

Brazil Economic Outlook

FIRST QUARTER 2018



Brazil: recovery gains momentum, but risks do not recede

1. The growth of the Brazilian economy has surprised upwards during 2017. That and the improvements in the global environment, especially the acceleration of global growth, reinforce the prospects for a (cyclical) recovery of the activity. We have thus revised upwards our growth forecasts Brazil. **We now estimate growth to have reached 1.0% in 2017 and expect it to increase to 2.1% in 2018 and 3.0% in 2019**
2. **Inflation has already bottomed out, but its acceleration from now on will be gradual, allowing the Central Bank to keep SELIC interest rates at historically low levels.** Specifically, inflation should reach 4.3% in 2018 and 4.7% in 2019, after having closed 2017 at 2.9%, while SELIC rates should soon reach 6.75% and remain at this level for a long time
3. Although in our baseline scenario the economy will continue to recover and the fiscal problem will be addressed with a reform of the social security and other measures at the beginning of the next government to be elected in Oct-18, **we can not rule out an alternative scenario where political and fiscal risks materialize, bringing the recovery to an end and perhaps even generating a new economic crisis**



GLOBAL

Global growth confirmed and
short-term risks moderated





Global growth confirmed

 **01** **Improved forecasts for the US, China and the Eurozone**
There is less short-term uncertainty

 **02** **More positive perspectives for emerging countries**
Greater global demand and increase in commodity prices

 **03** **More caution in the financial markets**
Expectations of lower liquidity may reduce flows to emerging markets

 **04** **Contained core inflation**
Although the downward pressure factors are disappearing

 **05** **Central banks continue their paths towards normalization**
The reasons for withdrawing stimuli are materializing

 **06** **Global risks**
Lesser in the short term; no changes in the medium and long term

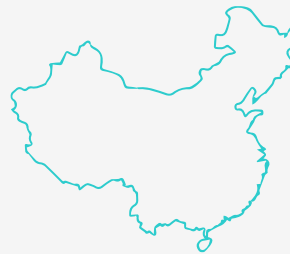
Reasons for optimism in large areas, although with caution

UNITED STATES



- Growth revised upwards
- Improvement in the labor market
- Approval of the tax reform
- Continuistic changes in the Fed

CHINA



- Moderate deceleration
- Some reforms already underway
- Positive conclusions at the XIX Congress of the CPC
- Greater potential growth

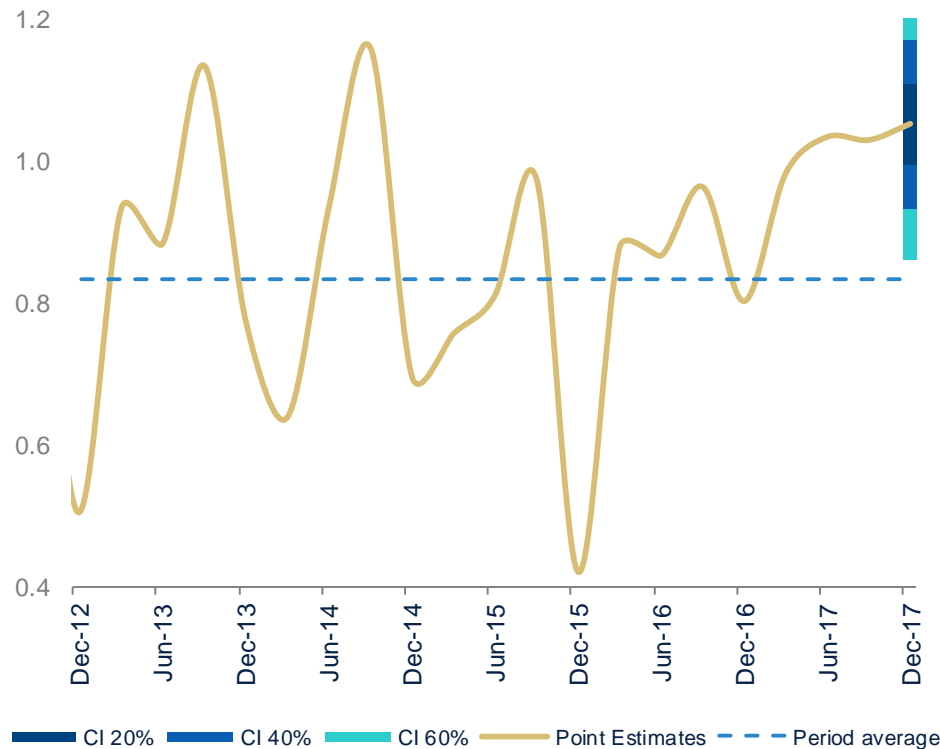
EUROZONE



- Greater growth than expected
- More robust domestic demand
- Lower political uncertainty
- Plans for greater integration

Robust and sustained global growth

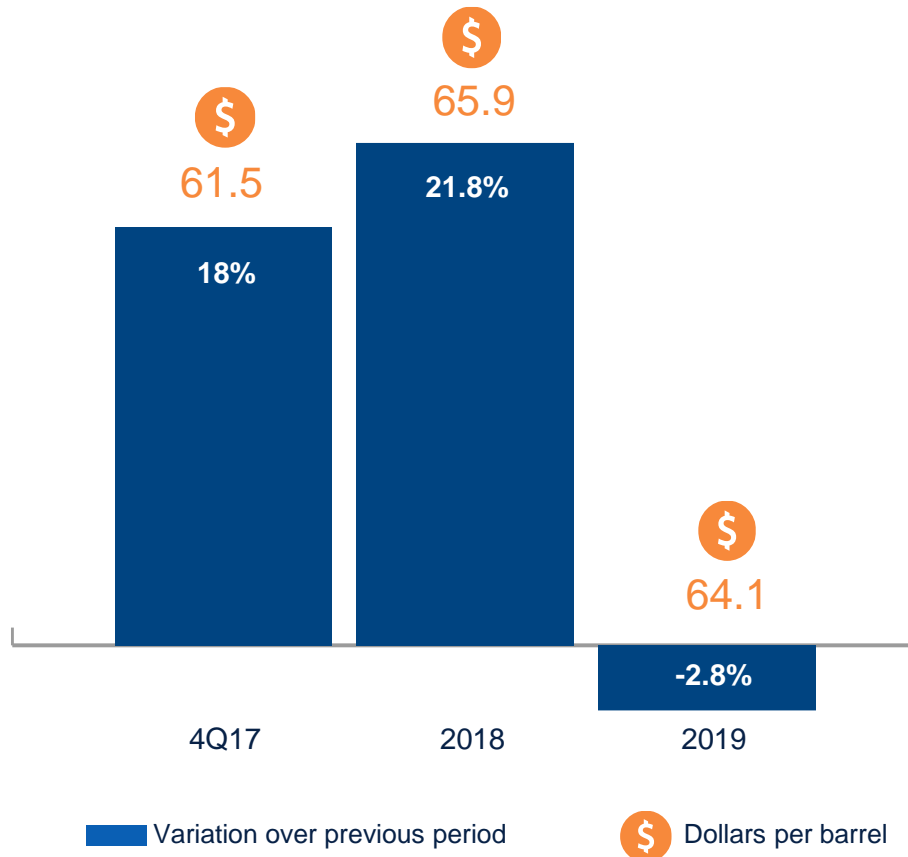
World GDP growth
(Forecasts based on BBVA-GAIN, % QoQ)



- ◆ The global economy continues to grow, supported by the recovery of the industrial sector
- ◆ Confidence indicators continue to improve, and anticipate that the outlook will continue to be positive
- ◆ Private consumption continues to sustain growth in advanced economies and gains momentum in emerging economies

The outlook for emerging economies improves

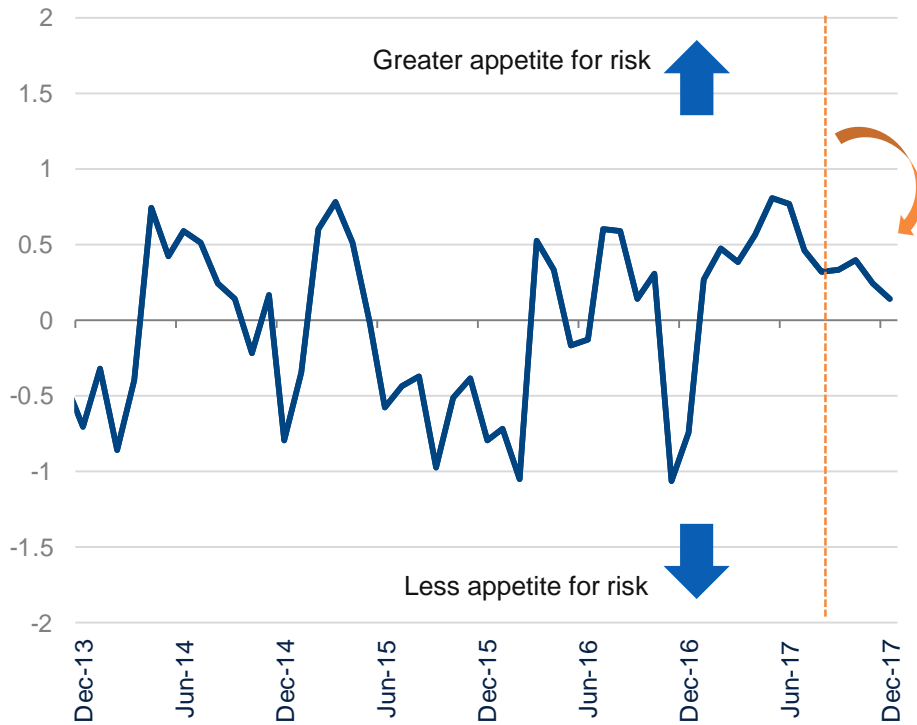
Price of oil
(Dollars per barrel, %)



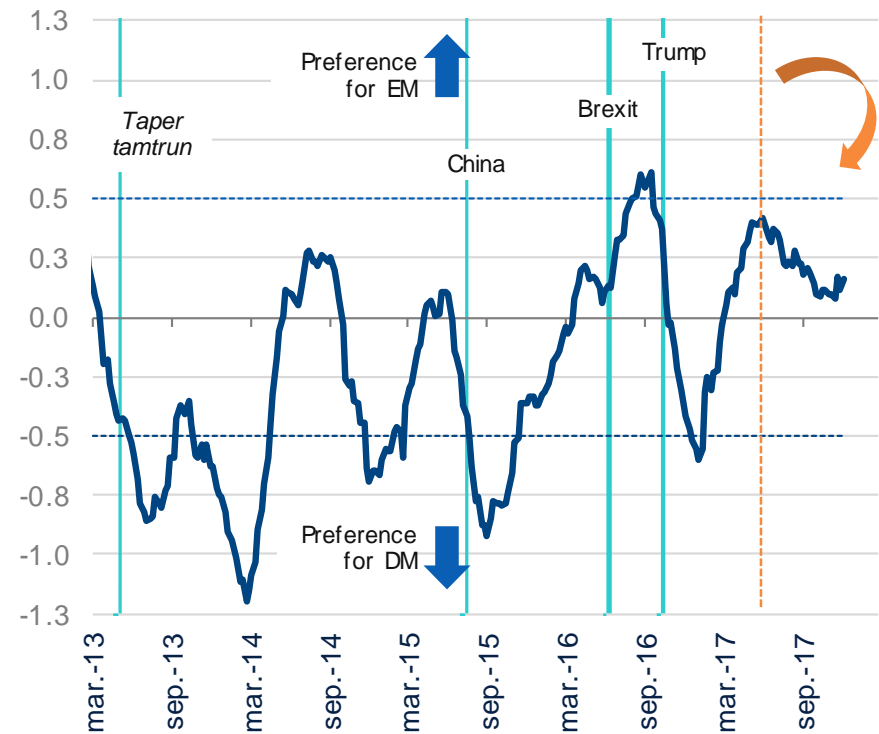
- ◆ The increase in oil prices reflects a greater global demand, which would account for 60% of such increase
- ◆ But this is also due to supply factors, linked to geopolitical risks and the correction of inventories
- ◆ Positive and significant impact on emerging economies that produce raw materials
- ◆ However, we still expect prices to converge to \$ 60 per barrel in the medium term, due to increased competition and structural changes in the energy sector

Caution in financial markets, with moderation of flows to emerging markets

Risk appetite indicator
(Factor 1 (global), EPFR flow analysis)

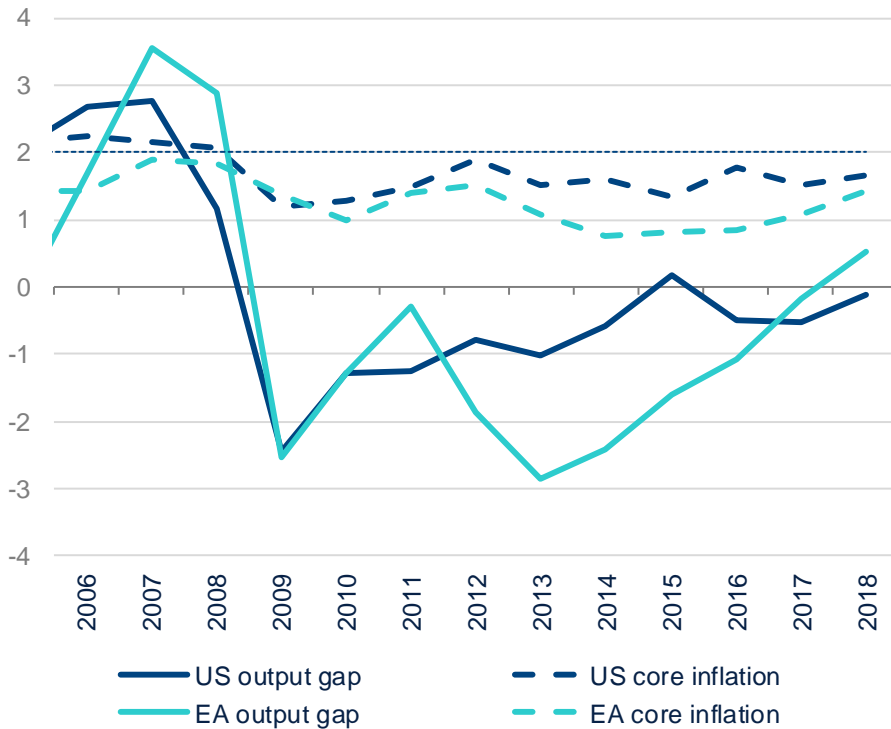


Investors appetite for emerging (EM) vs developed (DM)
(Inflows in EM vs. DM in % of assets under management)



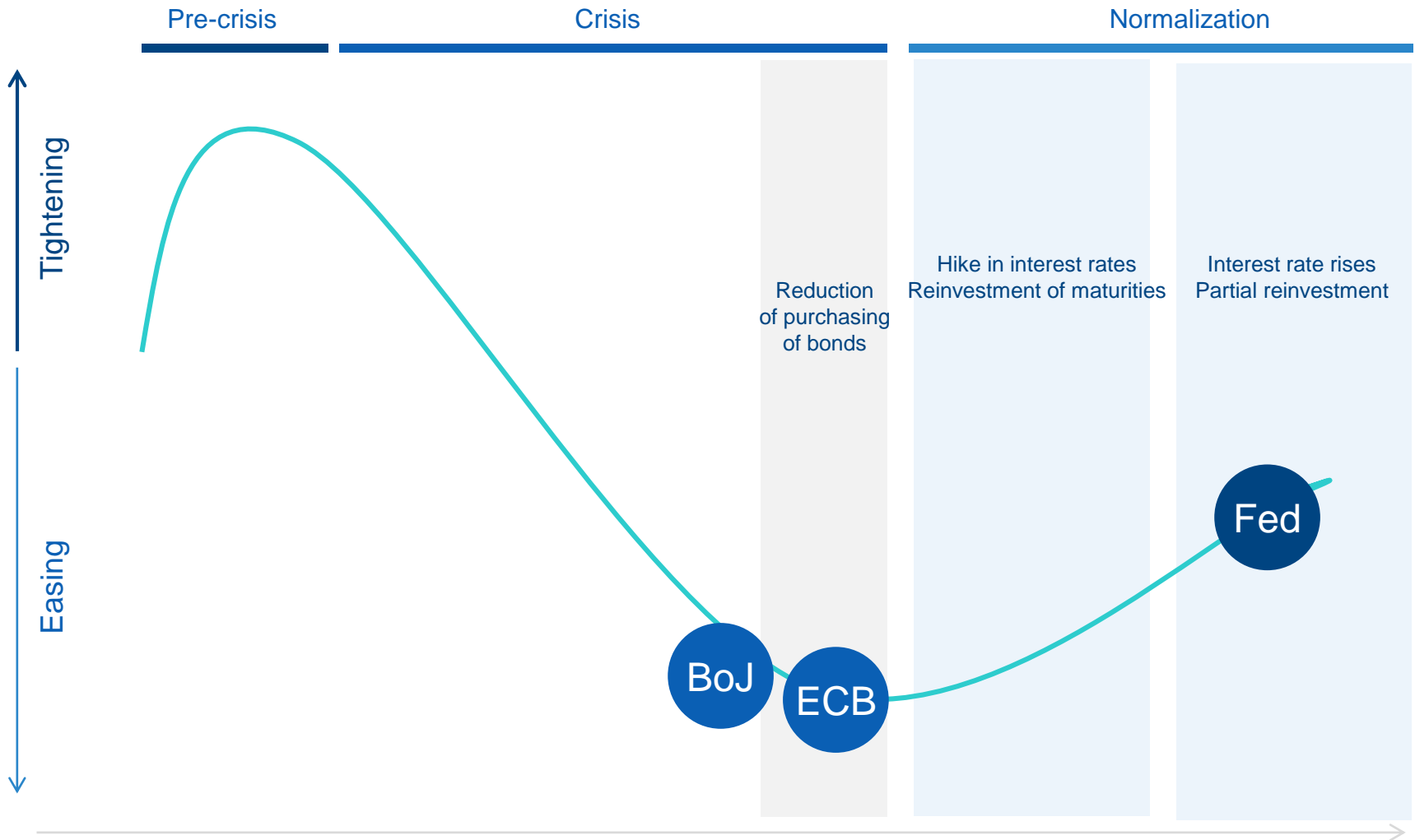
Contained core inflation

Production gap and core inflation
(% GDP potential, % YoY)



- ◆ Reduction of the idle capacity of the economy, but with **room to grow without strong inflationary pressures**
- ◆ **Less reaction of prices to the increase in activity**, for several reasons:
 - Globalization
 - Increased flexibility of the labor market
 - Low inflationary expectations
 - Reduced productivity growth
- ◆ **The increase in the price of oil will push up inflation in the short term**, facilitating the normalization of central banks in developed economies

Withdrawal of non-conventional monetary policy measures



Monetary policy normalization: accelerated in the case of the Fed, gradual in the case of the ECB



Tightening cycle and reduction of the balance in progress

Estimated rise of 75pbs in 2018 to 2.25% and reduction of the balance by 500,000 million dollars



QE reduction, but extension until September 2018

No rate hikes are expected until 2019

Focus: gain room for manoeuvre

Focus: avoid sudden acceleration of long-term rates

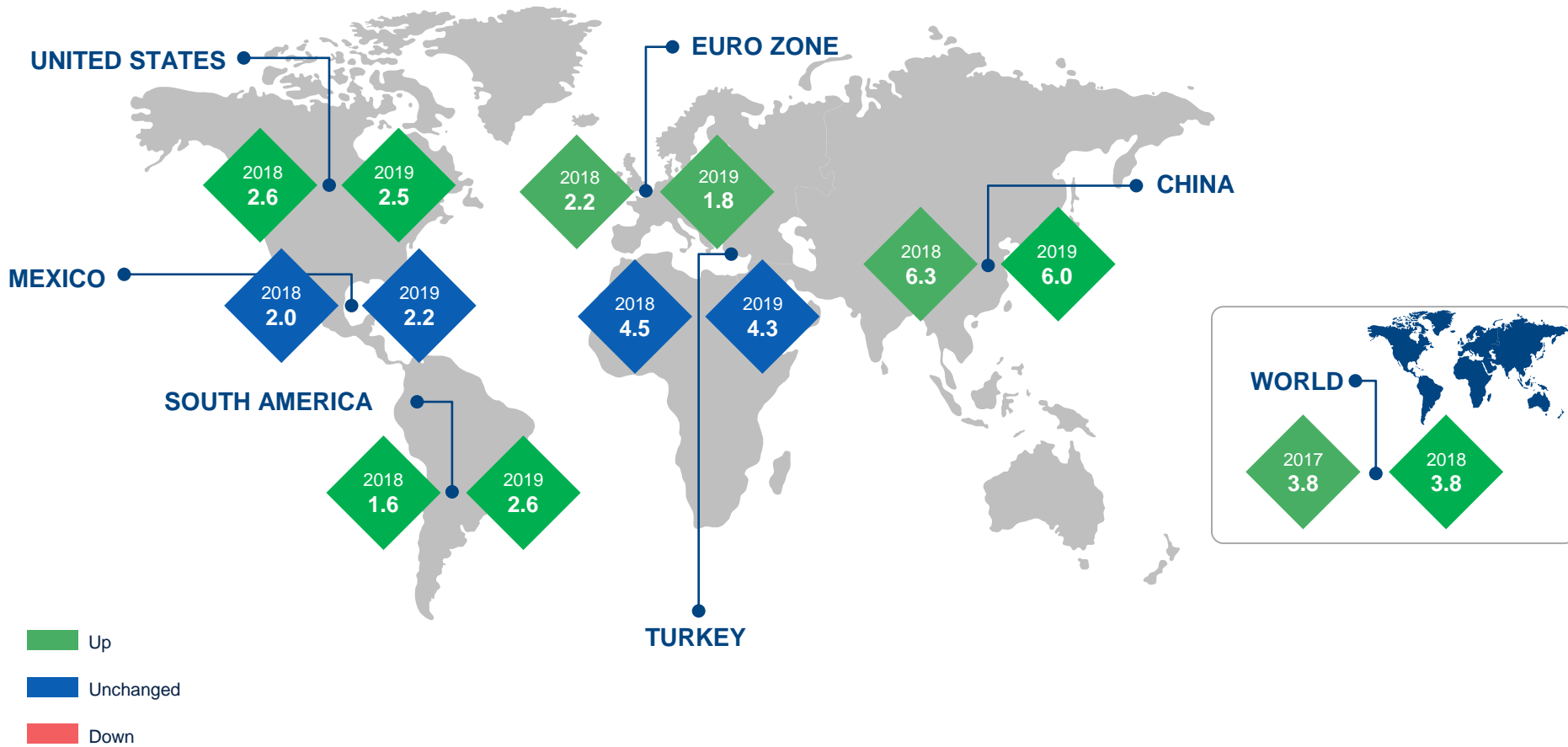
Elements of uncertainty:

Politics: changes in government ministries (Fed, ECB)

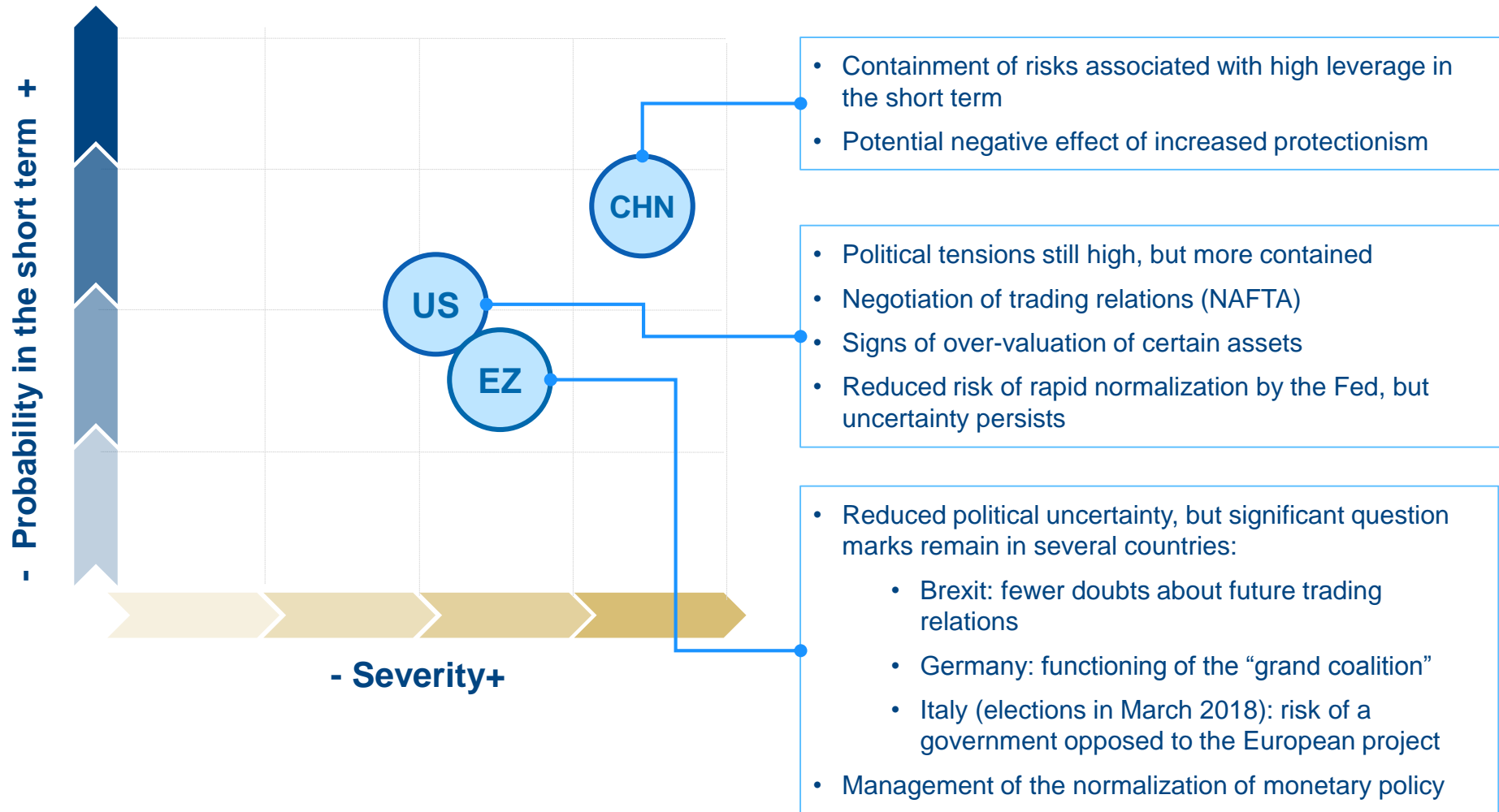
Macro : possible surprises in inflation

Markets: Long-term rates and slope of the curve

Generalized revision of the upward growth



Global risks: Fewer in the short term



* US: United States; EX: Eurozone; CHN: China. Source. BBVA Research

BRAZIL

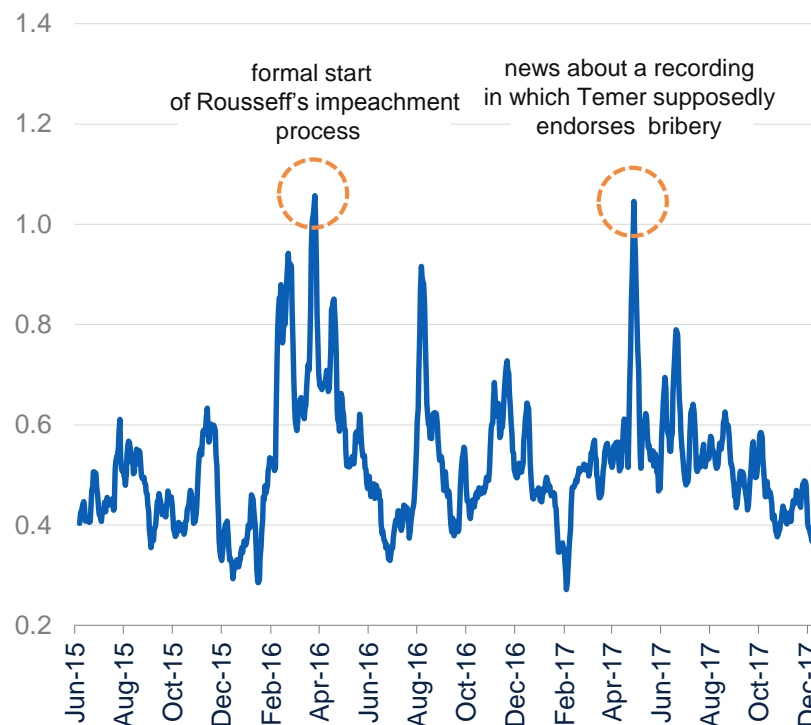
Recovery gains momentum,
but risks do not recede



Political tensions must increase again as the presidential elections of October approach

- ◆ Political tensions have fallen again in recent months. On one hand, uncertainty about the continuity of president Temer in office was reduced and, on the other hand, there are still several months left for the presidential elections
- ◆ **Lula, who can still be prevented from being a candidate due to a possible conviction for corruption, as well as the right-wing Jair Bolsonaro lead voting intentions, according to the polls**
- ◆ **It is not clear yet whether Lula or Bolsonaro would support orthodox economic policies and reforms (in particular, the social security one), which feeds political risks**
- ◆ In any case, the most likely is that they moderate their speech in case of victory or that a more centrist candidate emerges in the next few months and ends up winning the elections

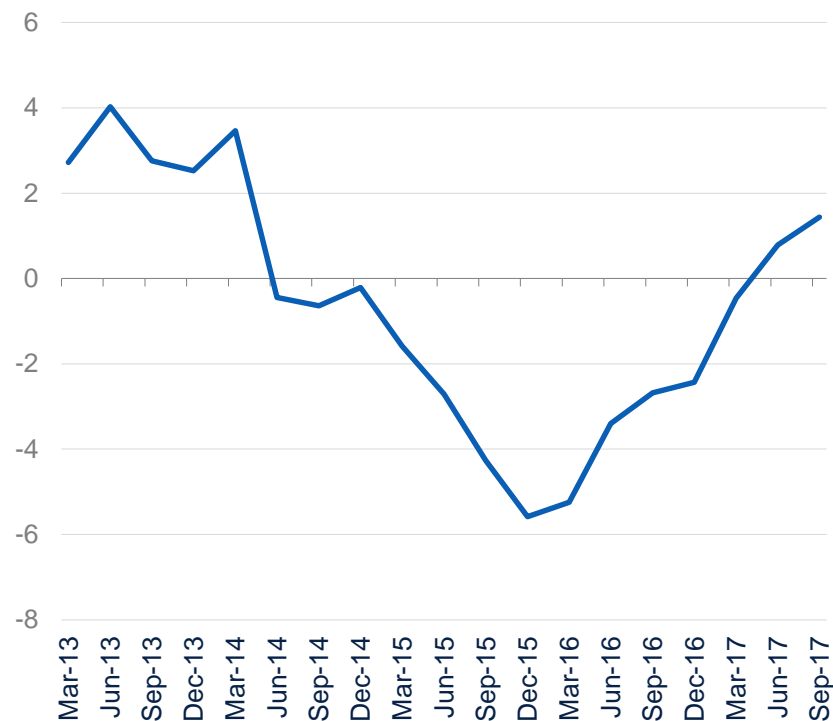
BBVA Research's index of political tensions in Brazil*
(7-days moving average)



The economic recovery has gained momentum throughout 2017

- ◆ The recession has been left behind. **GDP has been growing at positive rates for some quarters**
- ◆ In particular, growth reached 1.4% YoY (0.1% MoM) in 3Q17
- ◆ **Exports and private consumption have been contributing positively to GDP since the beginning of the year**
- ◆ In 3Q17 they grew 10.8% YoY (4.1% MoM) and 2.1% YoY (1.1% MoM), respectively
- ◆ Investment in fixed capital, which lost 30% since the second half of 2013, grew positively in the second half of 2017 (in 3Q17 in quarterly terms and in 4Q17 in annual terms)

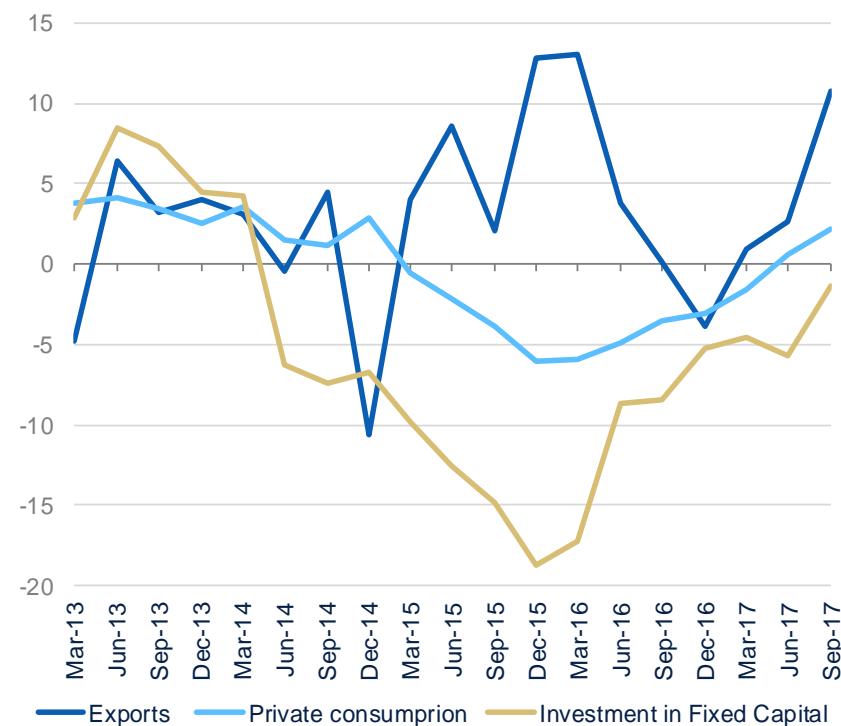
GDP growth
(% YoY)



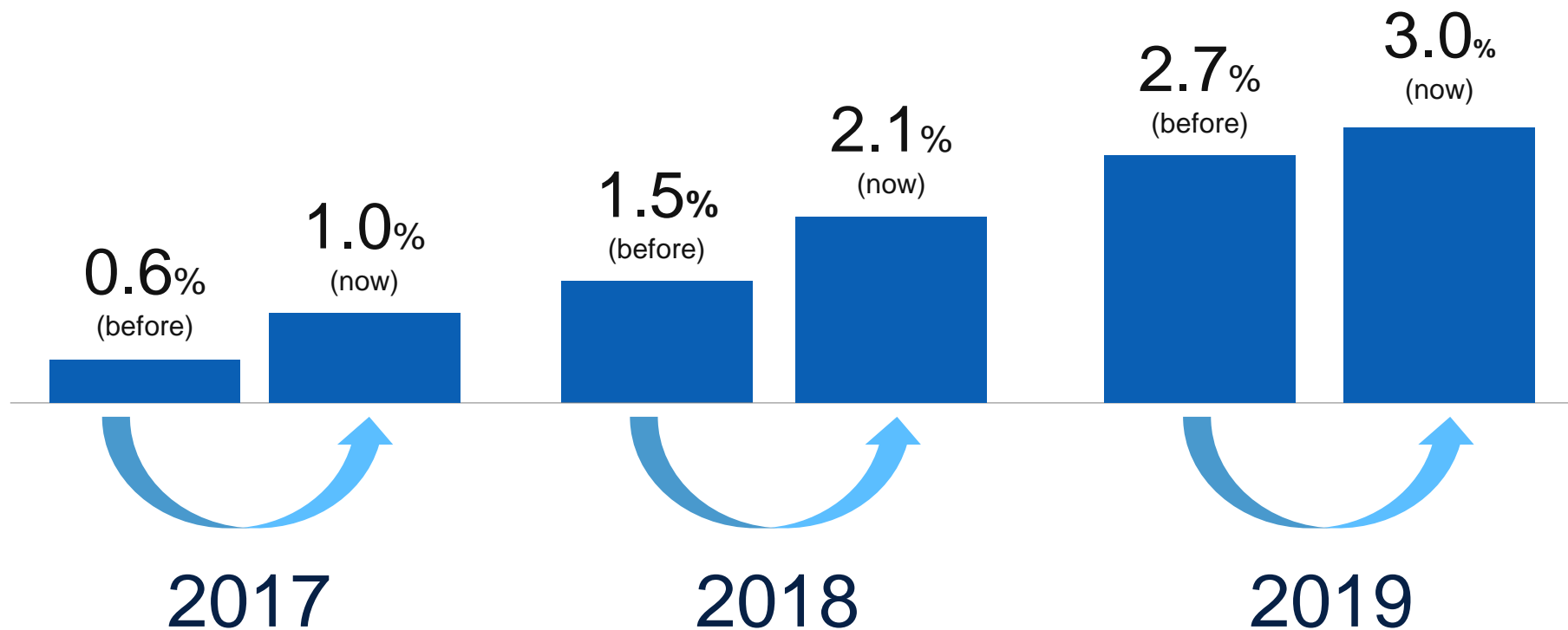
Robustness of exports and recovery of private consumption and investment sustain the cyclical recovery of the economy

- ◆ Exports are supported by the global environment, as well as by favorable terms of trade and exchange rate
- ◆ Private consumption, which represents two thirds of GDP, has been accelerating due to the moderation of inflation and improvements in the labor market, and despite the weakness of the credit market
- ◆ Unemployment reached 12.0% in Nov-17 (13.70% in Mar-17) helping the real wage bill to grow over 4% in recent months
- ◆ With respect to investment, it has been stimulated by the recovery of consumption, expansive monetary policy and the reduction of political uncertainty
- ◆ Both public consumption and expansion of imports continue to contribute negatively to GDP

Exports, private consumption and investment
(% YoY)



Growth prospects for Brazil improve, mainly due to a more positive global environment

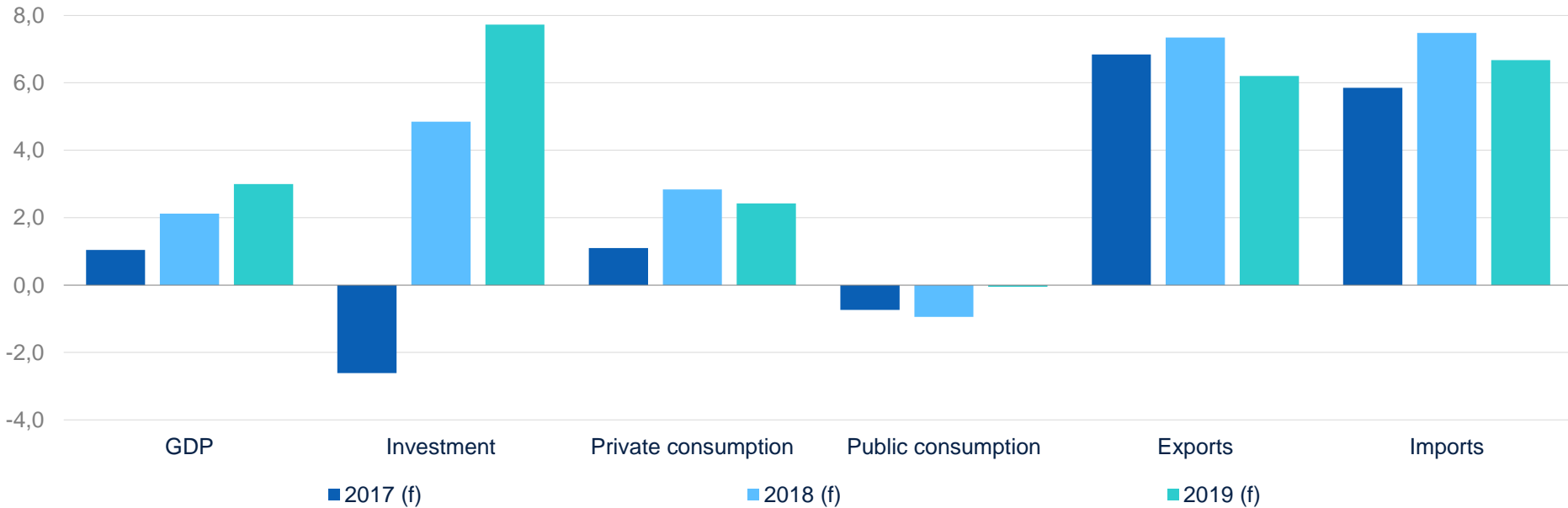


The greater strength of the recovery of activity in Brazil since the beginning of 2017 and, mainly, the better perspectives for global growth (particularly in China) have caused an upward adjustment in our forecast for the country

The approval of an ambitious social security reform during the final year of the Temer government is unlikely. Unaddressed fiscal problems and the political noise that the October elections must generate should together prevent a more robust economic recovery

In 2017 private consumption has started to grow positively again and in 2018-19 investment must do so; net exports will contribute less to GDP

GDP growth, by demand components*
(%)



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

Consumption and investment forecasts have been revised upwards, in line with the improved tone exhibited by recent data and improvement in the global environment

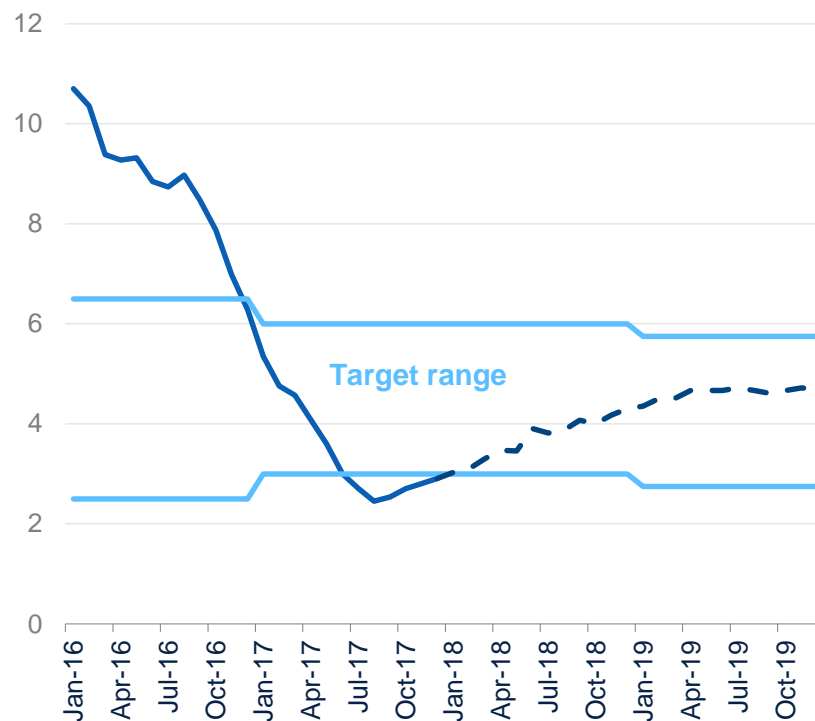
Exports must also grow more than previously expected, stimulated by further growth in the global economy. The expansion of domestic demand will support imports, reducing the net contribution of external demand to GDP

Inflation has already hit bottom

- ◆ Inflation closed 2017 at 2.95%, slightly below the target range and in line with our forecast
- ◆ We maintain our forecast that inflation will close 2018 at 4.3% and 2019 at 4.7%
- ◆ The acceleration of domestic demand, the expected (moderate) depreciation of the exchange rate and the view that food prices will exert ahead more pressure than in 2017, when they fell 1.9%, will all contribute for an acceleration of inflation throughout 2018 and 2019

Inflation

(IPCA; % YoY; forecast from Jan-18 onwards)

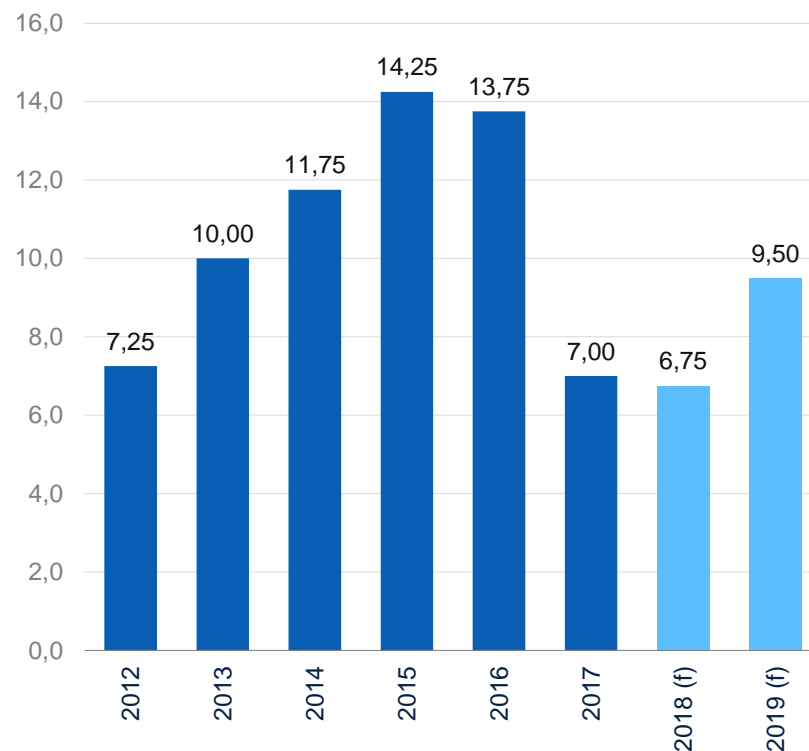


Monetary policy will remain exceptionally loose in 2018

- ◆ The Monetary policy easing cycle, started on Sep-16 when the SELIC interest rates was at 14.25%, is about to come to an end
- ◆ Specifically, we anticipate that the BCB will announce a 25 bp cut of the SELIC rate, bringing it to 6.75%, at its next monetary policy meeting in February, and that from then onwards it will keep it stable at this historically low level until the end of 2018
- ◆ In 2019, as inflationary pressures increase and interest rates in the developed economies are hiked, the SELIC rate would be adjusted upwards to 9.50%

Interest rates: SELIC

(% end of period; forecasts from 2018 onwards)

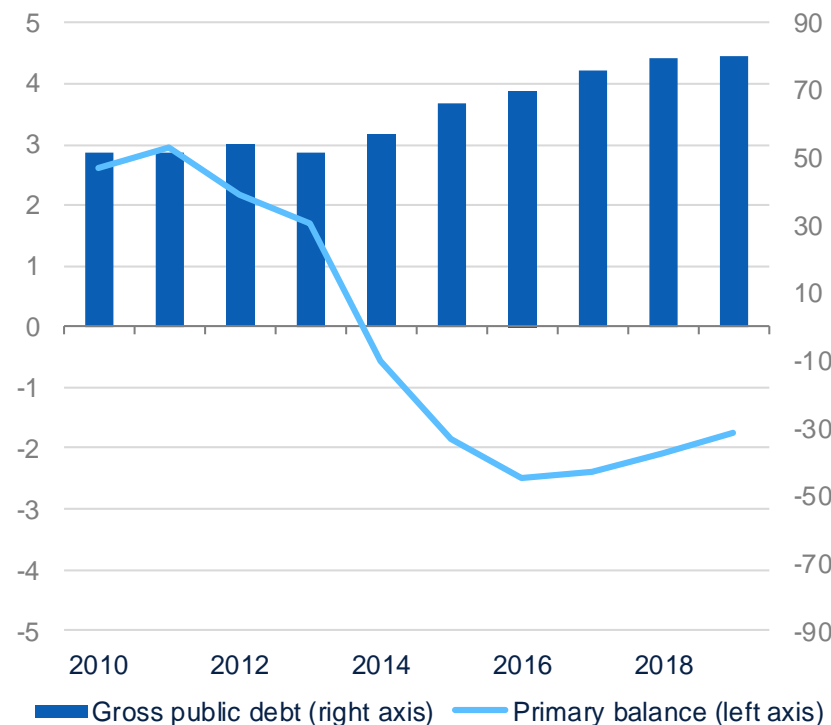


Fiscal situation: there is still no light at the end of the tunnel

- ◆ The economic recovery will drive tax collection up, benefitting public accounts. In particular, the recent recovery in public revenue will allow the government to meet the 2017 fiscal target (primary deficit of -2.5% of GDP)
- ◆ Anyway, even if activity growth surprises upwards, **a strong additional fiscal adjustment will be needed** so that - in the medium term - the spending ceiling rule will be met and - in the long term - the unsustainability of public debt will be avoided.
- ◆ In this sense, a reform of the social security and other complementary measures are needed
- ◆ **One of the biggest problems is that the current government will hardly manage to pass an ambitious social security reform and, while we continue to wait for the next president to do so at the beginning of his government, it is still not clear whether he will be willing or able to do so**

Public sector's primary result and gross debt

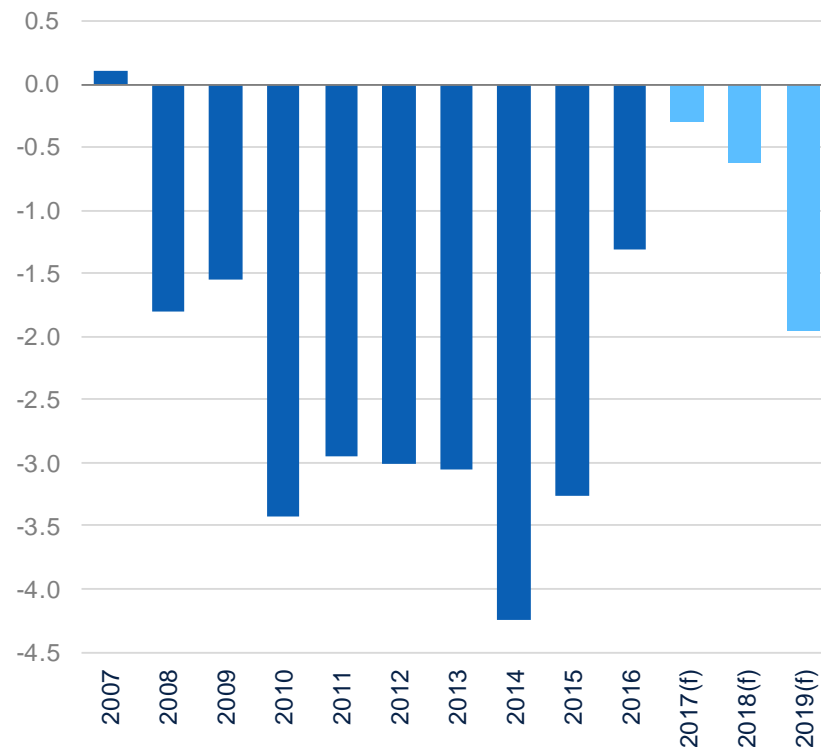
(% of GDP; forecasts from 2017 onwards)



The current account will deteriorate moderately, but the deficit will remain at low levels

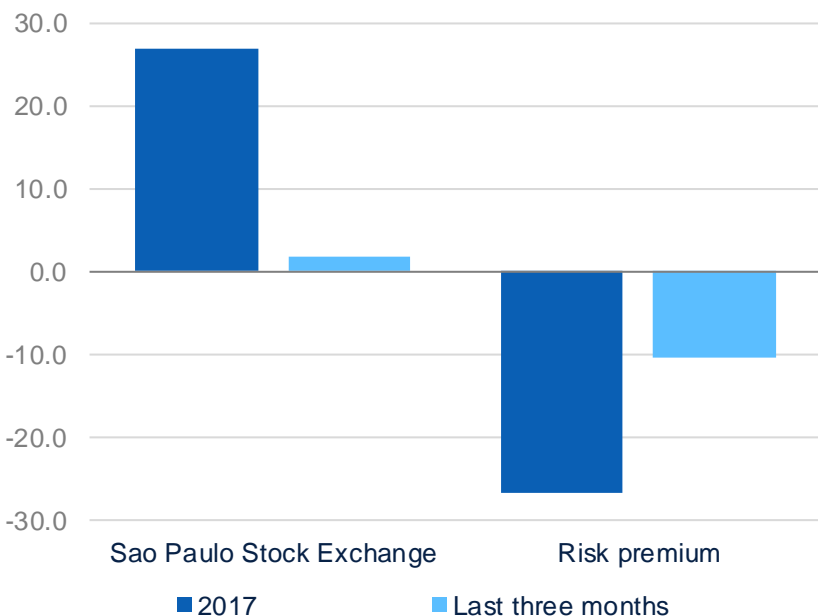
- ◆ The trade balance has been exceptionally high in 2017. On one hand, exports have grown robustly due to the global environment and a relatively depreciated exchange rate. On the other hand, imports remained relatively low, due to weak domestic demand
- ◆ Thus, the commercial balance of 2017, of around 3.3% of GDP, will contribute for driving down the current account deficit to historically low levels (close to 0.3% of GDP)
- ◆ The strengthening of domestic demand and the stability of the terms of trade should generate an increase in the current account deficit to around 0.6% of GDP in 2018 and 1.9% of GDP in 2019

Current account
(% GDP; forecasts from 2017 onwards)



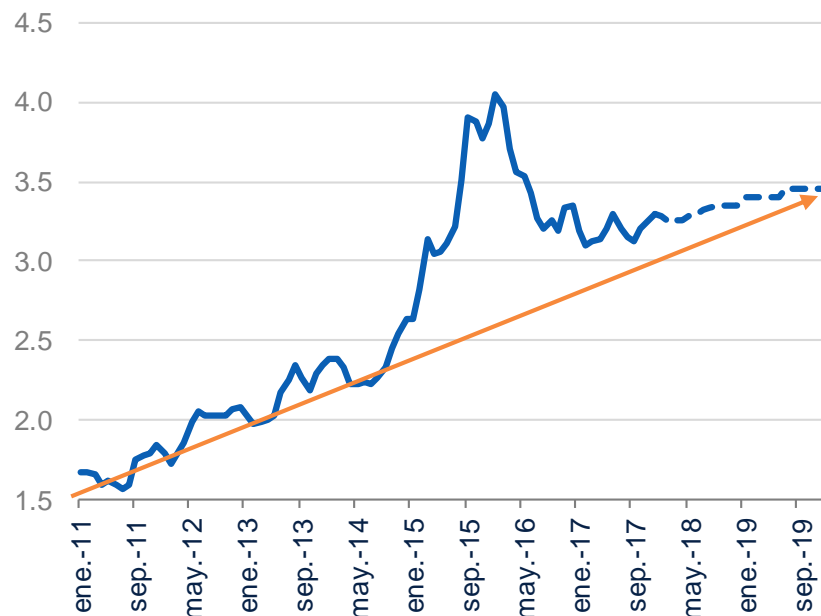
Financial markets continue to display a very positive tone, stimulated by the global environment and, in a certain way, downplaying local risks

Stock exchange and risk premium
(% variation in 2017 and in the last three months*)



* Variations in the last three months: from October 10, 2017 to January 10, 2018
Source: Datastream and BBVA Research.

Nominal exchange rate
(BRL / USD)

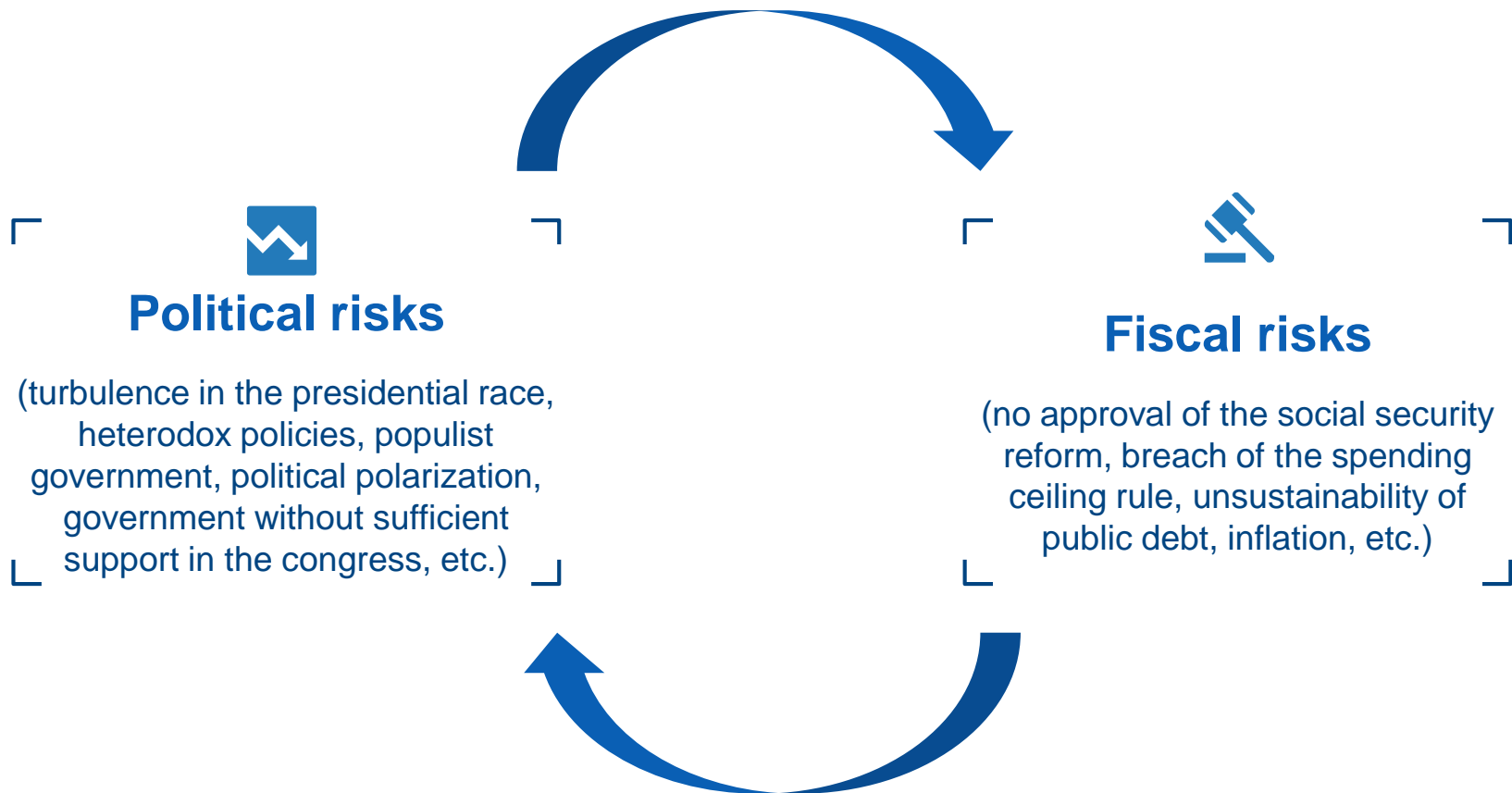


Source: Datastream and BBVA Research.

At the start of Jan-18, the Sao Paulo Stock Exchange reached historical maximum levels (in nominal terms), while the risk premium was around 220 bp, close to the values observed before the crisis, when the country still exhibited an investment grade

The exchange rate has appreciated 1% in real terms in 2017 (a nominal depreciation of 2%). The normalization of monetary policy in the US and the stability of the terms of trade will contribute for the Brazilian real to depreciate from 3.30 in Dec-17 to 3.35 in Dec-18 and 3.45 in Dec-19

Political and fiscal risks remain high, feeding each other



In our baseline scenario, the economy will continue to recover and the fiscal problem will be addressed with a reform of social security and other measures at the beginning of the next government, to be elected in October

However, it can not be ruled out that political and fiscal risks materialize, slowing down the recovery and even generating a new economic crisis, especially if the global environment stops being so positive

Brazil: recovery gains momentum, but risks do not recede

1. The growth of the Brazilian economy has surprised upwards during 2017. That and the improvements in the global environment, especially the acceleration of global growth, reinforce the prospects for a (cyclical) recovery of the activity. We have thus revised upwards our growth forecasts Brazil. **We now estimate growth to have reached 1.0% in 2017 and expect it to increase to 2.1% in 2018 and 3.0% in 2019**
2. **Inflation has already bottomed out, but its acceleration from now on will be gradual, allowing the Central Bank to keep SELIC interest rates at historically low levels.** Specifically, inflation should reach 4.3% in 2018 and 4.7% in 2019, after having closed 2017 at 2.9%, while SELIC rates should soon reach 6.75% and remain at this level for a long time
3. Although in our baseline scenario the economy will continue to recover and the fiscal problem will be addressed with a reform of the social security and other measures at the beginning of the next government to be elected in Oct-18, **we can not rule out an alternative scenario where political and fiscal risks materialize, bringing the recovery to an end and perhaps even generating a new economic crisis**



FORECASTS



BBVA Research forecasts for Brazil

	2016	2017(f)	2018(f)	2019(f)
GDP (%)	-3.5	1.0	2.1	3.0
<i>Private consumption(%)</i>	-4.3	1.1	2.8	2.4
<i>Public consumption (%)</i>	-0.1	-0.7	-0.9	-0.1
<i>Gross fixed investment (%)</i>	-10.3	-2.6	4.8	7.7
<i>Exports (%)</i>	1.9	6.8	7.3	6.2
<i>Imports (%)</i>	-10.2	5.9	7.5	6.7
Unemployment rate (average)	11.3	12.7	11.9	10.9
Inflation (end of period. YoY %)	6.3	2.9	4.3	4.7
SELIC rate (end of period. YoY %)	13.75	7.00	6.75	9.50
Exchange rate (end of period)	3.35	3.30	3.35	3.45
Current account (% of GDP)	-1.3	-0.3	-0.6	-1.9
Public sector's total fiscal result (% of GDP)	-9.0	-9.5	-8.5	-6.1
Gross public debt (% of GDP)	69.9	75.8	79.6	80.0

This report has been produced by the Latin America unit

Chief Economist for Latin America

Juan Manuel Ruiz

juan.ruiz@bbva.com

Enestor Dos Santos

enestor.dossantos@bbva.com

Cecilia Posadas

c.posadas@bbva.com

With the collaboration of: Global Economic Situations

Miguel Jiménez

mjimenezg@bbva.com

BBVA-Research

Jorge Sicilia Serrano

Macroeconomic analysis

Rafael Doménech

r.domenech@bbva.com

Global Economic Situations

Miguel Jiménez

mjimenezg@bbva.com

Global Financial Markets

Sonsoles Castillo

s.castillo@bbva.com

Long-Term Global Modelling and Analysis

Julián Cubero

juan.cubero@bbva.com

Innovation and Processes

Oscar de las Peñas

oscar.delaspenas@bbva.com

Financial Systems and Regulation

Santiago Fernández de Lis

sfernandezdelis@bbva.com

International Coordination

Olga Cerqueira

Olga.cerqueira@bbva.com

Digital Regulation

Álvaro Martín

alvaro.martin@bbva.com

Regulation

Financial Systems

Ana Rubio

arubiog@bbva.com

Financial Inclusion

Spain and Portugal

Miguel Cardoso

miguel.cardoso@bbva.com

United States

Nathaniel Karp

Nathaniel.karp@bbva.com

Mexico

Carlos Serrano

carlos.serranoh@bbva.com

Middle East, Asia and

Geopolitical

Álvaro Ortiz

alvaro.ortiz@bbva.com

Turkey

Álvaro Ortiz

alvaro.ortiz@bbva.com

Asia

Le Xia

Le.xia@bbva.com

South America

Juan Manuel Ruiz

juan.ruiz@bbva.com

Argentina

Gloria Sorensen

gsorensen@bbva.com

Chile

Jorge Selaive

jselaive@bbva.com

Colombia

Juana Téllez

juana.tellez@bbva.com

Peru

Hugo Perea

hperea@bbva.com

Venezuela

Julio Pineda

juliocesar.pineda@bbva.com