BBVA Research

Brazil Economic Outlook 2Q18

April 2018

Creating Opportunities

Main messages

- Economic activity recovers in Brazil. GDP grew 1.0% in 2017, leaving behind two years of recession, which should accelerate gradually going forward favored by a relatively favorable global environment, low inflation and an expansive monetary policy. We maintain our GDP growth forecasts of 2.1% in 2018 and 3.0% in 2019

- Political and fiscal developments will shape the economic performance. The sustainability of the economic recovery requires the adoption of structural measures to bring the fiscal deterioration to an end. A government with enough political capital to implement the needed fiscal measures can emerge from the presidential elections in October 2018, but the risks are not negligible

Index

01

Global environment: robust growth, but greater uncertainty

Robust global growth, but greater uncertainty

01

The pace of global growth continues...

...thanks to the recovery in investment and trade

02

Economic policies are extending the cyclical recovery

The US fiscal stimulus could underpin the other areas

03

Greater financial volatility

The unusual environment of low volatility has been left behind

04

Normalization of the monetary policy of central banks

somewhat faster than expected at the Fed, while the ECB has already taken the first steps

05

Uncertain effect of US protectionist measures

The direct effect of what has already been approved is not very sizable but could herald more aggressive measures

06

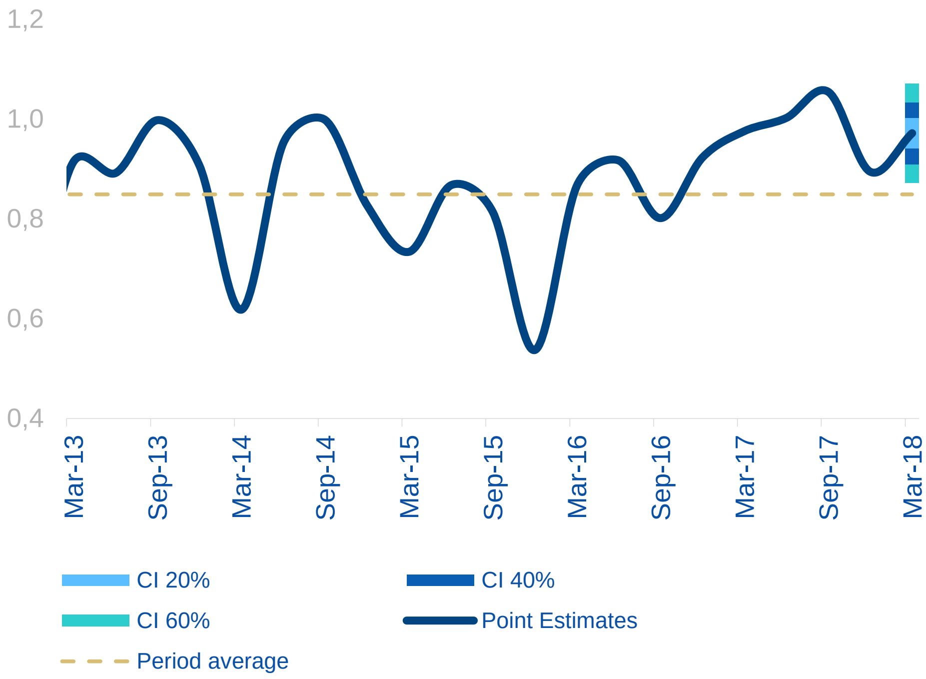
Global risks

Greater in the short term due to a possible escalation of protectionist measures

Robust global growth

World GDP growth

Forecasts based on BBVA-GAIN, % QoQ)

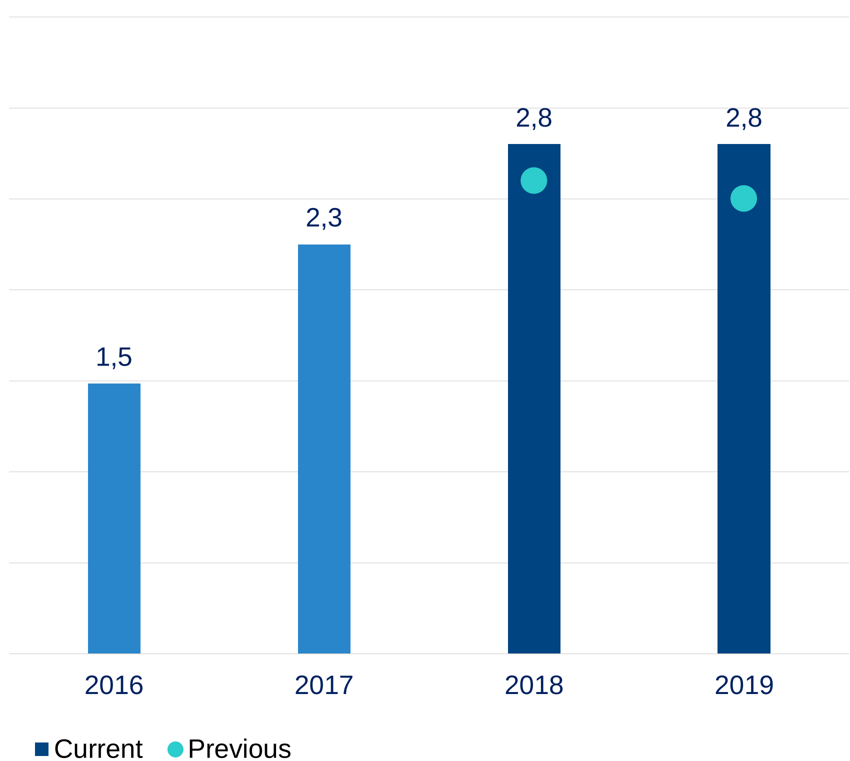


- Global growth continues, supported by the recovery in investment and trade
- Private consumption is softening, but remains a positive factor for the advanced economies and is gaining momentum in emerging economies
- Confidence indicators remain at high levels, but show signs of dampening

Source: BBVA Research

USA: greater economic growth due to fiscal stimulus

USA: GDP growth
(% YoY)

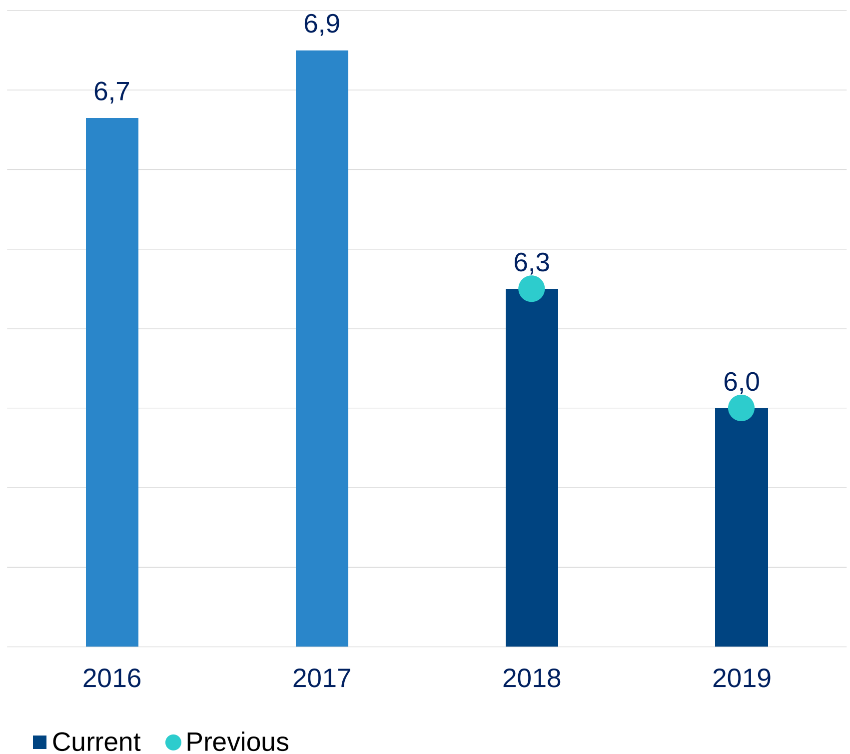


- Moderate effect of the new fiscal stimulus in the short term in an economy at full employment and lacking measures to support a significant increase in potential growth
- The favorable global environment and the soundness of domestic demand complement the positive effect of higher public spending (0.2 pp in 2018 and 0.3 pp in 2019)
- The likelihood of inflation temporarily overshooting the Fed target has increased, but will remain contained

Source: BBVA Research based on BEA data

China: stable growth and less political uncertainty

China: GDP growth
(% YoY)

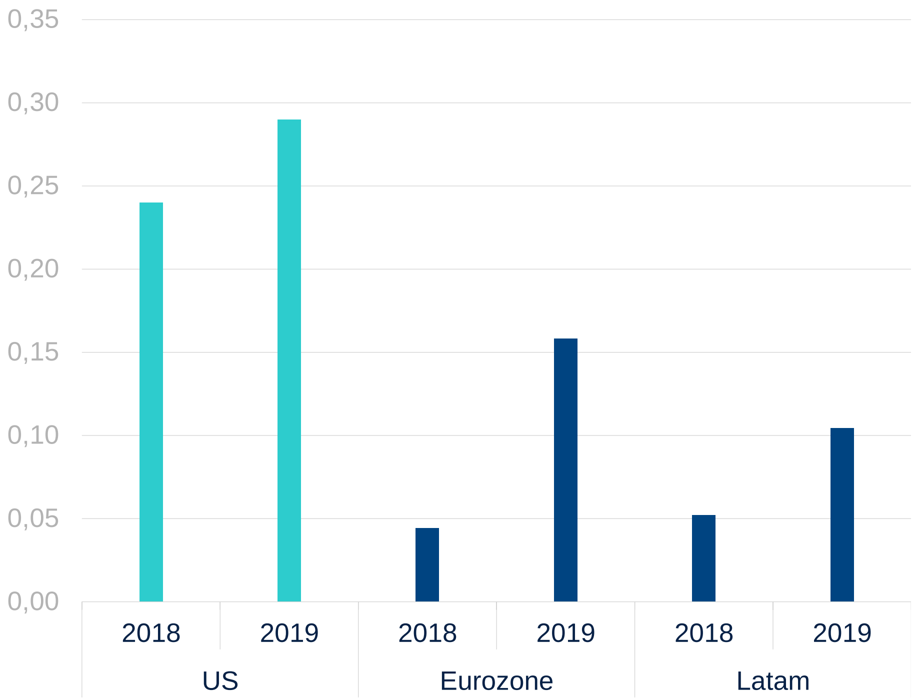


- The strength of credit and exports has helped to stabilize the economy in 1Q18
- No change in the scenario: growth slowing down throughout the year due to more prudent economic measures
- Increase in the likelihood of applying structural reforms and addressing financial vulnerabilities in the medium term
- Growing protectionism threatens the sustainability of exports

Source: BBVA Research based on CEIC

Higher growth in the US could underpin progress in other areas

Impact of the fiscal stimulus in the US on growth
(p.p.)

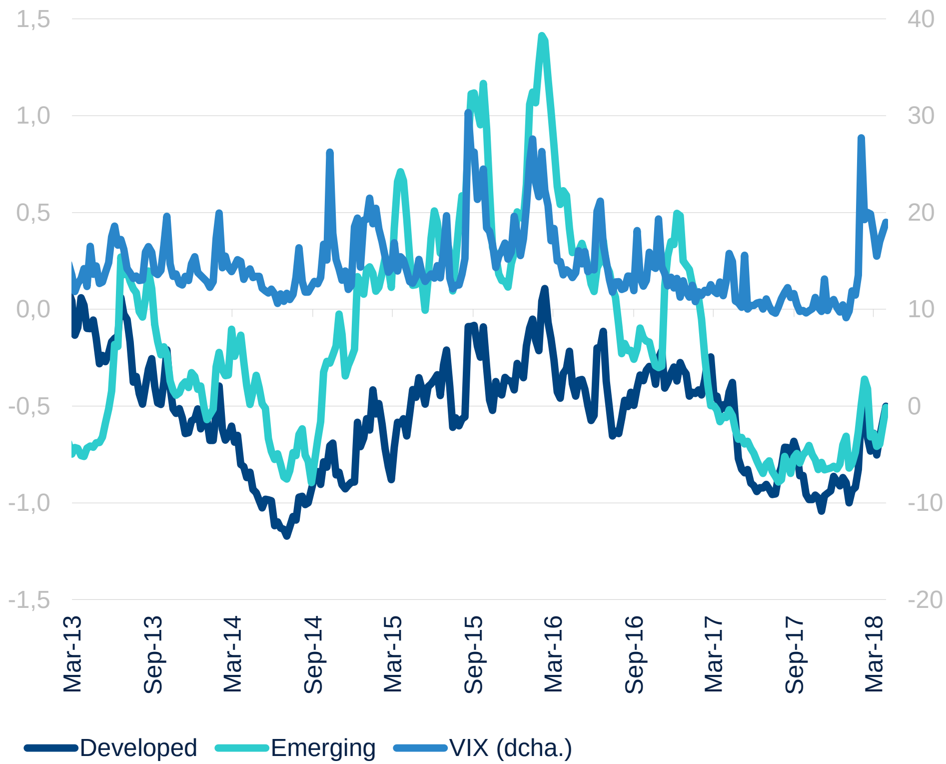


Source: BBVA Research

- The most significant impact should be observed in 2019, especially in the euro area
- Such support should offset some headwinds in other areas (political uncertainty in Latin America or increasing global volatility)
- Dollar weakness could diminish the positive impact of the increase in US demand

Financial conditions are beginning to reflect a less benevolent environment

VIX and BBVA Financial Stress Index
(%)



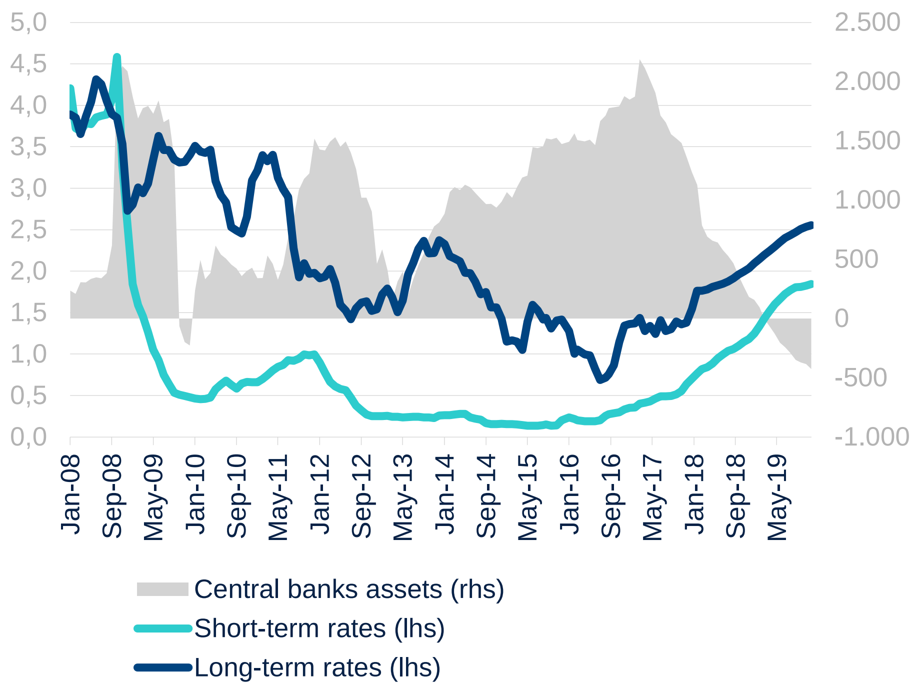
Source: BBVA Research based on Bloomberg

- The fear of an upturn in US inflation and the announcement of protectionist measures have triggered an increase in volatility and correction on stock markets
- The spill-over effect is proving limited, but everything will depend on the persistence of the current shock
- It is unlikely that the markets will be as obliging as regards uncertainty as in 2017

Financial conditions will be less accommodative

Global financial conditions*

(% and change in billion dollars)



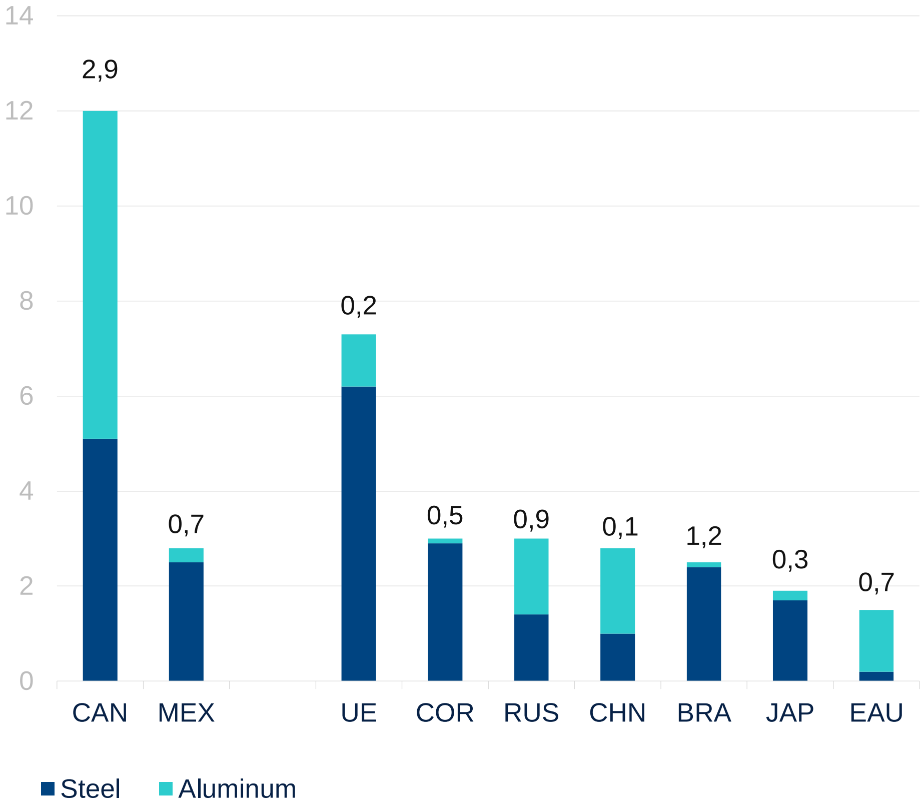
(*) Short and long term interest rates, average yield of German and US bonds over 3 months and 10 years. Includes assets on the balance sheets of the Fed, ECB, BoE and the BoJ
Source: BBVA Research, Fed, ECB, BoE and BoJ

- Fed rate hikes are picking up pace on increased economic dynamism: interest rates will be adjusted upward 75 bp more this year and another 50 bp in 2019
- 2018 will see the ending of QE
- In a context in which central banks will be scaling down their balance sheets and interest rates gradually rise...
- ... volatility shocks could be more frequent and persistent
- More cautious positioning by investors

The risk of an escalation of protectionism is prompting uncertainty over the global economy

USA: Imports of steel and aluminum and weight of total exports of each country*

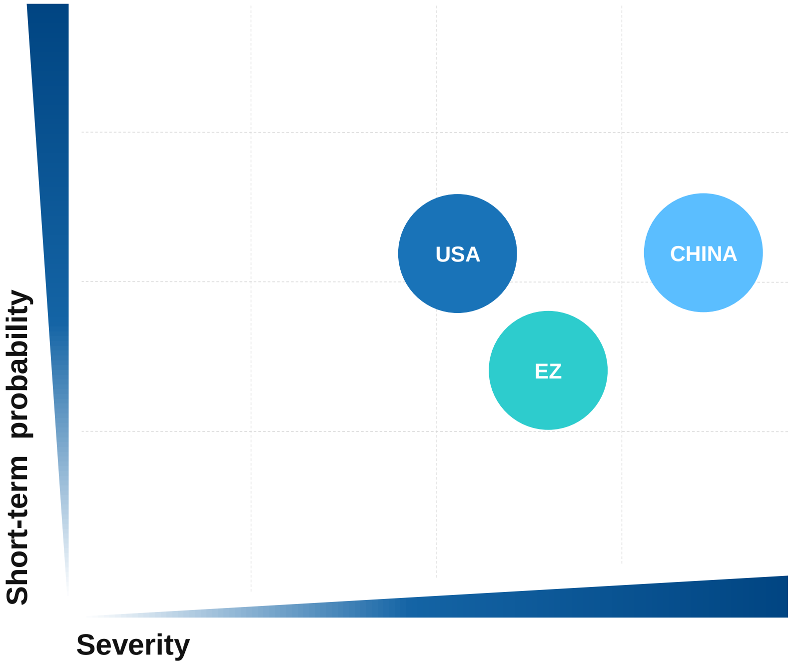
(billion USD, % of total exports)



*The value shown represents the % of the total exports of each country
Source: BBVA Research

- Tariffs on US steel and aluminum have a small direct impact:
  - ✓ they only represent a small portion of total exports
  - ✓ exemption for many countries until May
  - ✓ the greatest adverse impact might come from the indirect effects and the potential reaction of the affected countries
- The mutual tariff hike between the US and China (25%):
  - ✓ these have a bigger impact: 38% of exports to China (3% of the total) and 11% of exports to the US (2% of the total)
  - ✓ it may be only the beginning of a major escalation

Global risks: growing in the short term and with a focus on the US



CHINA

- Containment of risks associated with high leverage in the short term and the economic slowdown
- Potential negative effect of increased protectionism

USA

- Recent announcements increase the risk of protectionism
- Political controversy is still high, despite the fiscal stimulus
- Signs of over-valuation of certain financial assets
- Risks associated with the Fed exit (aggressive rate hikes in the face of a temporary spike in inflation) and its impact on the bond market

EUROZONE

- Increased political uncertainty after the elections in Italy
  - ✓ Italy: uncertainty about the formation of the new government. Risk of a policy that hinders the European project
  - ✓ Brexit: doubts about future trading relations
- Management of the normalization of monetary policy

Source: BBVA Research

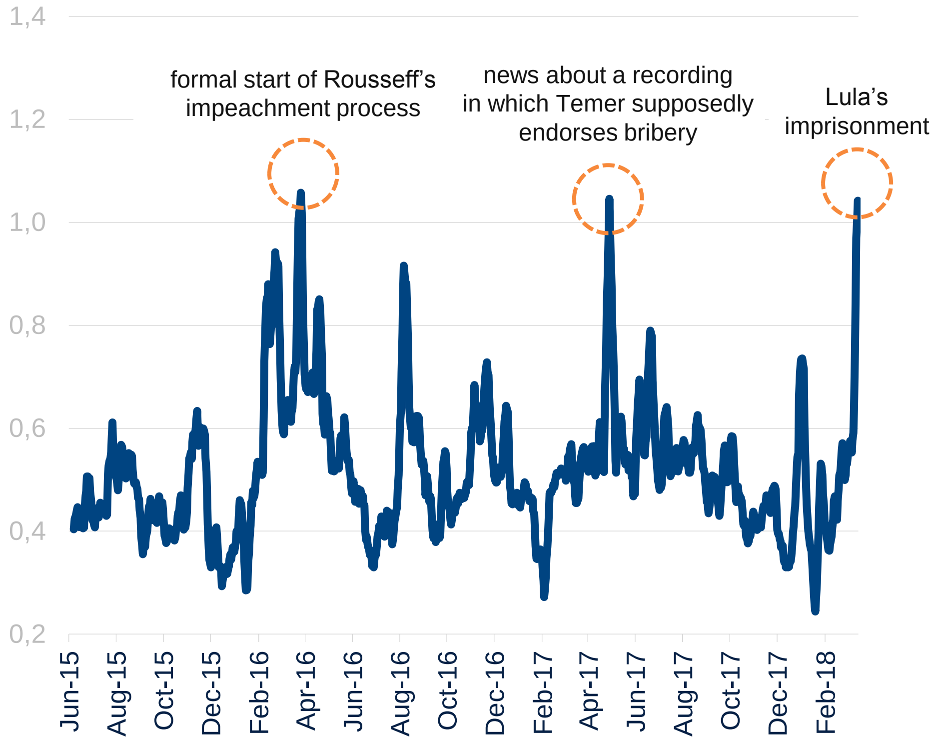
02

Brazil:
recovery in progress, with all eyes on politics and the fiscal adjustment

Political tensions will remain at a particularly high level in this presidential election year

BBVA Research's index of political tensions in Brazil (*)

(7-days moving average)



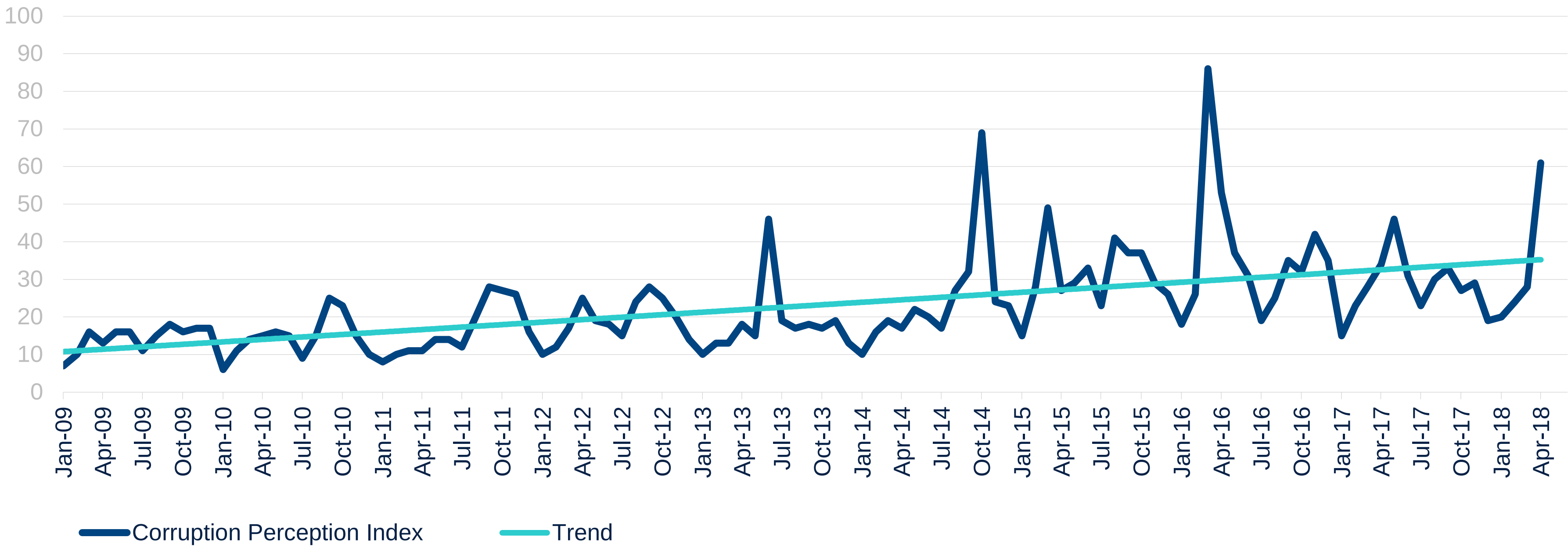
* Index of political tensions = share of news about politics * (1- average tone of news about politics)
Source: BBVA Research and GDELT

- In line with expectations, political noise has increased again
- The judicial process for corruption against Lula -which should prevent him from running in the upcoming presidential elections- has contributed to this
- There is still a lot of uncertainty about the outcome of the October presidential elections
- The risks are significant. Will the next president be able to calm the political environment? Will he be willing and able to address the fiscal problem?

Concerns about corruption will continue to have political and economic effects

BBVA Research`s corruption perception index (*)

(index ranging from 0 to 100)



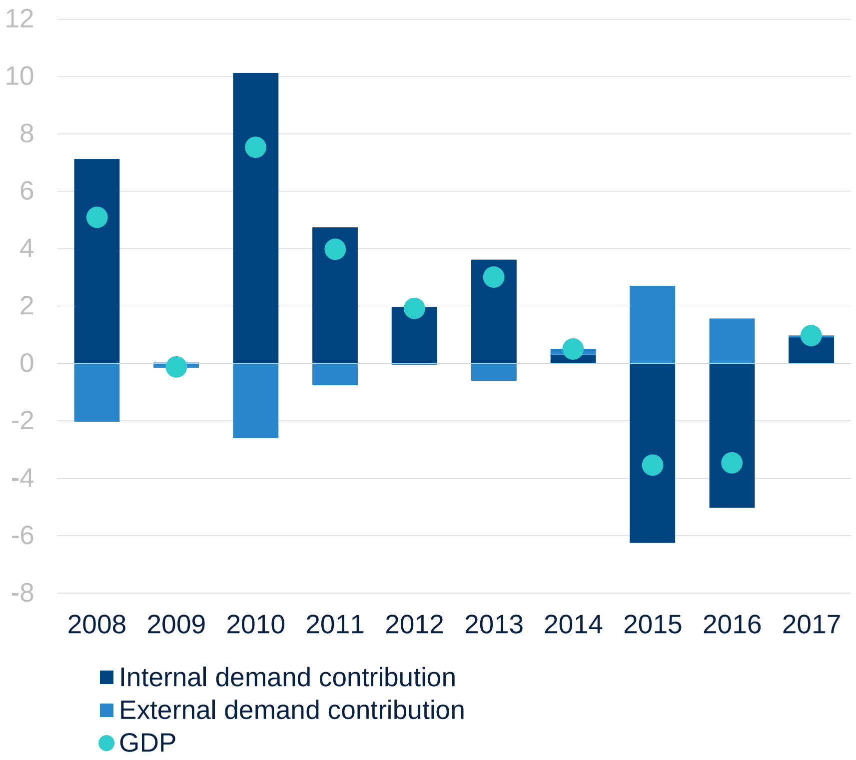
* For more details about the corruption perception index and its impacts, see our report "Assessing corruption with Big Data"
Source: BBVA Research base on Google Trends data

The perception of corruption is key to understanding the low approval ratings of the current government and, consequently, its difficulty in approving a social security reform

It will also be one of the central themes in the upcoming presidential elections. In addition, it will continue to negatively affect confidence indicators (*)

Despite the political noise, the economy exhibited a positive (but low) growth rate in 2017

PIB: Crecimiento
(%)



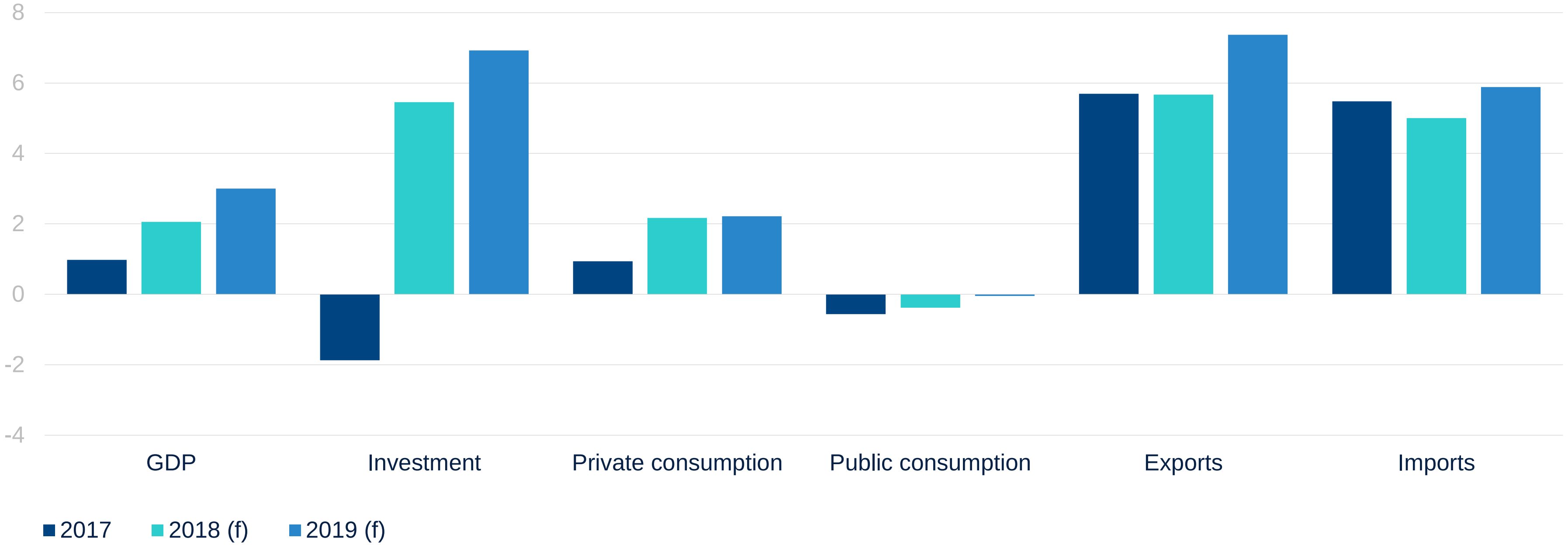
- The economy grew 1% in 2017 in line with our forecast
- The economic recovery has been driven by factors such as:
  - ✓ supportive global environment
  - ✓ low inflation
  - ✓ expansive monetary policy
  - ✓ agricultural production
  - ✓ adjustments made in previous years (inventory reduction, deleveraging, etc.)

Source: BBVA Research and IBGE

The recovery will continue ahead, more supported by domestic demand; we continue to expect a growth of 2.1% in 2018 and 3.0% in 2019

GDP growth, by demand components

(%)



* (f): forecasts
Source: BBVA Research

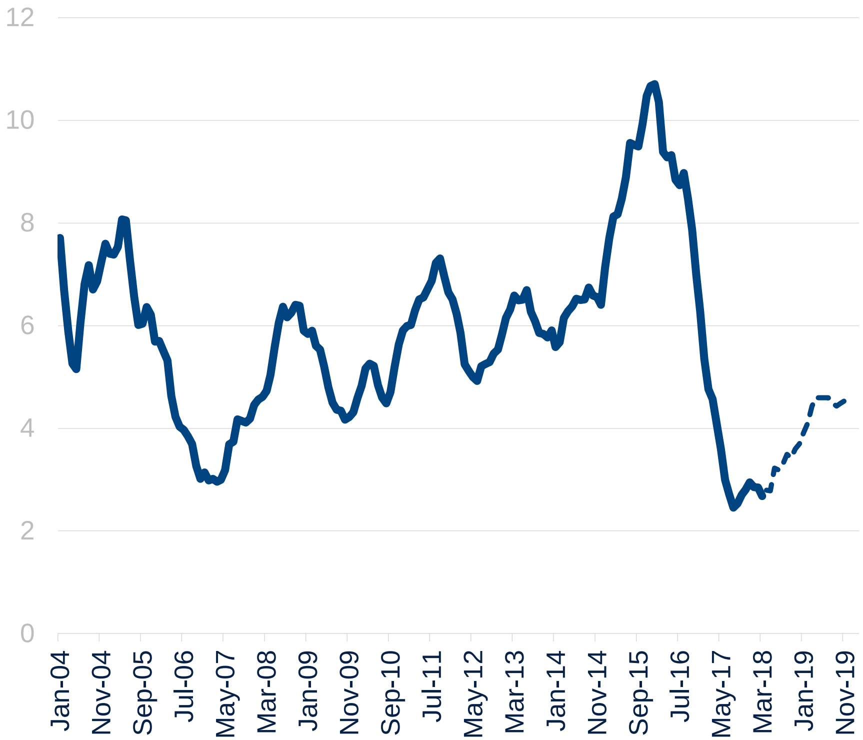
The global environment, inflation under control and expansive monetary policy should continue to support both the expansion of exports and the resumption of domestic demand

In our baseline scenario (subject to significant risks) political noise will ease and the social security reform will be approved in 2019, supporting the economic recovery

Inflation will continue at exceptionally low levels

Inflation

(IPCA; % YoY; forecasts from April-18 onwards)



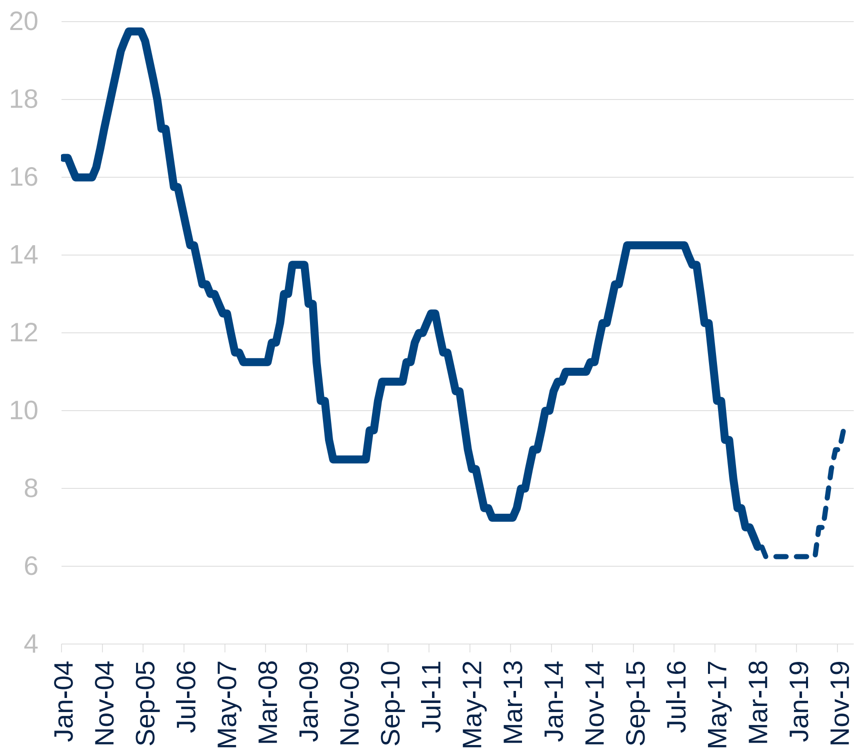
Source: BBVA Research and IBGE

- We revised down our inflation forecasts to 3.7% in 2018 and 4.5% in 2019
- The temporary conjunction of a series of factors is behind the fall of inflation in 2017-18:
  - low global inflation
  - weak demand
  - low food inflation
  - relatively stable exchange rate
- Each one these factors will be less supportive in 2019 than in 2018, which explains our perspective of an inflationary upturn next year

Low SELIC interest rates: a cyclical rather than structural phenomenon

Monetary policy interest rates: SELIC

(%, forecasts from May-2018 onwards)



Source: BBVA Research and BCB

- The Central Bank communication supports the view that the SELIC rate will reach 6.25% in May; it then must remain stable at that level at least until the end of 2018
- A rebound in inflation and the normalization of monetary policy in developed countries should force the BCB to start withdrawing the monetary stimulus in 2019, when the SELIC should reach 9.5%
- The structural reduction of interest rates requires the reduction of fiscal risk, something that has not yet happened

The fiscal problem: relatively under control in 2018, but ambitious measures will be required from the new government from 2019 on

Before 2017

- **Sharp deterioration of public accounts**, as a result of both the impact of economic moderation on public revenues and increase in spending, and **loss of investment grade**
- **Structural increase of the social security deficit**
- **Adoption of a ceiling for fiscal spending** (forbidding it to increase in real terms)
- **Primary result: -2.5% of PIB in 2016** (2004-13: +3.0%; 2014: -0.6%; 2015: -1.9%)
- **Public debt: 70% of PIB in 2016** (2013: 52%; 2014: 57%; 2015: 66%)

2017

- **Fulfillment of fiscal goals** (target for primary result, expenditure ceiling and golden rule) due to control of expenses, recovery of activity, low interest rates and BNDES's reimbursements to the Treasury
- **No approval of a social security reform**
- **Primary result: -1.7% of PIB**
- **Public debt: 74% of GDP**

2018

- **Fiscal goals will likely be met** due to control of expenses, recovery of activity, low interest rates and BNDES's reimbursements to the Treasury
- **Unlikely approval of an ambitious social security reform**
- **Primary result (forecast): -1.9% of GDP**
- **Public debt (forecast): 77% of GDP**

From 2019 on

- **Compliance with fiscal goals from 2019 on require the adoption of ambitious fiscal measures** such as a social security reform, increased taxes or flexibilization of fiscal expenditure (reduce proportion of earmarked revenues)
- **Only a government that has sufficient political capital will be able to adopt the fiscal reforms** needed to avoid a further deterioration of public accounts

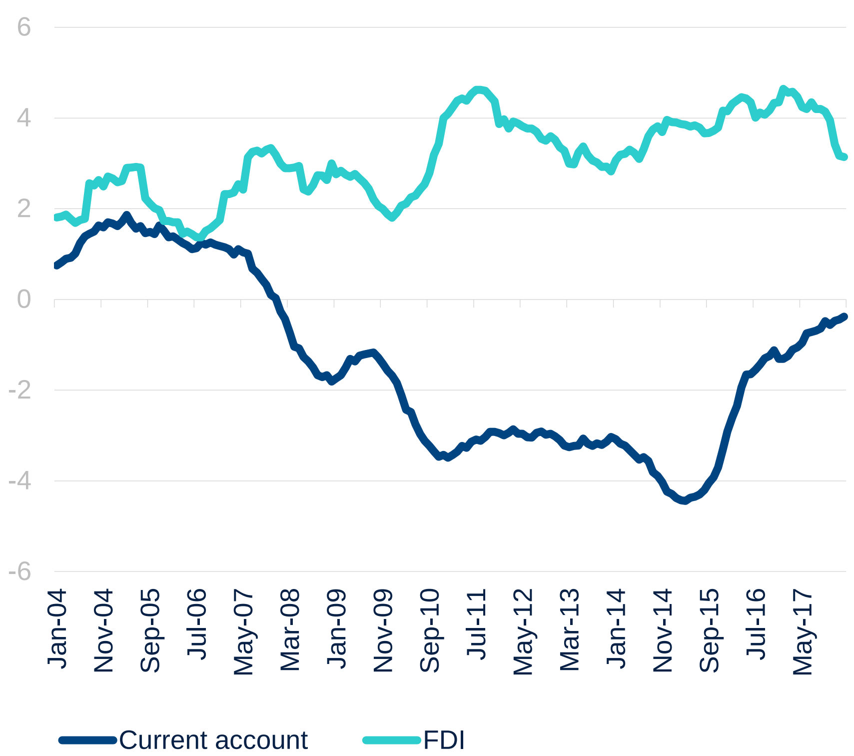
The previous fiscal deterioration has left the government with practically no margin to adopt fiscal measures to stimulate growth in the current cycle

The normalization of monetary policy in developed countries will gradually reduce financial market's degree of complacency with respect to the fiscal situation in Brazil

Improvement of the current account reflects a contrast between relatively robust global demand and weak domestic demand

Current account and foreign direct investment (FDI)

(accumulated in 12 months, % of GDP)

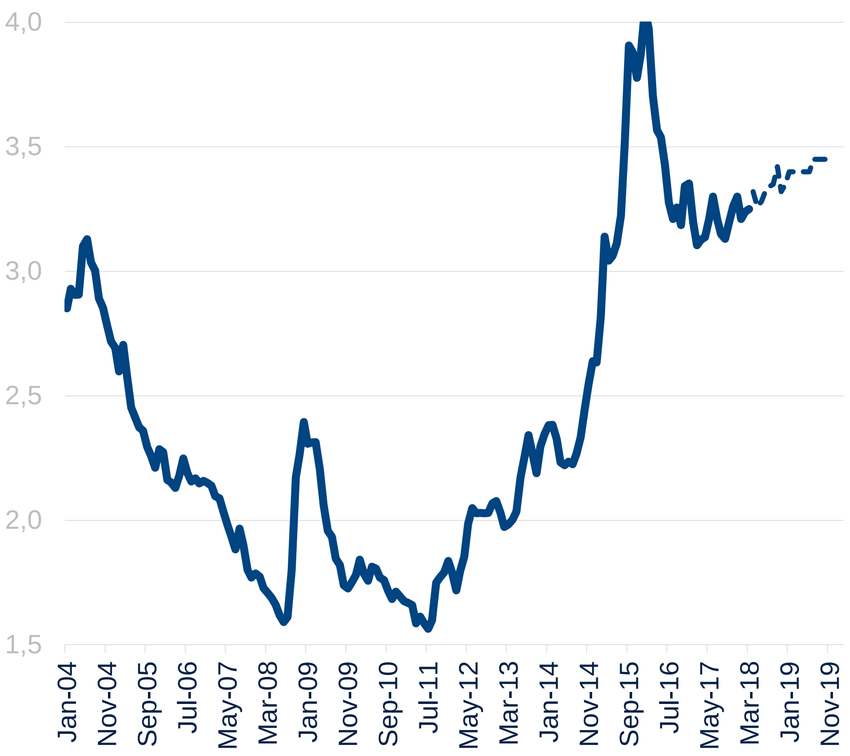


Source: BBVA Research and BCB

- In 2018, the current account deficit must remain at particularly low levels. Specifically, we expect it to close the year at 0.6% of GDP
- The greater dynamism of domestic demand should increase the pressures on the current account in 2019, when we expect the deficit to increase to 1.9% of GDP
- External risks are mostly under control, in contrast with the fiscal ones

Recent losses in local financial markets also reflect a reduction in the optimism regarding the country

Nominal exchange rate
(BRL per USD)



- Since mid-February the Brazilian real has depreciated 6% reaching 3.41 per dollar, the Sao Paulo Stock Exchange has lost 3% and the risk premium has increased 19 bp (8%)
- The recent correction is due to higher volatility in global markets and greater concern with local (political, fiscal) risks
- These risks should constrain the increase of local assets' prices, at least in 2018
- The exchange rate is expected to converge to 3.35 this year and to 3.45 in the next one

Source: BBVA Research and BCB

High political and fiscal risks

Political risks

(turbulence in the presidential race, heterodox policies, populist government, political polarization, government without sufficient support in the congress, etc.)

Fiscal risks

(no approval of the social security reform, breach of the spending ceiling rule, unsustainability of public debt, inflation, etc.)

In our baseline scenario, the economy will continue to recover and the fiscal problem will be addressed 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

03

Brazil:
forecasts table

Brazil forecasts

	2016	2017	2018 (f)	2019 (f)
GDP (%)	-3.5	1.0	2.1	3.0
Private consumption(%)	*-4.3*	*0.9*	*2.2*	*2.2*
Public consumption (%)	*-0.1*	*-0.6*	*-0.4*	*-0.1*
Gross fixed investment (%)	*-10.3*	*-1.9*	*5.5*	*6.9*
Exports (%)	*1.9*	*5.7*	*5.7*	*7.4*
Imports (%)	*-10.2*	*5.5*	*5.0*	*5.9*
Unemployment rate (average)	11.3	12.7	11.9	10.9
Inflation (end of period, YoY %)	6.3	2.9	3.7	4.5
SELIC rate (end of period, YoY %)	13.75	7.00	6.25	9.50
Exchange rate (end of period)	3.35	3.30	3.35	3.45
Current account (% of GDP)	-1.3	-0.5	-0.6	-1.9
Public sector's total fiscal result (% of GDP)	-9.0	-9.5	-7.4	-5.2
Gross public debt (% of GDP)	69.9	75.8	77.6	77.3

(f): forecast

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