BBVA Research

Brazil Economic Outlook

1Q19

January 2019

Creating Opportunities

Main messages

- The Brazilian economy will grow 2.2% in 2019 and 1.8% in 2020, stimulated by factors such as the expansive tone of monetary policy and the increase in confidence. However, prospects for growth recovery are now less positive, mainly due to the view that the global environment will be less favorable than previously expected

- We maintain the view that the new government will take measures to curb fiscal deterioration, including a reform of social security, which, however, would not be ambitious enough to trigger a better-than-expected macroeconomic scenario

- Inflationary pressures will continue to rise, mainly from the middle of 2019 onwards, reflecting the relative strengthening of demand as well as the exchange rate depreciation. In any case, the balance of risks for inflation has improved, which has created room for the central bank to postpone until the end of this year the beginning of the monetary tightening

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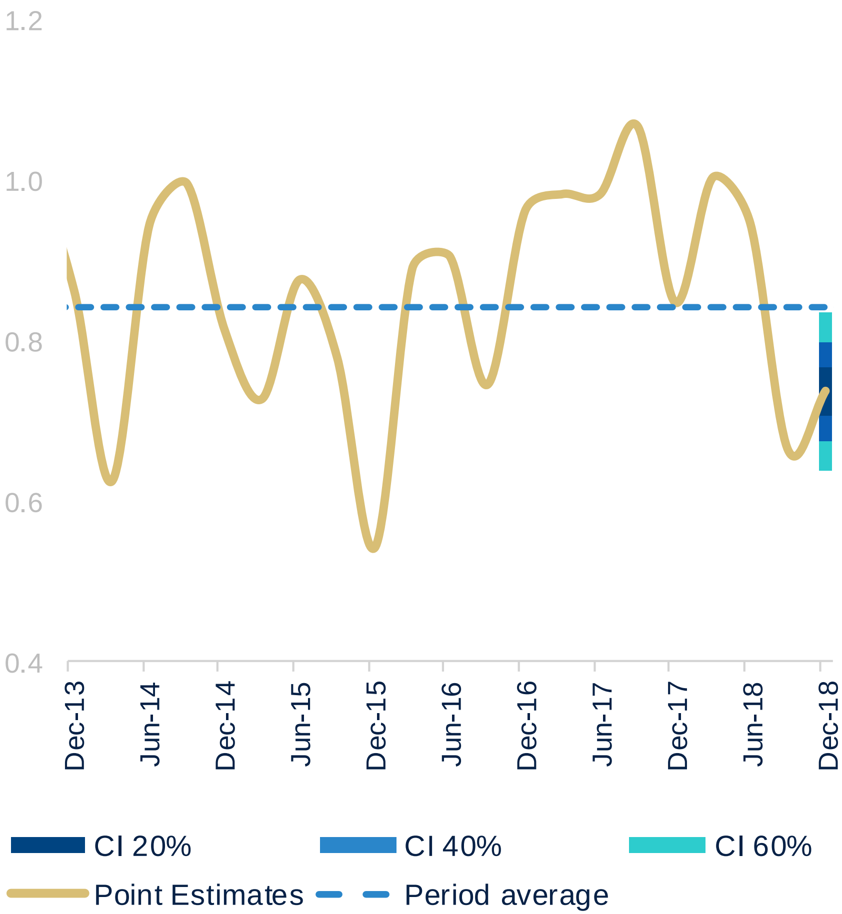
01

Global environment: moving towards a soft-landing of global growth, amid high uncertainty

Global GDP will likely recover somewhat in 4Q18, but the trend is clearly downwards

World GDP growth

(Forecast based on BBVA-GAIN, % QoQ)



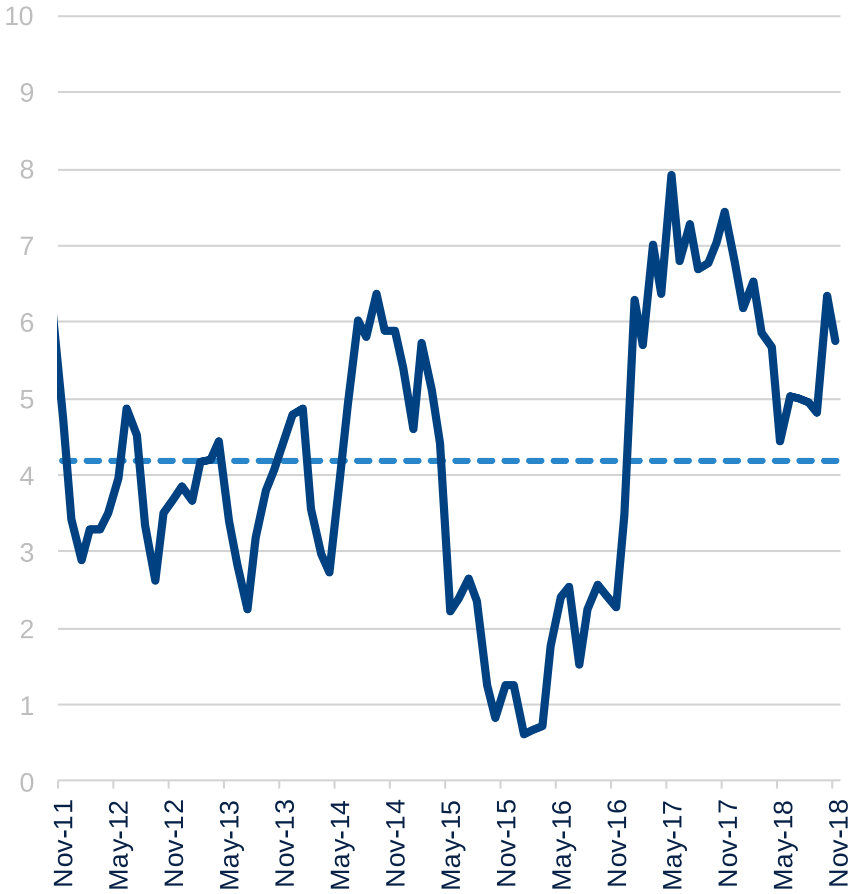
Source: BBVA Research

- Global growth is decelerating, but it remains solid
- The generalized deterioration of industrial production and trade suggest a more evident impact of protectionism
- The strong moderation of industrial confidence extends to other sectors, but the growth of private spending remains
- The high uncertainty continues at the beginning of the year and will continue to weigh on the growth

Global trade: effect of both increased tariffs and uncertainty on trade negotiations are now more evident

BBVA – Global exports of goods

(% YoY, 3-period moving average, nominal exports)

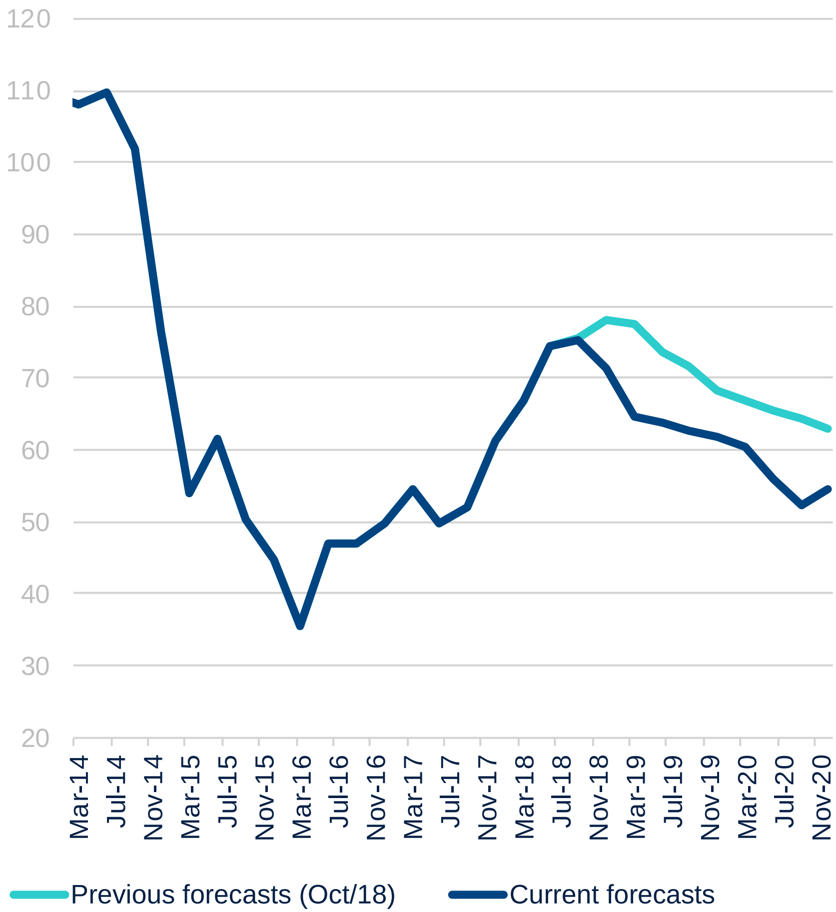


Source: BBVA Research

- World trade has shown strong volatility due to uncertainty about trade disputes
- The recent poor performance of exports in China is partly due to the previous front-loading of exports triggered by the possibility of new tariff increases, but its downward trend is worrying
- The worse-than-expected evolution of exports has also been observed in the rest of Asia and in Germany

Lower oil prices could drive global growth up by between one and two tenths in 2019-20

Oil prices
(Brent, USD per barrel)



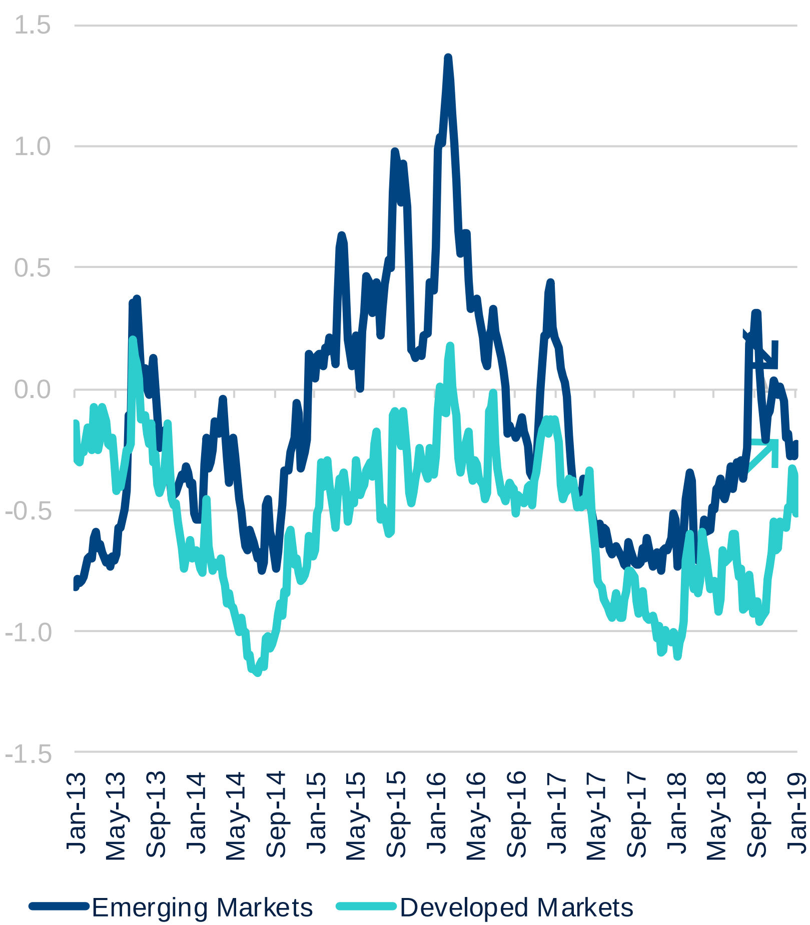
Source: BBVA Research

- Oil prices may recover in the short term due the announced production cuts
- However, the growing production in the US and lower global demand will push prices downwards more than expected throughout 2019-20
- The fall in prices will benefit world growth, but the effect on some Latam countries will be negative
- Copper forecasts were revised downwards, due to lower world growth, while soybean forecasts were adjusted upwards, due to the prospects for relaxation in the China - US trade relationship

Recent turmoil in the financial markets due to a risk of a sudden adjustment of global growth

BBVA's Financial Tensions Index

(Índex)



Source: BBVA Research

01

Developed markets (US) are at the center of the episode, where financial tensions have rebounded sharply

02

EM remained relatively resilient despite the global mood and the fall in oil prices

03

Investors have withdrawn **sizeable outflows from DM**, but EMs have failed to attract new flows

04

The **response of central banks**, particularly the Fed showing higher prudence/patience, has been key to halt tensions

Still soft landing, but more uncertain due to dependence on policies

Worse macro outcomes

Faster slowdown than expected (Protectionism+China)

Evidence that impact from **US fiscal stimulus** will fade earlier than expected

Higher financial stress

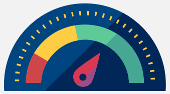
Risks of **global growth hard landing**

Tougher financial conditions

Three key assumptions in our projections:

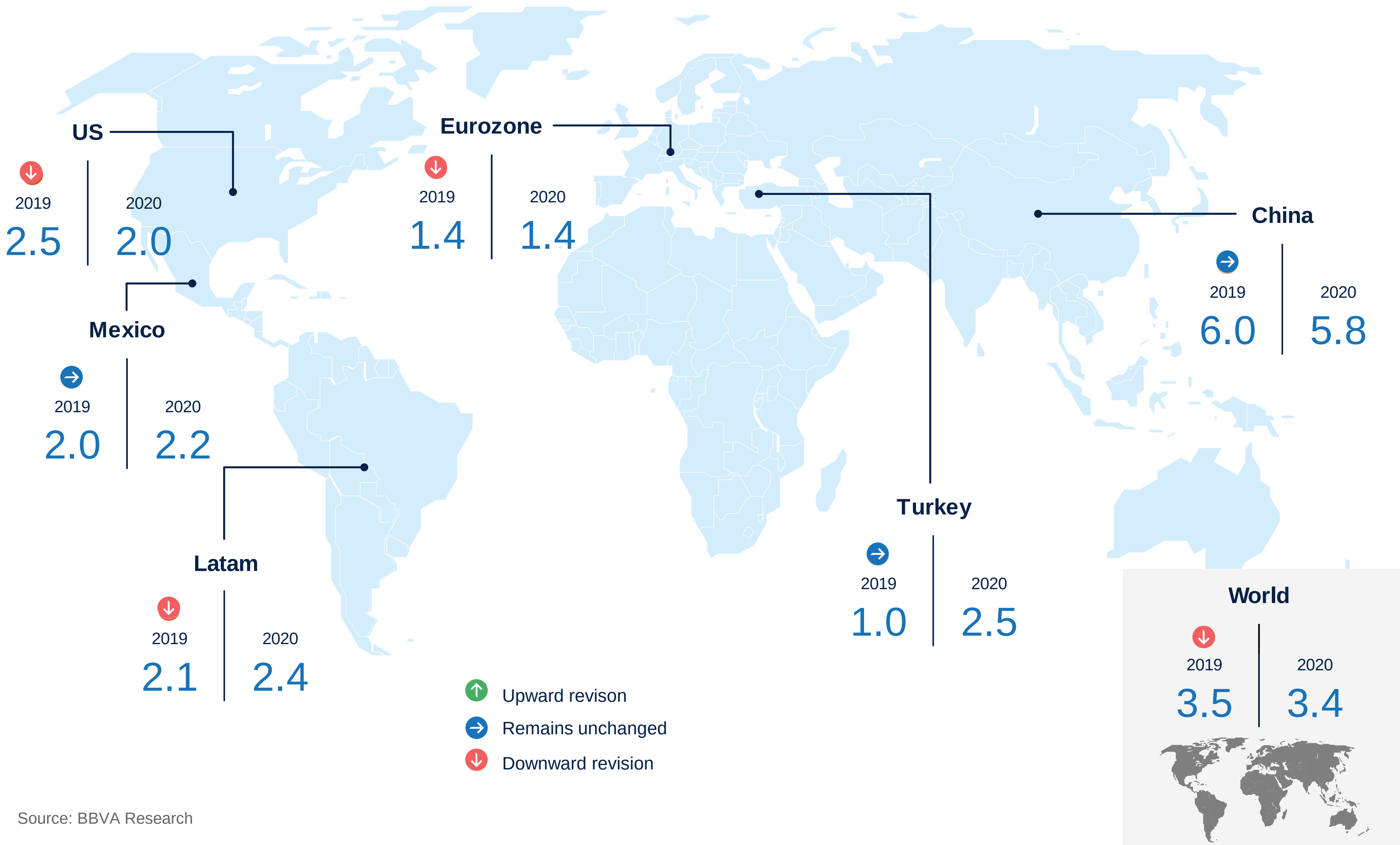
01
Easing US-China trade tensions with no changes in the auto sector

02
Orderly Brexit



03
Fed and ECB: more dovish and with more room of maneuver

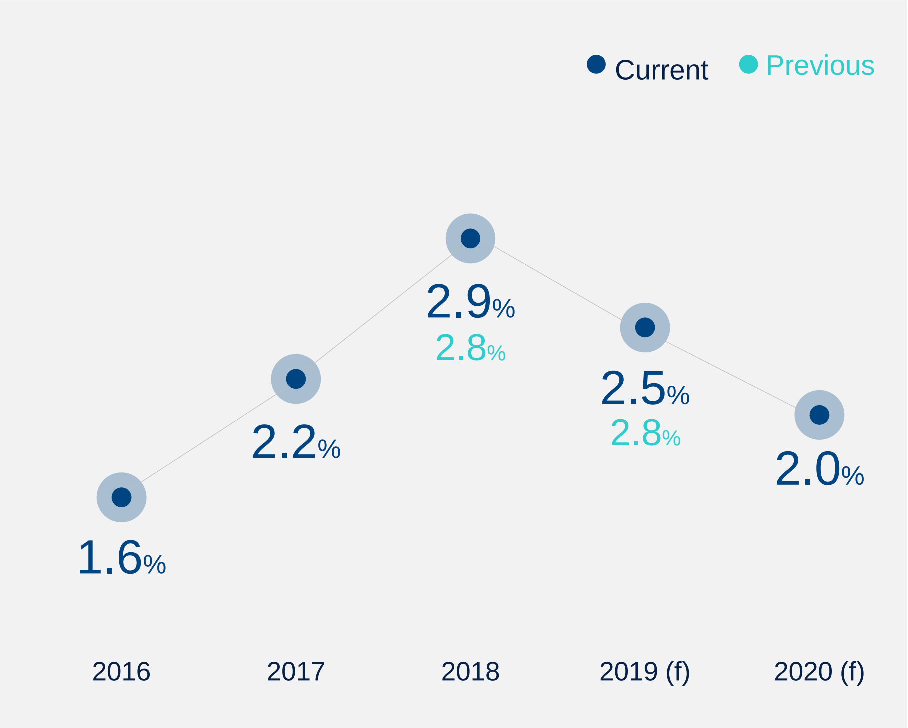
Widespread downward revision of growth, with moderation more evident in developed and emerging Asian countries



Source: BBVA Research

US: further growth slowdown due to the fading of fiscal stimulus and financial volatility

US: GDP growth
(% a/a)

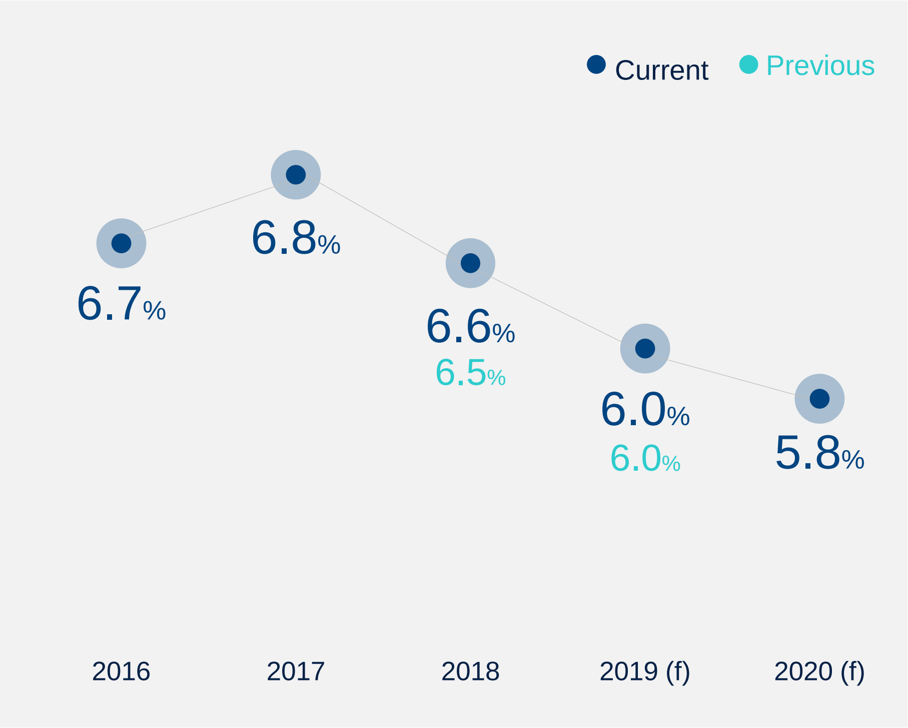


- A downward revision of GDP due to less optimistic prospects for private investment and public spending
- Private consumption will moderate following lower taxes' fading effects, and despite the strength of the labor market
- Inflation remains above the target, but will gradually converge to below-the-target levels in 2020
- The downside risks have increased due to the deterioration of the global environment; the risk of recession in the two-year horizon is also greater

(f) Forecast.
Source: BBVA Research , based on BEA data

China: policy priority is to avoid a hard-landing scenario

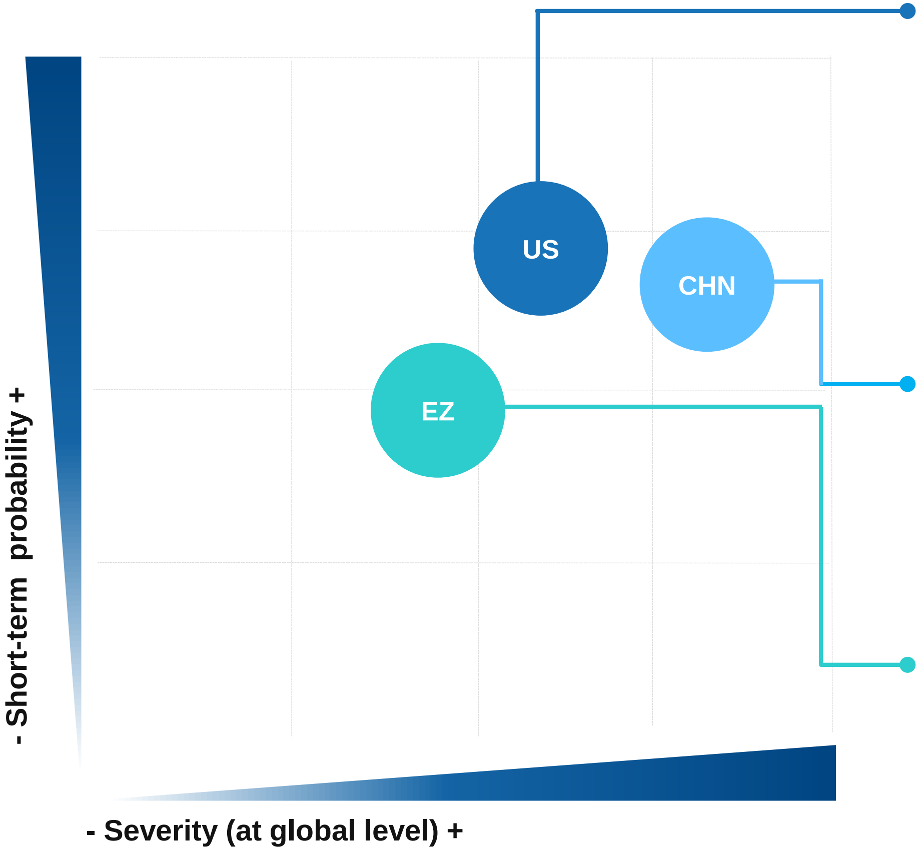
China: GDP growth
(%)



- Growth forecasts are maintained unchanged due to greater policy-stimuli
- Supportive fiscal and monetary measures are being extended, but attempts are made not to worsen existing financial vulnerabilities
- Protectionism remains the main risk. If its effects trigger additional stimuli, and the necessary deleveraging is slowed down, then a sharp depreciation of the exchange rate could be observed

(f) Forecast.
Source: BBVA Research, based on CEIC data

Global risks tilted to the downside: US recession fears, China's debt and trade war are the main sources of concerns



- **Economic recession: increasing** (trade concerns, political controversy -shutdown-, geopolitical issues, credit risk / corporate leverage)
- **Protectionism: high.** Negative spillovers on growth (investment, impact on certain sectors / states) and cost pressures
- **Fed's exit: falling**. Lower risk of overshooting (rates above neutral levels)

- **Disorderly deleveraging: relatively higher**. Growing debt overhang amidst further stimulus and flagging growth (also visible in household expenditure). Monitoring: RMB, corporate defaults, local government debt
- **Protectionism: high**. Big differences remain despite a potential trade deal in March19. Lack of advances in structural issues (intellectual property, FDI, WTO reform)

- **Political concerns: relatively higher**. Lack of advances in integration process on the eve of European Parliament elections
  - ***Brexit***: risk of a cliff-edge Brexit in March19
  - **Italy:** political and policy uncertainty remains. Banking concerns rising
- **Proteccionism:** contained but it could be not discarded (autos)
- **ECB's exit risk:** low. Pending on changes in the Board

Source: BBVA Research

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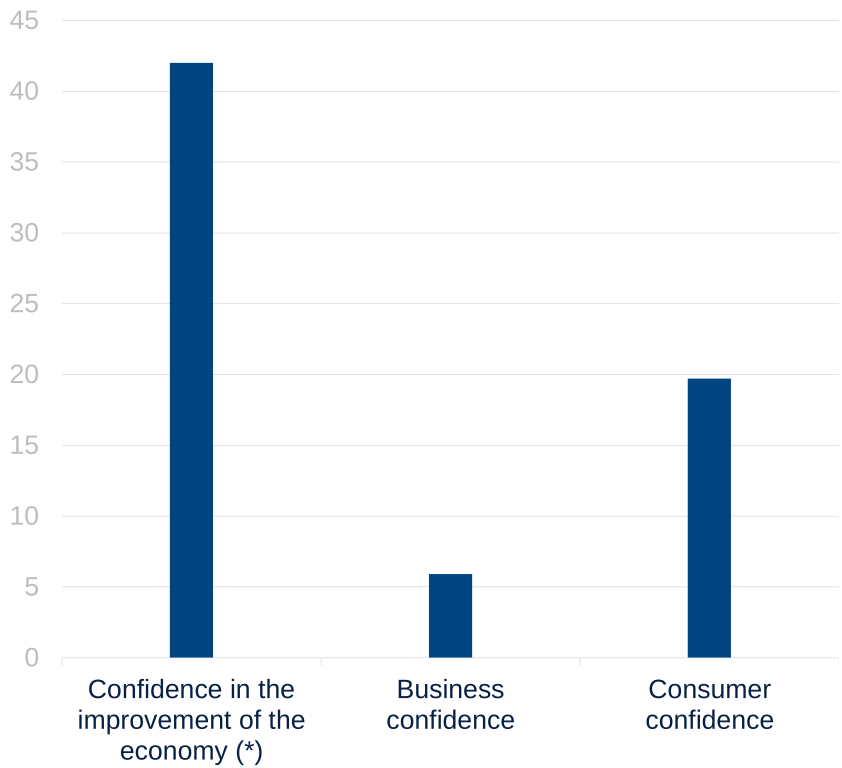
02

Brazil:
the economy will grow 2.2% in and 1,8% in 2020

The government of Jair Bolsonaro begins, with optimism regarding the evolution of the economy

Confidence indicators: cumulative increase between September and December 2018

(Base-points change)



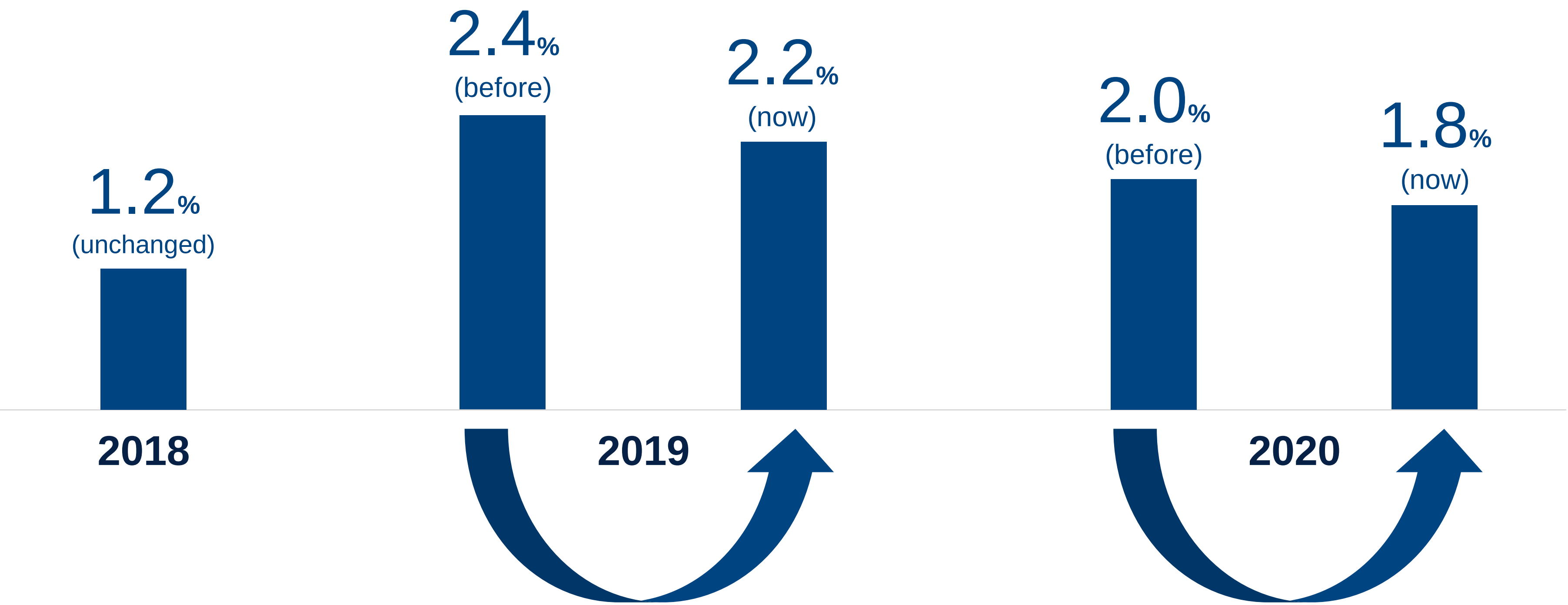
(*) Increase in the proportion of the population that expects the economy to improve in the coming months, according to Datafolha surveys.
Source: Datafolha, FGV, Fecomercio, BBVA Research

- Confidence in the economy has increased significantly
- Financial markets are also more optimistic, mainly due to the liberal agenda introduced by the new administration, which includes proposals for trade liberalization, fiscal adjustment, economic reforms, privatizations, etc.
- Since September, the Sao Paulo Stock Exchange index increased 20% and the exchange rate appreciated around 10%
- Greater confidence will continue to favor recovery
- However, optimism with the new government will hardly remain at such high levels, among other reasons because difficulties to approve reforms, with a fragmented and polarized congress, could be higher than anticipated

The most likely is that a social security reform will be approved, reducing, but not eliminating, fiscal problems

	Base scenario	Positive alternative scenario	Negative alternative scenario
Social security reform	A not very ambitious social security reform is approved	An ambitious social security reform is approved	A reform of social security is not approved
Fiscal outlook	Public debt continues to rise, although less than in recent years; new significant fiscal adjustments will become necessary	The conditions for public debt to trend down in the medium term are given	Public debt continues to increase significantly
Macroeconomic outlook	GDP growth converges to 2%	GDP growth converges to 3% or even more if other economic reforms are approved	Stagnation or even a new recession, in a context of growing doubts about the debt sustainability
Probability	60%	25%	15%

We maintain our view on the local drivers of growth, but we revise GDP forecasts downwards due to a less favorable global environment



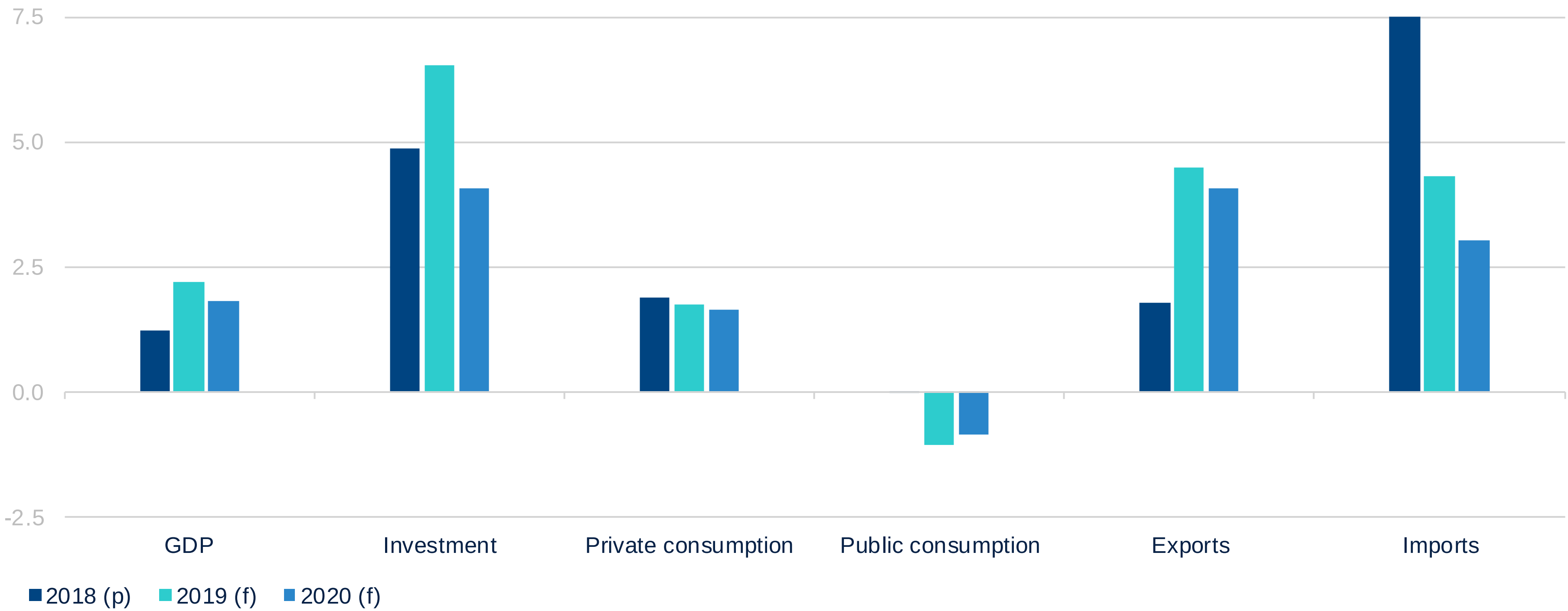
We keep our estimate for 2018 GDP growth unchanged at 1.2%, which would follow an expansion of 1.1% in 2017 and the 7% GDP contraction accumulated between 2015 and 2016

The 0.2 pp downward adjustments in our forecasts for 2019 and 2020 are due to global factors: lower global growth, higher financial volatility (mainly in the first half of 2019) and lower commodity prices

Growth in 2019 and 2020 will be supported mainly by the expansion of investments and exports

Growth of GDP and its components(*)

(%)



(*) (f) Forecasts
Source: BBVA Research

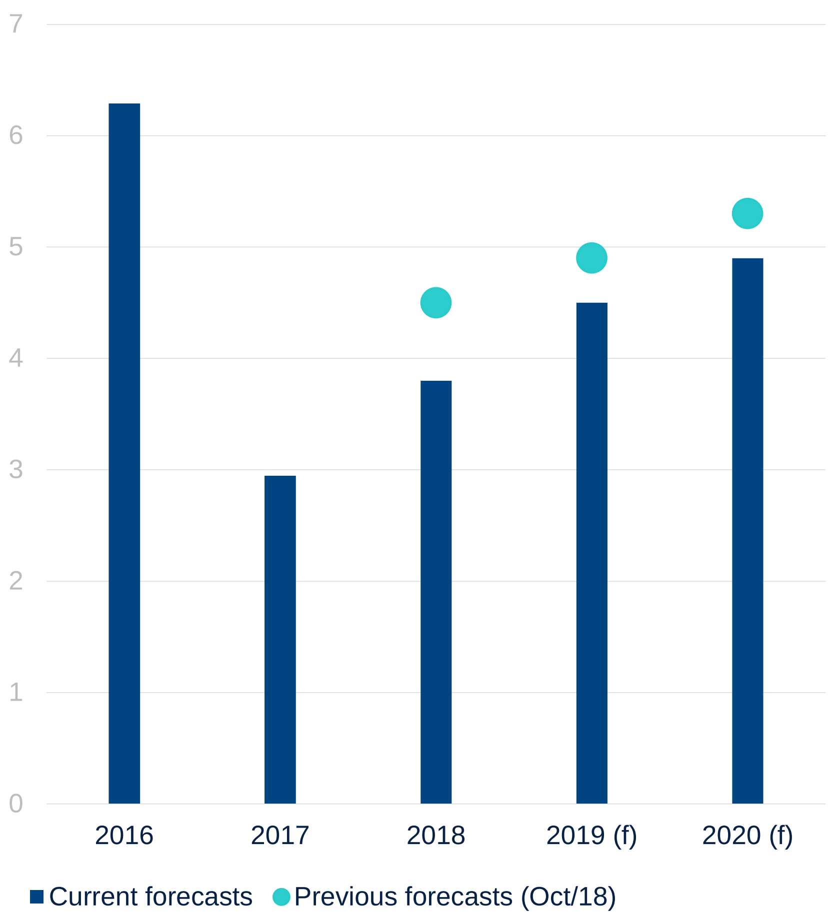
Expansive monetary policy and the increase in confidence will stimulate the performance of private consumption and investment, mainly in 2019

The depreciated exchange rate will continue to favor net exports in the coming years

Inflation will continue to rise, but less than previously expected

Inflation (*)

(y/y %; end-of-period)



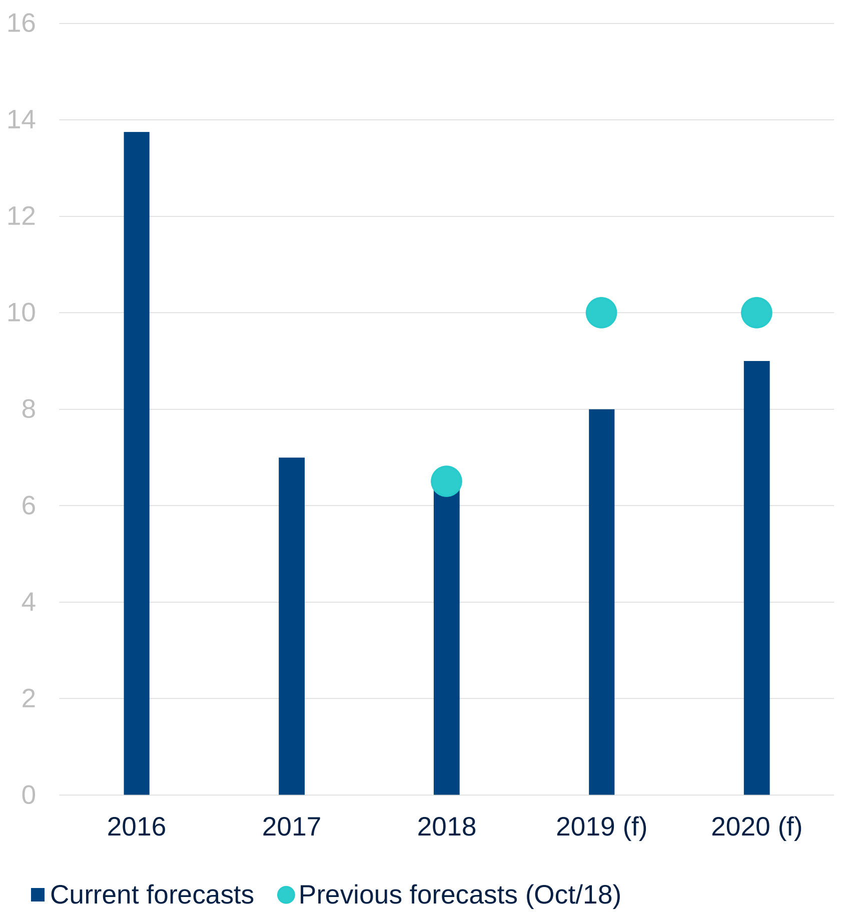
(*) (f) = Forecasts.
Source: BCB, BBVA Research

- Inflation closed 2018 at 3.8%, below both the expected level and the 4.5% target for the period
- We anticipate that inflationary pressures will increase further, mainly from the second half of 2019 onwards, in line with the depreciation of the exchange rate, the relative strengthening of demand and greater pressures from food prices
- Inflation would reach 4.5% at the end of 2019 and 4.9% at the end of 2020, above the inflation targets (4.25% in 2019 and 4.0% in 2020)
- This scenario for inflation is more benign than the one we had before as it incorporates the recent downward surprises in inflation figures, prospects of lower oil prices and weaker domestic demand forecasts

The better prospects for inflation will postpone the beginning of the monetary adjustment cycle

Interest rates: SELIC (*)

(y/y %; end-of-period)

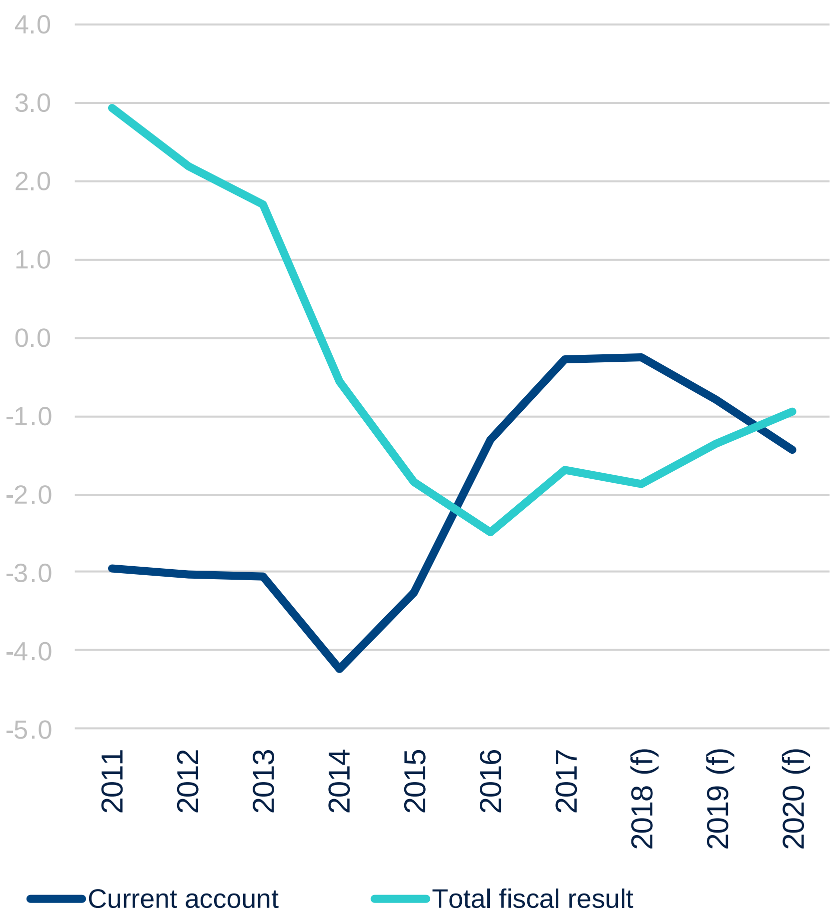


(*) (f) = Forecasts.
Source: BCB, BBVA Research

- With lower inflationary pressures and the prospect of a more gradual normalization of monetary policy in developed countries, the central bank now has room to postpone the beginning of the monetary tightening cycle
- More precisely, we expect the SELIC rate to start to be adjusted upwards in the second half of 2019, when inflation and expectations will likely be above the targets
- The monetary policy reference rate (SELIC) would converge to 8.0% at the end of this year and to 9.0% in 2020

Primary fiscal deficits will decline but will continue to be a source of concerns, while external deficits will increase but will remain under control

Primary balance and current account (*)
(% of GDP)

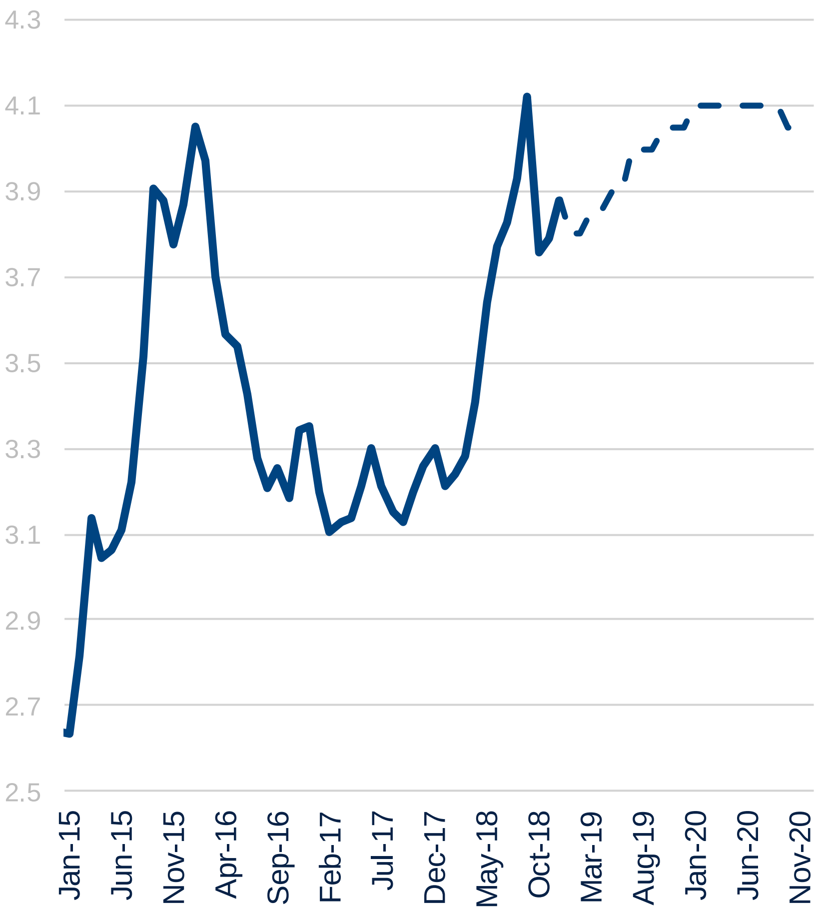


(*) (f) Forecasts.
Source: BCB, BBVA Research

- Primary fiscal deficits will trend down, thanks to the effect on revenue of higher GDP growth, a strict control of expenditures and one-off revenues
- Still, the adjustment of the fiscal balance ahead will be too slow
- In the coming years, the country will continue to produce primary deficits, which coupled with high interest payments will continue to prevent a clear improvement of the overall fiscal result and public debt, at least if a more ambitious social security reform is not approved
- With respect to the current account deficit, a gradual increase is expected in the coming years, but external accounts will continue to be no source of worry

The exchange rate will remain slightly more appreciated during the next few months, but by the middle of the year it will start to depreciate again

Nominal exchange rate (*)
(Brazilian real/ US dollar)



(*) Forecasts from January 2019 on.
SourceBBVA Research

- After depreciating strongly between April and September, the exchange rate appreciated around 10% in line with global markets and greater optimism with the Bolsonaro government
- The honeymoon of the financial markets with the new government will help to maintain the exchange rate relatively appreciated in the coming months, despite the fact that in this period global volatility will remain high
- However, starting in the middle of the year, the exchange rate will possibly begin to depreciate, as the difficulties in the approval of the reforms (especially the social security one) become more evident and in line with the expected moderation in commodity prices

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03

Brazil:
forecast table

Brazil forecasts

	2017	2018 (f)	2019 (f)	2020 (f)
GDP	1.1	1.2	2.2	1.8
Private consumption (%)	1.3	1.9	1.7	1.6
Public consumption (%)	-0.9	0.0	-1.1	-0.9
Investment in fixed capital (%)	-2.5	4.9	6.5	4.1
Exports (%)	5.7	1.8	4.5	4.1
Imports (%)	5.5	9.3	4.3	3.0
Unemployment rate (average)	12.7	12.2	11.1	10.0
Inflation (end of period, YoY %)	2.9	3.8	4.5	4.9
SELIC rate (end of period,YoY %)	7.00	6.50	8.0	9.0
Exchange rate (end of period)	3.30	3.88	4.05	4.05
Current account (% of GDP)	-0.3	-0.3	-0.8	-1.5
Public sector primary balance (% of GDP)	-1.7	-1.9	-1.4	-1.0

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