



BBVA Research

Brazil Economic Outlook

2Q19

April 2019

Creating Opportunities

Key messages



- **The recovery loses steam in Brazil.** The deceleration in the world economy, as well as slow and limited progress in the local adoption of economic reforms –particularly in the social security- will limit the economy’s capacity for growth in the coming years
- **We expect GDP to grow 1.8% in both 2019 and 2020, slightly above the 1.1% growth recorded in each of the previous two years.** Our forecast for 2019 has been adjusted downwards by 0.4 p.p., mainly due to poor incoming activity data, while the forecast for 2020 has remained constant
- **Inflation will remain relatively under control, but will be higher going forward than in the previous two years.** The progressive - albeit timid - recovery in domestic demand, the depreciation of the exchange rate and the normalization of food prices will contribute to the upward trend in domestic inflation
- **The SELIC interest rate will remain at the current expansionary level for a long period.** While weak domestic demand and the more accommodative tone of monetary policy in the US make an upward adjustment unlikely in the short term, rising inflation and fiscal risks leave little room for cuts

Contents

- 01** Global Environment: mild growth moderation
- 02** Brazil: the recovery loses steam
- 03** Brazil: forecast table



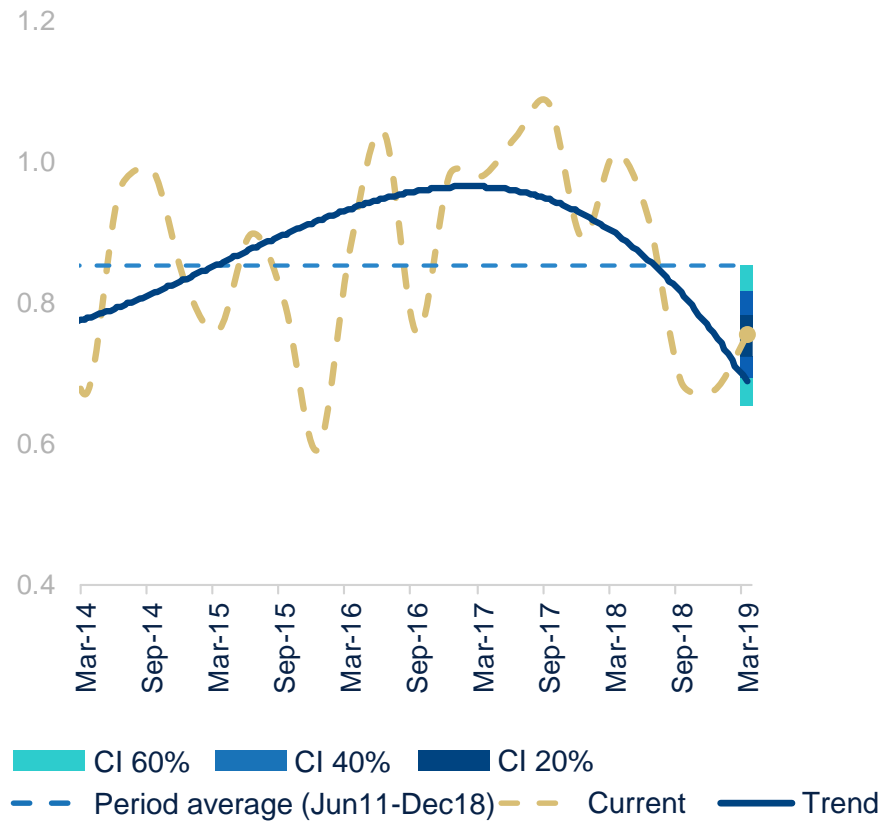
01

**Global Environment:
mild growth moderation**

Global GDP has moderated more than expected

World GDP growth

(Forecasts based on BBVA-GAIN % QoQ)

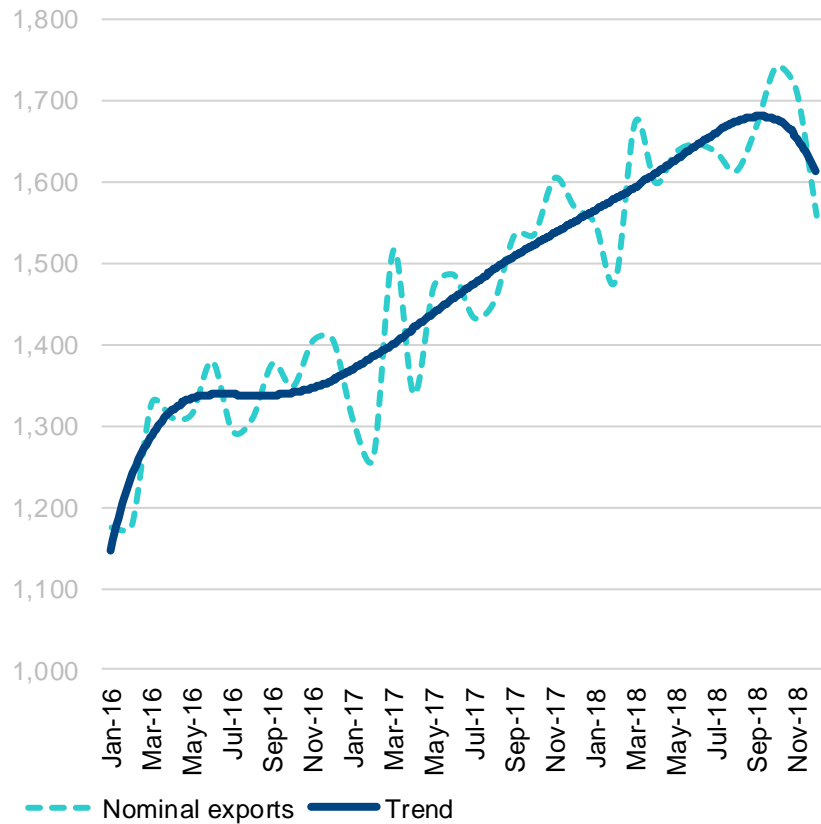


- Global growth has slowed due to China's structural moderation, high uncertainty in Europe, trade protectionism and the cyclical slowdown in the US
- A slight improvement is possible in the short, but activity will remain less dynamic than in previous years

Weak exports and investment, but private consumption remains relatively robust

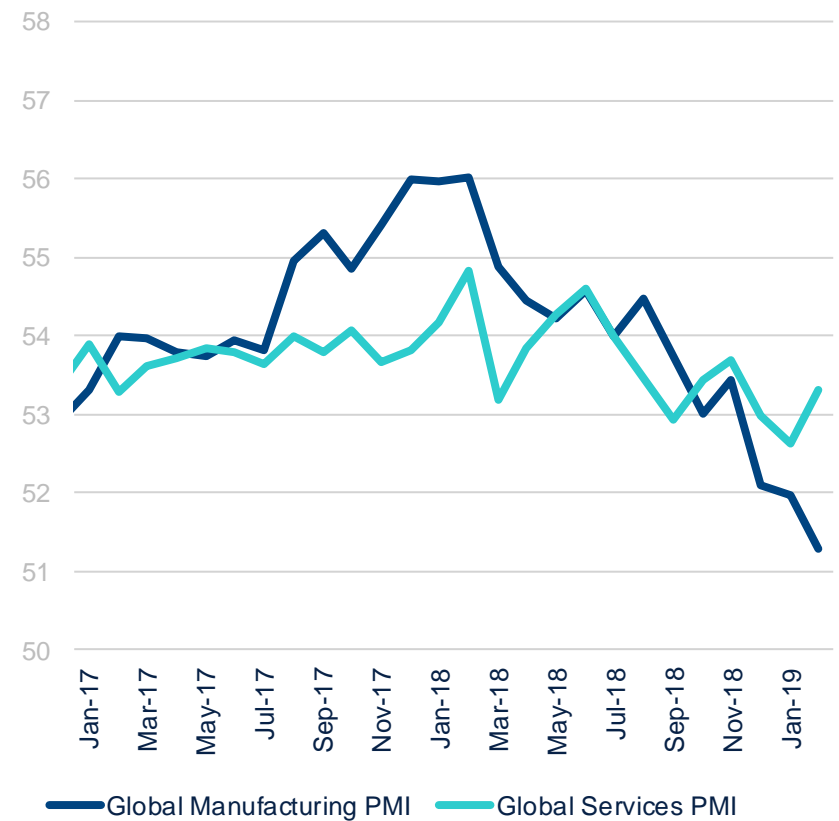
World Exports

(Thousands of dollars)



PMIs

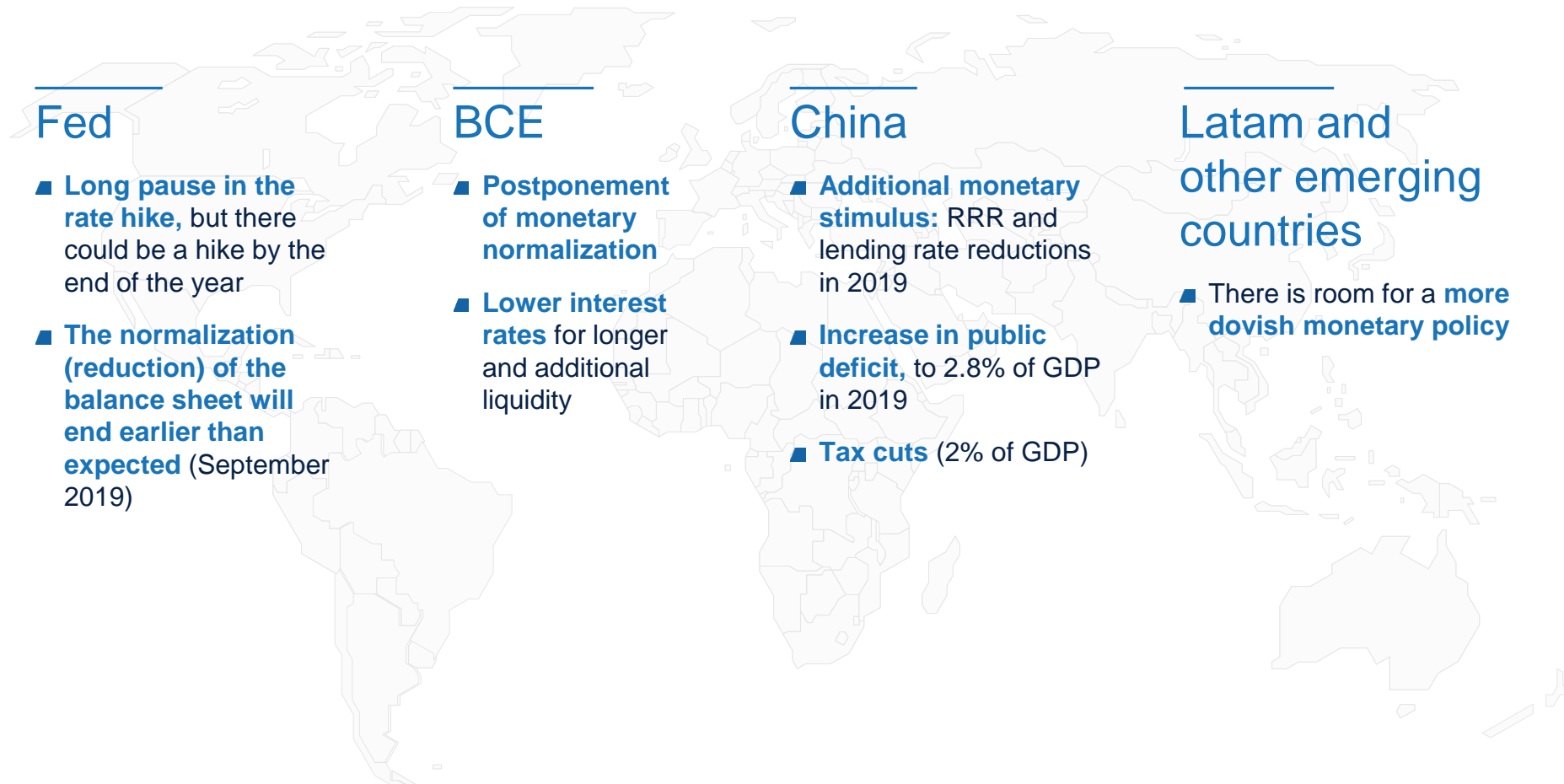
(Level)



Source: BBVA Research based on IMF data

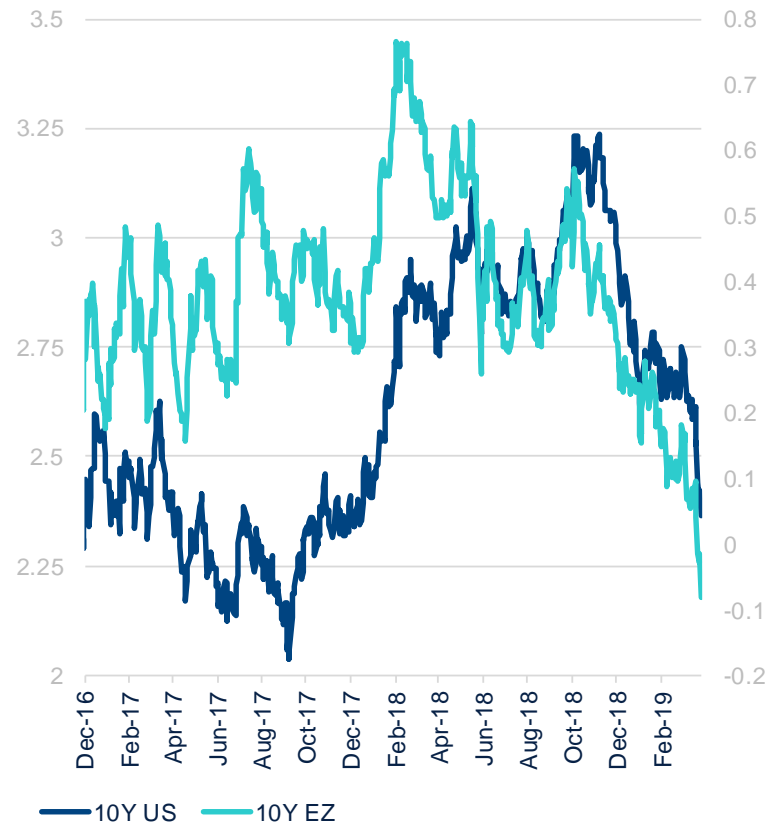
Source: BBVA Research based on IHS Markit data

Growth moderation has caused a shift in monetary policy in the US and the Eurozone, and new stimuli in China



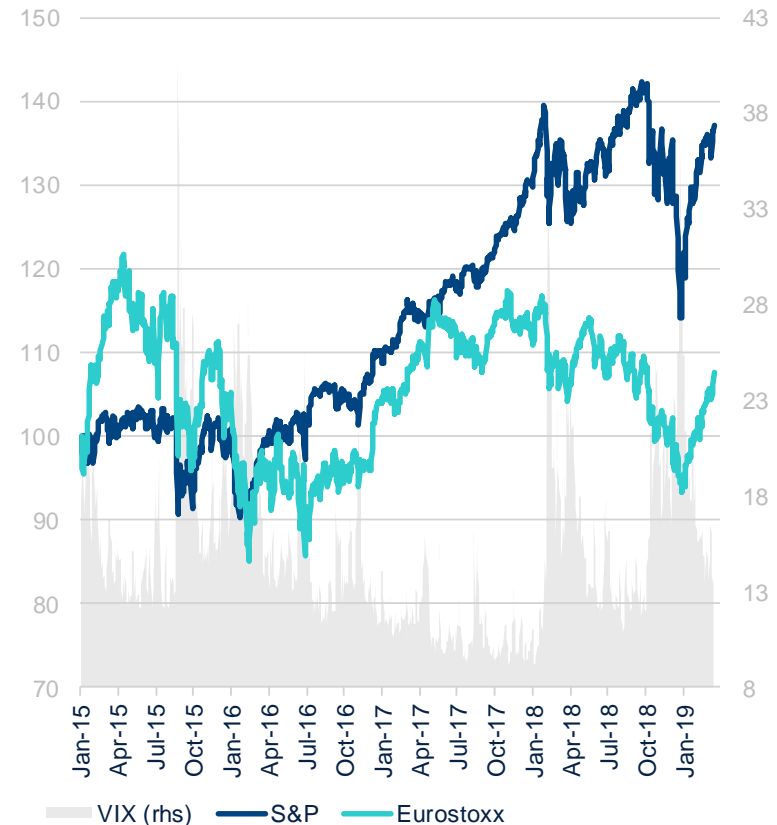
Markets: long-term yields excessively low due to cyclical risk and “safe haven” effect , with volatility limited by central banks' dovish tone

Sovereign debt yields
(%)



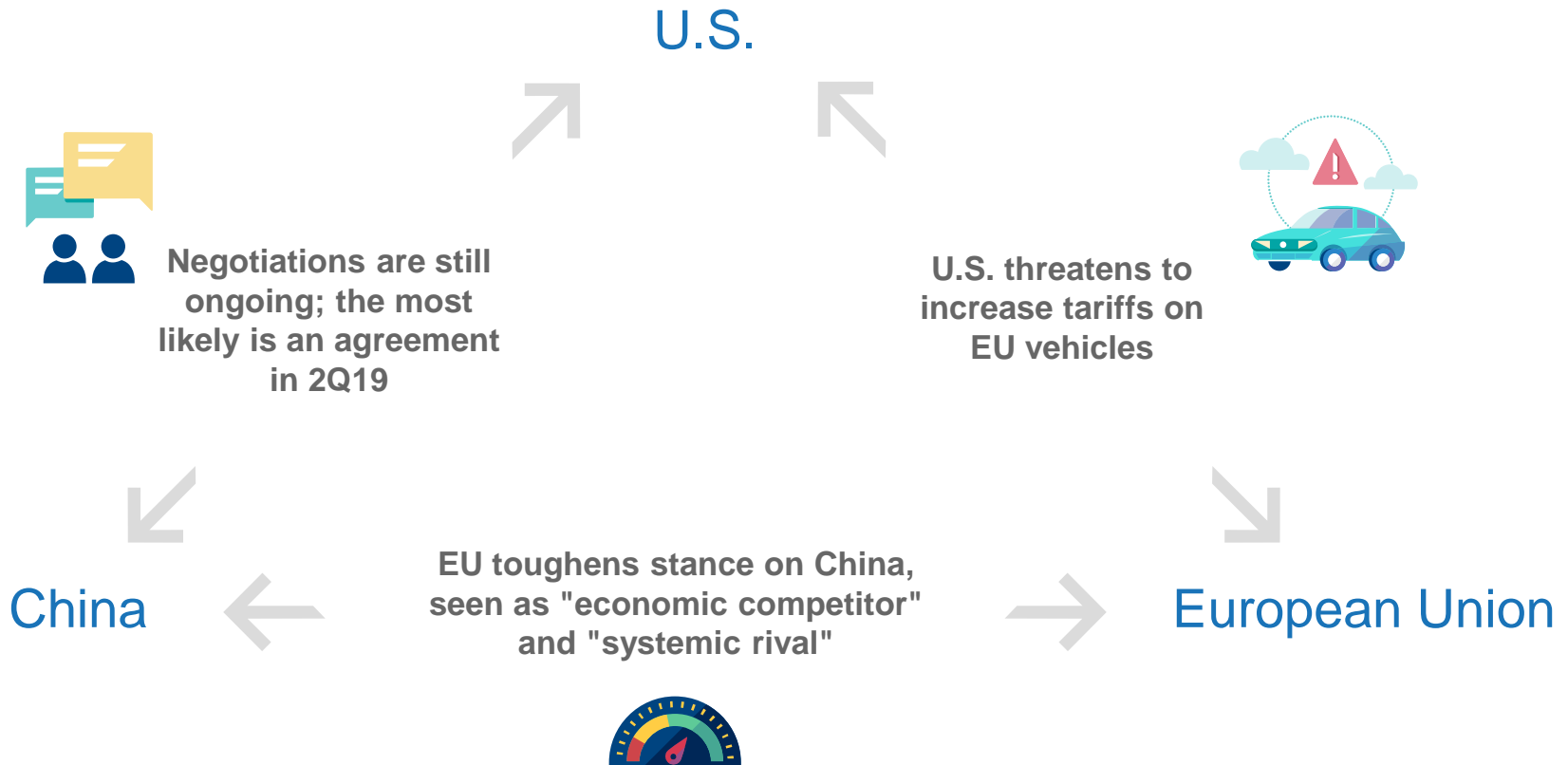
Source: BBVA Research based on Haver data

Equity indexes and Volatility (VIX)
(Base 100 in Jan-15 and %)



Source: BBVA Research based on Haver data

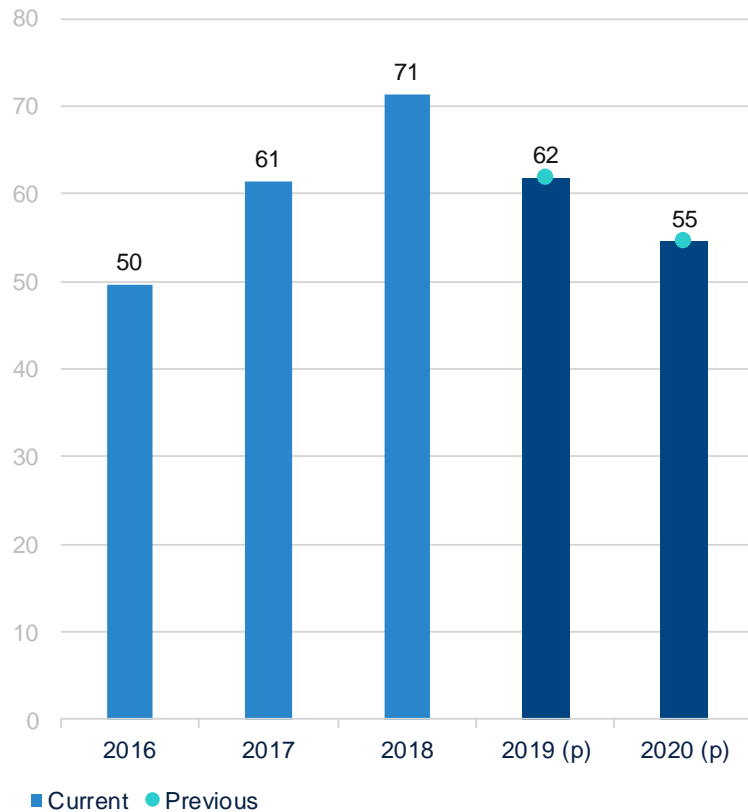
Protectionism: US-China trade agreement delayed, as the EU begins to gain prominence as focus of tensions



Oil markets: as expected, supply adjustments provided support to prices in 1Q19, which will likely move down from now onwards

Brent prices

(USD per barrel, end-of-period)



- Production cuts have driven oil prices up (65 dollars per barrel, on average, in 1Q19)
- We maintain prospects for lower prices in 2H19 and 2020, on slower economic growth and rising US supply
- The lower global demand will also favor a drop in copper prices, although we have revised our forecasts slightly up, mainly due to supply disruptions
- In the case of soybeans, we have revised our forecasts slightly upwards, but we continue to expect prices to recover moving forward

Action by central banks and an absence of "accidents" would enable global growth to soft-land

More signs of
global slowdown



New stimulus
policies



Assumption on the evolution of the global outlook: no "accidents"



01

Protectionism

An US-China trade agreement is still likely, despite the delay



02

Brexit:

Greater uncertainty, for a longer time



03

Financial

markets: volatility constrained by central banks' measures



04

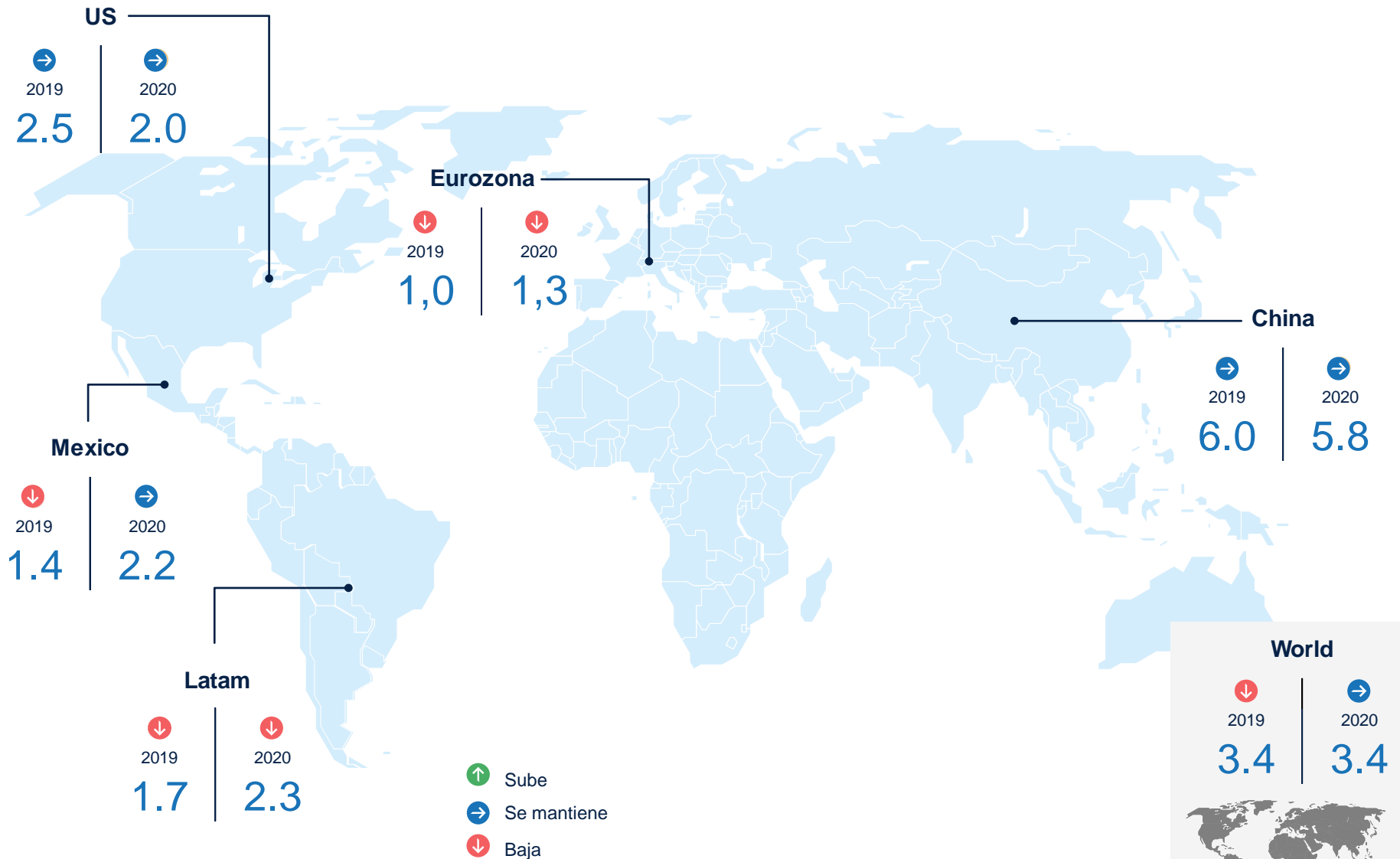
Oil:

Price moderation following the recent upturn



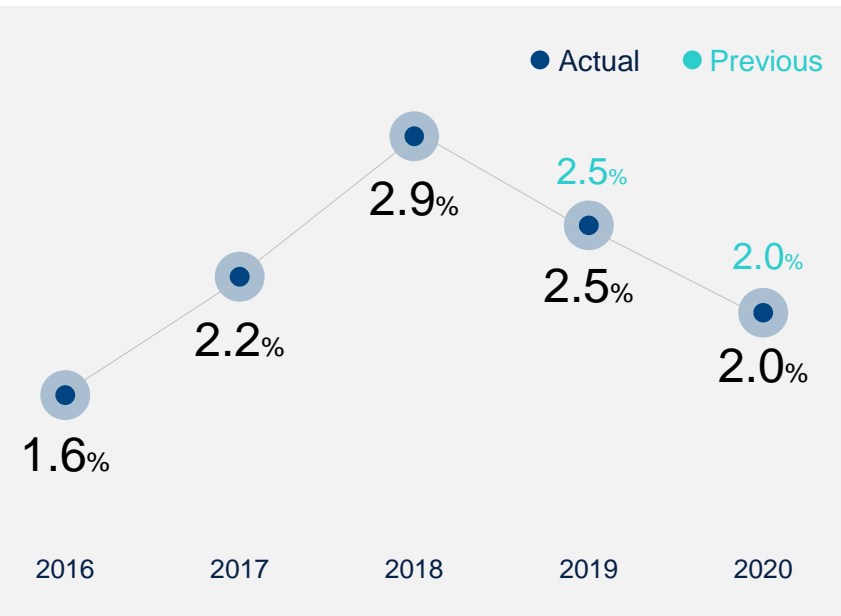
Global growth soft-lands

Without "accidents", global growth will decelerate gradually



US: a cyclical activity moderation and a more patient Fed

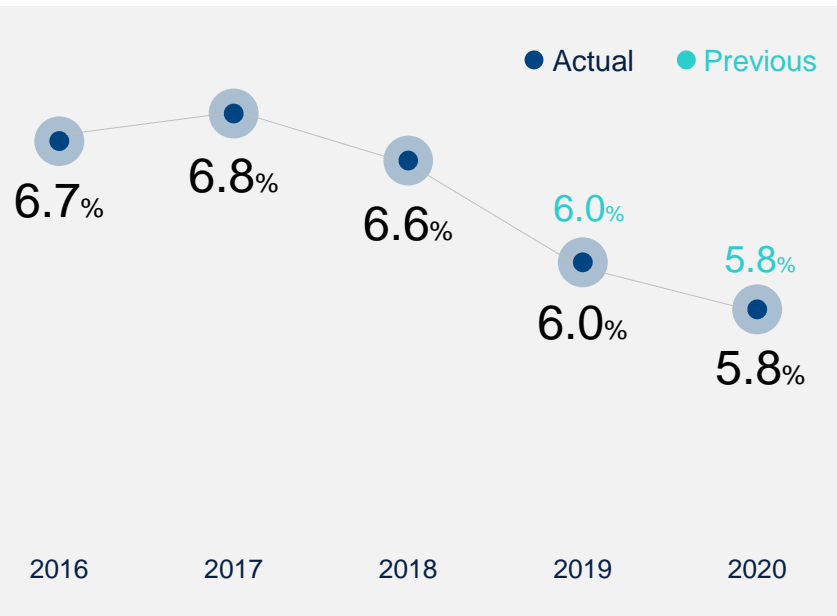
US: GDP growth (% y/y)



- Growth will continue to lose steam moving forward, converging to the potential rate
- Unchanged growth forecasts (with a downward bias), while the risk of recession remains high
- Inflation is expected to continue below the 2% mark during 2019

China: a trade deal with the US and more supportive policies to favor a soft-landing of the economy

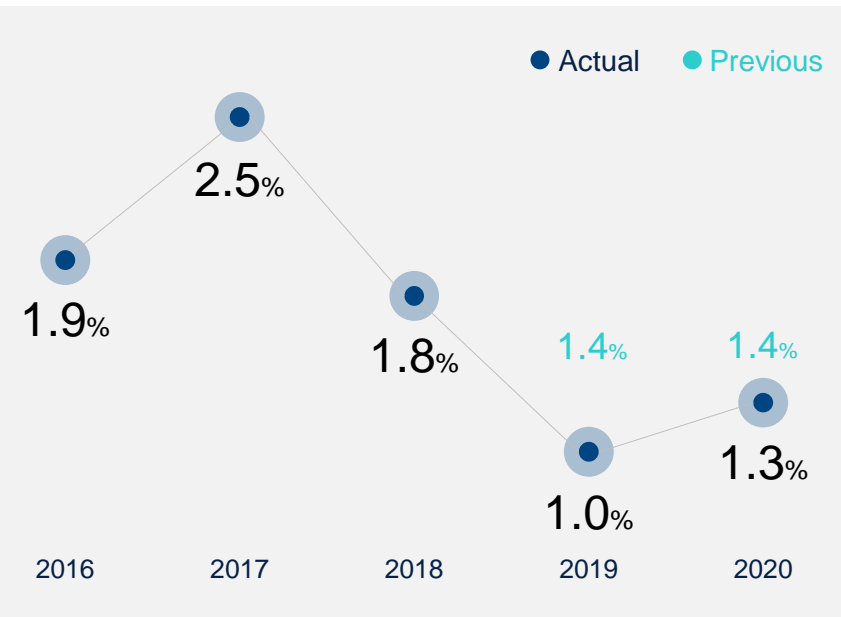
China: GDP growth (% y/y)



- The growth target was lowered to a range between 6.0% and 6.5%
- Growth deceleration is the **prime risk** throughout 2019
- **Monetary stimulus**: expected cuts in both RRR and lending rates
- **Fiscal stimulus**: tax cuts (mainly VAT) of 2% of GDP

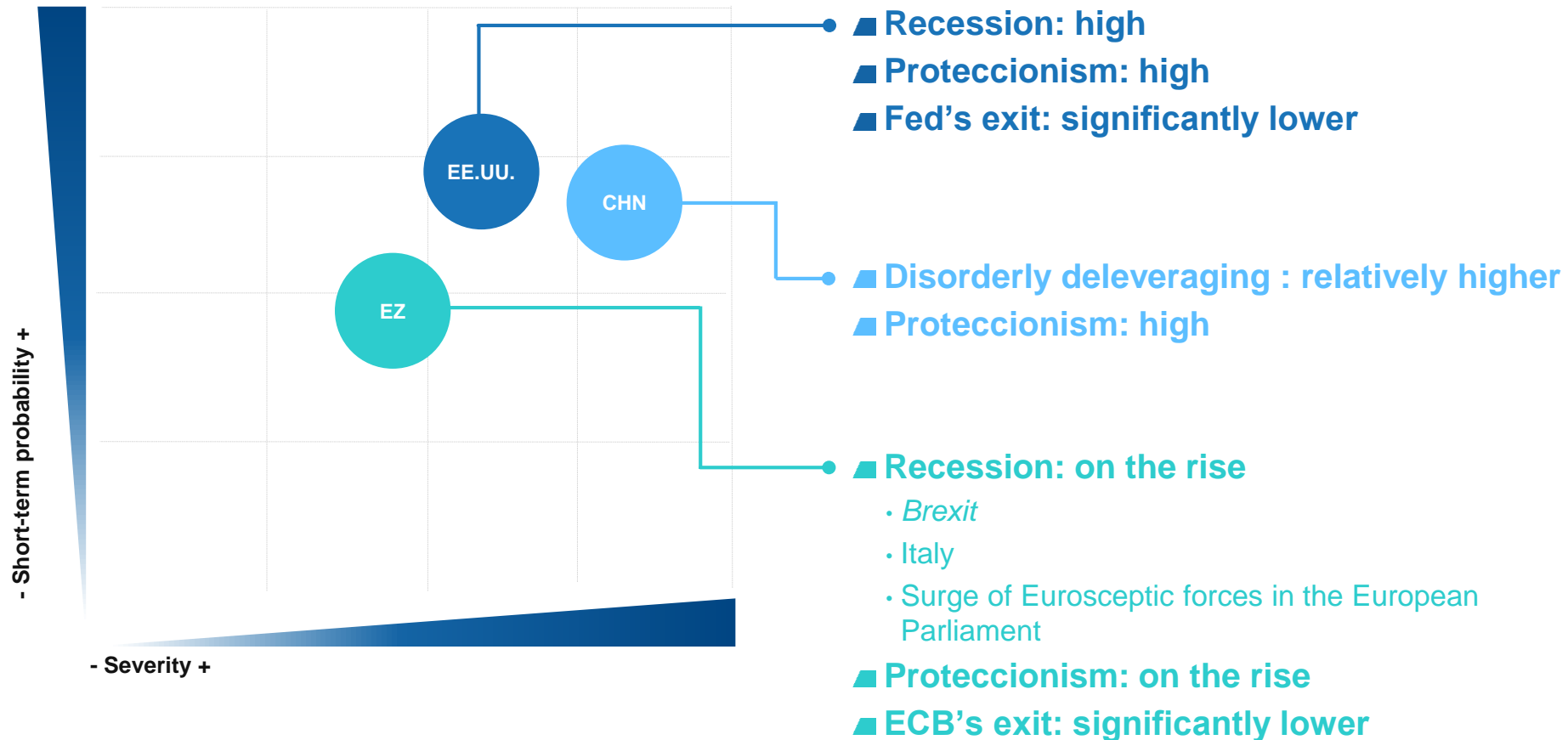
Eurozone: more prolonged activity weakness to cause lower growth in 2019, some recovery expected in 2020

Eurozona: GDP growth (% y/y)



- Downward revision of GDP growth forecasts
- Adjustment in activity expectations concentrated on exports and investment, given lower external demand and lingering uncertainties
- The euro is expected to appreciate from mid-2019 onwards, but at a more gradual pace than expected

Global risks: increasing fears about a recession in the US and in the Eurozone, in spite of central banks' broader support



Source: BBVA Research

Financial vulnerabilities can amplify the severity of the risks

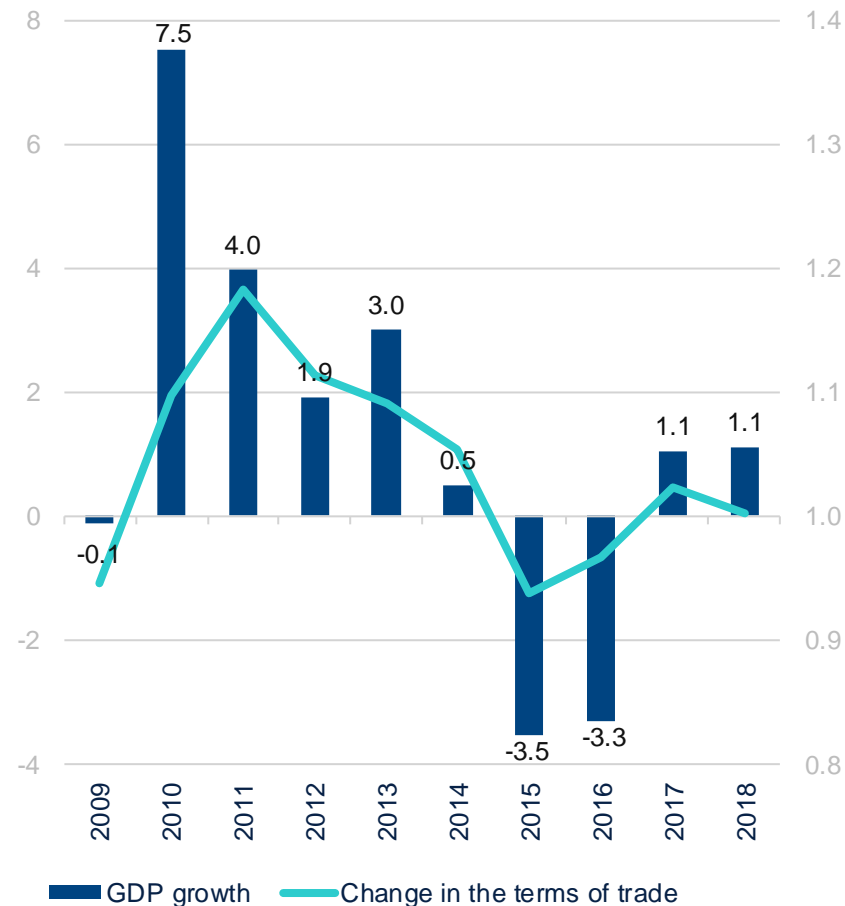


02

Brazil: the recovery loses steam

The Brazilian economy will grow by 1.1% in 2018, thus maintaining the low rate of expansion observed in 2017

GDP growth changes in terms of trade (%)

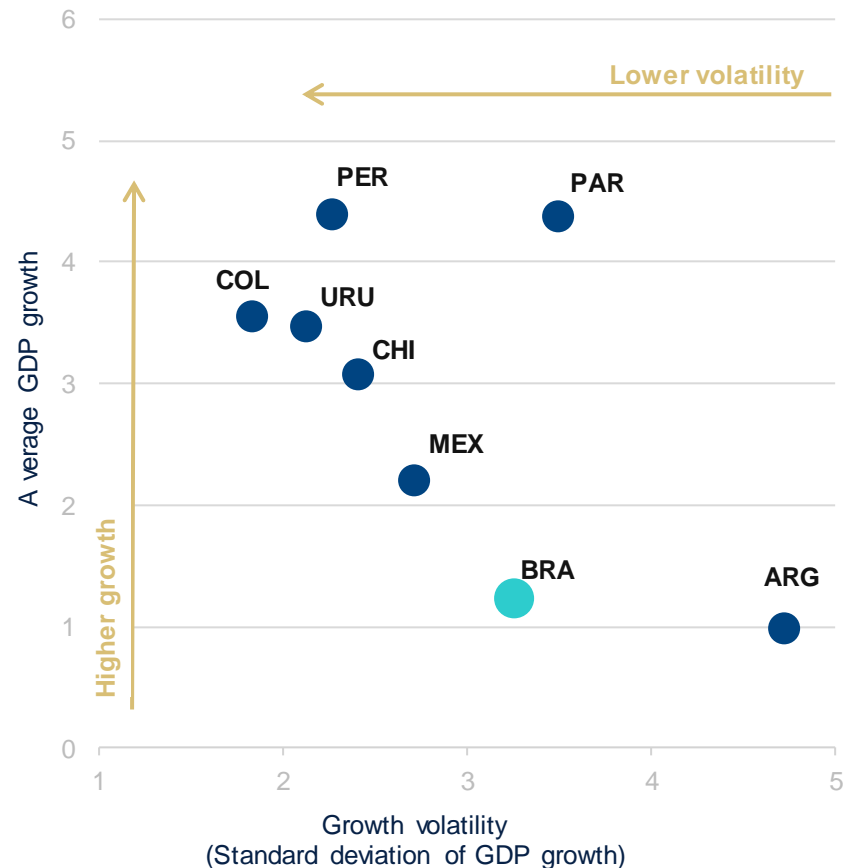


- Growth in 2018 was slightly below expectations (1.2%)
- GDP expansion was supported mainly by the **services sector** and the moderate recovery in **private consumption** and **investment**
- While the **expansive tone of monetary policy** and relatively robust **external demand** have contributed positively, **concerns about public accounts** and reduced **terms of trade** have hampered further expansion
- After having grown 1.1% in 2018, **GDP is 4.7% below its 2014 level**

In addition to being low, GDP growth in the last decade has been unstable

Average GDP growth and volatility over the last decade (2009-2018)

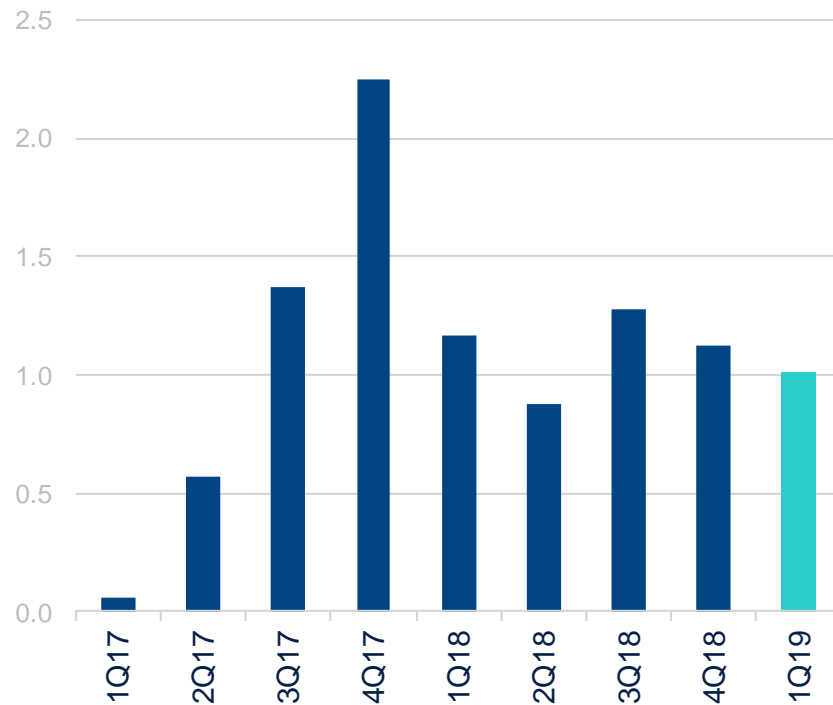
(%)



- Annual GDP growth averaged 1.2% in the last decade, among the lowest in Latin America
- Additionally, GDP growth in Brazil has also been more unstable, despite the greater diversity of its productive structure
- The volatility of the political environment and errors in the execution of economic policy, mainly in the fiscal area, have contributed fundamentally to this

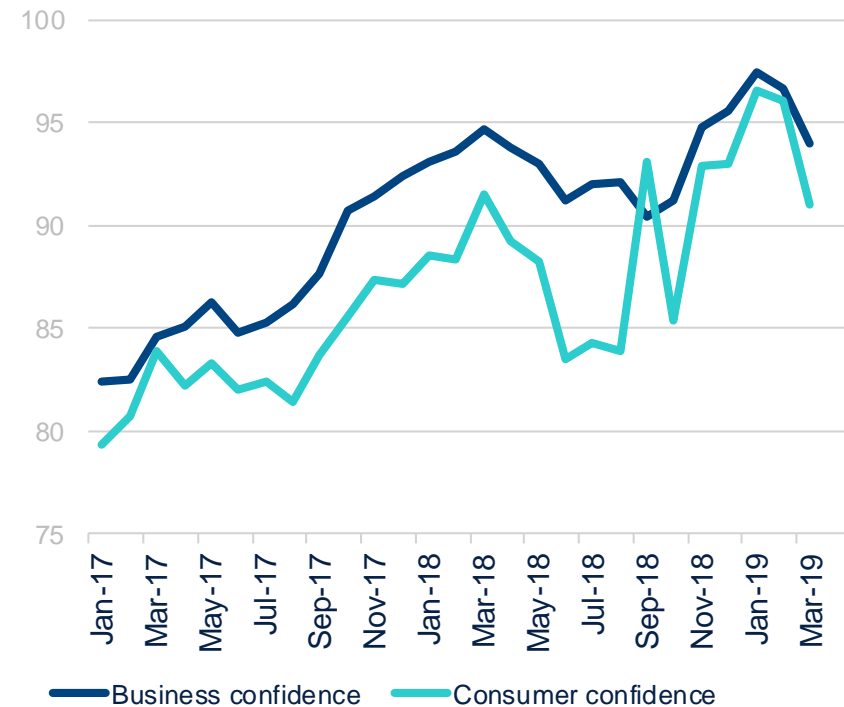
The process of economic recovery has lost momentum in recent months

GDP growth (*)
(% YoY)



* Value observed up to 4Q18. Forecast in the case of 1Q19.
Source: BBVA Research and BCB

Confidence indices
(%)

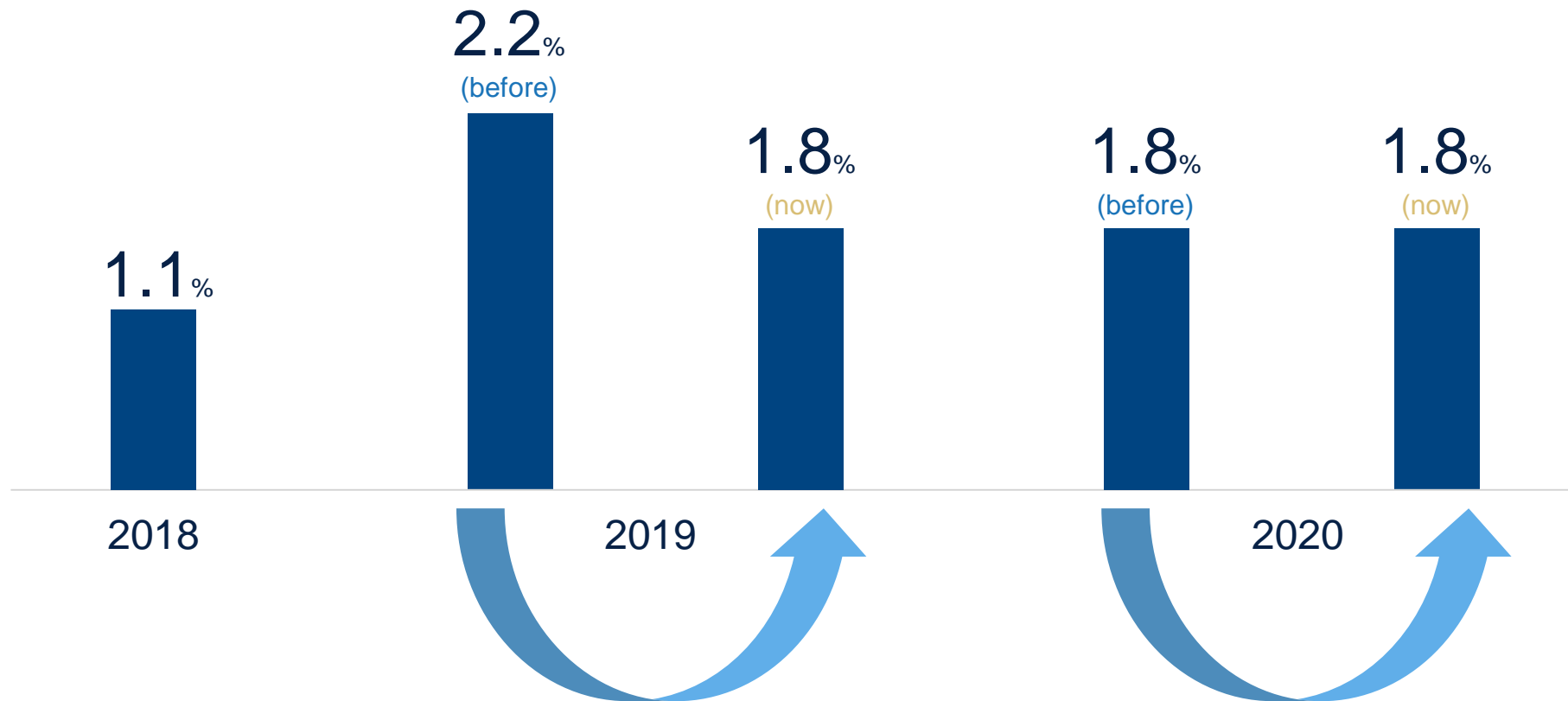


Source: BBVA Research and FGV

The loss of dynamism in the economy in recent months is in line with the slowdown in global growth

The improvement in confidence after Bolsonaro's election in Nov-18 has apparently been temporary

After a downward revision of the 2019 forecast, our expectation is for growth of 1.8% in 2019 and 2020

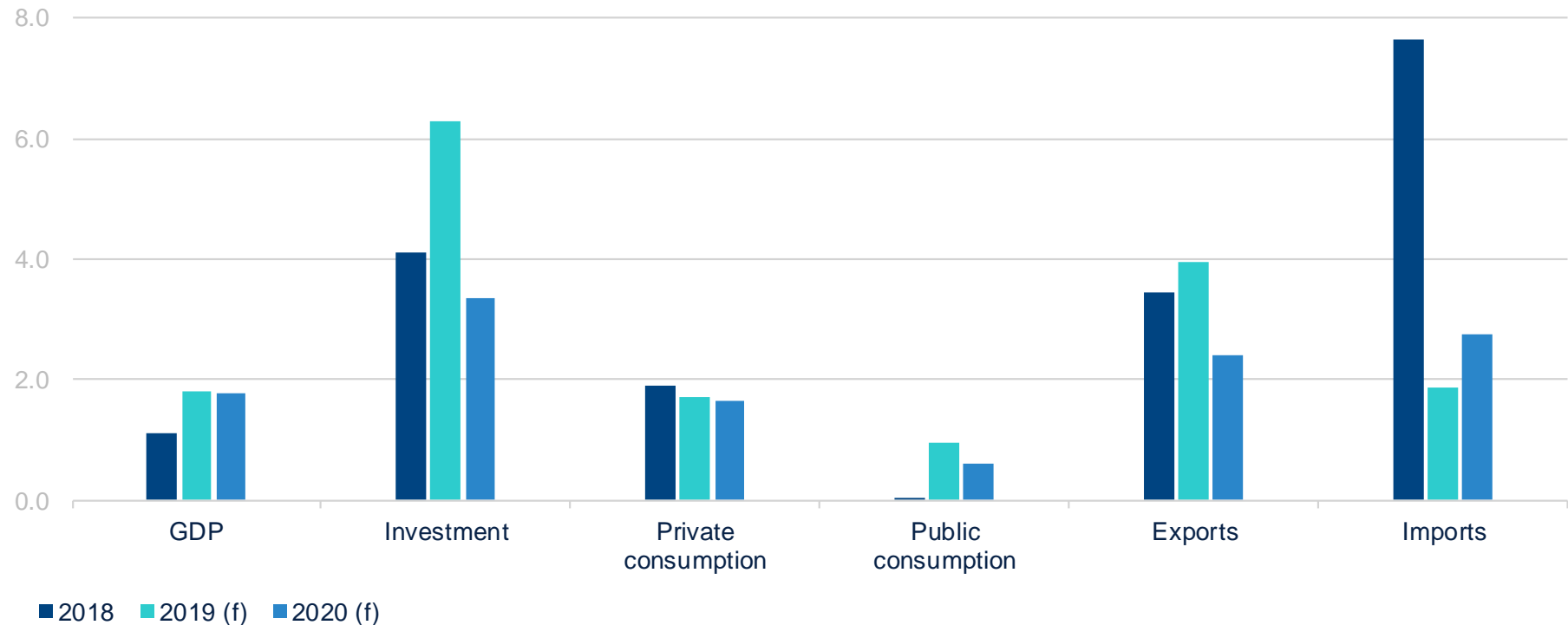


The global slowdown, which will generate a fall in Brazil's terms of trade, as well as limited progress in the adoption of reforms, particularly in social security, will limit the capacity for growth in the coming years

The expansive tone of monetary policy and some progress - although not too significant - in tackling fiscal problems will favor the recovery. In any case, by the end of 2020, GDP would still be below that of 2014

The greatest contribution to growth will come from investment and exports

Growth of GDP and its components(*) (%)



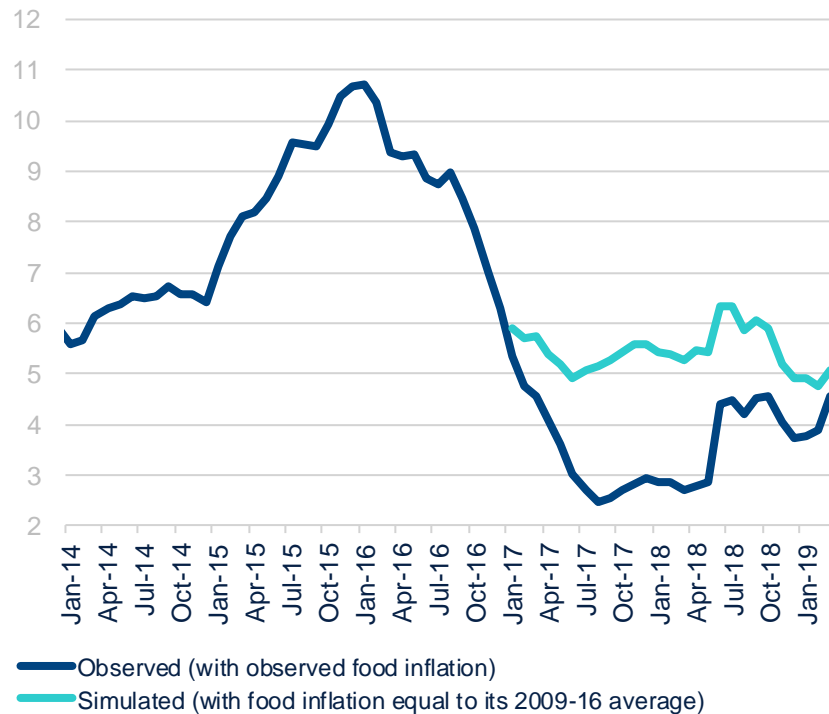
(*) (f) = Forecasts.
Source: BBVA Research

Investment is 27% below the pre-crisis level. Thus, there is scope for it to recover going forward, mainly if confidence increases and improvements in the labor market continue to support consumption

The slowdown in external demand and the expected fall of 2% in terms of trade in both 2019 and 2020 will hinder the dynamism of exports, which will nevertheless be favored by a more depreciated exchange rate

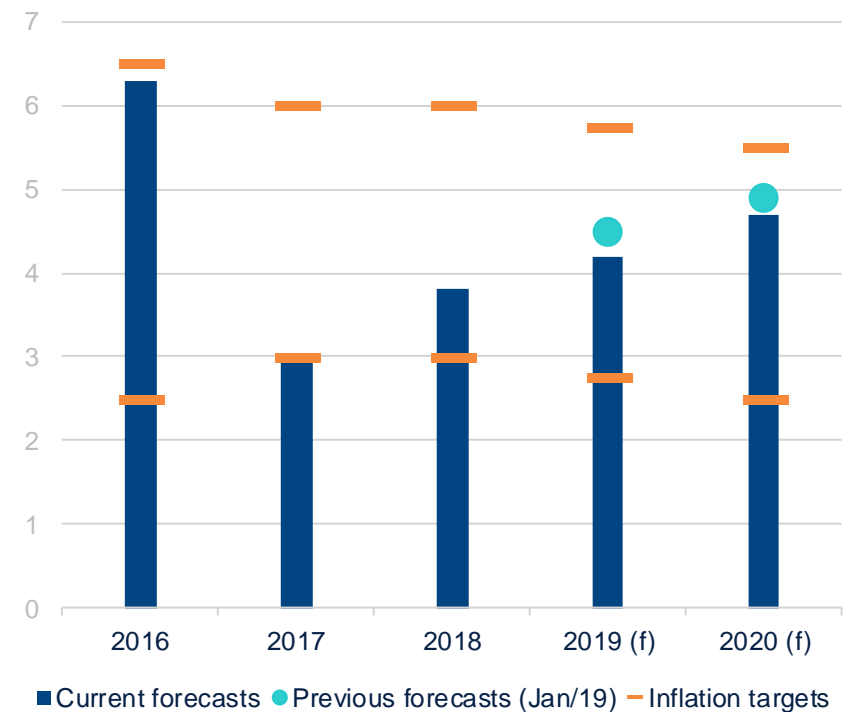
Inflation will remain relatively under control, but will be higher going forward than in the previous two years.

Inflation: IPCA (*)
(% YoY)



(*) For the inflation simulation as of January 2017, the food inflation observed has been replaced by the average food inflation in the 2009-16 period (8.75%). Source: BBVA Research and BCB.

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



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

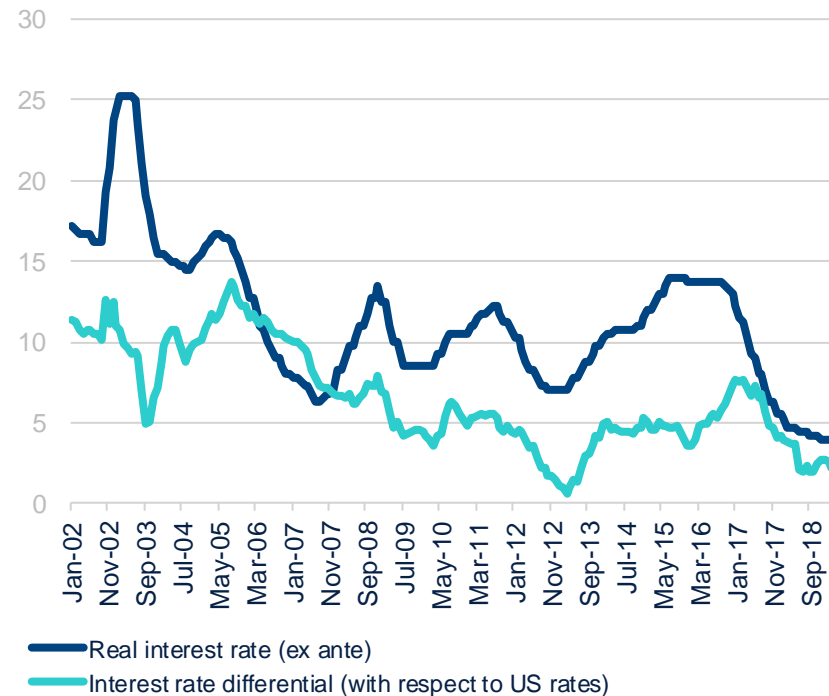
Inflation has tended to rise since mid-2018 despite weak demand, largely due to the normalization of food prices, which have started to increase again after an anomalous period of deflation

Despite the downward revision, we continue to expect inflation to rise, converging to the 2020 target range ceiling, backed by higher food prices, somewhat more robust domestic demand and the effects of the exchange rate depreciation

The beginning of the monetary tightening cycle will possibly be postponed to 2020 by the Central Bank

Real interest rate and spread with respect to the US benchmark interest rate

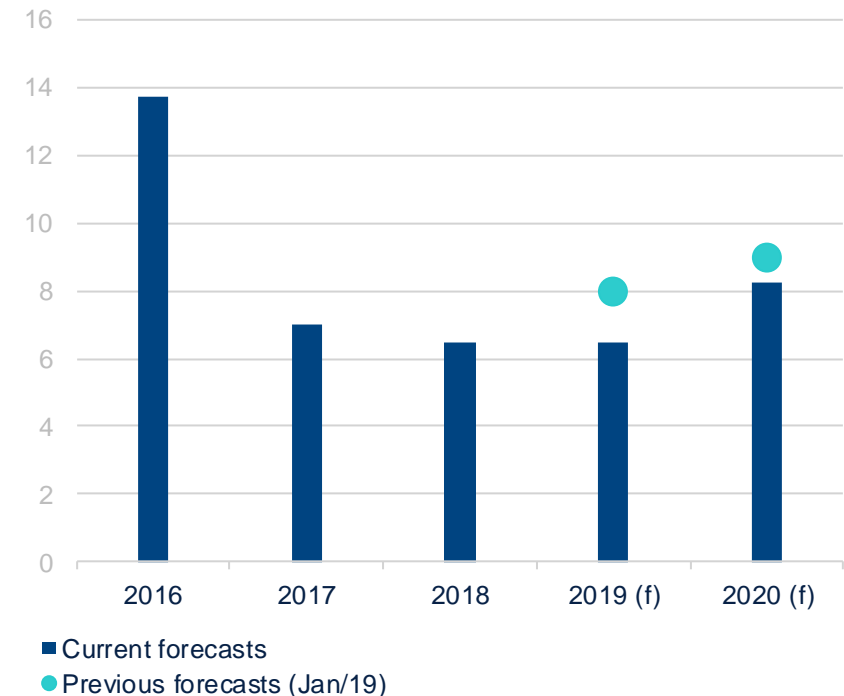
(p.p.)



Source: BBVA Research and BCB

SELIC interest rates (*)

(% YoY; end of period)



(*) (f) = Forecasts.

Source: BCB, BBVA Research

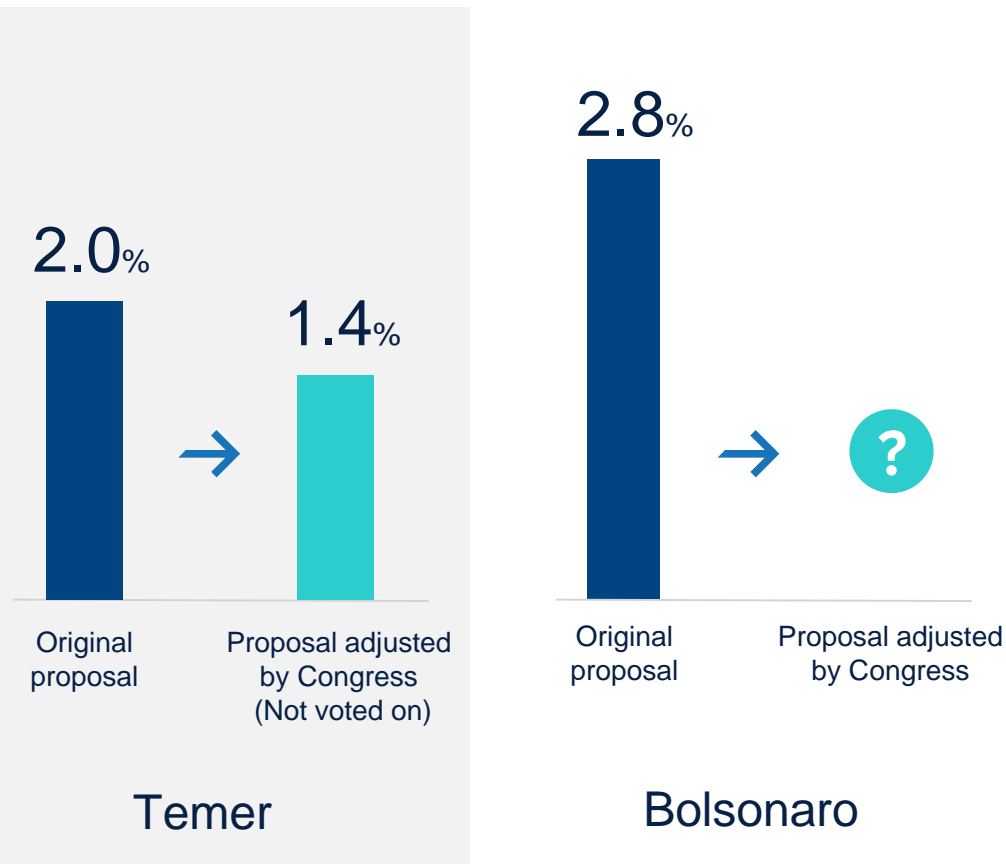
In the current context, in which US and Eurozone central banks have made a shift towards more expansionary policies, the Central Bank of Brazil has gained room to postpone the start of the tightening cycle

In any case, there is little room for interest rate cuts, given the upward trend in inflation and the actual historically low level of SELIC interest rates

The coming months will be decisive for social security reform; we are still expecting a less ambitious version to be adopted

Proposals for social security reform presented to the governments of Temer and Bolsonaro

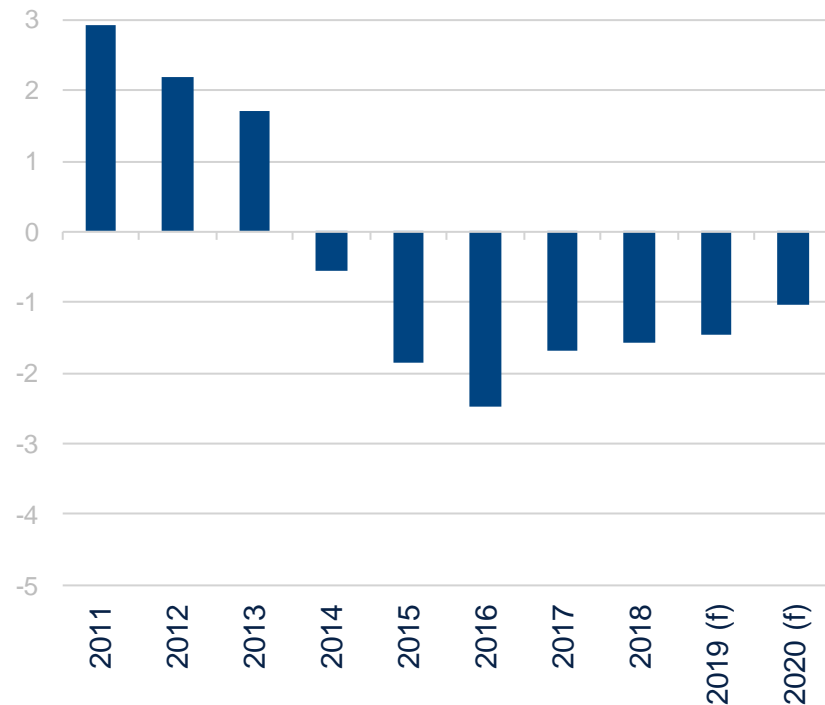
(Reduction of fiscal expenditure in ten years, as a % of GDP)



- The government has sent to Congress a proposal for a social security reform that would generate direct fiscal savings over the next ten years of BRL 1.1bn (~USD 290 billion), equivalent to a reduction in fiscal spending of 2.8% of GDP in ten years
- Congress will now analyse the proposal and will most likely modify it
- The reform proposed by the previous government, which in the end was not voted on, had its fiscal effect reduced by 30% after incorporating the adjustments made by Congress
- While a less ambitious version of the reform is most likely to be adopted, it is still unclear whether the government will have sufficient support in Congress to pass it

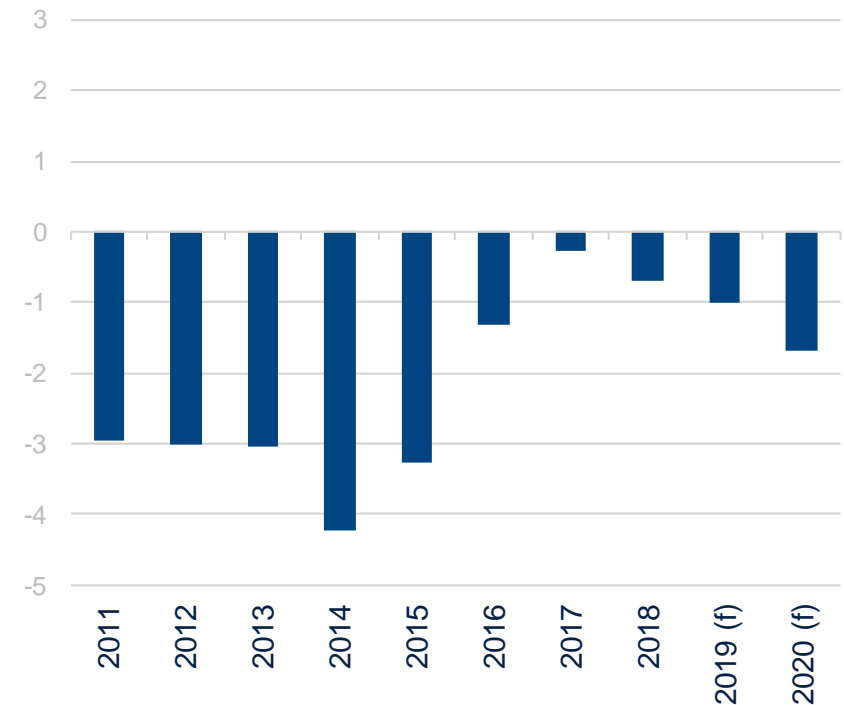
Fiscal deficits will be held back but remain worrisome and external deficits will increase but remain under control

Primary fiscal balance
(% of GDP)



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

Current account balance (*)
(% of GDP)



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

The control of public expenditure, in an environment of increasing revenue collection, will enable a very gradual reduction of the primary fiscal deficit in the coming years

The current account déficit will continue to increase, in line with the recovery of domestic demand and the expected fall in the terms of trade (2% in 2019 and another 2% in 2020)

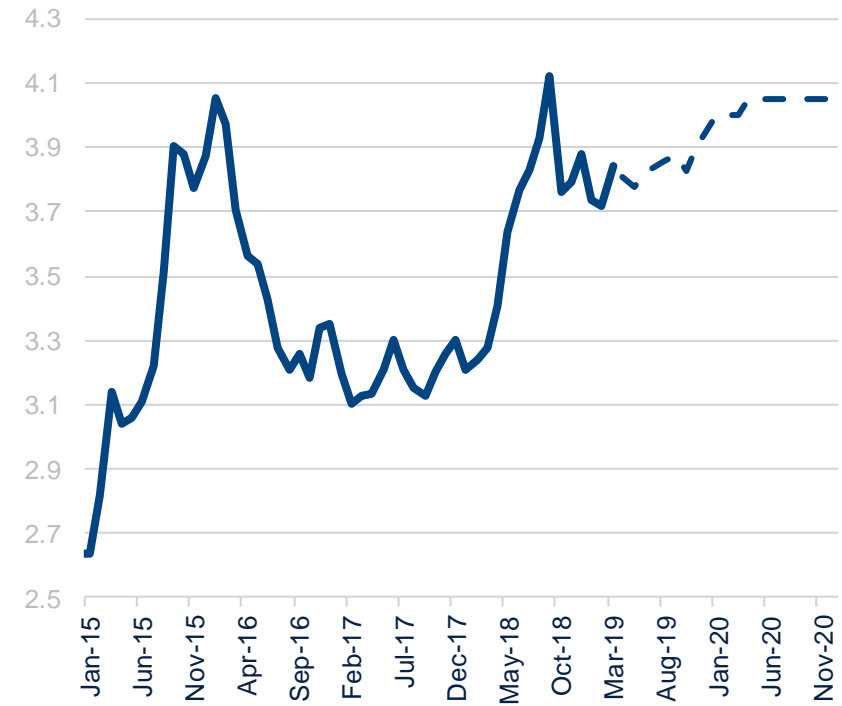
Lower tensions in global financial markets have supported the real which, however, could weaken going forward

BBVA Index of Financial Tensions in Brazil
(% YoY)



Source: BBVA Research and BCB

Nominal exchange rate (*)
(Brazilian Real / US Dollars)



(*) Forecasts as of April 2019.
Source: BBVA Research

The shift towards more accommodative policies by the main central banks has reduced financial tensions in both global and local markets. Thus, the exchange rate has neared US\$3.8 and could remain close to this level for some time

But the slow progress of both the economy and reforms, as well as the deterioration in the terms of trade, support the forecast of depreciation up to 3.95 at the end of 2019 and 4.05 at the end of 2020



03

Brazil: forecast table

Forecasts for Brazil

	2017	2018	2019 (f)	2020 (f)
GDP (%)	1.1	1.1	1.8	1.8
Private consumption (%)	1.3	1.9	1.7	1.6
Public consumption (%)	-0.9	0.0	0.9	0.6
Investment in fixed capital (%)	-2.6	4.1	6.3	3.3
Exports (%)	5.7	3.4	4.0	2.4
Imports (%)	5.5	7.6	1.9	2.8
Unemployment rate (average)	12.7	12.3	11.8	10.0
Inflation (end of period, YoY %)	2.9	3.8	4.2	4.7
SELIC rate (end of period, YoY %)	7.00	6.50	6.50	8.25
Exchange rate (end of period)	3.30	3.88	3.95	4.05
Current account (% of GDP)	-0.3	-0.7	-1.0	-1.7
Public sector primary fiscal balance (% of GDP)	-1.7	-1.6	-1.5	-1.0

(f) Forecast.

Source: BBVA Research