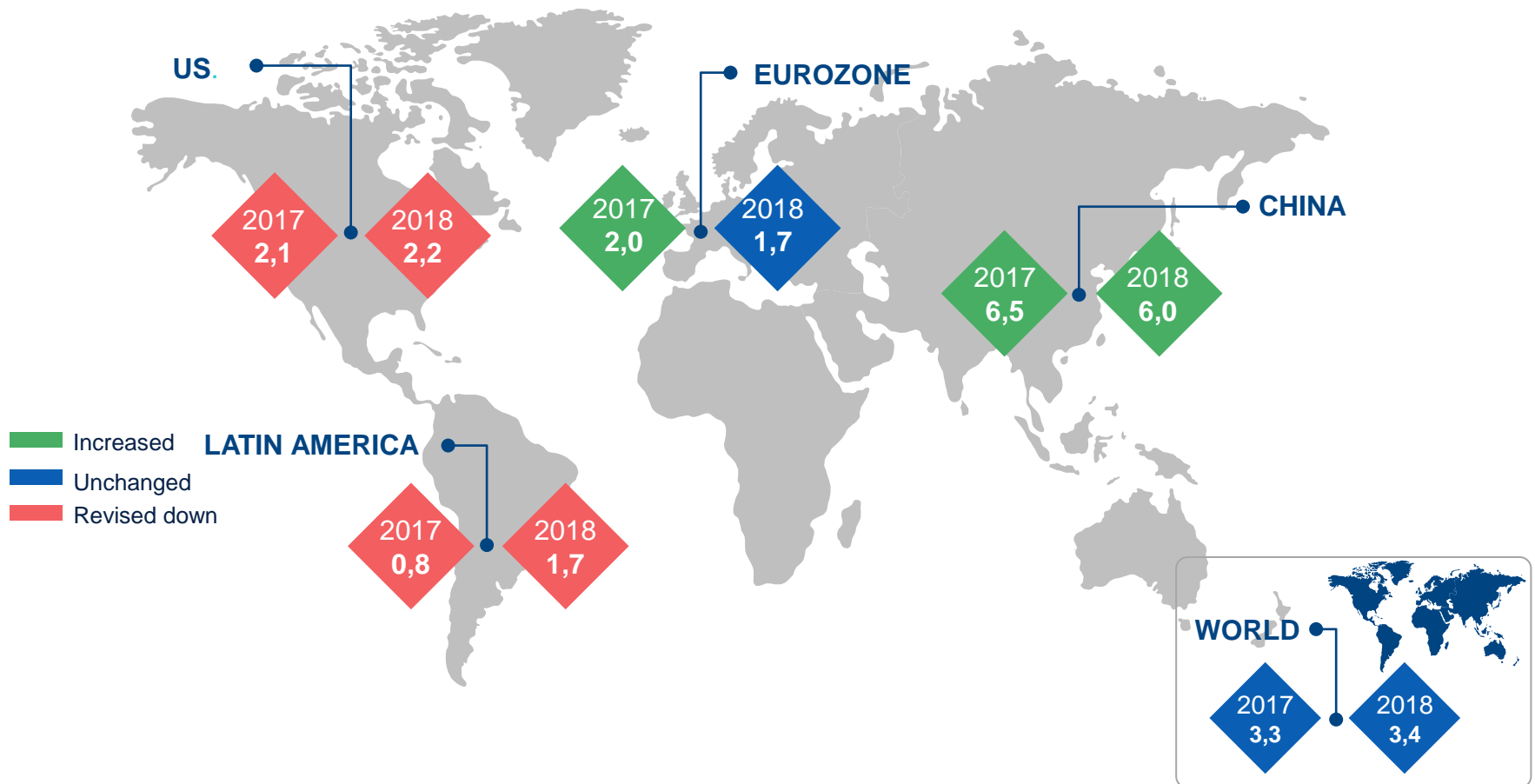
BBVA Financial Stress Index
(normalized)



- ◆ Volatility has decreased to very low levels despite uncertainty about economic policies
- ◆ Brazil is the exception in Latam, due to high political noise
- ◆ Reversal of expectations of deflation in US have maintained low long-term interest rates
- ◆ Capital flows to emerging economies have continued
- ◆ Risk of complacency in financial markets

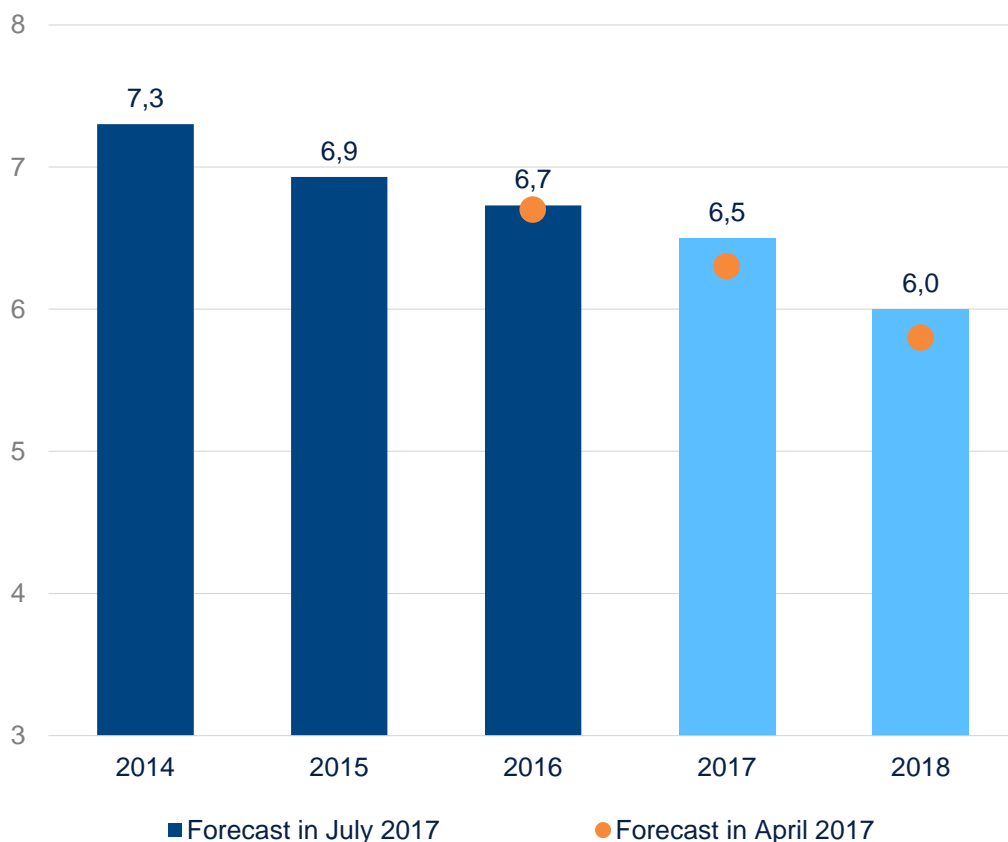
Source: BBVA Research

Growth revised up in Europe and China, down in US and Latin America



China: (fiscal) policy impulses effective in the short run

China: GDP growth (%)



◆ We revised up our growth forecasts for 2017-18, due to incoming data and the fiscal impulse. Gradual deceleration underway, slower than anticipated

◆ Prudent monetary policy. Fiscal policy continues to support growth

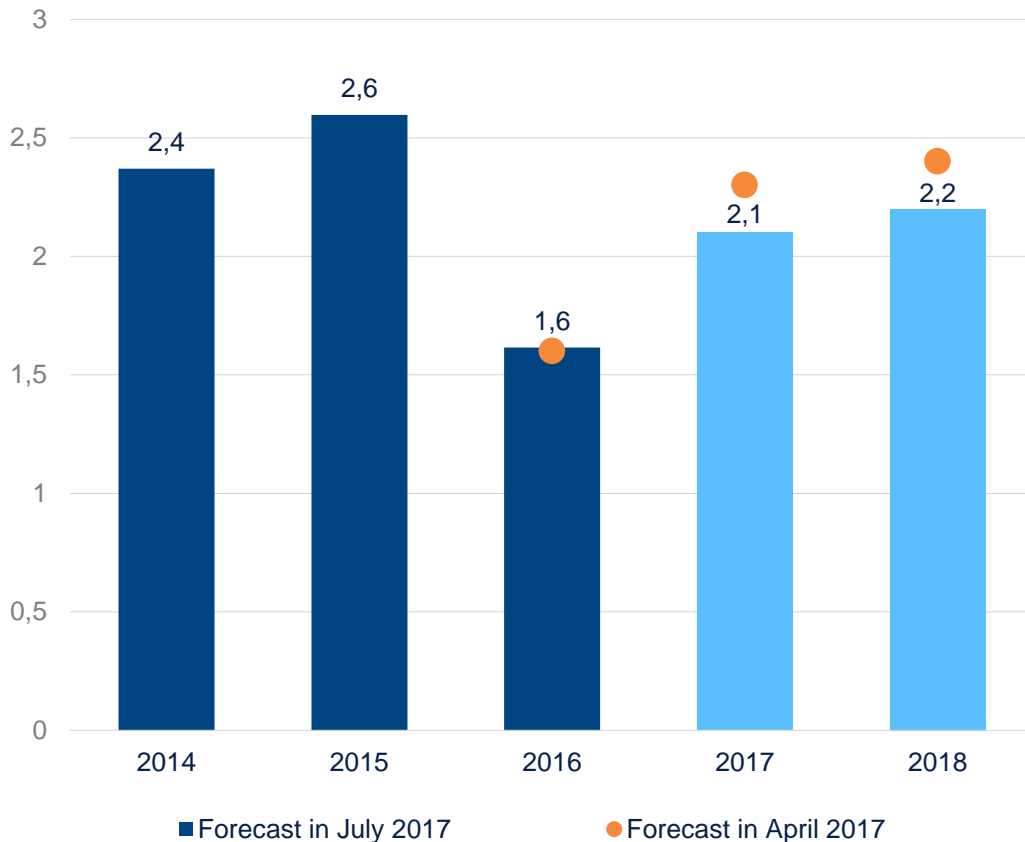
◆ Risks in the medium run continue to increase

- Slow rebalancing of growth towards services and consumption
- Financial fragilities continue to accumulate due to growth still based on debt and favoring shadow banking system.

US: fiscal impulse hard to materialize

US: GDP growth

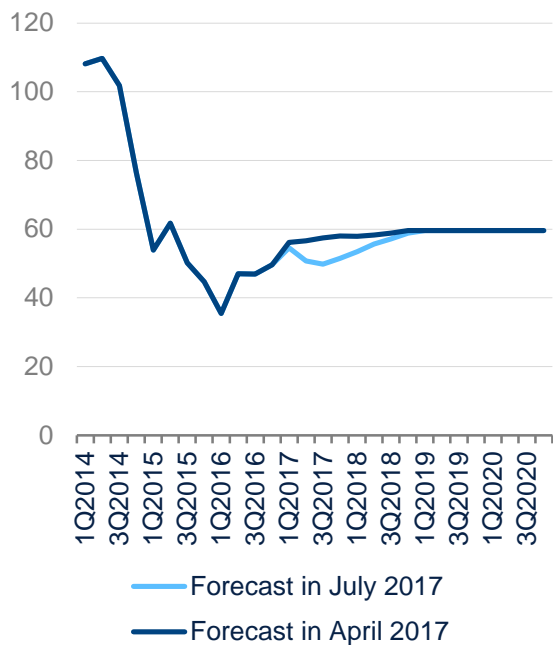
(%)



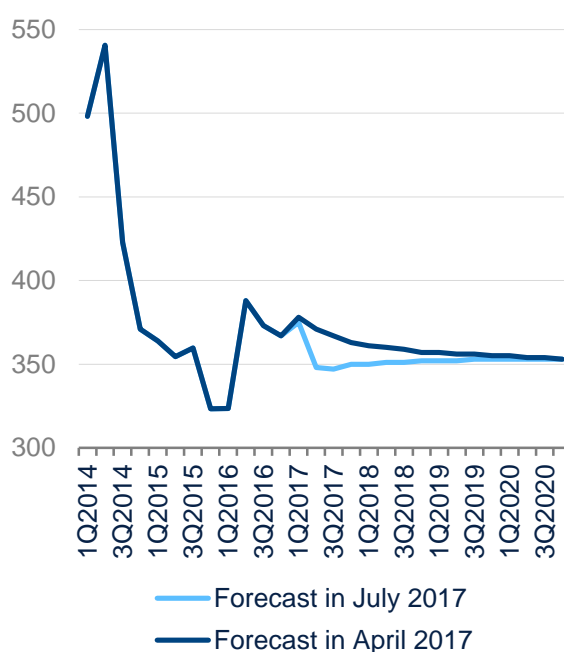
- ◆ Growth revised down in 2017-18
Stimulus measures will probably not be implemented in the short-run
- ◆ Fed: strong labor market and convergence of inflation to 2% justify policy normalization
- ◆ Risks stemming from protectionism diminish but uncertainty about economic policies remain

Commodity prices adjusted down in the short run, on concerns about strong supply

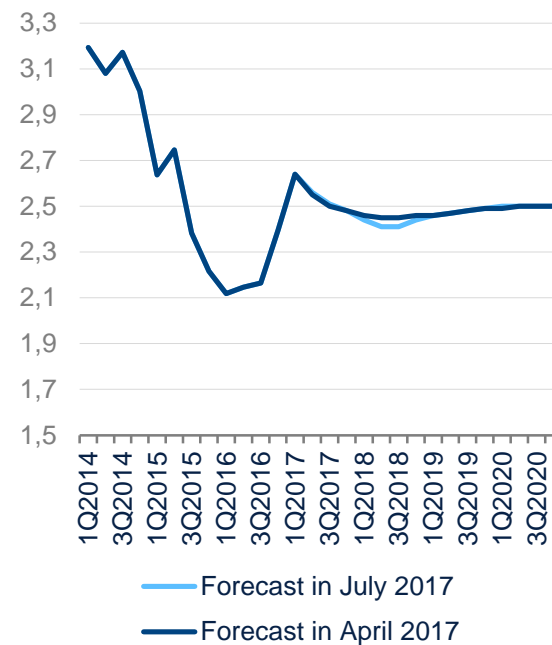
BRENT OIL
(USD/B)



SOYBEANS
(USD/mT)



COPPER
(USD/lb)



Source: BBVA Research and Bloomberg

Oil prices will continue to be dragged by strong supply and high inventories. We maintain expectations of 60USD/b in the long run, given lower capital expenditures in exploration.

Strong supply also affects soybean and copper prices in the short run. No significant changes in long-run view for commodity prices.

Global risks most relevant for Brazil are related to US policies and rebalancing in China

1



Lingering **uncertainty about economic policies** to be implemented in US, though the risk of protectionism is reduced

2



Policy stimulus in China to support investment continues to accumulate financial vulnerabilities

3



Political risks in Europe diminish but remain around Brexit negotiations, banking problems in some countries and elections in Italy.

4



Risks stemming from **monetary policy normalization**, especially in the US, given divergence with market expectations

BRAZIL

Political tensions threaten
the economic recovery

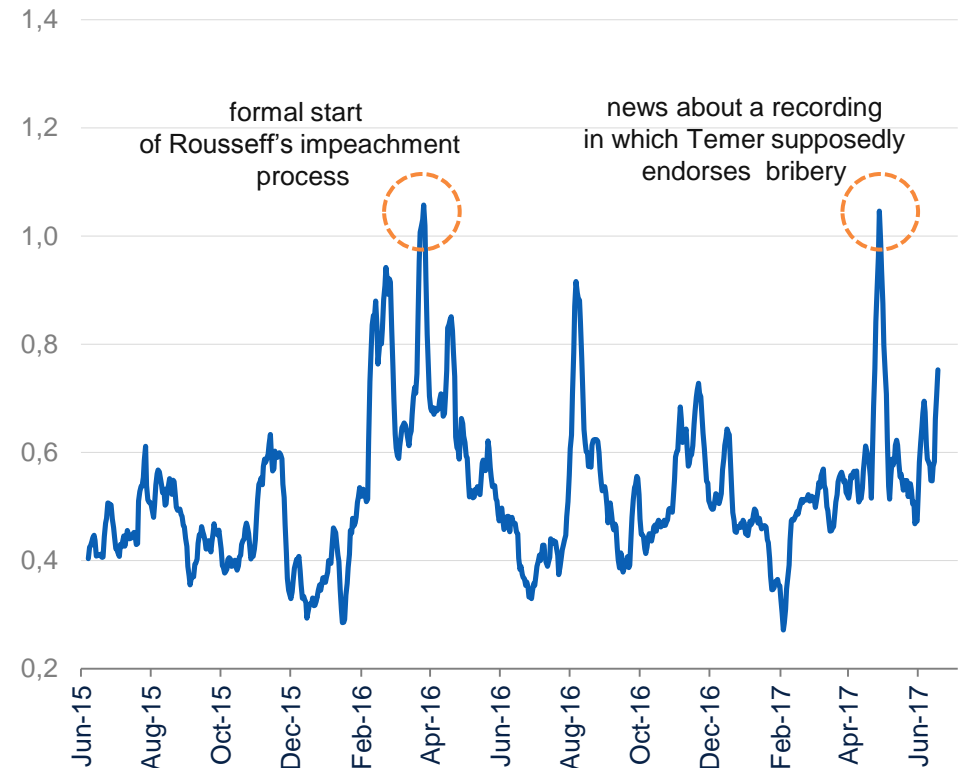


New upsurge in political tensions

- ◆ The release in May of a recording in which the current president Temer supposedly endorses the payment of bribes has generated a new rise in political tensions.
- ◆ **Uncertainty has once again reached exceptionally high levels.**
- ◆ Temer or whoever might possibly replace him until 4Q18 elections will hardly have the needed support to push the reform agenda. Thus, we do not expect the approval of an ambitious social security reform during 2017-18.

BBVA Research's index of political tensions in Brazil*

(7-days moving average)

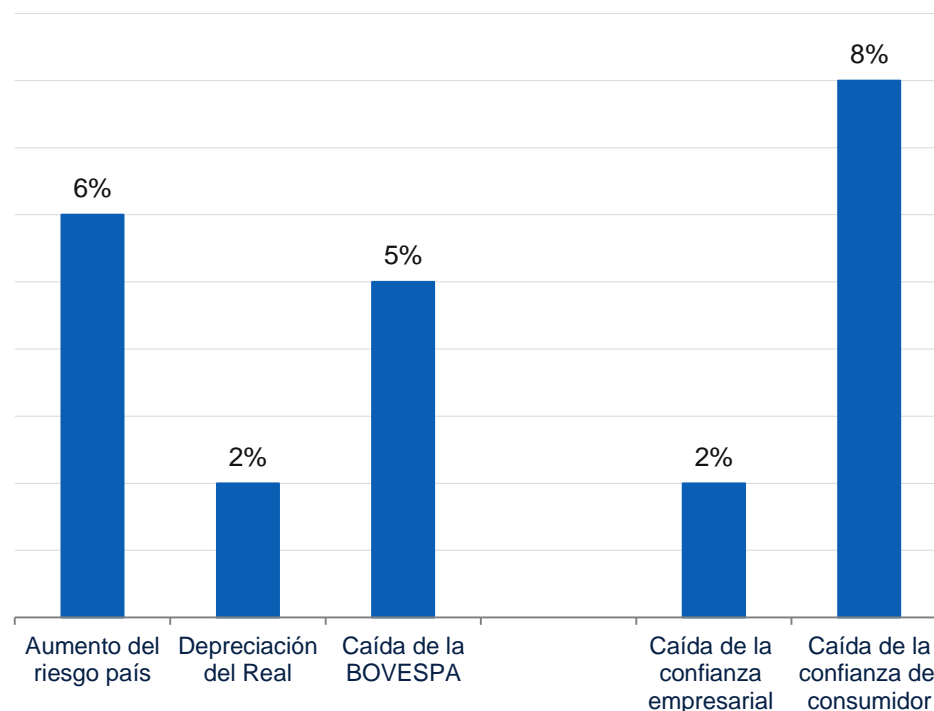


The increase in political noise has had negative, but limited effects on the economy up to now

- ◆ Increased political noise has led to declines in confidence and the price of local assets.
- ◆ However, the impact has been small given the magnitude of the increase in uncertainty. To some extent this is due to the perception that economic policies will remain in any case broadly unchanged.
- ◆ This relative decoupling between the economy and politics is not sustainable; either political tensions are reduced or -more likely- the economy will be significantly affected.

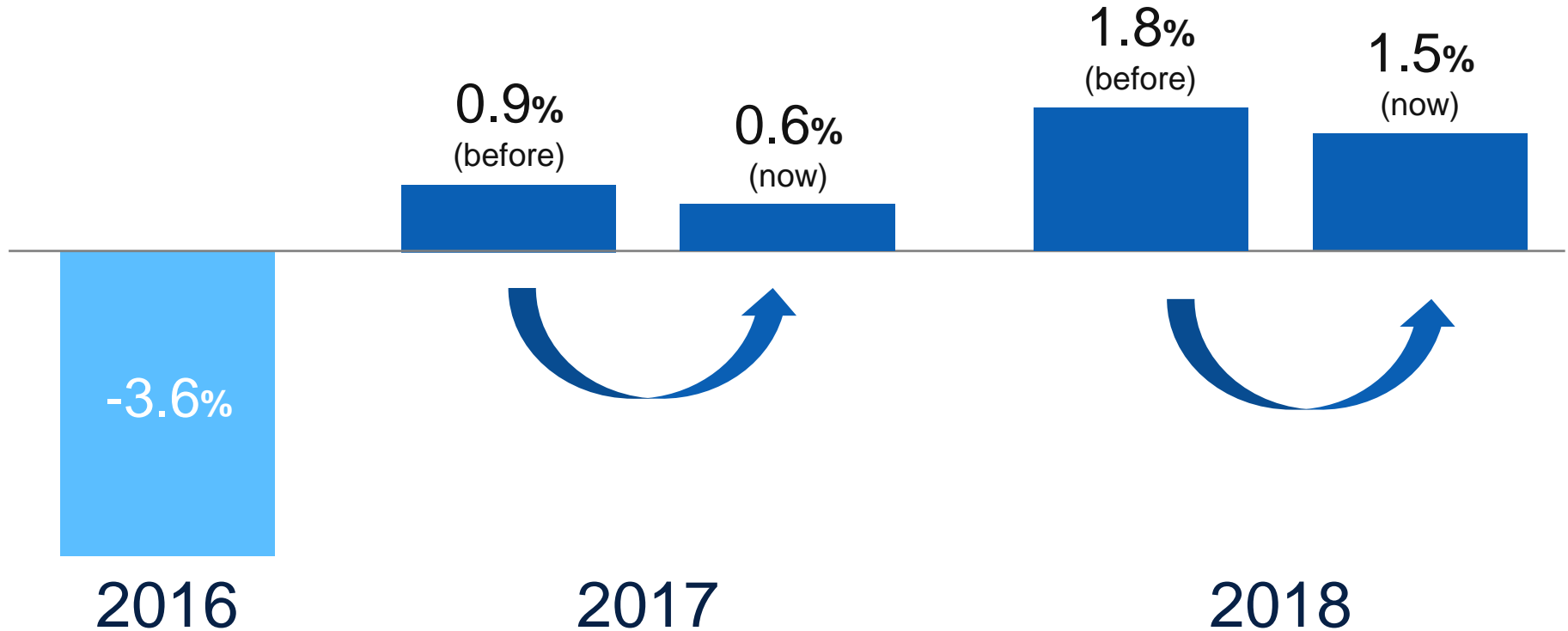
Selected financial variables and confidence*

(% change, from the day before the news on Temer's recording until July 18)



Source: BBVA Research and BCB. * Percentage change from the day before the news on Temer's recordings (May 17, 2017) until July 18. Confidence figures refer to change between April and June.

Our outlook for Brazil now includes a higher level of political noise; for that reason we adjust our GDP forecasts downwards



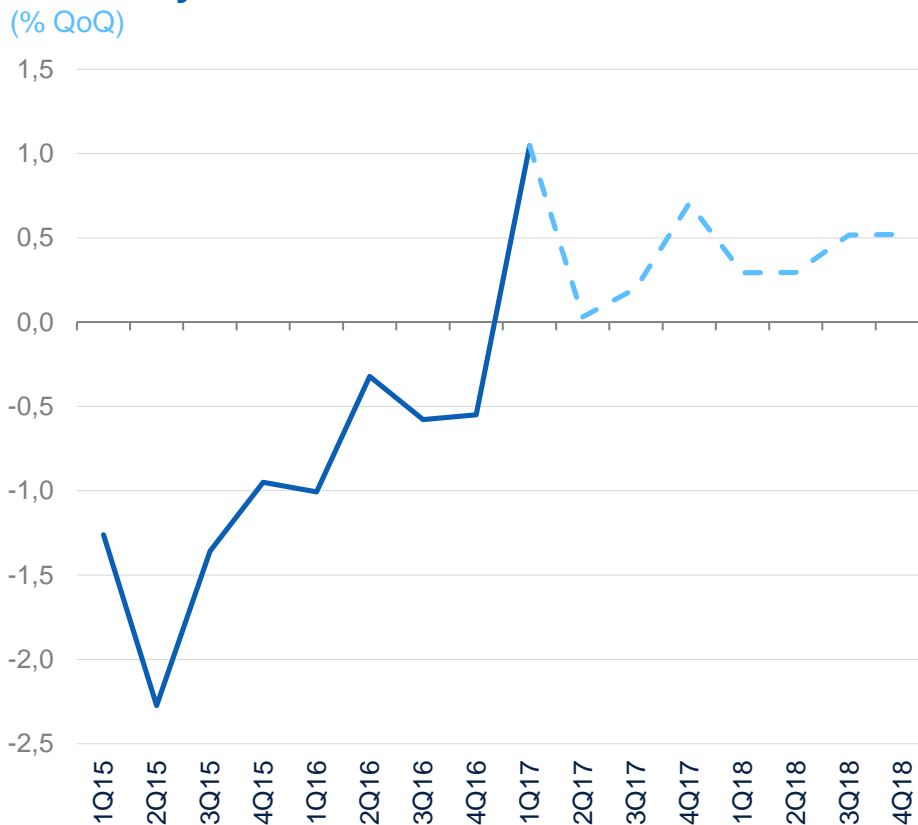
As we think that political noise will remain at higher levels for a longer time (which will prevent the adoption of an ambitious social security reform during 2017-18), we revised down our forecasts for GDP.

Lower forecasts also reflect the impact of the downward revision in our forecasts for our commodity prices (largely due to a better supply outlook).

We continue to expect a gradual recovery of economic activity

- ◆ GDP expanded in 1Q17 after having contracted the previous eight . Growth in the period (1.1% QoQ) topped expectations.
- ◆ In spite of the greater uncertainty (and of signs of a weaker GDP growth in 2Q17), a series of factors should favor a cyclical recovery ahead: falling inflation, expansive monetary policy, positive evolution of exports, etc.
- ◆ We can only speak of a solid and lasting recovery after political tensions moderate in a significant way.

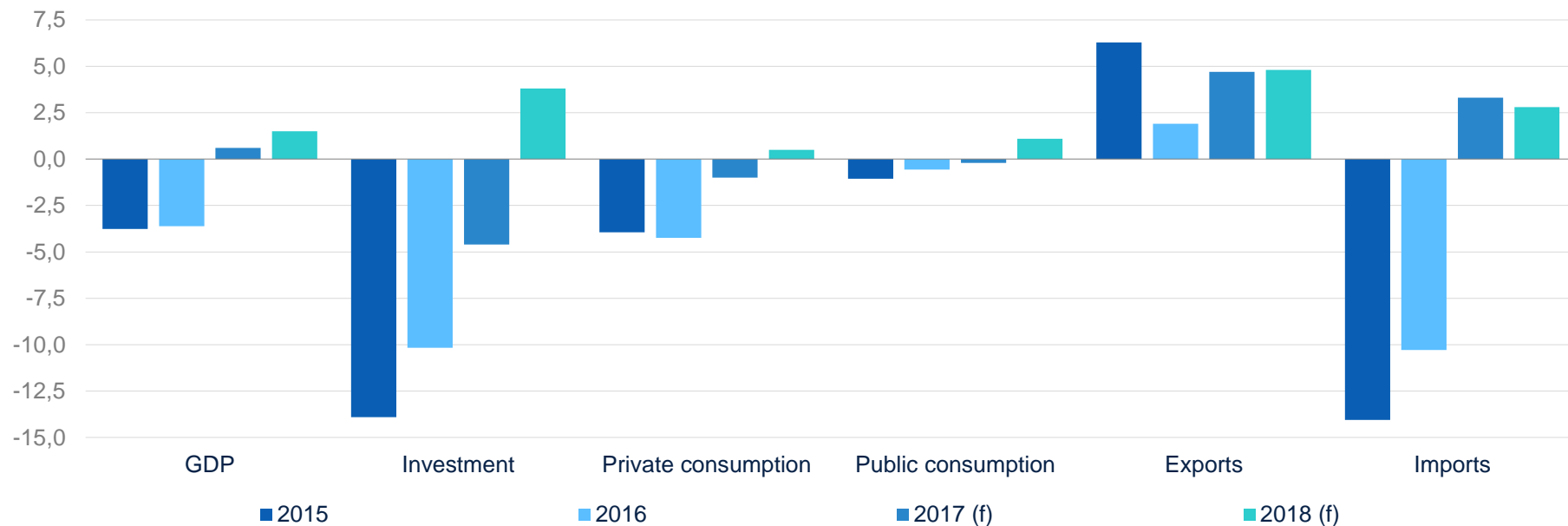
Quarterly evolution of GDP



The recovery will be based on the dynamism of exports and the stabilization of domestic demand in 2018

GDP growth, by demand components*

(%)



Source: BBVA Research and IBGE. * (f) = forecasts

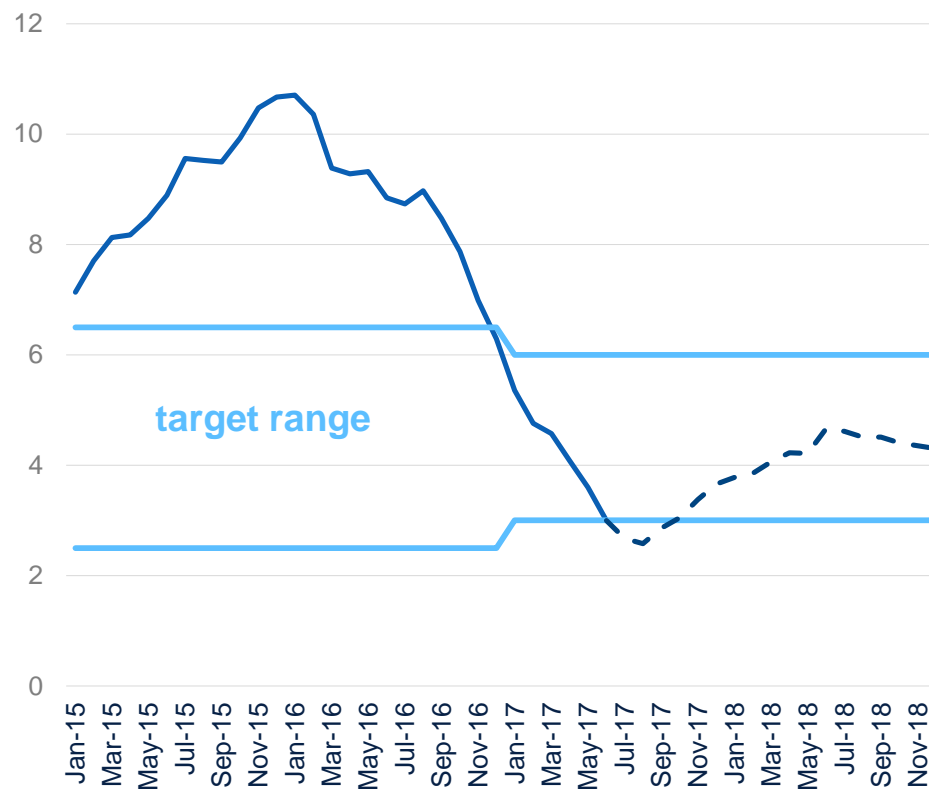
Exports should continue to contribute to growth, thanks to a relatively favorable exchange rate, higher terms of trade than in previous years, higher external demand, recovery in Argentina, etc.

The increase in political noise should postpone the recovery of investment, which now is expected to begin only in 2018. Despite the lower inflation, private consumption should contribute positively to GDP only next year, when labor market is expected to finally stabilize

One of the main determinants of the recovery will be the sharp and still ongoing deceleration of inflation

- ◆ Inflation has dropped from almost 11.0% at the beginning of 2016 to 3.0% in July.
- ◆ In the coming months inflation will be below the target range.
- ◆ We expect it to close 2017 at 3.7% and 2018 at 4.3% (0.6 pp and 0.2 pp below our previous forecasts).
- ◆ Favorable price dynamics determined by several factors:
 - weak domestic demand
 - relatively stable exchange rate
 - food prices (favorable supply shock)
 - more credible monetary policy

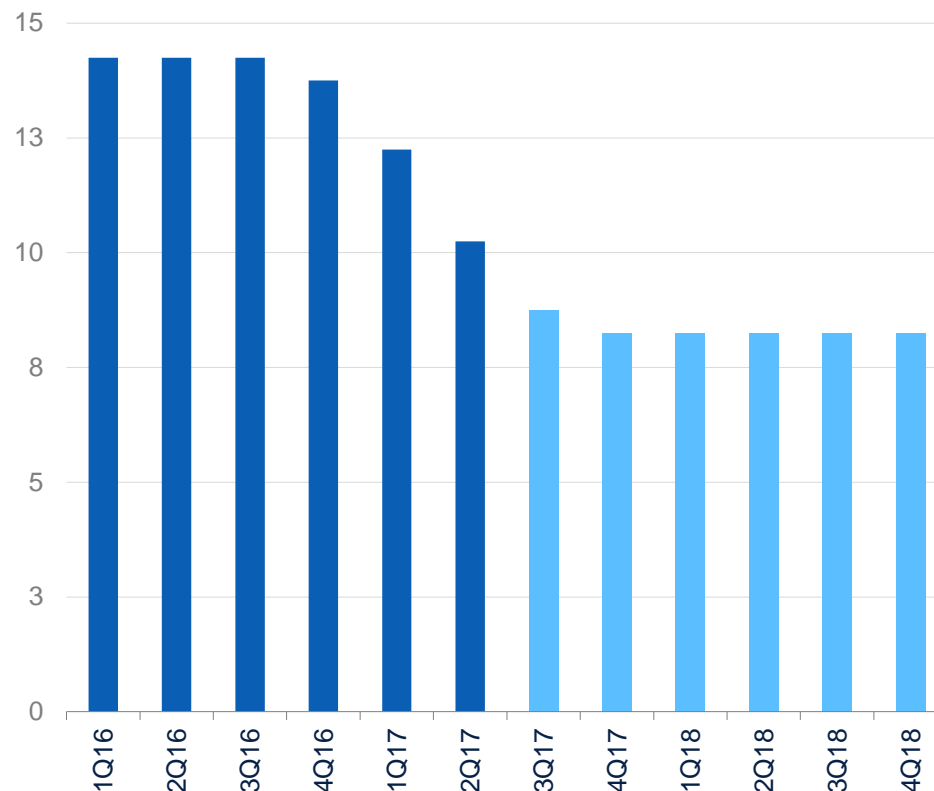
Inflation
(IPCA; % YoY)



Despite the greater uncertainty, the fall in inflation creates room for further interest rate cuts

- ◆ The Selic rate reached 10.25% after two cuts of 100 bps in the last monetary policy meetings.
- ◆ Increased uncertainty and doubts about the progress of the social security reform may make the BCB more conservative in the future and announce more moderate cuts.
- ◆ Anyway, the sharp fall in inflation and the anchoring of expectations mean that monetary conditions will continue to be eased in the coming months.
- ◆ **We continue to expect the Selic rate to reach 8.25% in 4Q17 and remain at that level for a long period.**

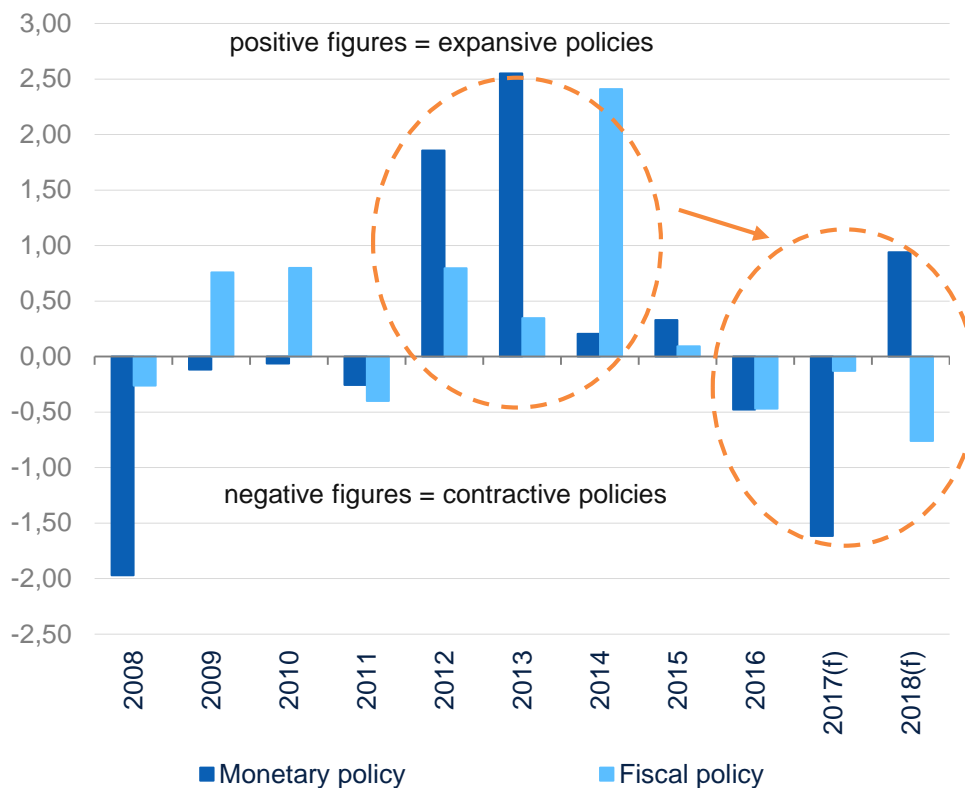
Monetary policy interest rate: SELIC
(%)



Monetary policy will stimulate economic activity while fiscal policy will play a pro-cyclical role

- ◆ The cuts in the Selic rates imply that monetary policy will exhibit an expansive tone from now on.
- ◆ Following the serious fiscal distortions generated in 2012-2014, the government has been forced to cut public expenditure and even to officially prevent it from growing in real terms in the future.
- ◆ In addition, the government will likely have to raise taxes to meet fiscal targets (primary deficits of 2.3% of GDP in 2017 and 1.9% of GDP in 2018).
- ◆ There is currently no room for countercyclical fiscal policy.

Tone of monetary and fiscal policies*

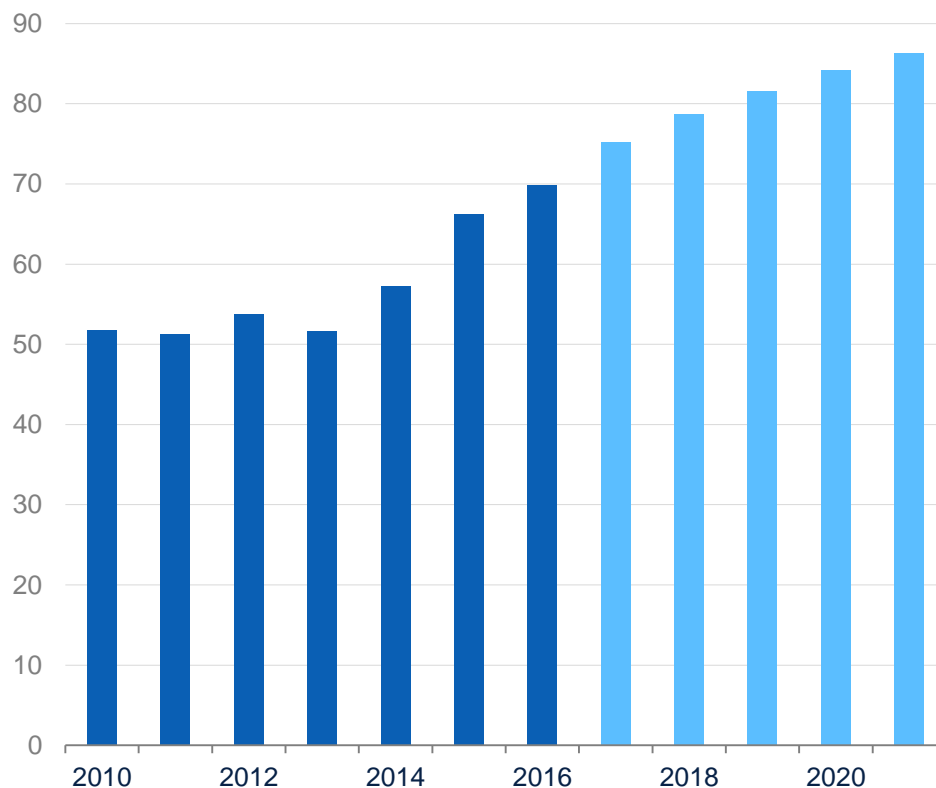


Source: BBVA Research and FMI. * Tone of monetary policy: annual average, obtained as the difference between the neutral interest rate in real terms and the effective interest rate (also in real terms). Tone of fiscal policy: variation of the cyclically-adjusted primary result as a share of potential GDP, with inverted sign.

The fiscal problem: the public debt will continue to increase significantly in the coming years

- ◆ Low growth and the difficulty to make additional fiscal adjustments means that the deterioration of the public accounts will continue over the next years.
- ◆ Compliance with the already approved law that imposes a ceiling on public spending and a possible reform of social security would create the conditions for the moderation of public debt from 2021-22, when it would reach around 87%.
- ◆ **If an ambitious social security reform is not implemented in the coming years (we do not expect it to be approved in 2017-18), the deterioration of the debt would continue beyond 2021-22.**

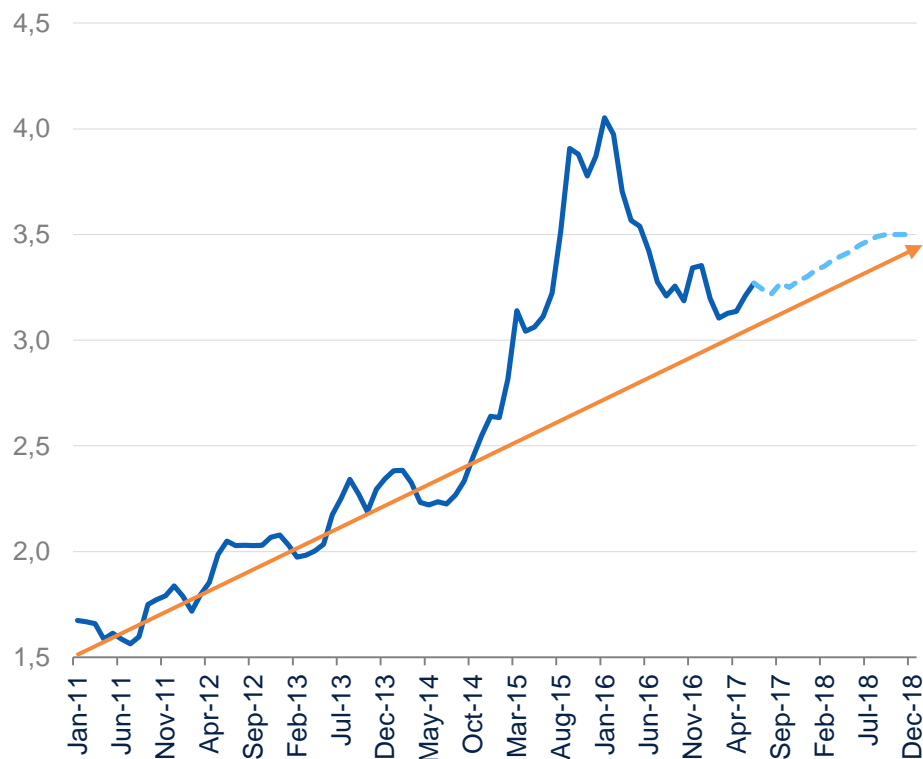
Gross public debt
(% of GDP)



The exchange rate exhibits strength in the face of turmoil, but should weaken ahead

- ◆ After losing 7% and reaching 3.32 on the day that a recording allegedly incriminating President Temer was reported, the Brazilian real (BRL) gradually appreciated to reach 3.17, a relatively appreciated level
- ◆ Political noise, the increase in fiscal risk and the reduction of the gap between local and external interest rates support the view that the BRL tends to depreciate in the coming months.
- ◆ We forecast the BRL to reach 3.30 at the end of this year and 3.50 at the end of 2018.

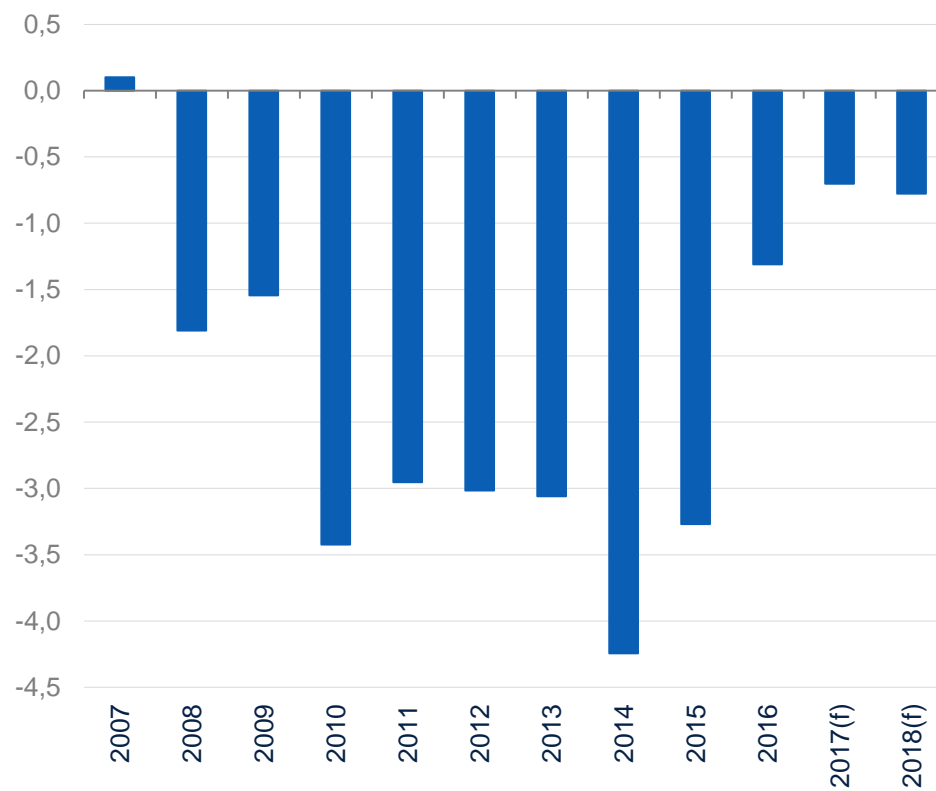
Nominal exchange rate
(BRL / USD)



Current account deficits under control

- ◆ After a reduction of the current account deficit from more than 4% of GDP in 2014 to about 1% of GDP, the external adjustment is practically over.
- ◆ In both 2017 and 2018 the external deficit should be slightly below 1%.
- ◆ While imports of goods and services will recover slightly after a fall of more than 40% in previous years, exports will remain relatively dynamic.

Current account
(% of GDP)



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FORECASTS



Brazil forecasts

	2015	2016	2017(f)	2018(f)
GDP (%)	-3.8	-3.6	0.6	1.5
<i>Private consumption (%)</i>	-3.9	-4.2	-1.0	0.5
<i>Public consumption (%)</i>	-1.1	-0.6	-0.2	1.1
<i>Gross fixed investment (%)</i>	-13.9	-10.2	-4.6	3.8
<i>Exports (%)</i>	6.3	1.9	4.7	4.8
<i>Imports (%)</i>	-14.1	-10.3	3.3	2.8
Unemployment rate (average)	8.3	11.3	13.5	12.9
Inflation (end of period, YoY %)	10.7	6.3	3.7	4.3
Selic rate (end of period, YoY %)	14.25	13.75	8.25	8.25
Exchange rate (end of period)	3.87	3.35	3.30	3.50
Current account (% of GDP)	-3.3	-1.3	-0.7	-0.8
Public sector's total fiscal result (% of GDP)	-10.2	-9.0	-8.1	-7.3
Gross public debt (% of GDP)	66.2	69.9	75.2	78.7