BBVA Research

Brazil Economic Outlook
4Q18

October 2018

Creating Opportunities

Key messages

- The Brazilian economy will continue to recover slowly in the coming years. We expect GDP to grow 1.2% in 2018, 2.4% in 2019 and around 2.0% afterwards

- The gradual strengthening of domestic demand and the normalization of food prices, among other factors, will help to drive both inflation and interest rates upwards. Inflation should converge to 4.9% in 2019, above the 4.25% target for the period, after closing 2018 at 4.5%. In an environment of greater pressures on prices, interest rates would be adjusted upwards, from 6.5% to 10.0%, throughout 2019

- The exchange rate is expected be around 3.8 in the remainder of the year and during 2019, partly due to the reduction of political uncertainty after the October presidential elections

- The next government will likely take measures to reduce fiscal vulnerability, although it will hardly manage to approve an ambitious social security reform

- A more positive macroeconomic scenario, mainly in terms of growth, requires a more aggressive fiscal adjustment than expected and a series of reforms to increase productivity, something that now seems unlikely

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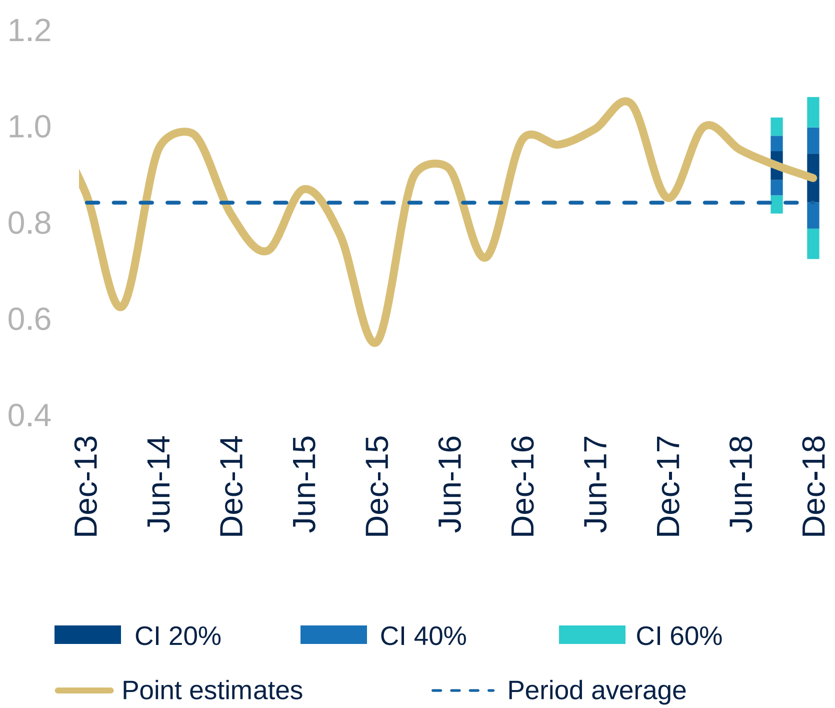
01

Global environment:
Positive global inertia continues, although risks are intensifying

More moderate global growth

World GDP growth

(Forecasts based on BBVA-GAIN, % QoQ)



Source: BBVA Research

- Slight moderation of global growth towards rates slightly below 1% QoQ in 2H18
- Activity data remains strong, but has lost momentum as protectionism weighs down on confidence, trade and investment
- Apart from this volatility, world trade has improved and stabilized after the slowdown at the beginning of the year

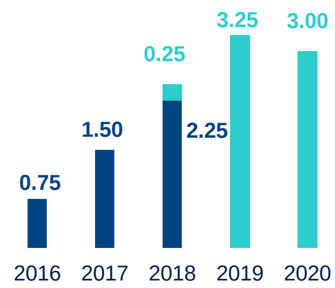
Monetary policy continues to normalize; the Fed and the ECB will take divergent paths from 2019 onwards

Assessment

Interest rates

Balance sheet reduction continues (US$450 billion in 2018)

More rate hikes in 2019, but the cycle is ending (natural interest rate)

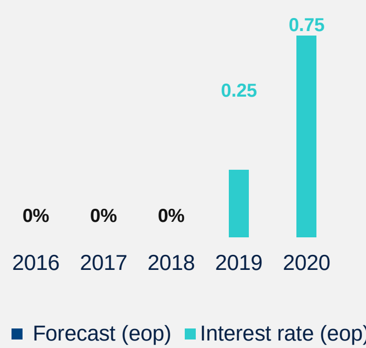


End of QE in Dec-2018

Total reinvestment at least until Dec-2020

Repayment of TLTROs as from June 2020

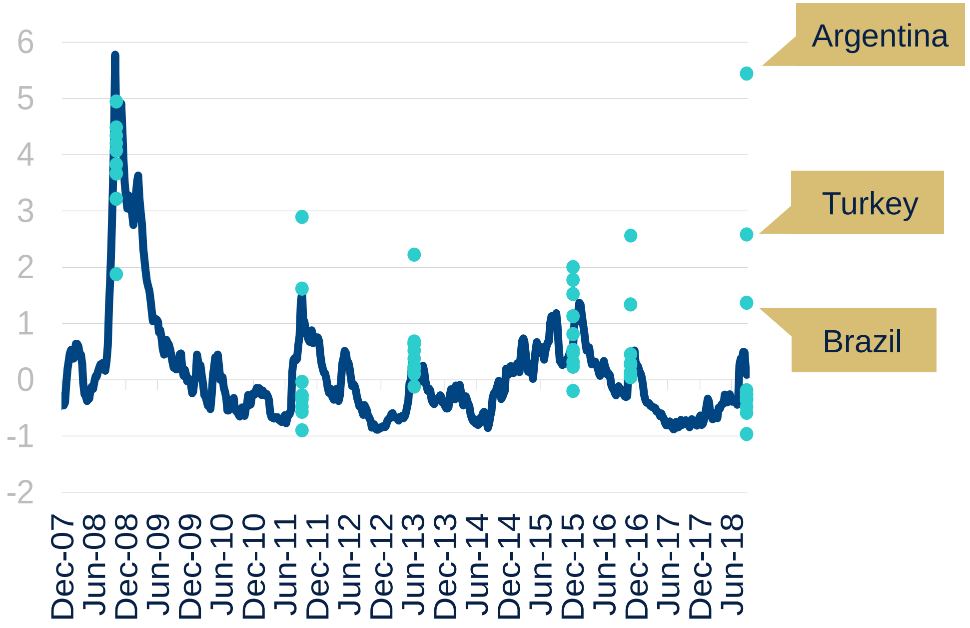
Anchored expectations of low rates for an extended period of time. **No interest rate increases expected before September 2019**



Source: BBVA Research

Financial tensions have rebounded in emerging markets, but have been less synchronized than in previous tension episodes

BBVA index of financial tensions for emerging economies
(Index)

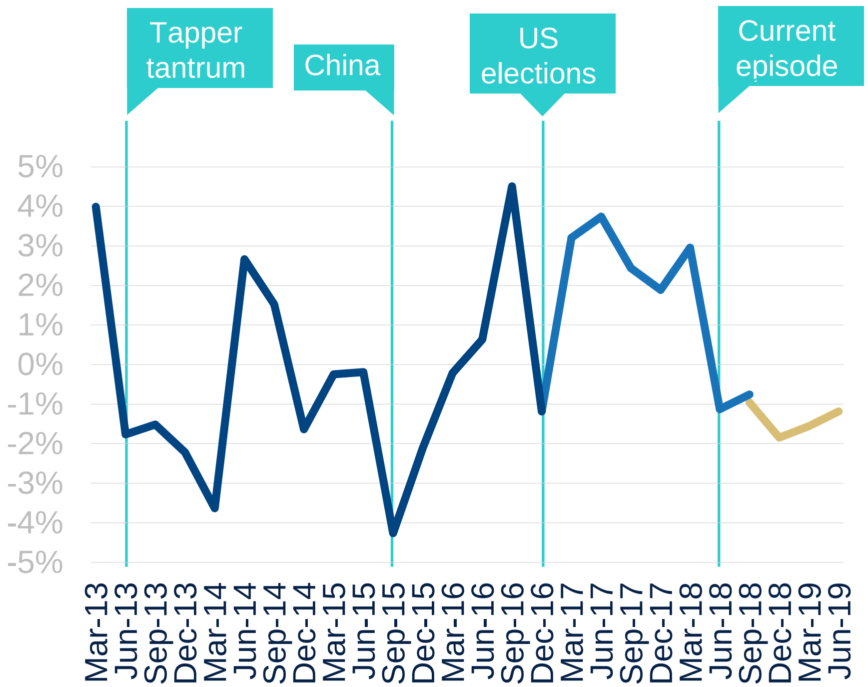


Source: BBVA Research

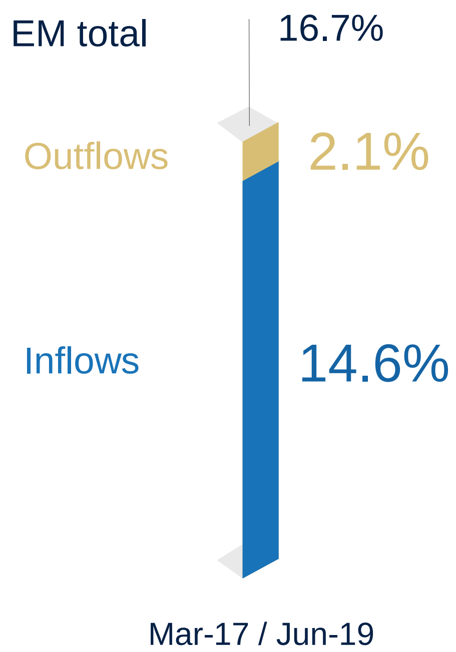
- Emerging markets are under greater stress which translates into a currency depreciation
- There is differentiation: tensions have been concentrated in particular in the most vulnerable economies. We are not looking at a systemic crisis in emerging markets
- The adoption of economic policy measures (monetary and fiscal) is allowing for some stabilization

Persistent capital outflows from emerging economies, but far away from a typical sudden-stop episode

Portfolio flows to emerging economies
(% of total assets under management, monthly data)



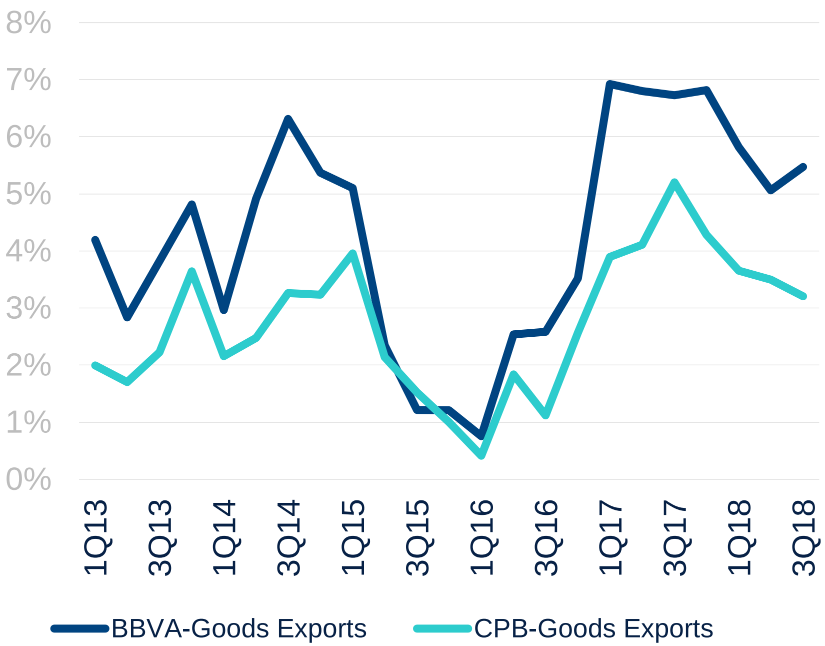
Cumulative flows in the last 5 quarters
(% of cumulative amount since January 2017)



Source: BBVA Research

Trade loses momentum after the strength exhibited in 2017, but will continue to support global growth

World export of goods
(QoQ, constant prices)



- The trade war has so far had a limited impact but it may be reflecting the advancement of international exchanges
- Increased volatility of trade flows as a result of uncertainty in some countries..
- ...especially because of trade tensions, the political situation and the depreciation of currencies in emerging economies

Source: CPB World Trade Monitor and BBVA Research

U.S. and China have announced higher tariffs, but with an estimated limited effect on global GDP

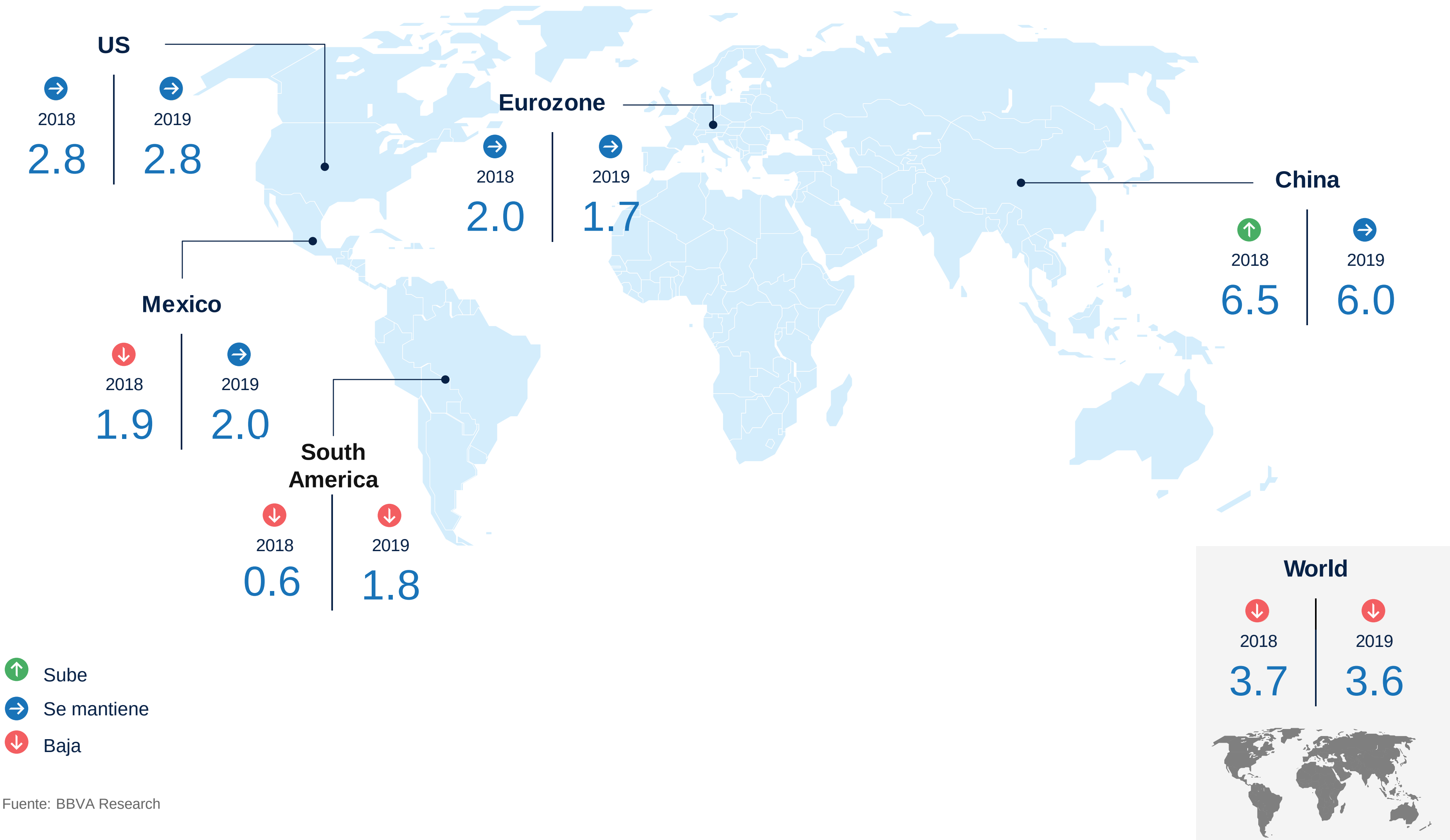
Effect on GDP growth of US tariff increases and the response by other countries

(2018-20, pp)

- The impact on the growth of the measures adopted so far through the trade channel could be limited but the indirect effects could be considerable especially for China and emerging economies
- The signing of the USMCA trade agreement reduces uncertainty with Mexico and Canada, pending its approval
- In Europe the increase in tariffs on automobiles is currently frozen although it will be renegotiated from November onwards

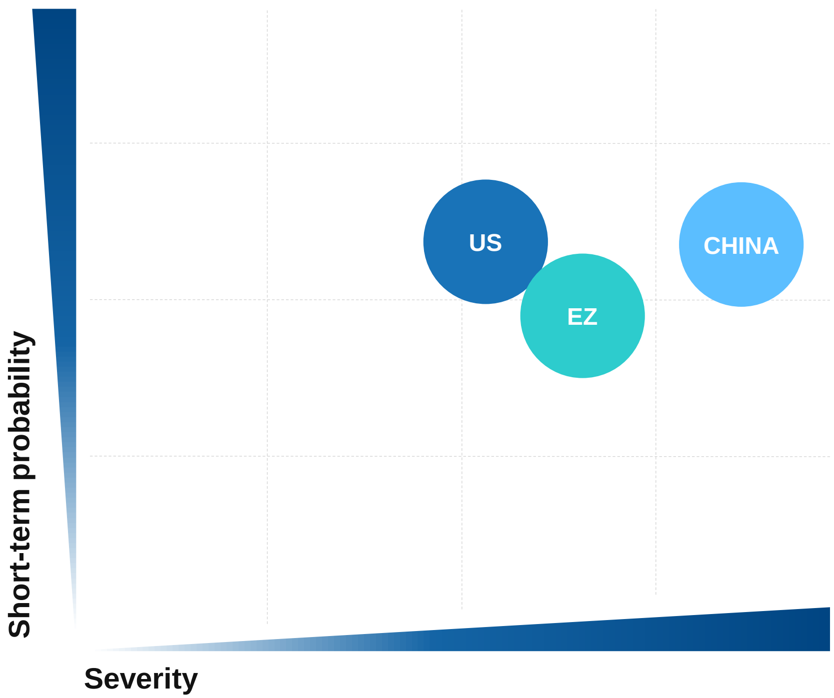
Approved increase of tariffs: US (25% on steel, 10% on aluminium, 25% on Chinese imports for the value of US$50 billion and 10% on imports for the value of US$200 billion); China (25% on US imports for the value of US$50 billion and 10% on imports for the value of US$60 billion)
Source: BBVA Research

The downward revision of growth in emerging economies explains the expected moderation of global growth in 2019



Fuente: BBVA Research

Global risks: protectionism and the Fed's exit strategy remain the most relevant risks but political uncertainty is increasing in Europe



Source: BBVA Research

CHINA

- Protectionism: on the upside (new tariffs and reprisals) with an impact on domestic policies (financial stability, reforms)
- High indebtedness: more contained in the short-term but higher in the medium-term (private debt continues to rise)

USA

- The Fed's exit strategy: high. Higher-than-expected rate hikes
  - Differential impact on emerging markets
- Protectionism: on the rise and concentrated on China
- Economic recession: low probability but rising
- Signs of financial instability in some assets

EURO ZONE

- Political risk: on the rise, led by tensions in Italy and B*rexit*
- Protectionism: more contained. Focus on the automotive sector
- The ECB's exit strategy: low

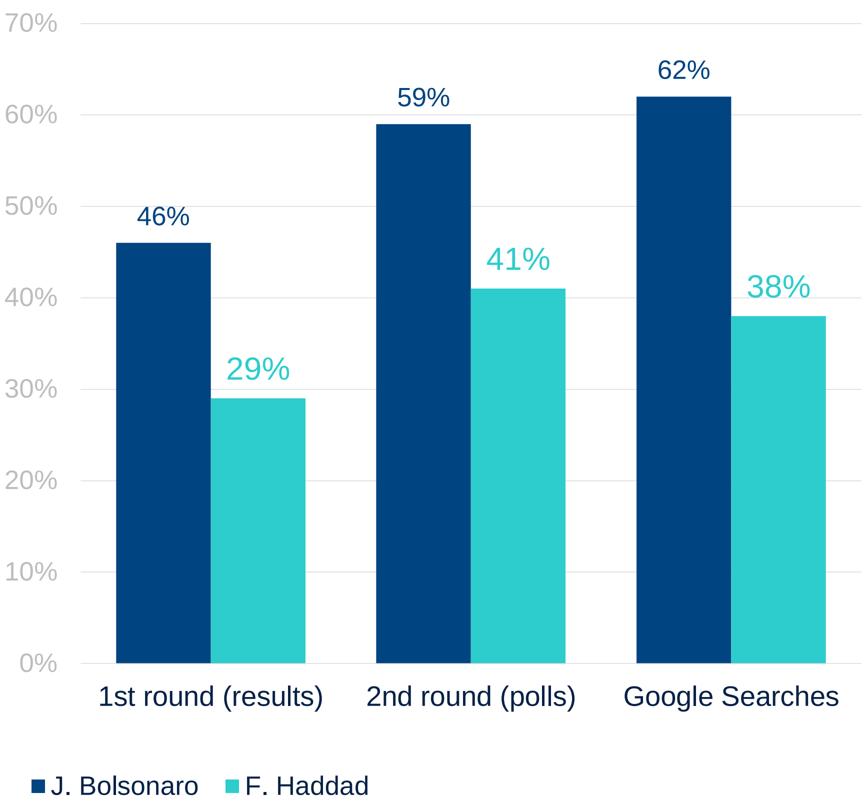
Tensions in Emerging Economies may amplify the impacts of the global risks mentioned above
("second round" effects on world growth)

02

Brasil:
A slow recovery ahead

Jair Bolsonaro, the favorite to be the president of Brazil between 2019 and 2022

Elections: result of the 1st round, 2nd round poll and Google searches (*)
(%)



(*) Results of the 1st round and polls: proportion of valid votes. In the 1st round the other candidates together got 25% of the valid votes. The DATAFOLHA poll was conducted on October 17 and 18. Google searches refer to searches related to the topic "government" made between October 15 and 22.
Source:TSE, IDATAFOLHA, GoogleTrends, BBVA Research

- The conservative J. Bolsonaro and the leftist F. Haddad will compete for the presidency of Brazil in the second round of the elections on October 28, with the first being the clear favorite
- A new Congress emerged from October 7th elections. It will continue exhibiting a very high degree of fragmentation, with a somewhat more conservative profile in comparison to the previous one.
- The fragmentation of the Congress will be a challenge for governance. The next president will have to build a coalition of many parties to pass important measures and reforms

The fragmentation of the Congress, political polarization and market pressure will reduce the room for maneuver of the next government

Base scenario: the most likely is that a not very ambitious fiscal adjustment is implemented

Markets will leave little space for a less pragmatic economic policy. Thus, whoever is the next president, will be forced to present a plan to stop the deterioration of public accounts and maintain macroeconomic stability. As the political environment will remain polarized, and taking into account that Congress will be very fragmented, it will be difficult to approve an ambitious reform of the pension system (which is key to guarantee the sustainability of the public debt). Most likely, a decaffeinated reform will be implemented, as well as other measures to increase revenue and reduce public spending. Building on these assumptions about the policies of the next government, we detail in the next slides our macroeconomic scenario for Brazil in the coming years.

Positive alternative scenario: A more aggressive reform of the pension system would create the conditions for greater economic growth

An ambitious pension system reform, i.e. one that ensures the solvency of public debt in the medium and long term, would generate a significant appreciation of the exchange rate and allow the country to grow above 3% in the coming years, mainly if other policies and reforms that stimulate the increase of productivity are adopted .

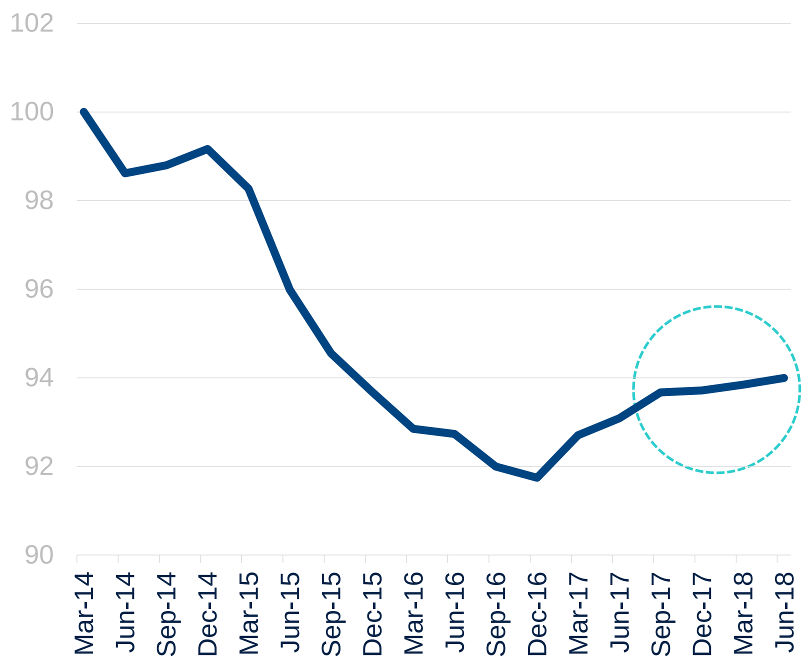
Negative alternative scenario: Not addressing the fiscal problem could generate a new crisis

The lack of concrete measures to curb the fiscal deterioration would have a negative impact on confidence. Also, the exchange rate would depreciate, increasing the pressure on domestic prices and on interest rates. In such an environment, a crisis like 2015-16 could not be ruled out.

GDP growth moderated and financial volatility increased amidst increasing political uncertainty

GDP: quarterly evolution since 1Q14

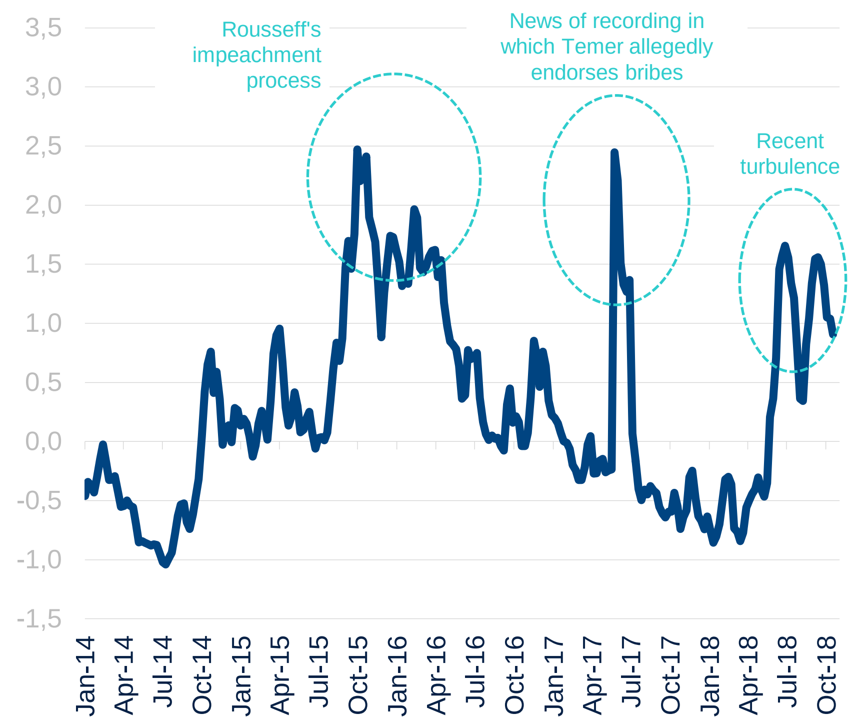
(Index = 100 in 1Q14; seasonally-adjusted series)



Source: IBGE, BBVA Research

BBVA index of financial tensions

(average since Jan-06 = 0)

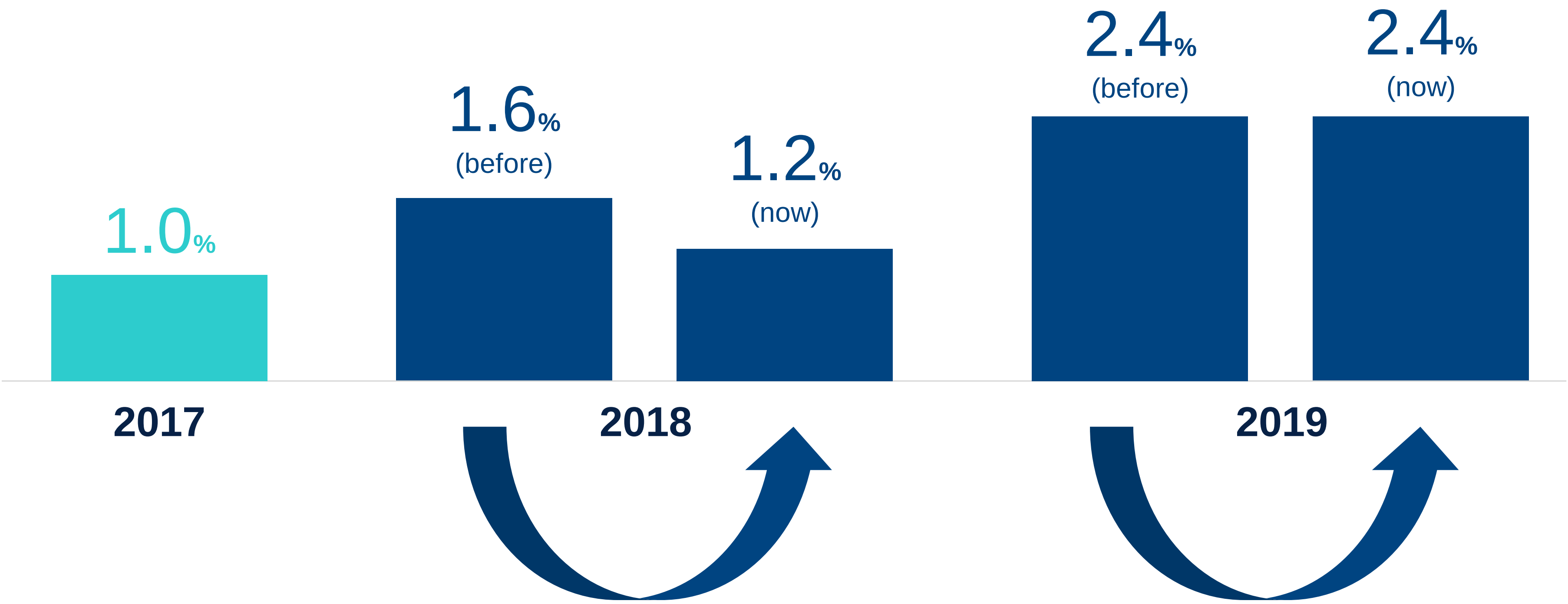


Source: BBVA Research

GDP growth moderated in the last three quarters (when average growth was of 0.1% QoQ) after a stronger expansion in the first three quarters of 2017 (when average growth was of 0.7% QoQ). GDP is currently 6% below the pre-crisis level

Financial tensions have increased once again over the last few months . However, in the last few weeks, the tone has been (excessively) positive because of markets' increased optimism regarding the political scenario after the elections

We revised down our growth forecast: the recovery of the activity will be even more gradual than expected



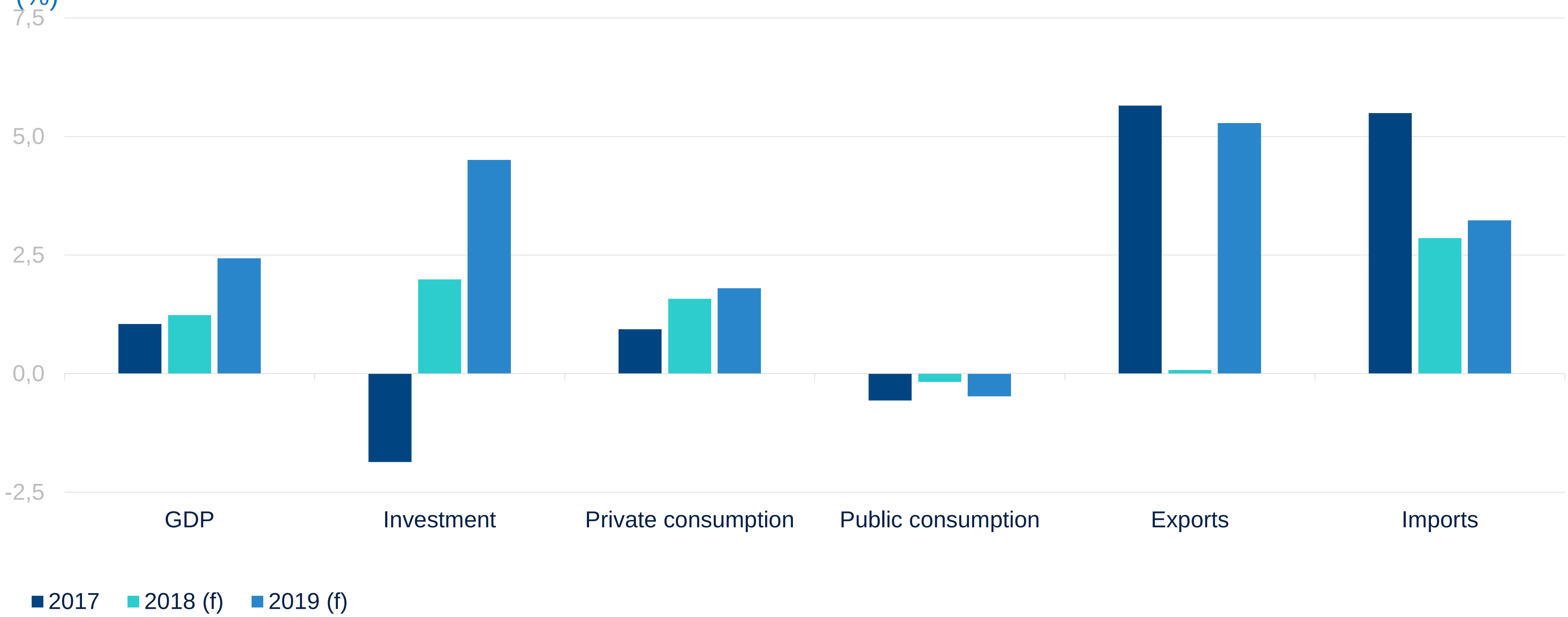
The recent moderation of economic activity and the increase of volatility in financial markets, amidst increasing political uncertainty, have led us to a further downward revision of GDP growth in 2018

We maintain the forecast of 2.4% for 2019, with a downward bias. From 2020 onwards GDP growth would be around 2.0%. A stronger expansion would require the approval of economic reforms, which now seem unlikely

The greater dynamism of private consumption and, especially, of investment will be the main drivers of the recovery

Growth of GDP and its components(*)

(%)



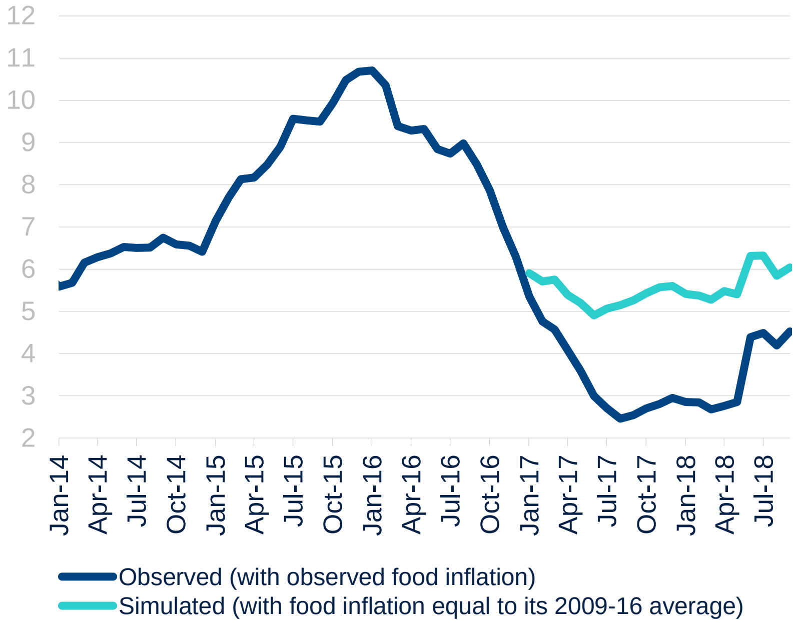
(*) (f) = Forecasts.
Source: BBVA Research

We have revised downwards our forecasts for investment, but we still think that it will lead the process of gradual recovery of the economy in the coming quarters. The main driver would be the likely rebound of confidence after the elections

In the coming quarters, GDP growth should accelerate somewhat. Specifically, we expect a GDP expansion of around 0.6% QoQ during the second half of 2018 and also during the next year

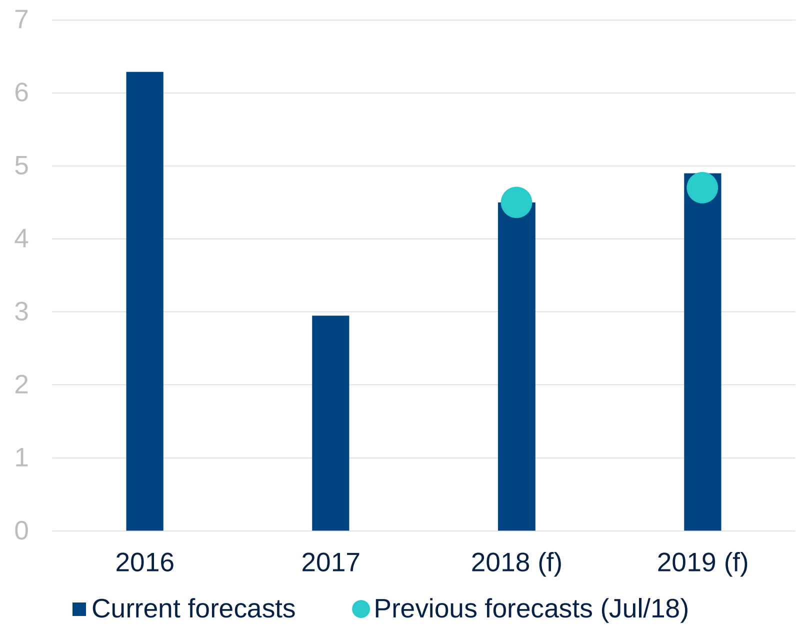
Inflation should reach 4.5% this year and converge to 4.9% in 2019, somewhat above the target

Inflation: IPCA(*)
(% YoY)



(*) For the simulation of inflation from January 2017 on, observed food inflation is replaced by the average food inflation in 2009-16 (8.75%).
Source: BBVA Research

Inflation: IPCA(*)
(% YoY; end of period)



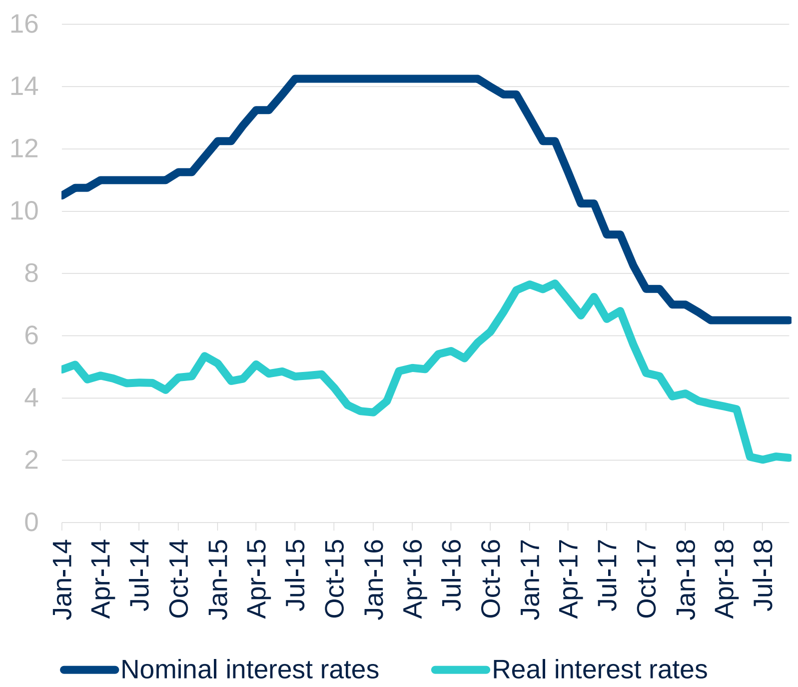
(*) (f) = Forecasts.
Source: BBVA Research

Inflation had been at very low levels until recently, basically due to short-term factors (weak demand, positive effects of weather conditions on food supply, low energy prices...) In recent months these factors have stopped contributing so benignly ...

... something that will continue to happen as we move forward. We foresee, thus, an increase of the upward pressures on domestic prices in 2019, so that inflation must be above the 4.25% target for the period

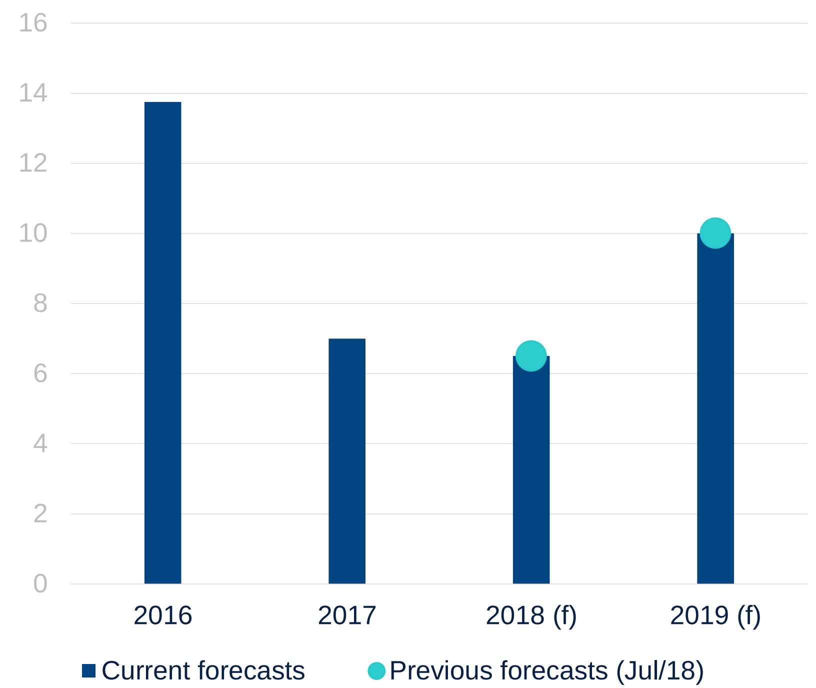
The Central Bank will soon begin to tighten monetary conditions

Interest rates: SELIC
(% YoY)



Source: BBVA Research

Interest rates: SELIC(*)
(% YoY; end of period)



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

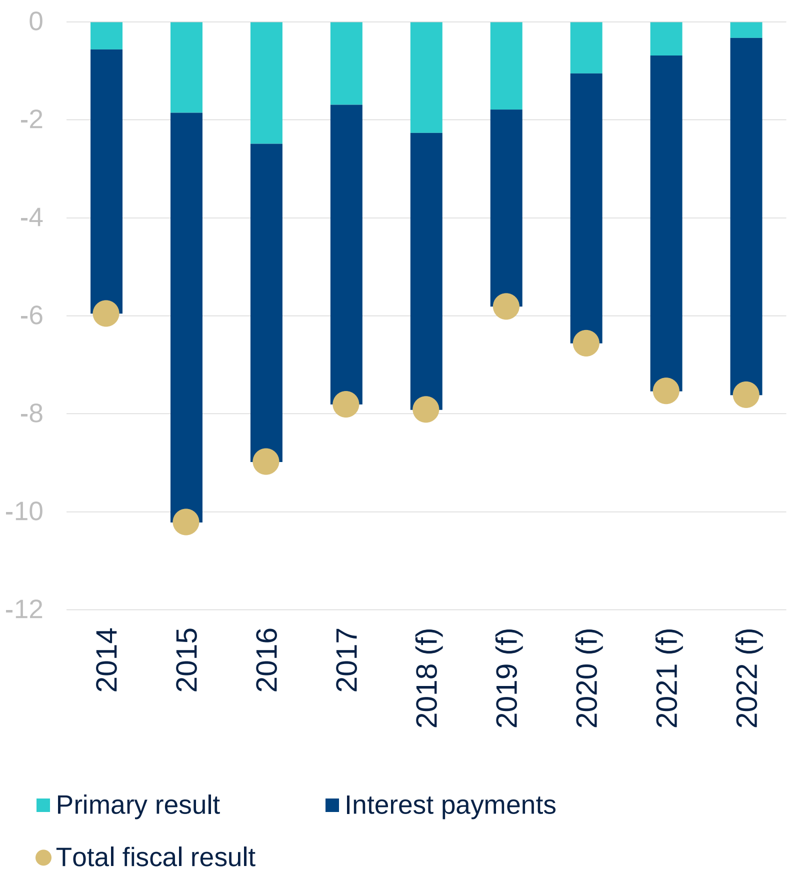
We expect a first rise in SELIC interest rate at the first monetary policy meeting of 2019 (in February). Additional adjustments will make the SELIC interest rate to converge to 10% over the next year

The next government will have the power to change the members of the board of the Central Bank of Brazil, since the institution is not legally independent. Despite the risks, in principle no negative surprises are expected

Fiscal adjustment measures and greater GDP growth would allow the primary deficit to fall, but interest payments would remain high

Fiscal results(*)

(% of GDP)



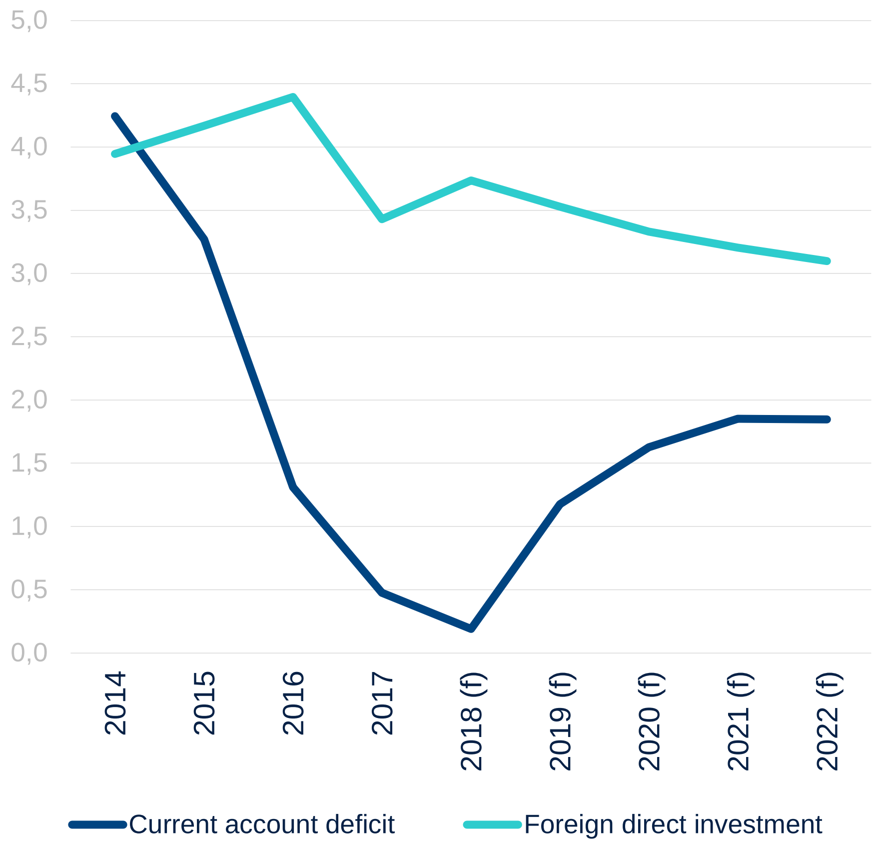
(*) (f) = Forecasts.
Source: BCB, BBVA Research

- There is still a lot of uncertainty about how the next government will address the fiscal problem
- Under the pressure of markets, the next government is likely to take measures to reduce fiscal vulnerability
- In any case, the fragmentation of the Congress and political polarization make an ambitious reform of social security unlikely
- We foresee a gradual reduction of the primary deficit in the coming years; however, interest payments could increase as a consequence of an increase of the SELIC interest rate
- Public debt, currently 77% of GDP, will continue to rise

External accounts: there are no signs of vulnerability

Current account deficit and foreign direct investment in Brazil(*)

(% of GDP)



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

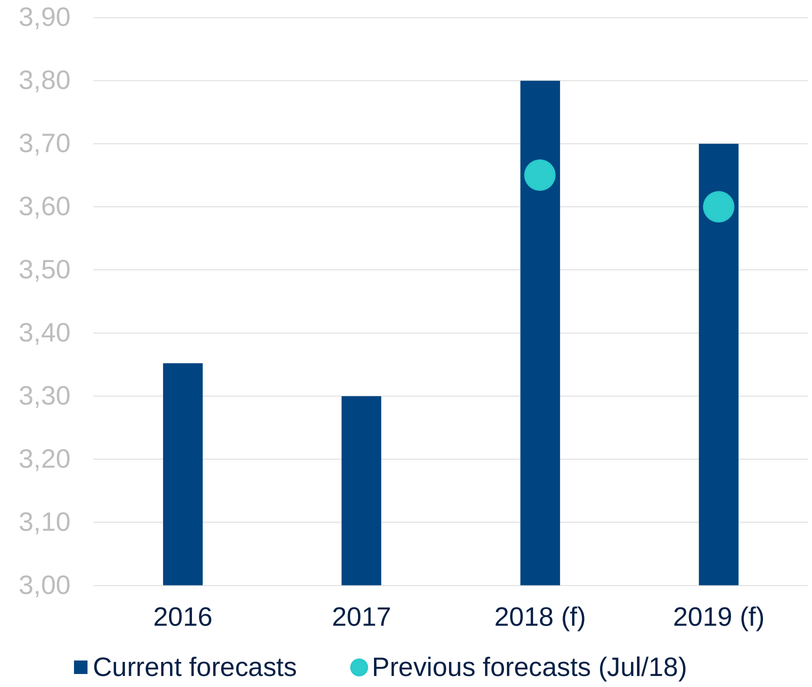
- The situation of external accounts is relatively positive:
  - International reserves are high (20% of GDP)
  - The total external debt is close to 15% of GDP, lower than the level of international reserves
  - 82% of external debt is long term
  - More than 90% of public debt is denominated in local currency
  - The current account deficit is limited (0.8% of GDP in August)
  - Foreign direct investment in Brazil remains relatively robust (3.6% of GDP in August)
- However, the greater dynamism of domestic demand will cause an increase in the current account deficit in the coming years

Calm after the storm in foreign exchange markets

Nominal exchange rate
(USD / BRL)

Source: BBVA Research

Nominal exchange rate(*)
(USD / BRL; end of period)



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

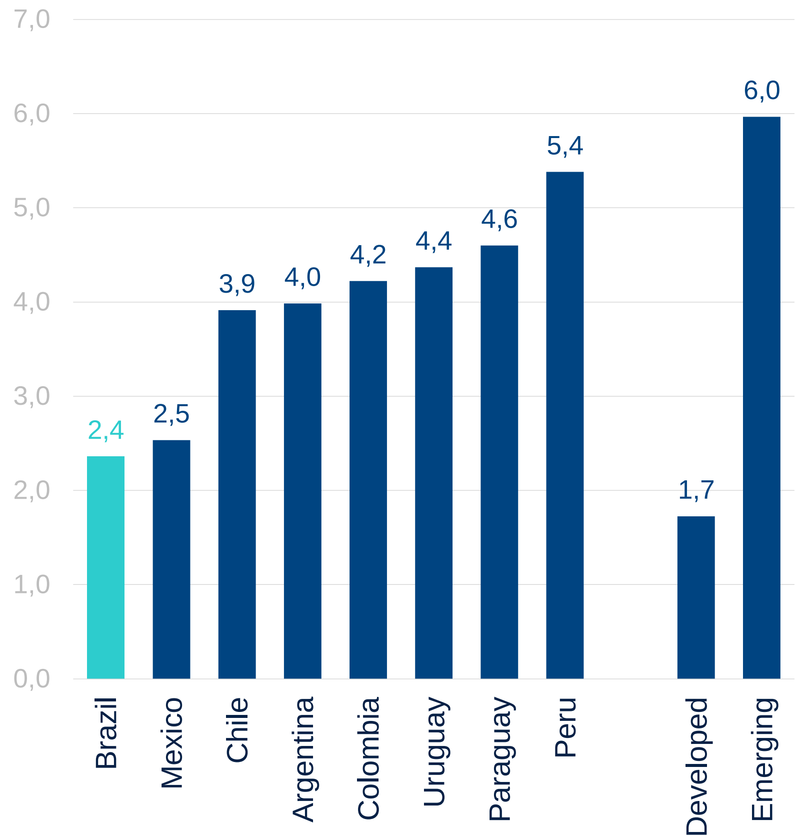
In the last few weeks, the exchange rate appreciated significantly, from around 4.15 to about 3.7, largely due to an (excessively?) positive perception of the scenario after the elections by the markets

Volatility may return, mainly after the elections, when the economic policy for the next four years will begins to be unveiled. We expect the Brazilian real (BRL) to float around 3.8 over the forthcoming quarters

All in all, Brazil will hardly be able to recover in the coming years the lost growth

GDP growth: 2003 – 2017 average

(%)



Source: BBVA Research, FMI

- Even if the expected recovery of activity materializes, Brazil's growth will remain relatively modest, around 2%
- Therefore, the country will continue to grow less than most Latin American and emerging economies, and even less than some developed economies (at least in per capita terms)
- This will not be a novelty: between 2003 and 2017 Brazil's average growth was of 2.4%, while most of the other economies of the region grew at least 4% and emerging economies grew around 6%
- Recover lost growth in the coming decades would require, among other things, structural reforms that increase productivity

03

Brasil:
Forecast table

Brazil forecasts

	2016	2017	2018 (f)	2019 (f)
GDP	-3.4	1.0	1.2	2.4
Private consumption (%)	-4.3	0.9	1.6	1.8
Public consumption (%)	-0.1	-0.6	-0.2	-0.5
Investment in fixed capital (%)	-10.3	-1.9	2.0	4.5
Exports (%)	1.9	5.7	0.1	5.3
Imports (%)	-10.2	5.5	2.9	3.2
Unemployment rate (average)	11.3	12.7	12.3	11.0
Inflation (end of period. YoY %)	6.3	2.9	4.5	4.9
SELIC rate (end of period. YoY %)	13.75	7.00	6.50	10.00
Exchange rate (end of period)	3.35	3.30	3.80	3.70
Current account (% of GDP)	-1.3	-0.5	-0.2	-1.2
Public sector fiscal balance (% of GDP)	-9.0	-7.8	-7.9	-5.8

(p) Forecast.
Source: BBVA Research

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