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Brazil Economic Outlook
3Q18

July 2018

Creating Opportunities

Key messages

- Increased financial tensions in emerging markets, including Brazil, in line with the process of withdrawal of monetary stimuli in the United States and protectionist threats. At local level, tensions have been fueled by political uncertainty and the fiscal imbroglio. The relative strength of the Brazilian external accounts has prevented the situation from becoming even more difficult.

- Growth prospects deteriorate: the recovery process will be more gradual than previously expected. Financial volatility, the negative effects of exchange rate depreciation on inflation and thus on the ability of monetary policy to stimulate the economy, doubts about whether the next government will face fiscal problems and the consequences of the recent truckers' strike, among other factors, make it more likely that growth in 2018 and 2019 will be 1.6% and 2.4%, respectively, instead of 2.1% and 3.0% as previously expected.

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Global environment:
global growth continues, but risks are intensifying

Global growth continues, but risks are intensifying

01

The pace of global expansion is being maintained, but is less synchronized

Growth is robust in the US due to the fiscal stimulus and stable in China, but it has been reduced in Europe

02

Increased protectionism

At the moment, its impact on growth is limited, but it could be greater if the measures under discussion were to be implemented

03

Increase in the price of oil

Higher inflation and drag on growth in oil-importing countries

04

Different pace of monetary normalization in Europe and the United States

Strengthening of the dollar and tightening of global financial conditions

05

More volatility in emerging markets

Increased financial tensions due to increased financing costs and protectionist threats

06

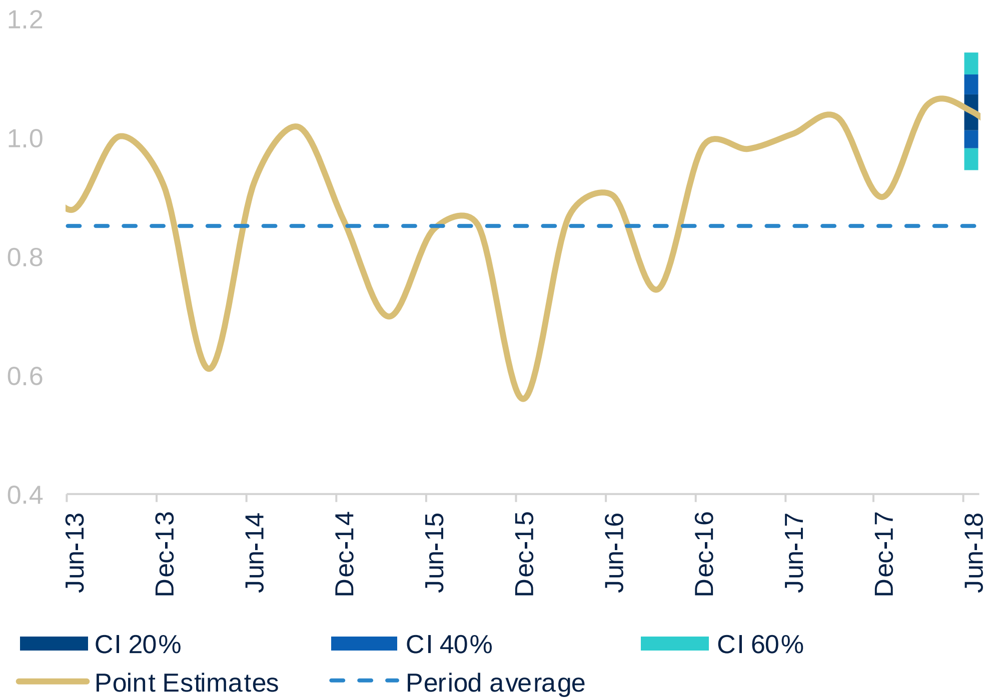
Global risks are intensifying

The possibility of a trade war comes together with greater risks in emerging economies and in Europe

Robust global economy despite growing uncertainty

World GDP growth

(Forecasts based on BBVA-GAIN, % QoQ)



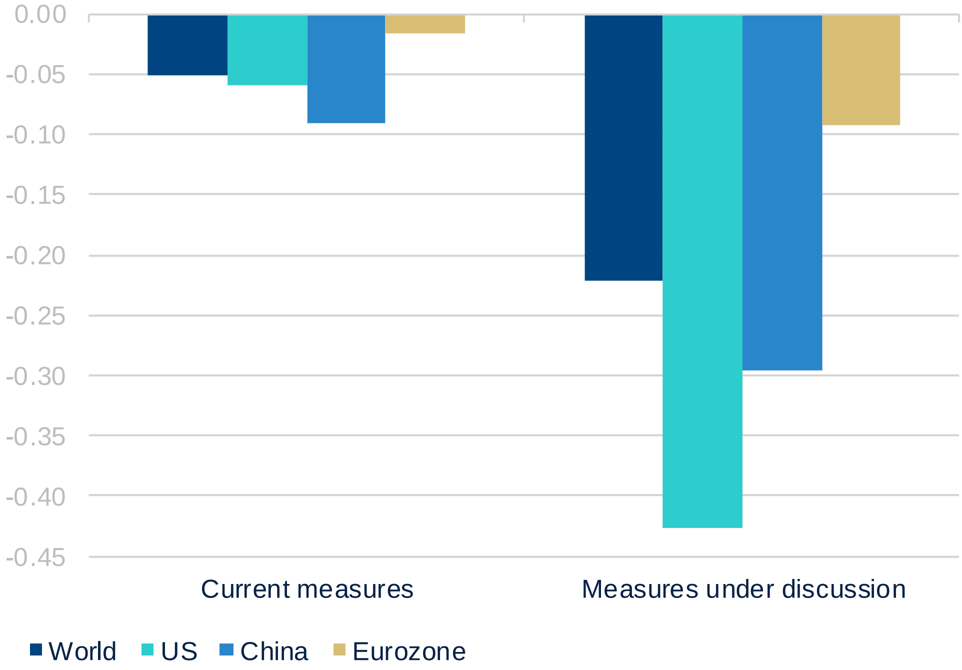
- Global growth continues, supported by private consumption and investment, but with growing differences by region
- World trade continues to show a positive trend, although it is losing momentum and still does not reflect the protectionist escalation
- Confidence indicators show some moderation, but remain at high levels

Source: BBVA Research

Limited effect of approved tariff increases, but significant if those being discussed are implemented

Effect on GDP growth of US tariff increases and the response by other countries

(2018-19, pp)

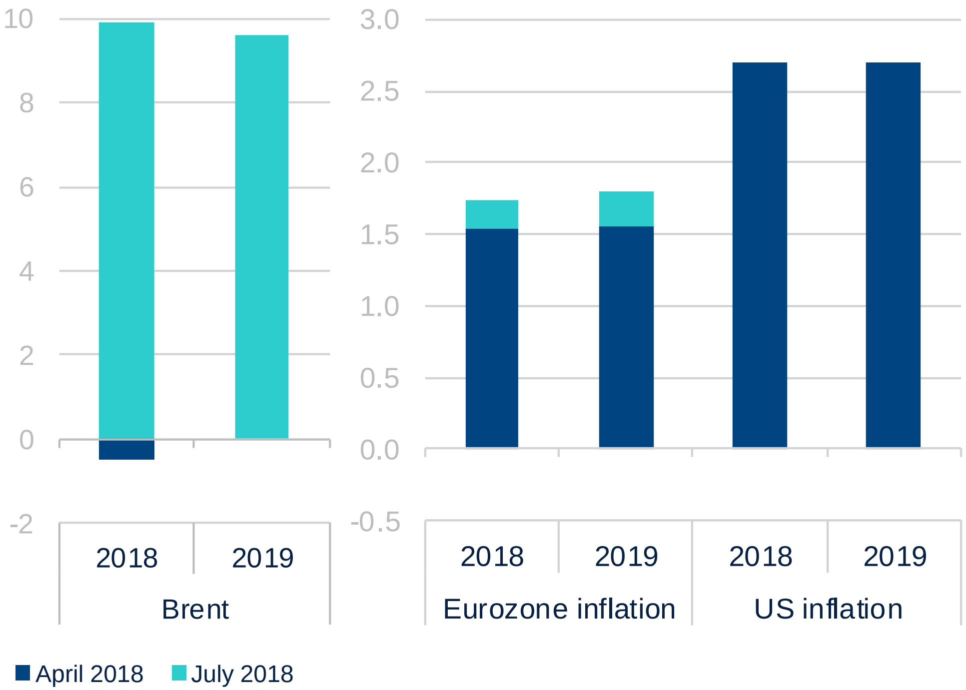


Measures announced: tariff increase to 25% on steel, 10% on aluminium and 25% on Chinese imports for a value of US$50 billion.
Measures under discussion: Tariff increases up to 20% on cars and Chinese imports for a value of US$200 billion.
Source: BBVA Research

- The tariff increases approved by the US would have a limited direct impact. Indirect effects, via economic confidence and financial channel, could be felt in 2H18
- With a protectionist escalation, the negative effect on growth would also be significant in the US
- The effect, smaller in Europe, would differ by country and would, above all, affect Germany and the countries in Eastern Europe
- The growth of global GDP could be reduced by around 0.2 pp just due to the trade channel

The rise in the price of oil will push inflation upwards and could weigh down growth

Upward revision of the price of oil and inflation
(%)



- The increase is due to a reduction in supply. The price will remain relatively stable in 2018 and 2019
- Higher inflation in the euro zone, although below the target, while core inflation will increase gradually from very low levels
- In the USA the impact will be lower, but inflation will remain above the target in 2018-19
- The exit strategy of the Fed and the ECB is reinforced

Source: BBVA Research

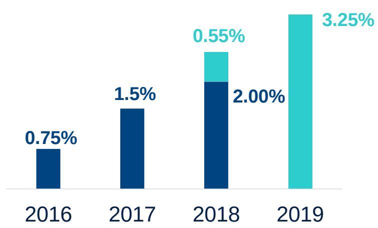
Fed and ECB return to conventional monetary policy each at a different pace

Assessment

Interest rates

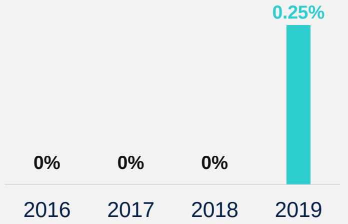
- **Reduction** of US$450 billion in 2018

- The pace of **rate hikes accelerates in 2018**



- **Gradual ending of QE between September and December 2018**

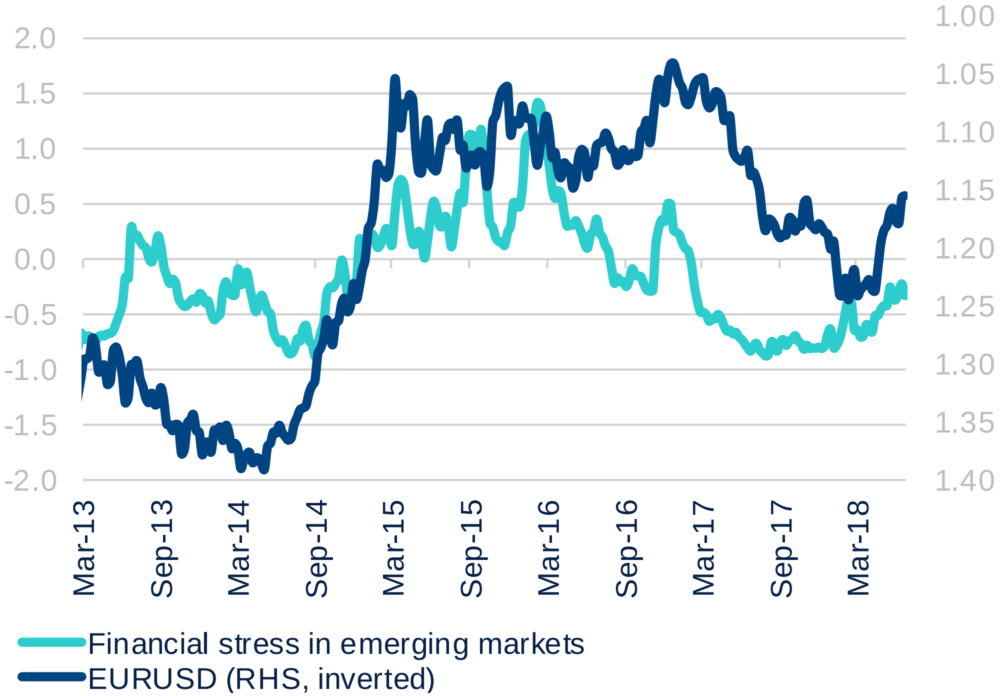
- **Delay** in **rate hikes** until **September 2019**



Source: BBVA Research

The strength of the US dollar and higher interest rates are causing an adjustment in emerging markets

EUR-USD exchange rate and BBVA index of financial tensions in emerging markets

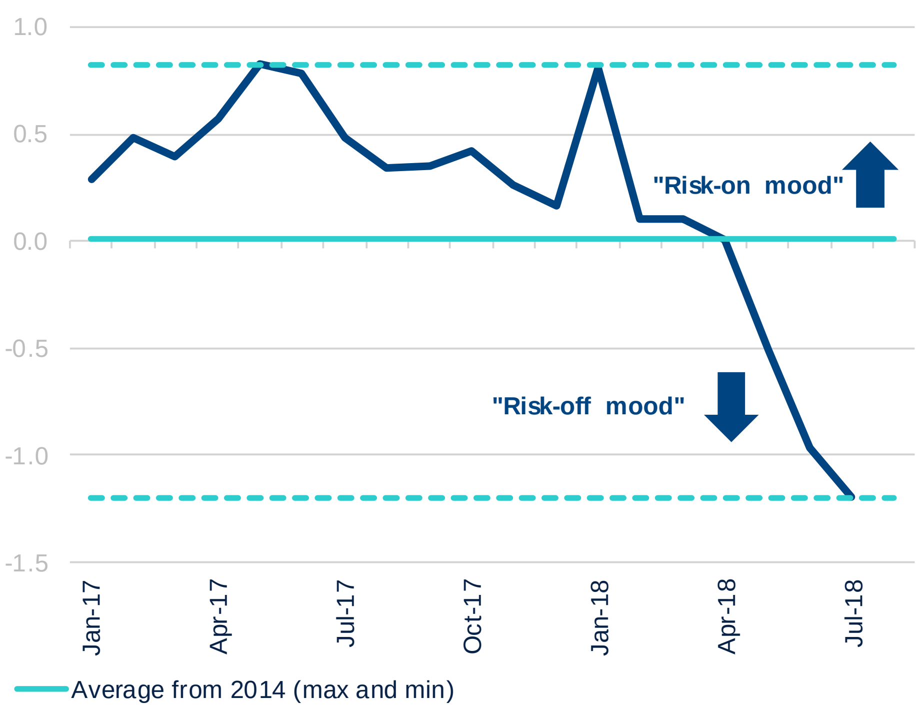


- The most vulnerable countries are those with the greatest trade deficit and the greatest need for external financing
- Shift towards a tightening of monetary policy in emerging countries (except China) to avoid further depreciation of their currencies
- The increase in financial tensions also reflects the intensification of trade disputes

Source: BBVA Research based on Bloomberg

Protectionism and political factors lead to a growing risk aversion

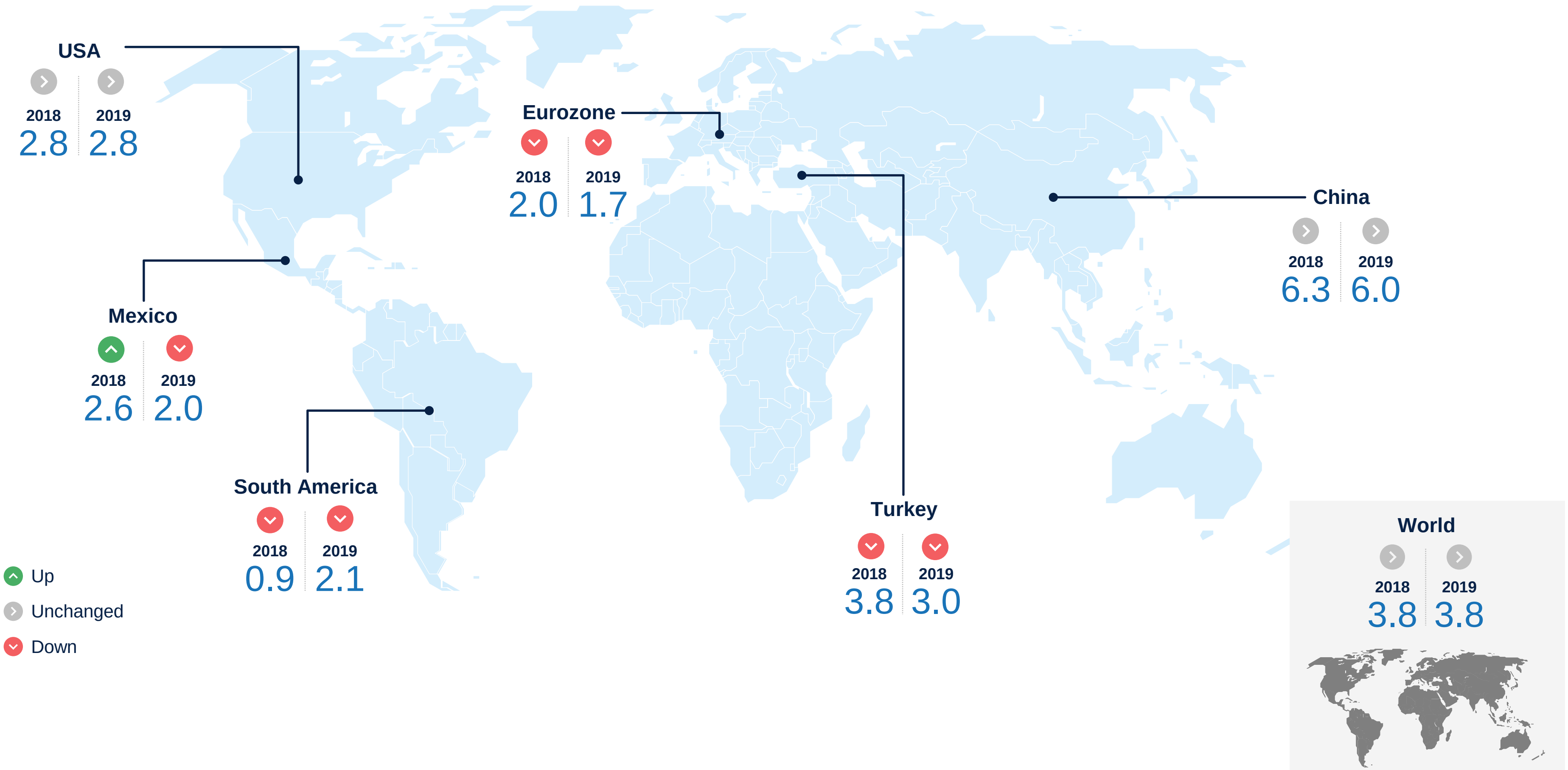
Risk appetite/aversion indicator



- Investor sentiment has shifted from a framework of risk-taking (and even a certain complacency) to one of risk aversion
- The change is causing a rotation of flows between assets: from emerging markets to developed ones, and from equities to bonds
- Trade tensions could lead to an environment of flight towards quality

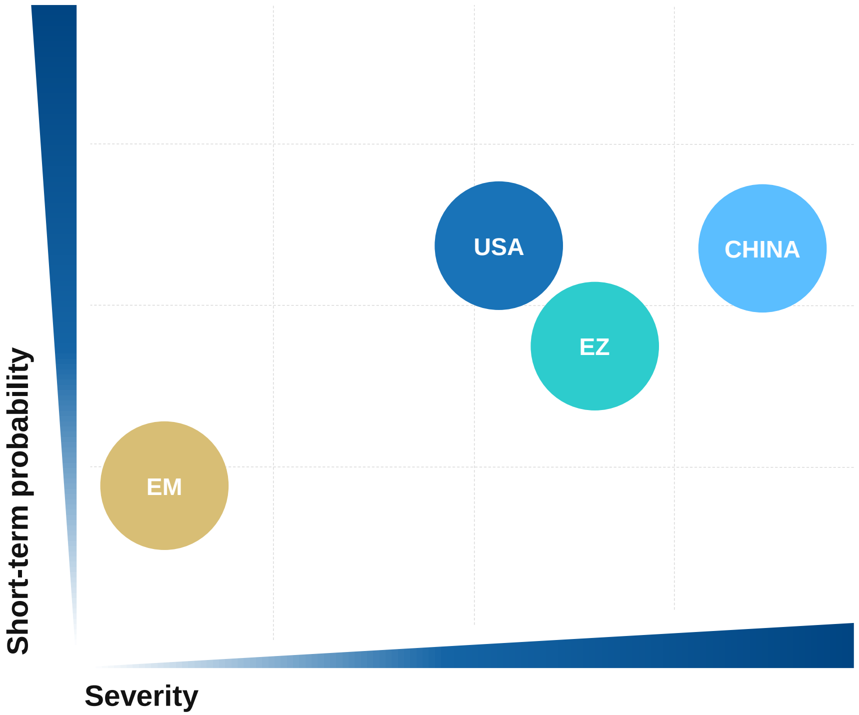
Source: BBVA Research

Stable growth in the US,
but a slowdown in other areas



Source: BBVA Research

Global risks: the main one is a trade war, but those associated with emerging economies and Europe are increasing



CHINA

- High indebtedness: more contained but still high
- Protectionism: upwards (retaliation) with possible impact on domestic policies (financial stability, reforms)

USA

- Protectionism: upwards
- The Fed exit strategy: high.Aggressive rate hikes in the face of a temporary increase in inflation
- Signs of over-valuation of certain financial assets

EUROZONE

- Political uncertainty: on the upswing, led by Italy. Brexit: risk of a rough departure
- Protectionism: on the upside with a focus on the auto sector
- Exit strategy by the ECB: on the downside (delay of rate hikes)

EMERGING ECONOMIES

- Upward. Global risks and domestic vulnerabilities in some countries are raising the risk of a systemic crisis

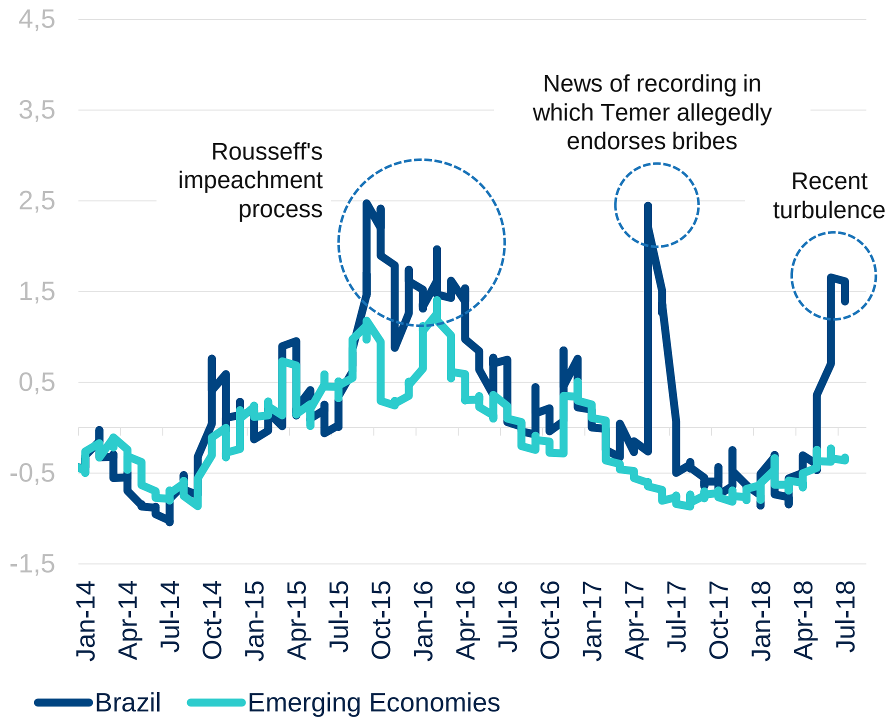
Sourcce: BBVA Research

02

Brazil:
deterioration of the growth prospects of the economy

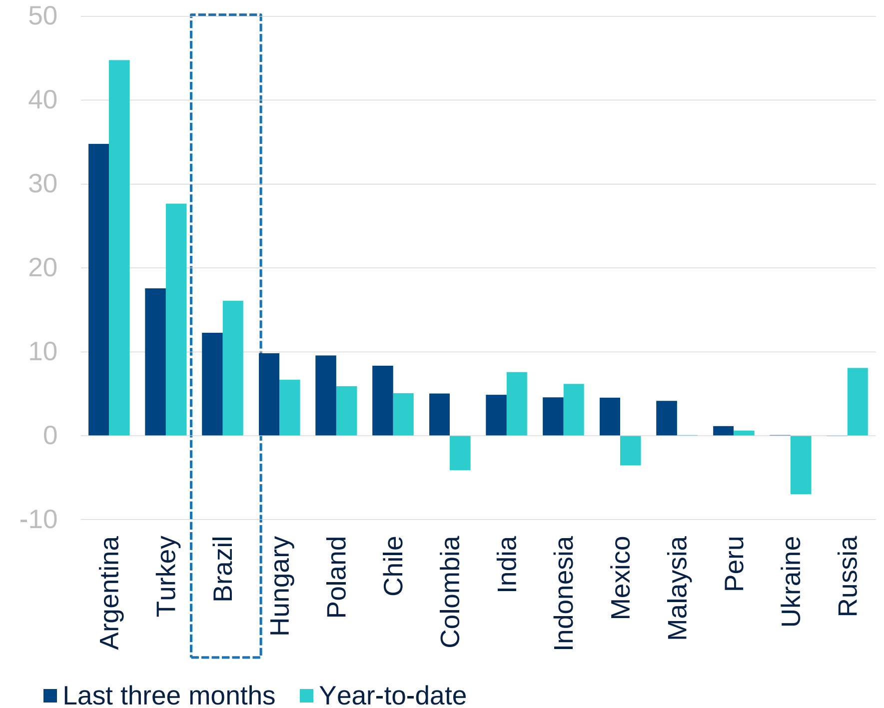
Recent financial tensions helped put an end to the excessive optimism of the markets with regard to Brazil

BBVA index of financial tensions
(average since Jan-06 = 0)



Source: BBVA Research

Currency depreciation in emerging countries (*)
(percentage change)



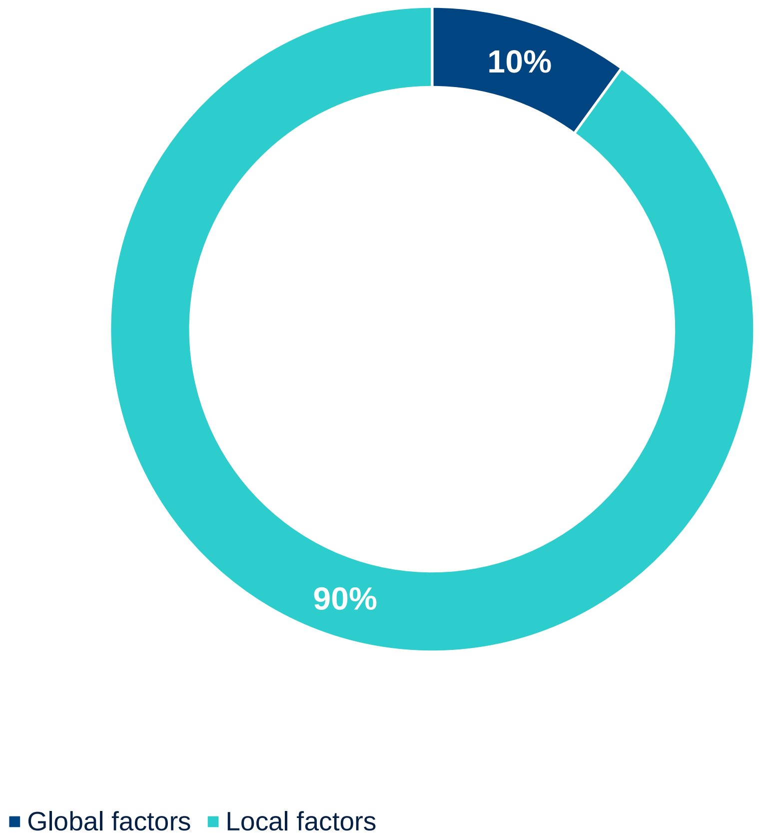
(*) A positive value indicates a depreciation of the local currency. Data up until 13 July.
Source: Bloomberg

Until a few months ago, the markets seemed to be ignoring the risks related to the increase in interest rates in developed countries as well as those associated with political and fiscal uncertainty in Brazil.

Despite the interventions of the Central Bank (BCB), the real has been among the currencies most affected by recent turbulence. The Sao Paulo Stock Exchange has shrunk 9% and the country risk increased 19% (up to 298 bps) in the last three months

Recent financial volatility: triggered by global factors, fueled by local factors

Currency depreciation: weights of global and local factors in the year-to-date



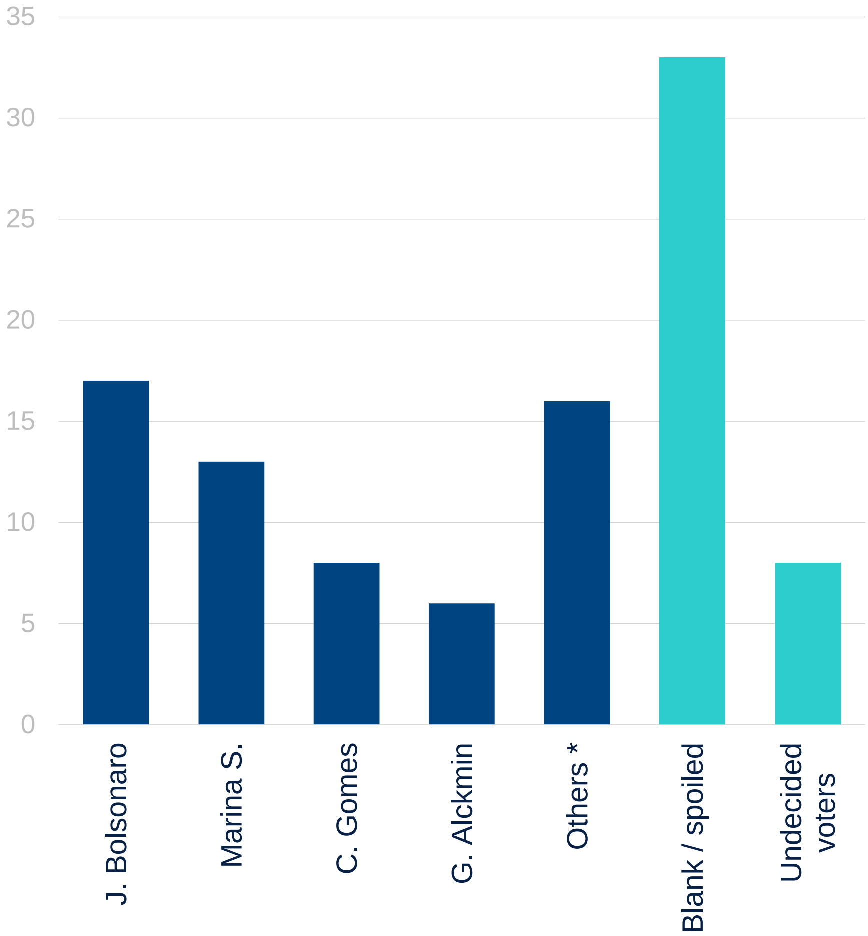
Source: BBVA Research

- The increases in interest rates in the United States and protectionism threats were the main triggers of the recent correction in financial assets prices in emerging economies, including the depreciation of the exchange rate in Brazil
- The exchange rate depreciation was sharper in Brazil than in other regions. Although the external indicators of the Brazilian economy are relatively positive, some local factors have significantly contributed to weaken the Brazilian real
- Among these local factors are:
  - increased political uncertainty
  - the fiscal imbroglio

Political uncertainty: the race for the presidency is still fairly wide open

Presidential poll

(conducted between 21-24 June 2018)

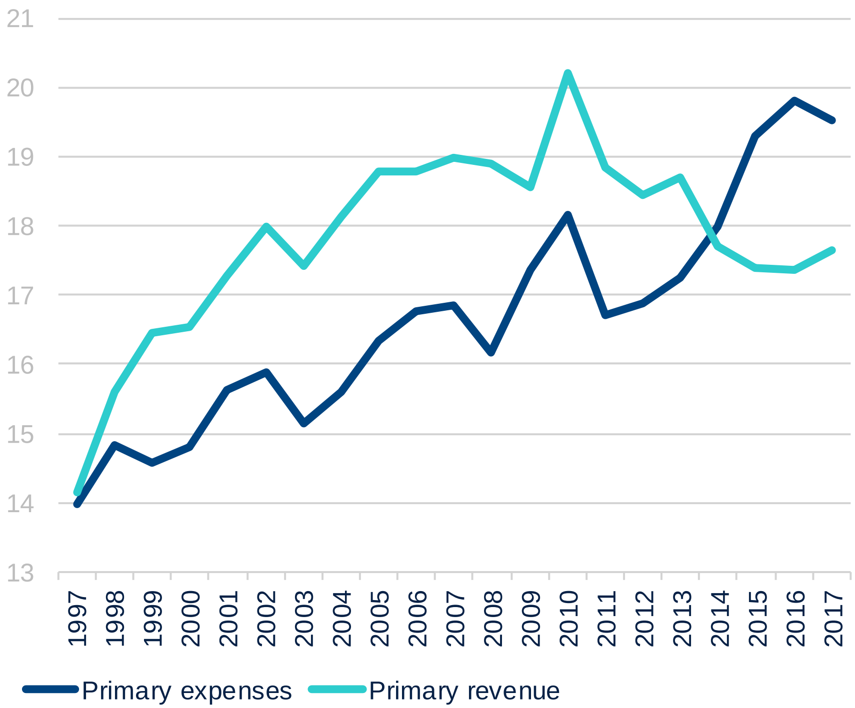


* Sum of the candidates with less than 5% of voting intention.
Source: CNI/IBOPE

- There are still many candidates with possibilities of winning the presidential elections in October
- The biggest favourite would probably be Lula, who for judicial reasons is unlikely to be able to run as a candidate
- Polls show that the proportion of blank and spoiled ballot papers could be exceptionally high
- This, as well as the historically low approval of the current government, is reinforcing the perception of social weariness and repudiation of the political class

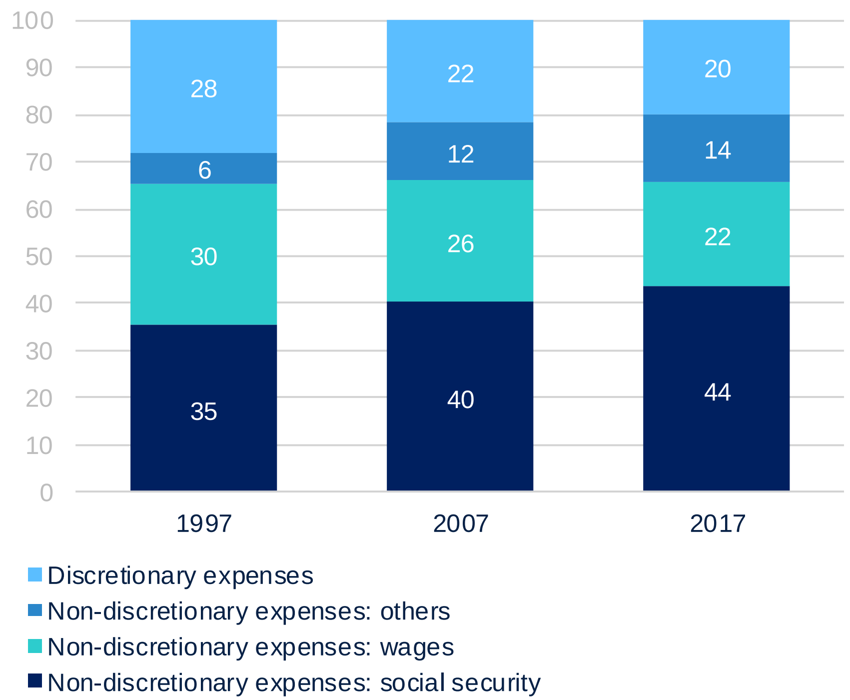
Political uncertainty fuels doubts about whether the structural deterioration of public accounts will be reversed in the coming years

Primary expenses and revenues (*)
(% of GDP)



(*) Primary expenses and income of the federal government.
Source: IPEADATA, BBVA Research

Breakdown of primary expenses (*)
(% of total expenses)



(*) Federal government expenses.
Source: IPEADATA, BBVA Research

The tax increases and controls on spending (including the introduction of a ceiling on its growth) announced in recent years have been insufficient to reverse the negative fiscal trends. Public debt, for example, continues to rise (77% of GDP in May)

Public expenditure remains high, largely due to the increase in the expenses in which the government has no discretionary power to reduce, as is the case of social security expenses

How to deal with the fiscal imbroglio? There are no easy solutions...

01
By increasing taxation?

The level of taxation in Brazil is already excessively high. Raising taxes is a politically costly option that, in addition, would damage the competitiveness of the private sector. A privatization programme could be an alternative, but would have a high political cost and a relatively limited fiscal impact. Another option would be to reduce the fiscal benefits granted to specific sectors of the economy

02
By reducing public spending?

Taking into account the high level of public spending, it may be the best alternative in economic terms. In any case, the margin to cut costs without a reform of social security or a reform to reduce the proportion of non-discretionary spending is very low. These reforms require a government with a high level of political capital: both Dilma Rousseff and Michel Temer tried unsuccessfully to adopt measures in this direction...

03
By increasing economic growth?

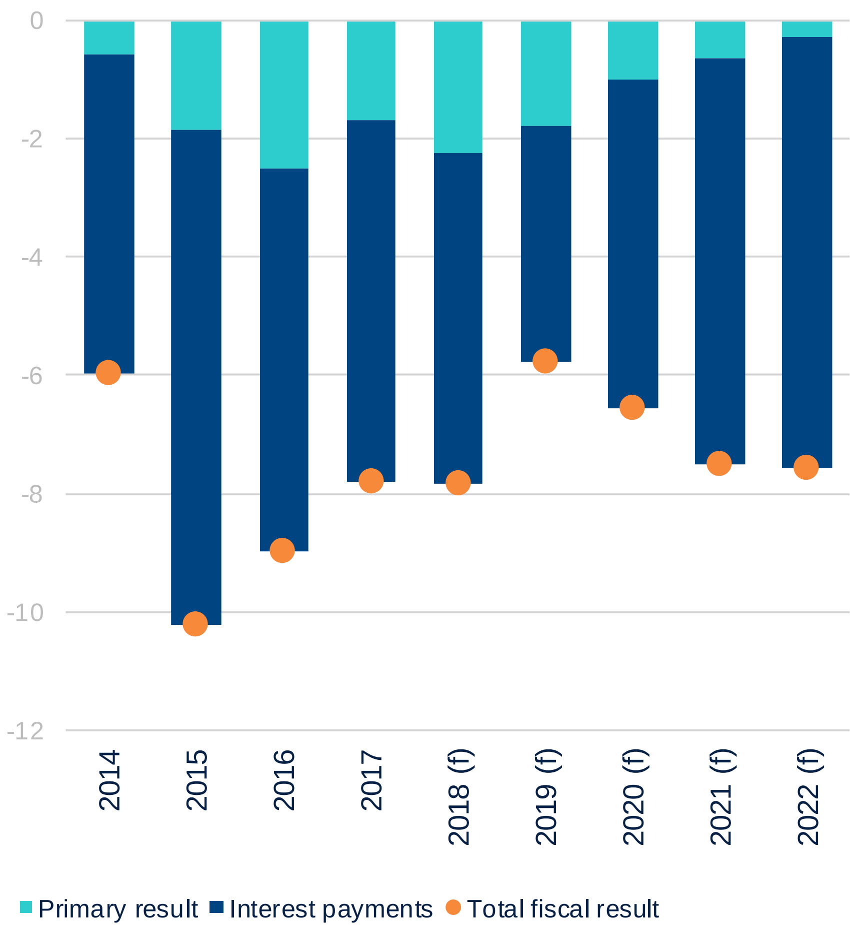
A significant increase in growth would increase the collection of taxes and improve the public accounts, as was observed between 2004 and 2013. However, an expansion stimulated by external factors now seems unlikely given the moderation of the Chinese economy and of commodity markets. An expansion based on internal factors is difficult if reforms that increase productivity are not made and if the fiscal imbroglio is not faced

04
By yielding to the temptation to increase inflation to facilitate payment of the debt?

Without an independent management of monetary policy by the central bank, there could be a temptation to increase inflation to facilitate the payment of non-indexed public debt. It would be a dangerous alternative, with potentially very negative results, as shown by Brazil’s economic history...

Measures to improve the fiscal situation are expected from 2019, but an ambitious reform of social security seems less likely

Fiscal balance (*)
(% of GDP)



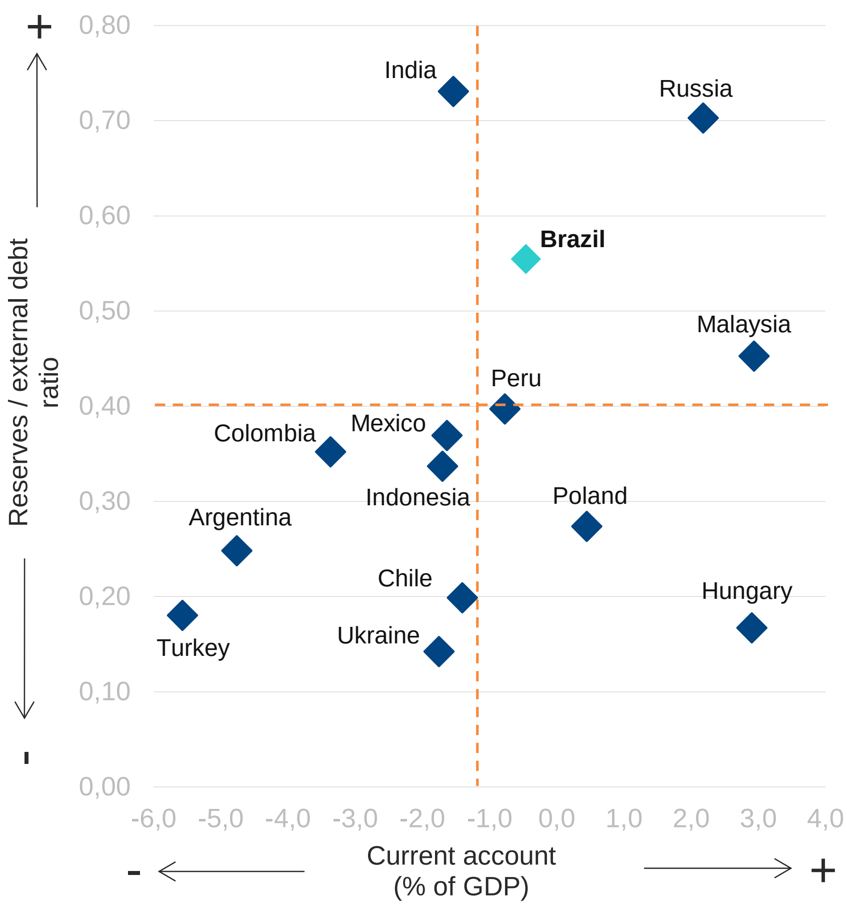
(*) (f) = forecasts.
Source: BCB, BBVA Research

- Given the political uncertainty, it is difficult to foresee how the fiscal problem will be faced in the future
- The next government is likely to announce measures to increase taxes and reduce spending to calm the markets and to meet fiscal objectives, which could even be relaxed
- An ambitious reform of social security is less likely
- So is a scenario of fiscal inaction, given its high economic cost (increase in financing costs and inflation, a more depreciated exchange rate, lower GDP growth, etc.)

Having the external accounts under control has prevented recent volatility from becoming even more marked

External indicators for selected emerging economies

(Current account balance and reserves / external debt ratio)

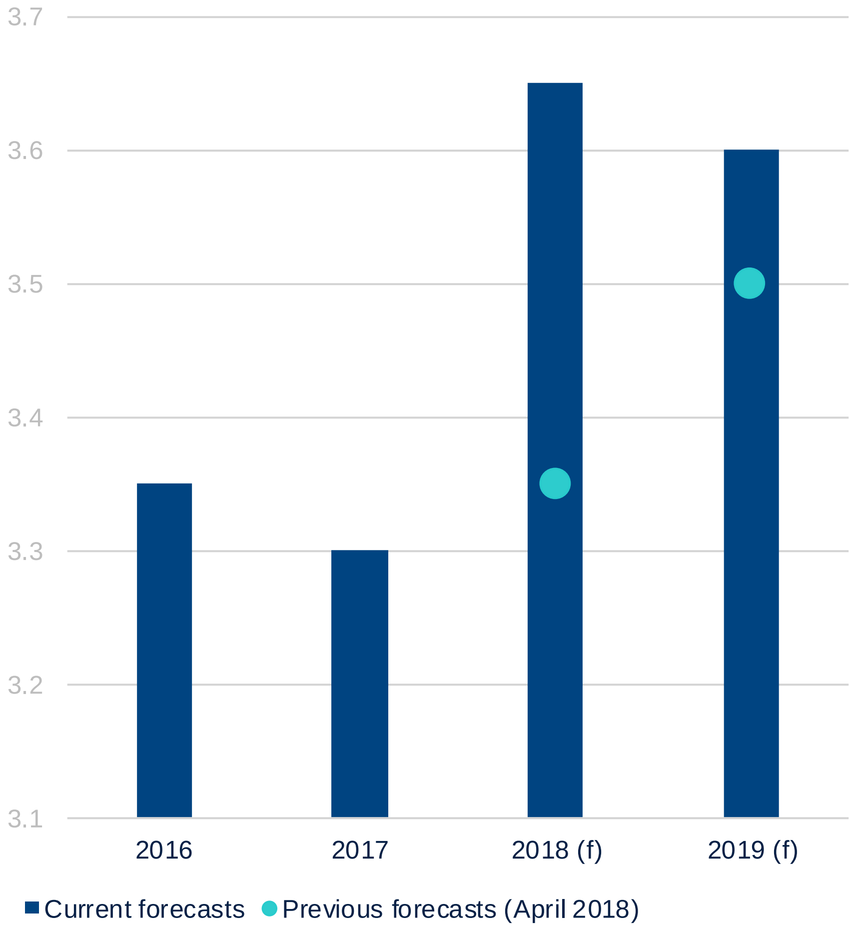


Source: : BBVA Research, BIS, IIF, IMF, World Bank, National sources

- While political uncertainty and fiscal problems contributed to recent financial tensions, the relatively good state of the external accounts prevented an even more difficult scenario
- Brazil has US$382 billion in international reserves, equivalent to 19% of GDP or 350% of short-term external debt
- The current account deficit is currently low (0.6% of GDP), lower than direct foreign investment in the country (3.1% in May)
- We expect the external deficit to remain at low levels (0.3% of GDP in 2018 and 1.4% of GDP in 2019), in line with a depreciated exchange rate and weak domestic demand

The exchange rate will remain at more depreciated levels than those observed up until a few months ago

Exchange rate
(Real / US dollar)



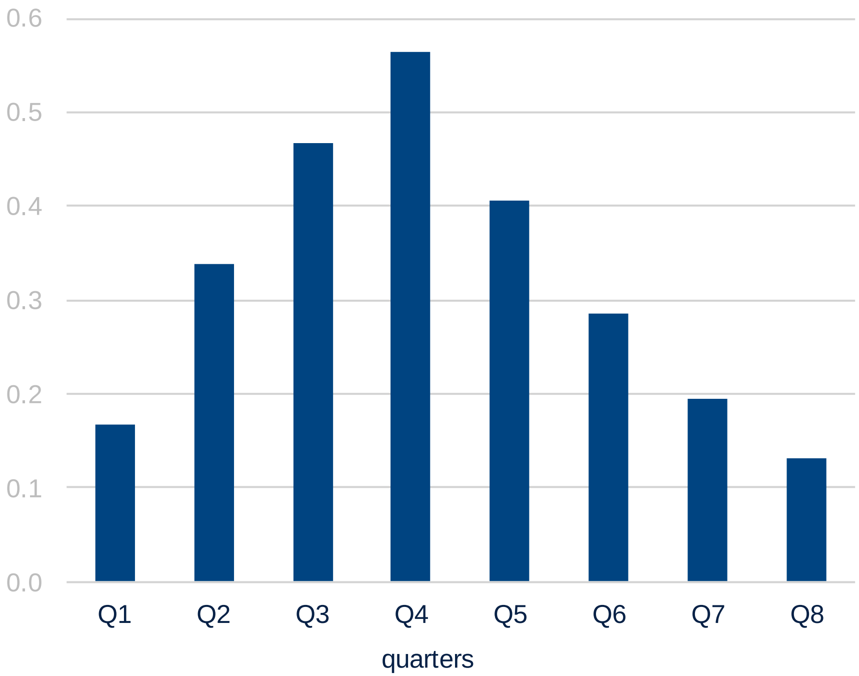
Source: : BBVA Research

- The depreciation of the real has been stronger than we expected, despite the fact that the central bank has intervened heavily through the sale of f exchange rate swaps.
- There is little margin for the real, which is at around 3.85 per US dollar, to appreciate in the short term. Volatility will remain high at least until the October presidential elections
- The reduction of uncertainty after the elections and the possible positive signals of the new government on the fiscal issue should allow some appreciation of the exchange rate from the end of the year on

The exchange depreciation will generate greater inflationary pressures

Effect on the inflation rate of a 10% depreciation of the exchange rate

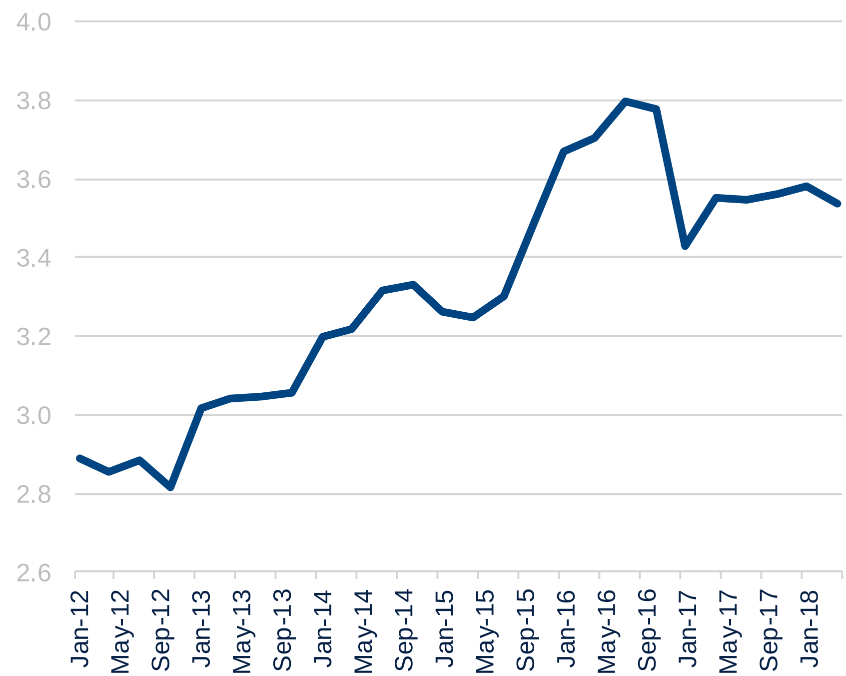
(cumulative effect, in basis points)



Source: BBVA Research

Degree of pass-through over the last years (*)

(in %)



(*) Coefficient associated with external prices / exchange rate obtained from the estimation of a Phillips Curve for Brazil

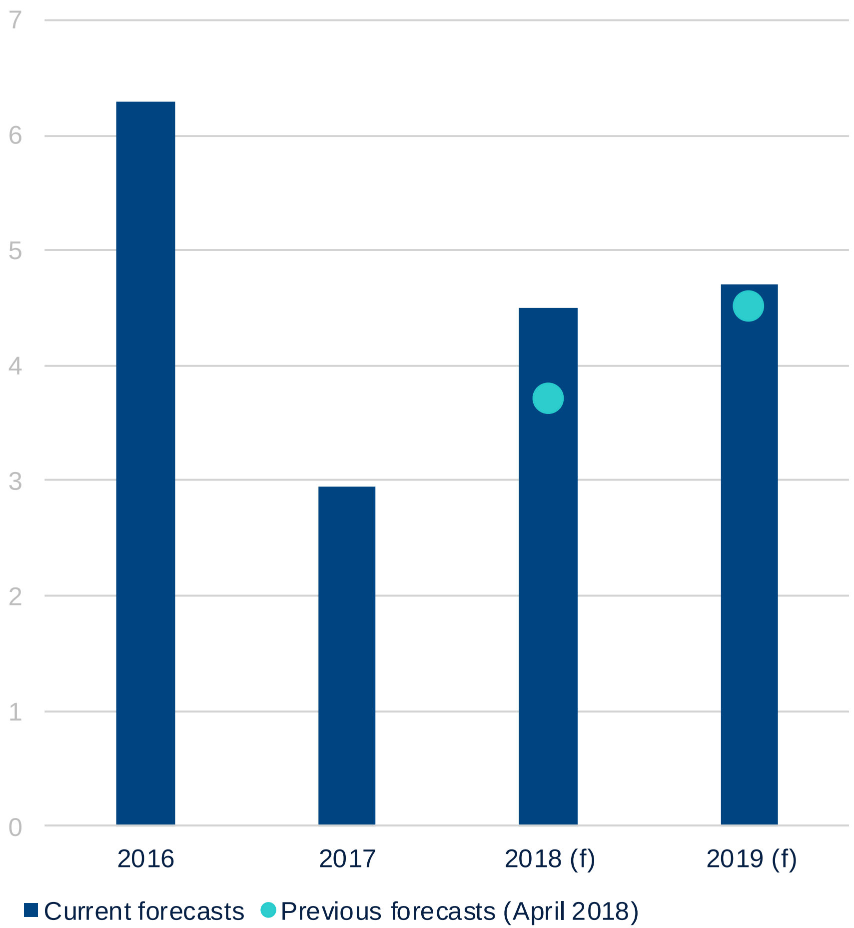
Source: BBVA Research

Our estimates suggest that in the current environment a 10% depreciation in the exchange rate has an accumulated effect on inflation of almost 0.6 percentage points in a 12-month period

They also show that the degree of pass-through in Brazil is currently lower than 2 or 3 years ago, although higher than in the previous period (from 2012 to mid-2015)

Inflation on the upside

Inflation: IPCA
(in %, end of period)

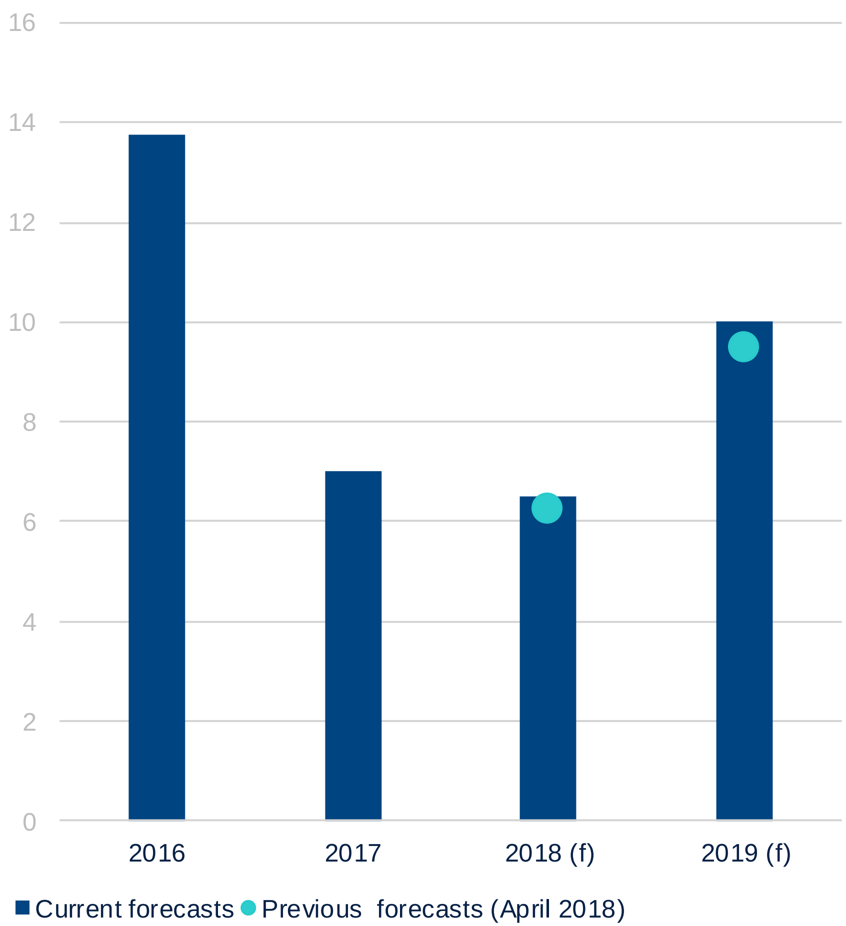


Source: BBVA Research

- Inflation, which remained below 3.0% between January and May, reached 4.4% in June, largely due to the shortages caused by the truckers' strike
- Taking this into account, as well as the heavy depreciation of the exchange rate and the higher price of oil, among other factors, we have adjusted our inflation forecasts upwards, from 3.7% to 4.5% in 2018 and from 4.5% to 4.7% in 2019

Less expansionary monetary policy

Interest rates: SELIC
(in %, end of period)

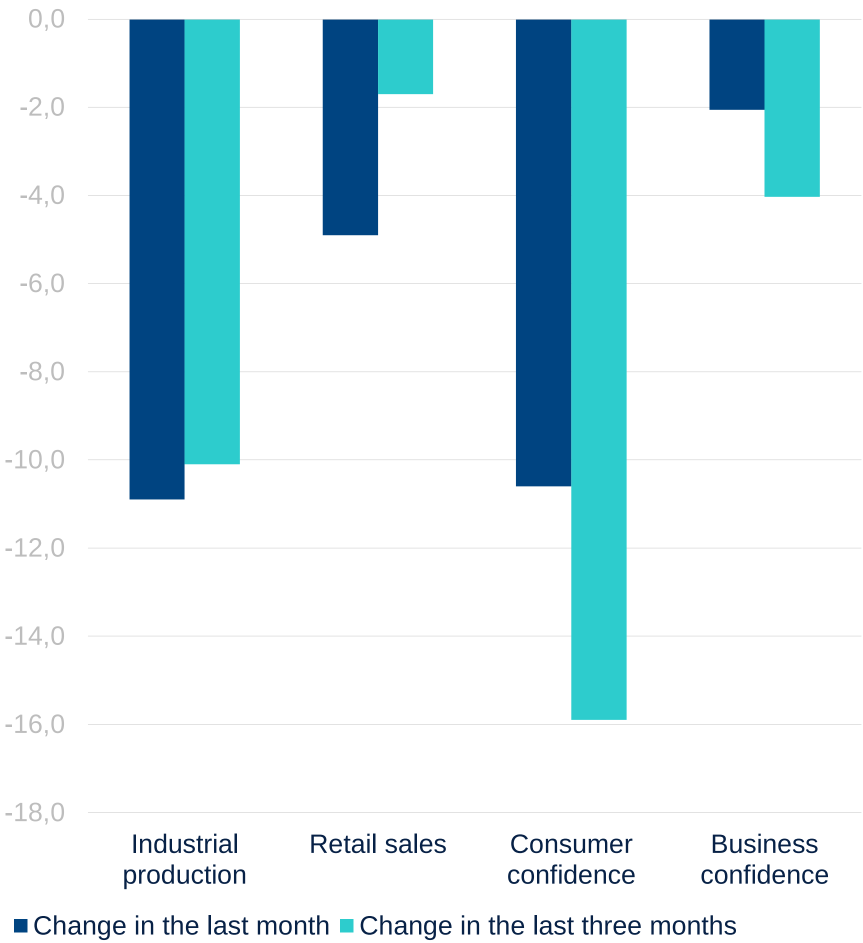


Source: BBVA Research

- The exchange rate depreciation has caused the BCB to keep interest rates at 6.50% instead of cutting them by 25 bps in June
- They will most likely remain at 6.50% until the beginning of 2019, when inflationary pressures will force the BCB to start a monetary tightening cycle (earlier and more aggressive than previously expected)
- Guaranteeing the independence of the BCB in the coming years will be fundamental: the level of debt and the spending ceiling rule create certain incentives to increase inflation in an environment in which inflation targets are being cut (4.25% in 2019, 4.0% in 2020 and 3.75% in 2021)

The recent truckers' strike has also had negative effects on the economic environment…

Indicators of economic activity (*)
(change in %)



(*) Last month available: May, in the cases of industrial production and retail sales; June, in the case of confidence indicators. Retail sales: broad indicator.
Source: IBGE, CNI and FGV

- The truck drivers' strike, caused by factors such as the increase in the price of fuel and supported by a large part of the population, generated a situation of shortages in the last days of May
- The situation caused a strong upswing in prices and a significant reduction in economic activity, which could be reversed in the coming months to some extent
- It is also possible that the episode could negatively affect confidence during a more prolonged period, hindering the recovery of the economy

...there is, therefore, a series of factors contributing to a deterioration of growth expectations in Brazil

01 Less favourable global environment

02 Probable slowdown of the Argentinian economy

03 Lower growth than expected in 1Q18

04 Increased political uncertainty

05 Lower probability of fiscal reforms and adjustments

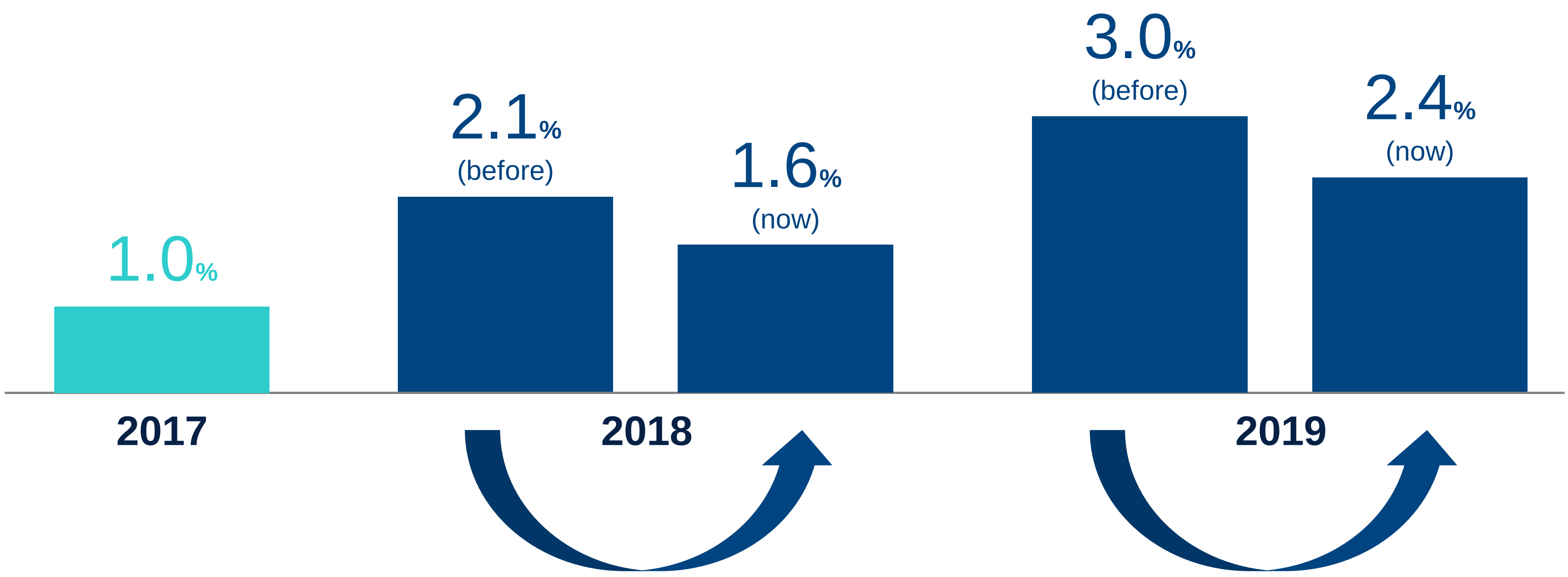
06 Greater financial volatility

07 Higher inflation

08 Less expansionary monetary policy

09 Effects of the truckers' strike

We have revised the growth forecasts for Brazil downwards; the recovery will be slower than previously expected



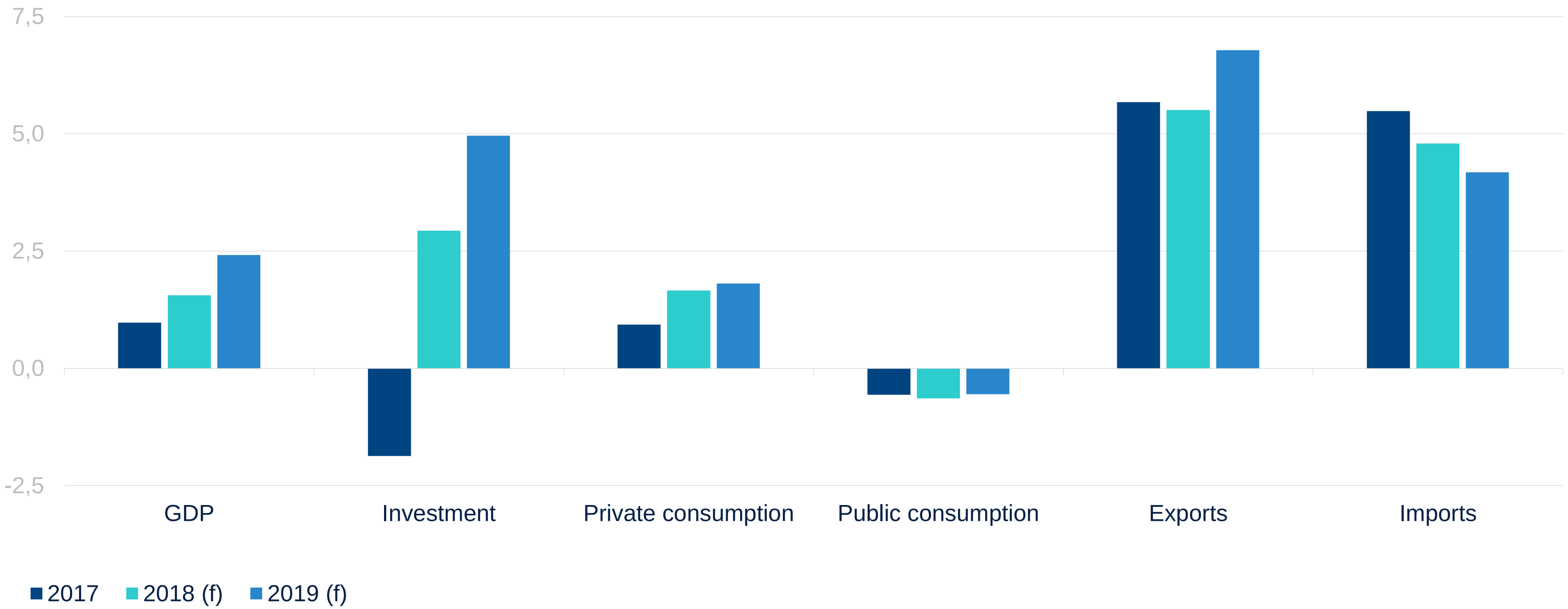
Despite the reduced optimism, the recovery of growth must continue, supported by relatively solid global demand, the performance of the agricultural sector, the expansive tone of monetary policy and the adjustments made in previous years, etc.

Likewise, growth could slow if there is no progress in resolving fiscal problems, mainly in the case of a further increase in global risk aversion

The recovery of private consumption and investment will be gradual, exports will continue to contribute positively

Growth of GDP and its components(*)

(%)



(*) (f) Forecasts.
Source: BBVA Research

We have revised downwards our forecasts for private consumption and investments, in line with the deterioration of the macroeconomic picture in recent months

Although we expect a lower contribution of domestic demand to growth, the outlook for external demand is more favorable, due to the effects of greater depreciation of the exchange rate and the lower pressure of domestic demand on imports

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03

Brazil:
Forecast table

Forecasts for Brazil

	2016	2017	2018 (f)	2019 (f)
GDP	-3,5	1.0	1.6	2.4
Private consumption (%)	-4.3	0.9	1.7	1.8
Public consumption (%)	-0.1	-0.6	-0.6	-0.5
Investment in fixed capital (%)	-10.3	-1.9	2.9	5.0
Exports (%)	1.9	5.7	5.5	6.8
Imports (%)	-10.2	5.5	4.8	4.2
Unemployment rate (average)	11.3	12.7	12.3	11.0
Inflation (end of period, YoY %)	6.3	2.9	4.5	4.7
SELIC rate (end of period, YoY %)	13.75	7.00	6.50	10.0
Exchange rate (end of period)	3.35	3.30	3.65	3.60
Current account (% of GDP)	-1.3	-0.5	-0.3	-1.4
Public sector fiscal balance (% of GDP)	-9.0	-7.8	-7.8	-5.8

(f) Forecast

This report has been produced by the Latin America Unit

Head Economist, 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 Macroeconomic Scenarios
Miguel Jiménez
mjimenezg@bbva.com

BBVA Research

Jorge Sicilia Serrano

Macroeconomic Analysis
Rafael Doménech
r.domenech@bbva.com

Digital Economy
Alejandro Neut
robertoalejandro.neut@bbva.com

Global Macroeconomic Scenarios
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.delaspena@bbva.com

Financial Systems and Regulation
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Digital Regulation and Trends
Álvaro Martín
alvaro.martin@bbva.com

Regulation
Ana Rubio
arubiog@bbva.com

Financial Systems
Olga Cerqueira
olga.gouveia@bbva.com

Spain and Portugal
Miguel Cardoso
miguel.cardoso@bbva.com

United States
Nathaniel Karp
Nathaniel.karp@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Turkey, China and Big Data
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

Colombia
Juana Téllez
juana.tellez@bbva.com

Economic Outlook
Hugo Perea
hperea@bbva.com

Venezuela
Julio Pineda
juliocesar.pineda@bbva.com

ENQUIRIES TO: BBVA Research: Calle Azul, 4 Edificio de la Vela - Floors 4 & 5 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 _/ Legal Deposit: M-31254-2000