BBVA Research

Brazil Economic Outlook

3Q19

July 2019

Creando Oportunidades

Key messages

Persistent trade tensions and the slowdown in world growth will negatively impact the Brazilian economy. However, a new round of policy stimulus, in particular by the Fed and the ECB, may create some room for maneuver to the country.

The increased pessimism on GDP growth does not extend beyond 2019. The recent signs reinforce the prospects for approval of the social security reform in the second half of the year, which is expected to create the conditions for a gradual recovery of confidence and then of the economy. Thus, the **2020 growth forecast of 1.8% is maintained unchanged**, and has now an upward bias.

The forecast for GDP growth in 2019 is revised downwards from 1.8% to 0.9. The growing pessimism on short-term activity is mainly explained by the significant downside surprise in growth figures in the first half of the year, which is related both to a more negative global environment and a strong deterioration in confidence.

The U-turn by the Fed as well as the good news regarding the approval of the social security reforms and the associated reduction of fiscal risk, in a context where inflation remains under control, will allow the announcement of new expansive measures. In particular, **the central bank will likely take interest rates from 6.5% to 5.5%**, from September (or even before) till the beginning of 2020.

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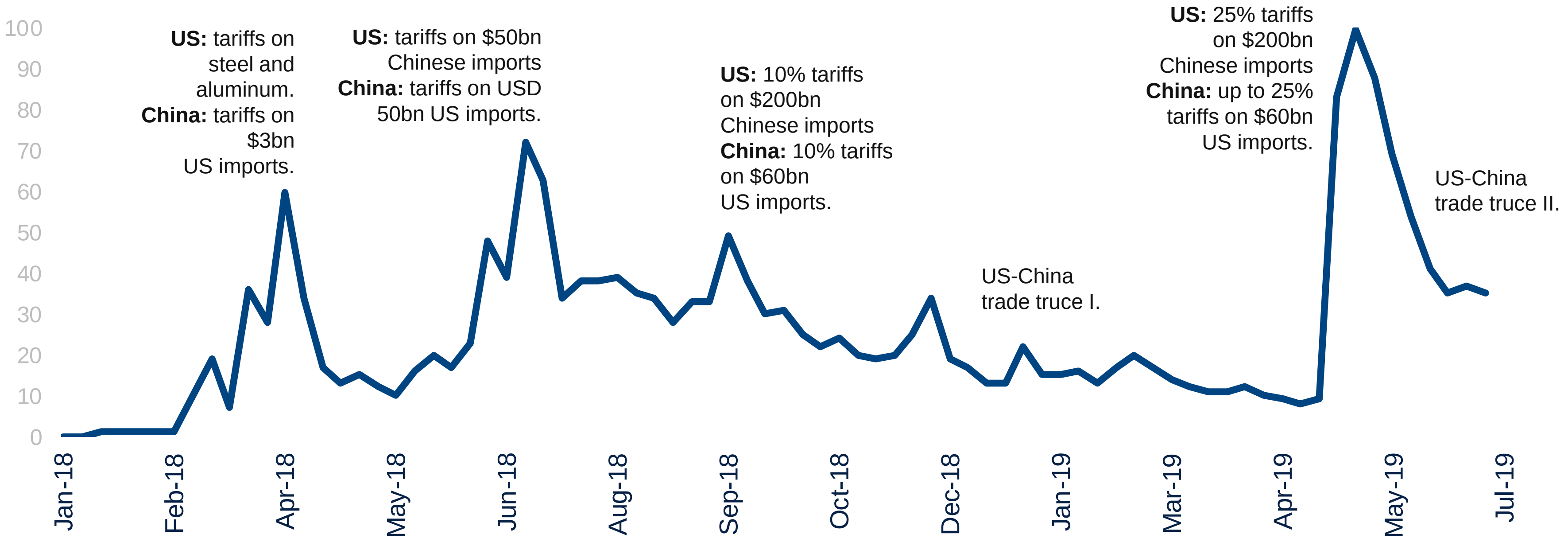
Índex

01

Global environment: growth will soft-land, amidst stimulus measures and trade tensions

The protectionism escalation continues to be a source of global uncertainty, even after the most recent US-China trade truce

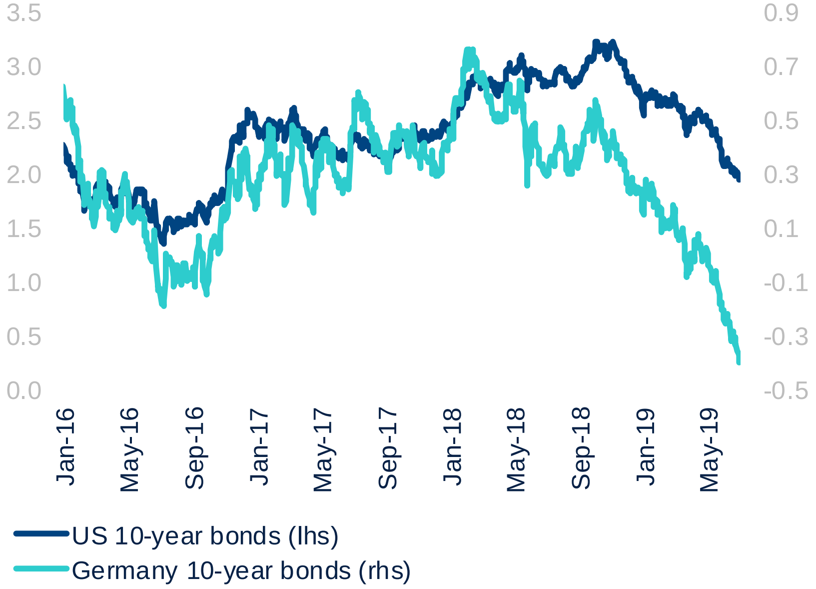
TRADE WAR INDEX: WORLDWIDE GOOGLE SEARCHES ABOUT THE TOPIC "TRADE WAR" (INDEX: 0 TO 100)



Source: BBVA Research, Google Trends

In financial markets, a flight to safety

SOVEREIGN DEBT YIELDS
(%)



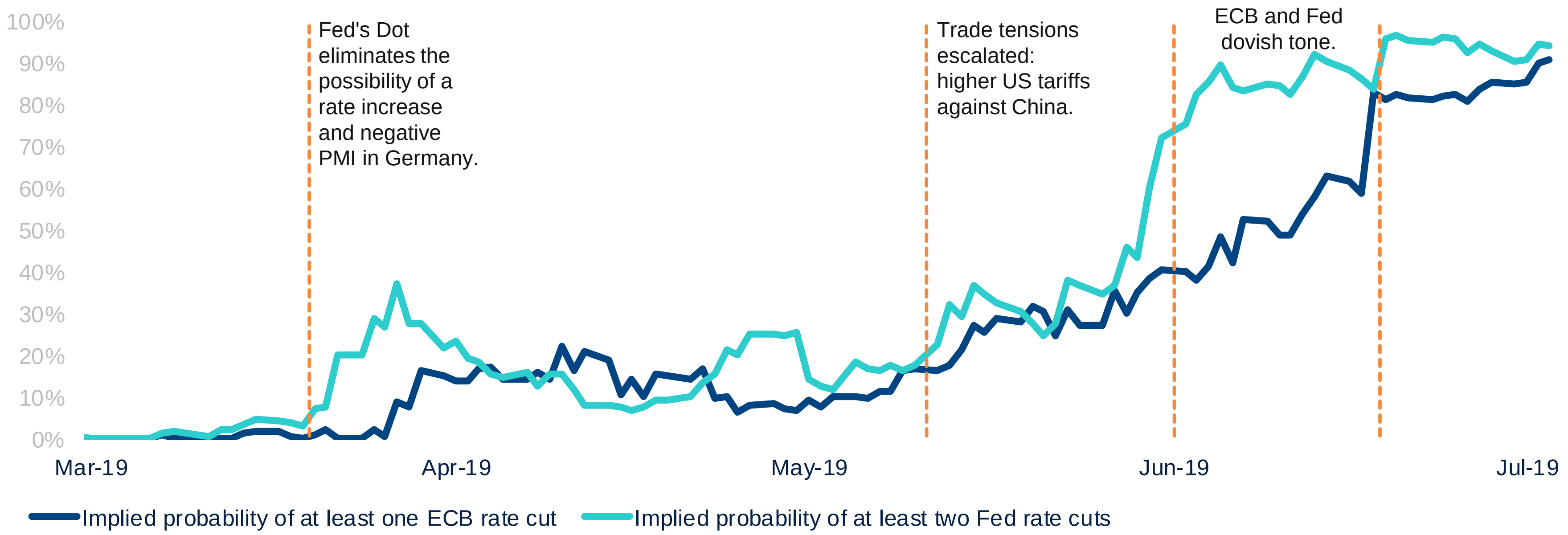
Source: BBVA Research and Bloomberg

- Growth risks and trade tensions led bond yields to very low levels.
- U-turn by the Fed and the ECB triggered search for yield and gains in periphery markets...
- ...but no signs of risk-on mood.

With persistent uncertainty and low inflation, central banks have reassessed their monetary stance and consider new measures

PROBABILITY OF RATE CUTS BY THE FED AND THE ECB, ACCORDING FINANCIAL MARKETS

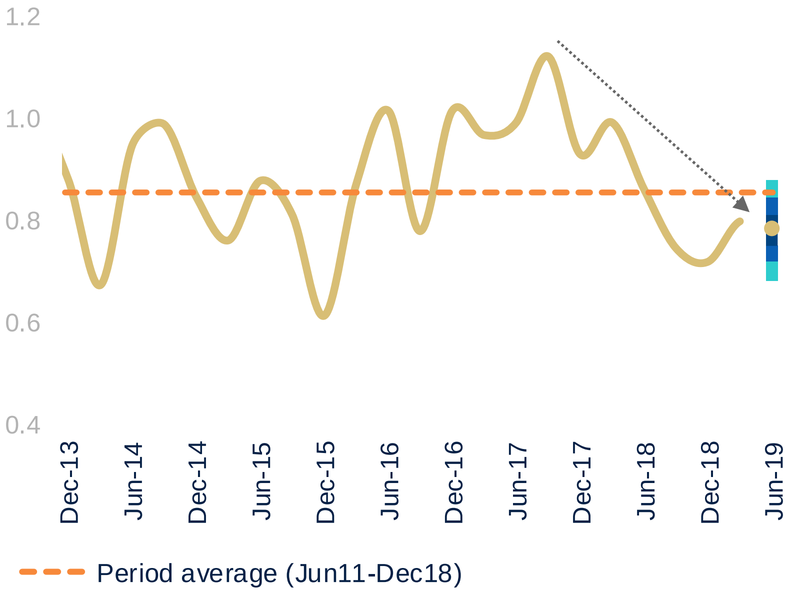
(%)



Source: BBVA Research and Bloomberg

Global growth continues on a soft downward path, despite a rebound in the first quarter

WORLD GDP GROWTH
(FORECASTS BASED ON BBVA-GAIN % QOQ)



Source: BBVA Research

- Growth has been particularly low since the middle of 2018.
- Weak performance of exports and manufacturing
- 1Q19 growth was higher than expected, while prospects for 2Q19 are broadly unchanged.

Looking ahead, policy stimulus is expected to offset the effect of protracted trade tensions

High trade tensions

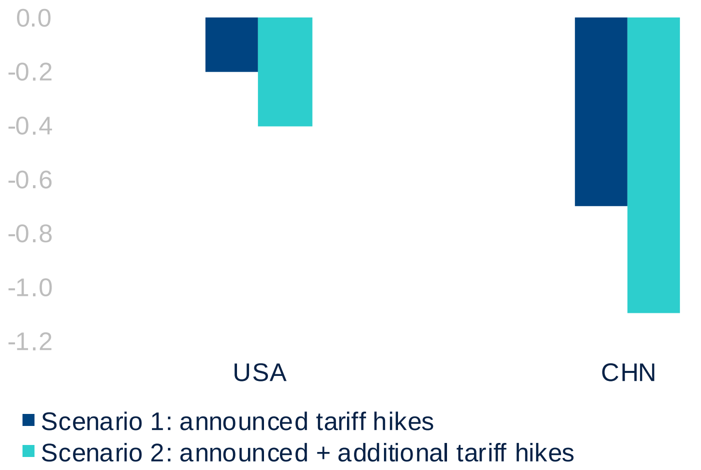
- Irreversible damage has already been done.
- Strategic rivalry is here to stay.
- Lingering uncertainty to weigh on business decisions.

Further stimulus

- FED and ECB: rate cuts in the short-term.
- China: further stimulus expected.
- Financial tensions will likely remain under control.
- Capital flows into EM are expected to slow down.

Trade tensions will have a negative effect on global growth

IMPACT ON GDP LEVEL OF TWO TRADE WAR SCENARIOS ON THE US AND CHINA
(TWO YEARS, PP)



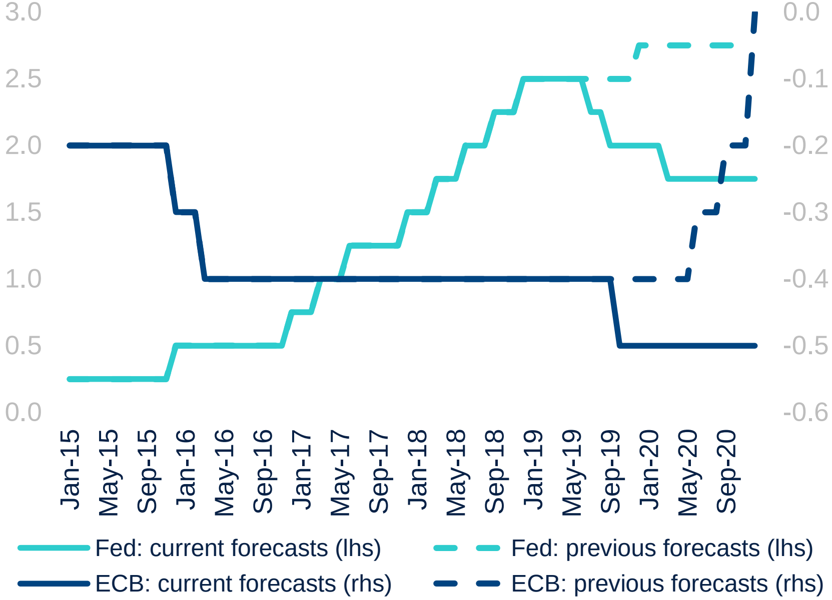
Scenario 1: Approved: 25% tariff increase on steel, 10% on aluminum, 25% on Chinese USD250bn imports. China's retaliation: 25% on USD110bn on US imports.
Scenario 2: All Chinese imports: Previous simulation +25% on all Chinese imports (more than USD500bn). China's retaliation: 25% on USD130bn on US imports.
Source: BBVA Research

IMPACT ON GDP LEVEL OF TWO TRADE WAR SCENARIOS ON SELECTED COUNTRIES
(TWO YEARS, PP)

Scenario 1: Approved: 25% tariff increase on steel, 10% on aluminum, 25% on Chinese USD250bn imports. China's retaliation: 25% on USD110bn on US imports.
Scenario 2: All Chinese imports: Previous simulation +25% on all Chinese imports (more than USD500bn). China's retaliation: 25% on USD130bn on US imports.
Source: BBVA Research

The policy reaction to a more negative global environment will continue to be led by central banks

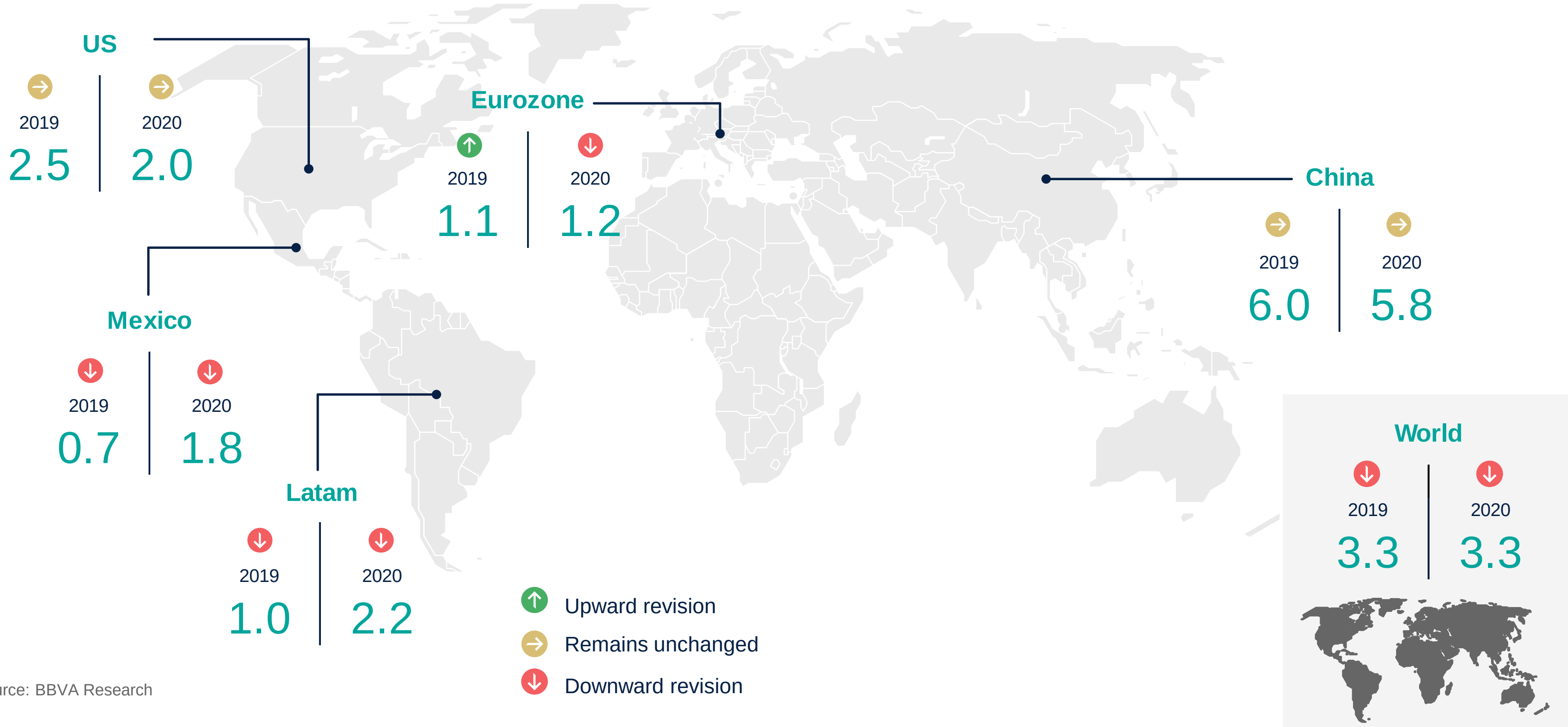
FED AND ECB: INTEREST RATES (*)
(%, END OF PERIOD)



(*) In the case of the ECB, deposits interest rates.
Source: BBVA Research

- Growth risks and low inflation set the stage for lower rates for longer.
- Fed: up to 75bps rate cuts.
- ECB is now expected to:
  - cut depo rates by 10bps in 3Q19.
  - adopt a tiered deposit system.
  - strengthen forward guidance.
- In China, fiscal policy will also play a role in the effort to sustain growth.

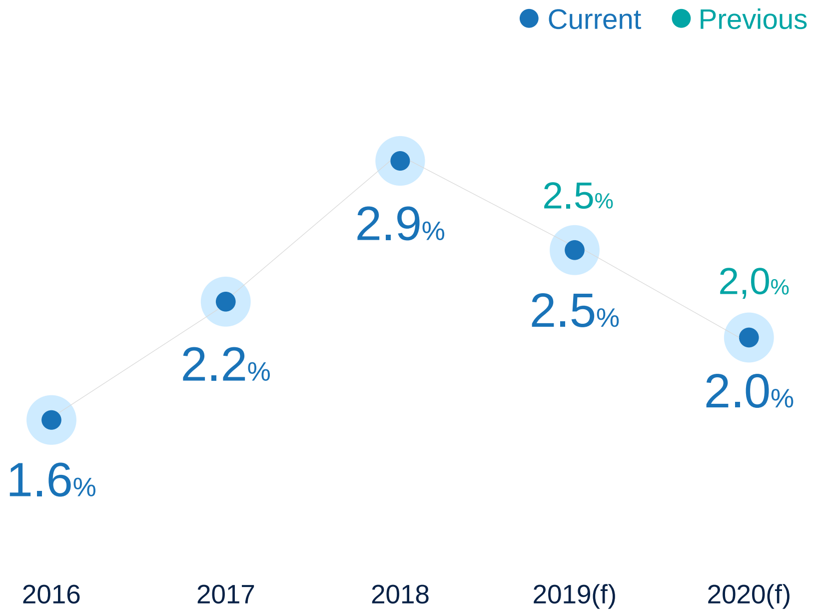
Global growth will stabilize at relatively lower levels



Source: BBVA Research

US: growth to slow down, with a larger than previously expected support by the Fed

GDP GROWTH
(%)

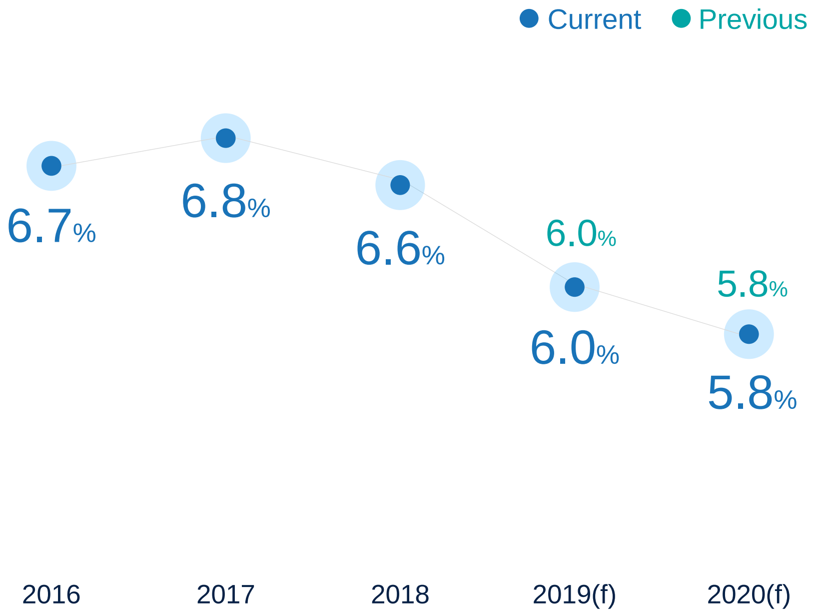


(f) Forecast.
Source: BBVA Research

- GDP growth will trend closer to potential moving forward.
- Core inflation is expected to remain below Fed's 2% target.
- Probability of recession remains high, tilting risks to the downside.

China: further policy measures to counterweight headwinds from trade tensions

GDP GROWTH
(%)

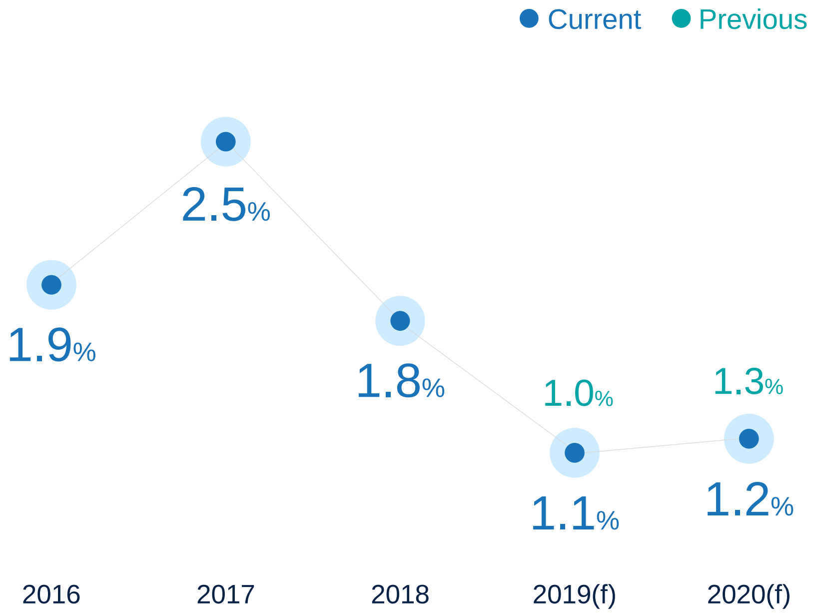


(f) Forecast.
Source: BBVA Research

- More stimulative measures:
  - debt issuance by local governments.
  - targeted monetary stimulus.
  - increase in public deficit.
- Better outlook for consumption, than for exports and investment.
- Risks: trade war, growth hard-landing and disorderly deleveraging.

Eurozone: softer growth from 2H19 on due to the persistence of both industry weakness and uncertainty

GDP GROWTH
(%)

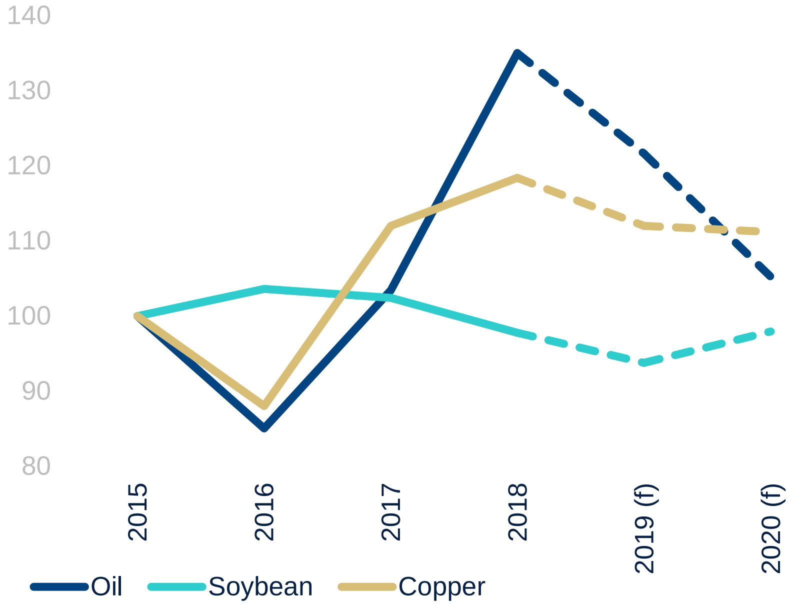


(f) Forecast.
Source: BBVA Research

- Uncertainty remains high due to trade issues and Brexit.
- Monetary policy to support mainly domestic demand.
- Slightly expansive fiscal policy.
- A gradual increase of core inflation is still expected.

A more negative global environment weighs on commodity prices

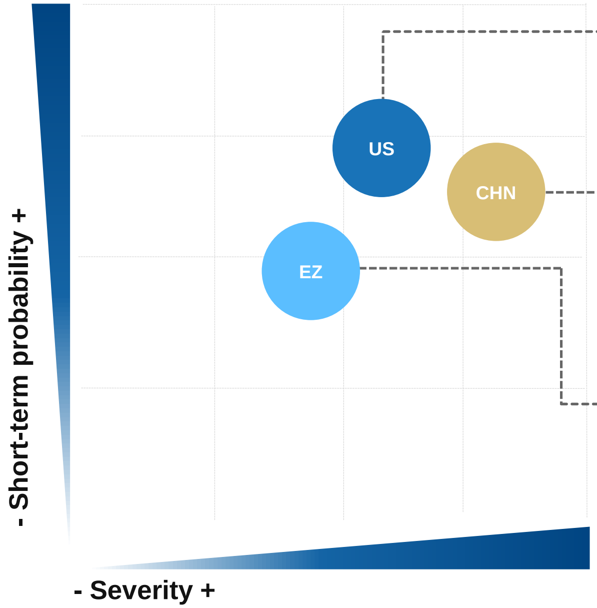
COMMODITIES: ANNUAL AVERAGE PRICES
(INDEX: 2015 AVERAGE = 100)



(f) Forecast.
Source: BBVA Research

- Uncertainty and weaker global growth will affect prices negatively.
- Rising US shale production will help to keep oil prices limited, despite output cuts and supply disruptions.
- Soybean forecasts revised down on weakening demand and high inventories.
- Room for higher copper prices in 2020; demand for electric cars to be supportive in medium/long run.

Global risks: moving upwards on the back of a full-scale trade war, especially given its potential impact on China



Source: BBVA Research

- Recession: very high
- Protectionism: higher

- Protectionism: higher
- Disorderly deleveraging : relatively higher

- Growth concerns: relatively high
  - *Brexit*
  - *Italy*
- Protectionism: still contained but increasing

Financial vulnerabilities can amplify the severity of the risks

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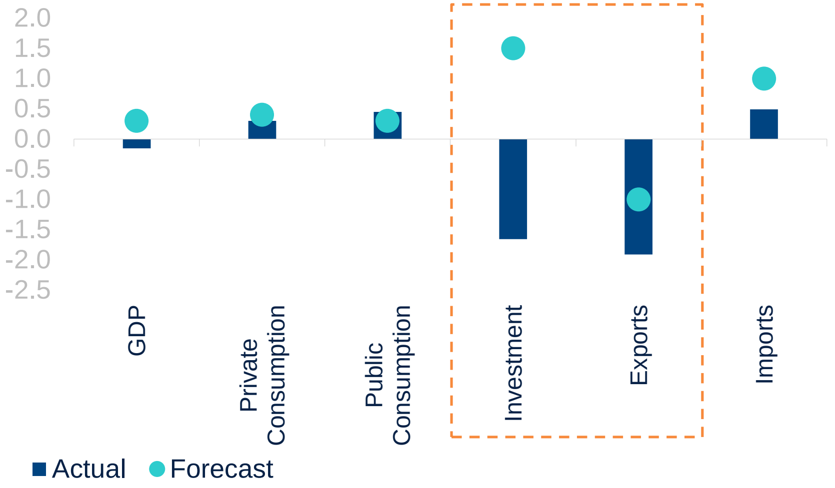
02

Brazil: recovery prospects remain in place, despite weaker growth at the beginning of 2019

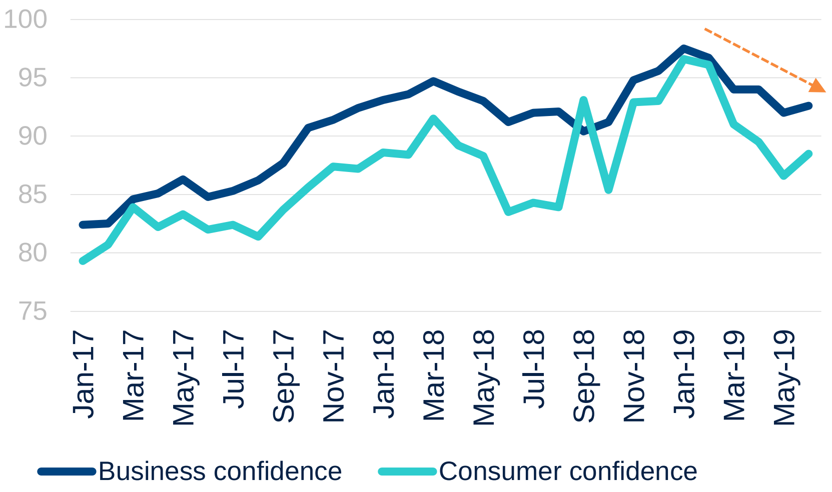
Growth has weakened at the beginning of 2019 thanks to the global environment and the deterioration in confidence

GDP GROWTH: 1Q19
(% Q/Q)



Source: BBVA Research, IBGE

CONFIDENCE INDEXES
(JUN-10 TO JUN-15 AVERAGE = 100)

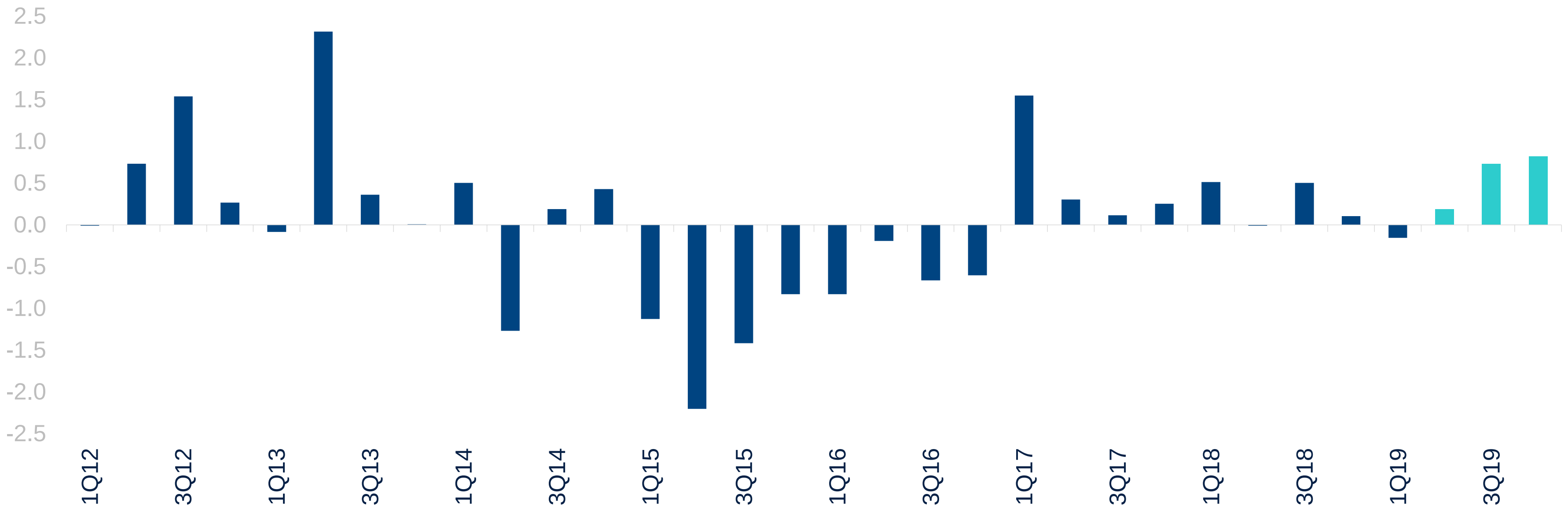


Source: BBVA Research, FGV

Among the external factors that helped to drive growth down in 1H19 is the lower demand from Argentina. And among the internal ones, the increase in inflation (until May), the contractionary fiscal policy and political noise. In this context, investment and exports have performed particularly badly.

Going forward, economic activity will likely strengthen

GDP GROWTH (*)
(Q/Q %)



(*) Forecasts from 2Q19 to 4T19
Source: BBVA Research

The key to the expected growth recovery: the approval of the social security reform

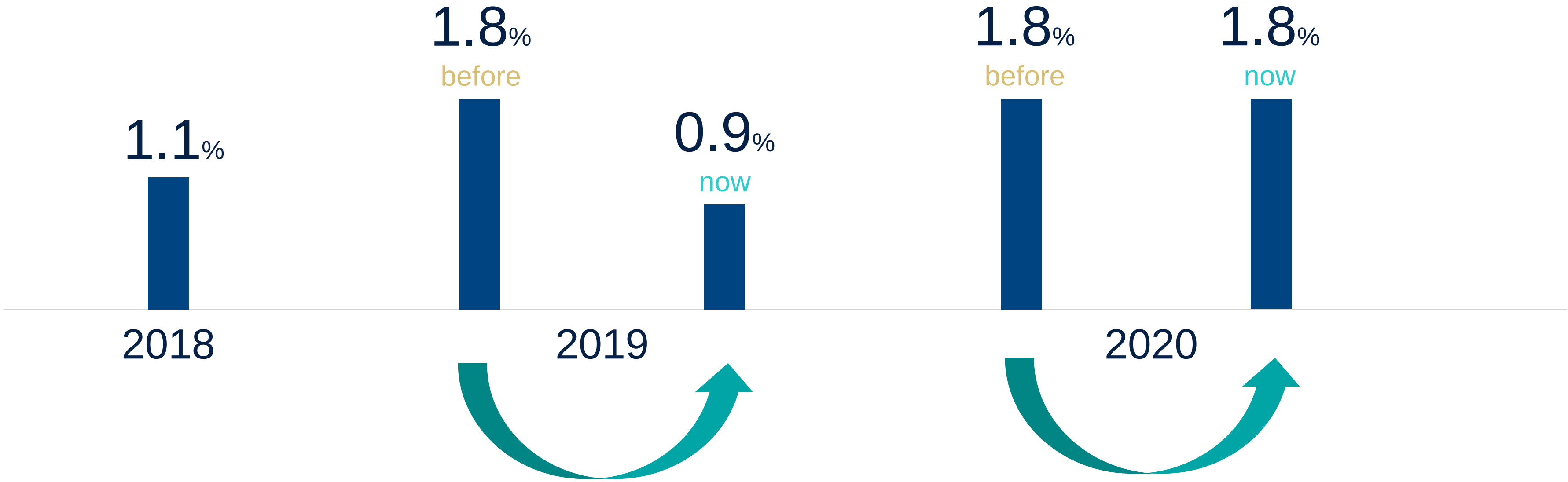
Recent progress reinforces the perception that the reform will be soon approved

- The lower house approved in a first-round vote, with some adjustments, the social security bill presented by the government to tackle increasing pension spending.
- Before moving to the upper house, where it will be analyzed and then voted, the reform needs to be approved in a second-round vote by the lower house.
- Recent advances show that approving the reform in 2H19 is within reach…
- … and suggest that total fiscal savings may be larger than we expect (around BRL 650bn in 10 years).

Approving the reform will pave the way for growing confidence and new stimulus measures

- The approval of the reform will significantly reduce, without eliminating, the fiscal risk.
- Thus, there will be more room for stimulus measures:
  - Monetary policy: cuts in interest rates and in reserve requirements.
  - Fiscal policy: use of parafiscal funds (FGTS), and maybe a less strict control of expenditure and public credit
- The reform will have a positive effect on the economy via the confidence channel.
- Once the reform is approved, the government will be able to use its political capital in other structural measures (trade opening, tax reform, privatizations, etc.).

2019 GDP forecast revised down on weak incoming data, but the approval of the social security reform will support the recovery in 2020

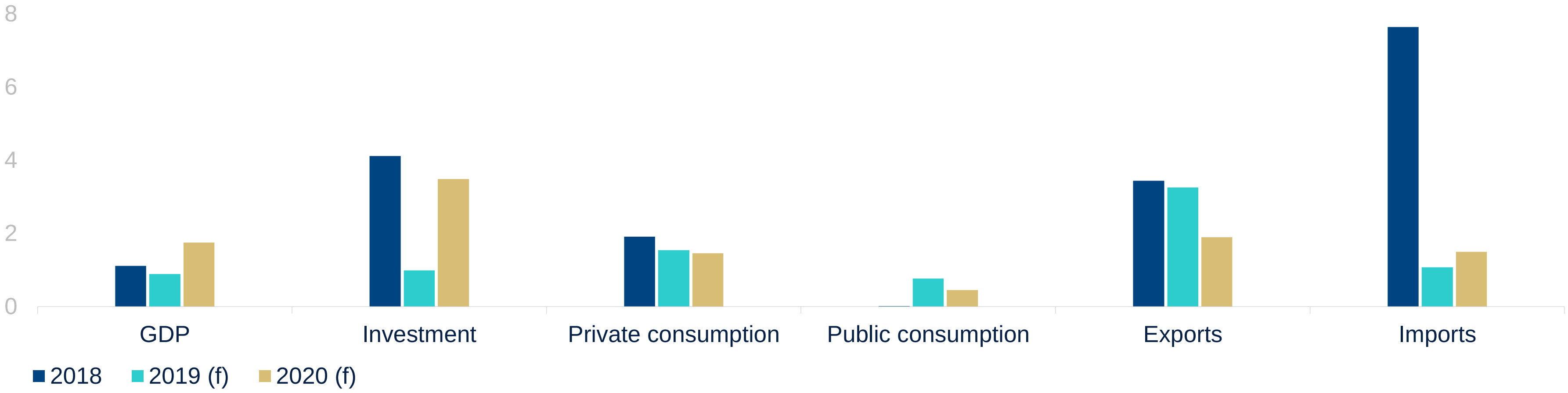


The forecast of 0.9% for 2019 growth has a downside bias as external and internal factors could further delay the recovery process. However, the forecast of 1.8% for 2020 growth now has an upward bias given the most positive news on the reform of social security.

The weakness of exports and investment is behind the downward revision of GDP in 2019; both elements are key to the recovery in 2020

GROWTH OF GDP AND ITS COMPONENTS (*)

(%)

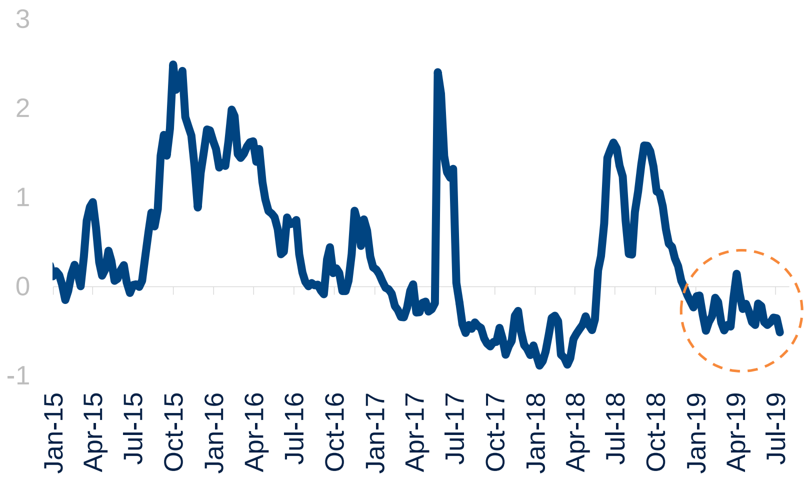


(*) (f) Forecasts.
Source: BBVA Research, IBGE

Progress towards approval of the social security reform, an improvement in confidence and new measures of stimulus, mainly by the central bank, will contribute to a moderate rebound of GDP growth moving forward.
In 2020, growth will also benefit from a positive statistical effect (1.2 pp) due to low growth at the beginning of 2019.

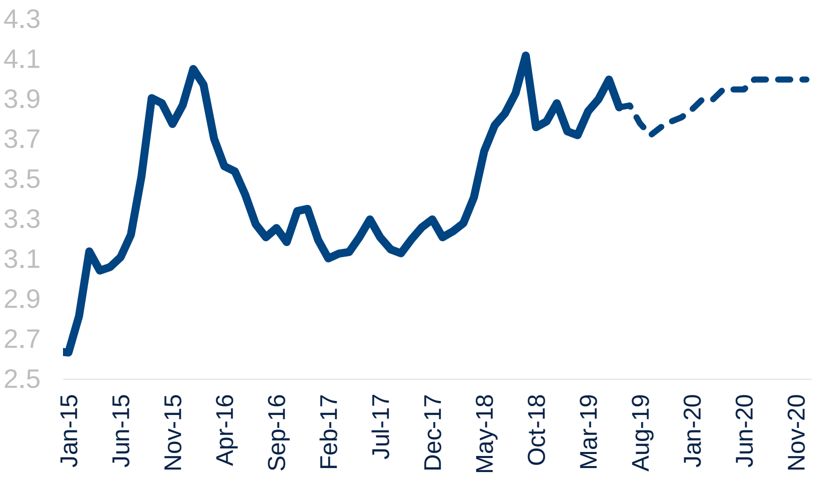
The Fed's U-turn has kept financial volatility at relatively low levels and supported the real

BBVA INDEX OF FINANCIAL TENSIONS IN BRAZIL
(2006-2019 AVERAGE = 100)



Source: BBVA Research, BCB

NOMINAL EXCHANGE RATE (*)
(BRAZILIAN REAL / US DOLLAR)

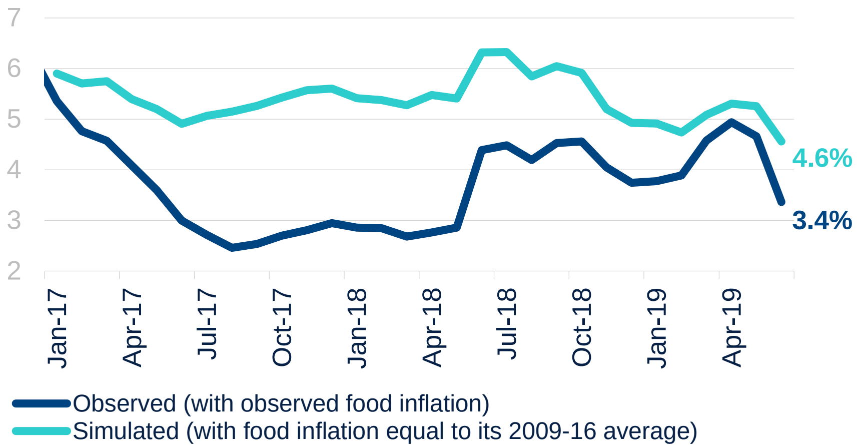


(*) Forecasts from Jul-19 onwards.
Source: BBVA Research

The better-than-expected news on the reform to reign on pension expenditure have also contributed to the recent appreciation of the exchange rate. Nonetheless, in an environment of higher concern about the world economy, we still see little room for a significant appreciation of the exchange rate moving forward.

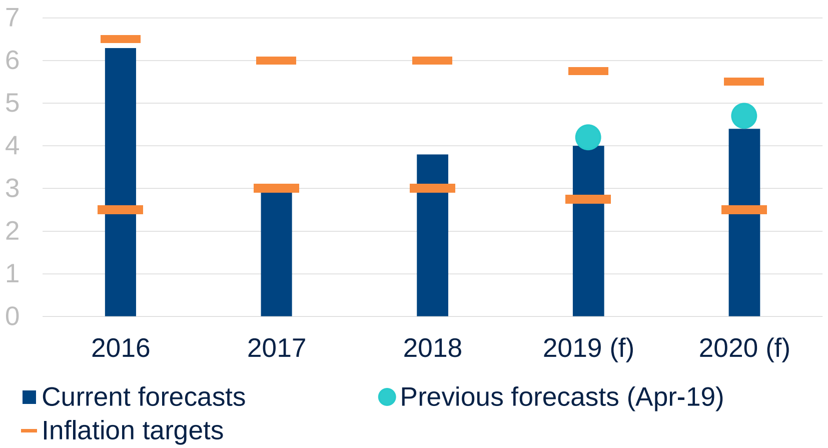
The relative exchange rate stability and the lack of significant demand pressures help to keep inflation under control

INFLATION: IPCA (*)
(Y/Y %)



(*) 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, BCB

INFLATION: IPCA (*)
(Y/Y %; END OF PERIOD)

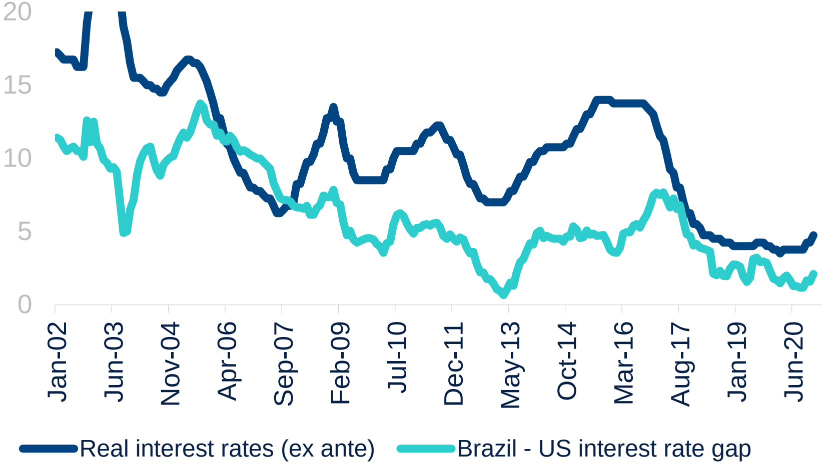


(*) (f) Forecasts.
Source: BBVA Research, BCB

The lower growth in 2019 and a somewhat more appreciated exchange rate are behind the downward revision of inflation forecasts. Nonetheless, we continue to expect that inflation - which has fallen to 3.4% in Jun-19 due to a favorable base effect - trend upwards ahead, as the real gradually weakens and domestic demand strengthens.

The conditions have been created for the central bank to soon cut interest rates

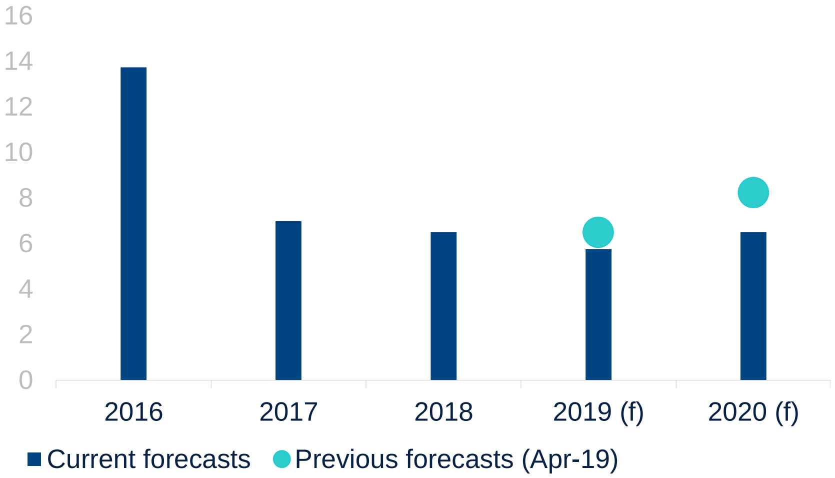
REAL INTEREST RATE AND SPREAD WITH RESPECT TO THE US BENCHMARK INTEREST RATE (*) (PP)



(*) Forecasts from Jul-19 onwards.
Source: BBVA Research, BCB

SELIC INTEREST RATE (*)

(Y/Y % ; END OF PERIOD)

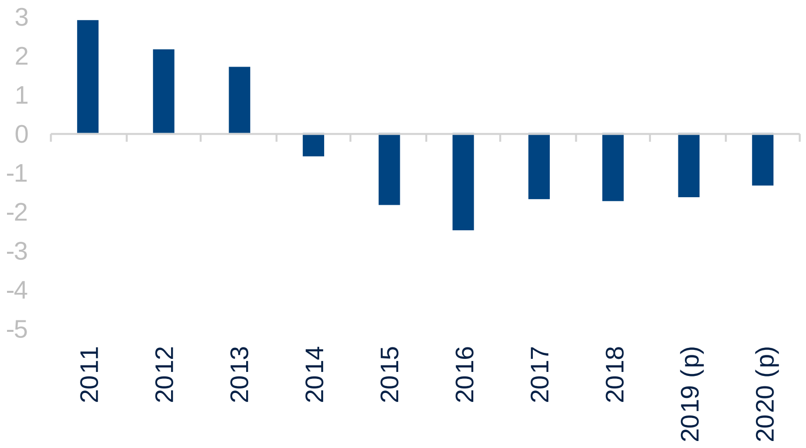


(*) (f) Forecasts.
Source: BBVA Research, BCB

The more dovish tone of monetary policy in the US, the progress in the approval of the social security reform and lower growth in 1H19 will allow the central bank to start in Sep-19 (or even before) a monetary easing cycle to take the SELIC interest rates down from 6.5% to 5.5% at the beginning of 2020.

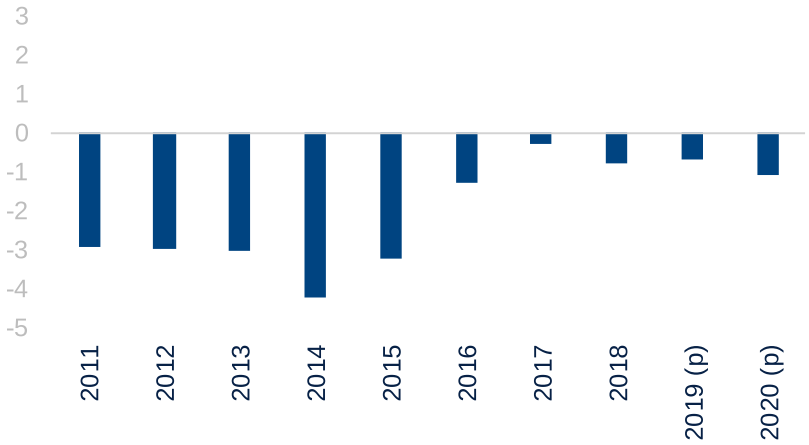
Primary deficit will decline slowly ahead, helping to keep fiscal risks alive, even if the social security reform is approved

PRIMARY FISCAL BALANCE (*)
(% OF GDP)



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

CURRENT ACCOUNT BALANCE (*)
(% OF GDP)

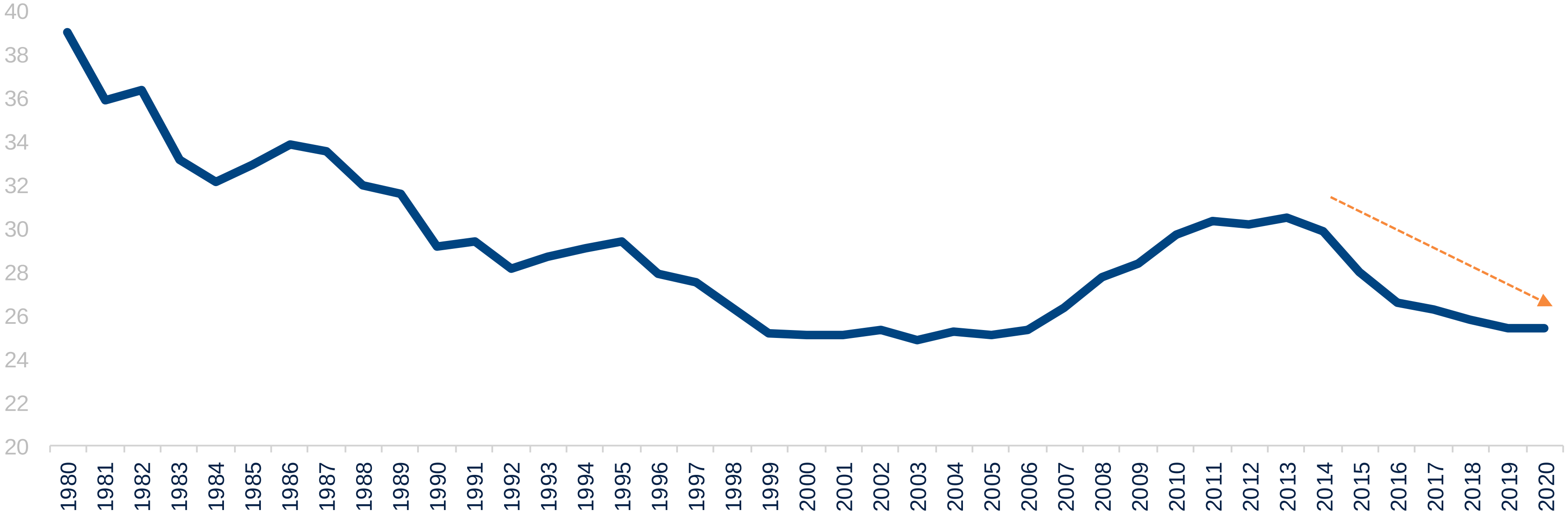


(*) (f) Forecasts.
Source: BBVA Research

Approving the social security reform is key to reduce fiscal risks, but preventing public debt from trending up in the long term will require additional adjustments in the future.
Regarding external accounts, we expect the current account deficit to remain low, close to 1% of GDP, in 2019 and 2020.

The poor performance of productivity continues to prevent Brazil from closing the per capita income gap with respect to the US

GDP PER CAPITAL IN BRAZIL AS A SHARE OF GDP PER CAPITA IN THE US (*)
(%, PPP ADJUSTED)



(*) Forecasts for 2019 and 2020.
Source: BBVA Research, IMF

A trade opening would boost productivity and income; the EU-Mercosur agreement is, therefore, good news

EU – Mercosur trade agreement: an opportunity to boost trade

- The EU and the Mercosur have reached a political agreement for a trade deal, which will have to be approved by the parliaments of all involved countries. That will require time.
- The agreement offers an ample potential for the expansion of foreign trade within Mercosur, especially in Argentina and Brazil, which are the most closed countries in the block.
- EU will liberalize almost 100% of industrial goods trade and 81,7% of agricultural products (17,7% will have quotas, and 100 agricultural products are excluded).
- Mercosur will liberalize 90% of industrial products in a progressive way (10 years on average), including cars (current tariff of 35%), car parts (14-18%), machinery (14-20%), chemicals (up to 18%) and pharmaceuticals (up to 14%).
- Mercosur countries will put in place legal guarantees protecting from imitation 357 high-quality European food and drink products recognized as Geographical Indications.
- The agreement will enhance political dialogue and increase cooperation in areas such as migration, digital economy, research and education, human rights, environment protection, etc.

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03

Brazil: forecast table

Creando Oportunidades

Brazil: forecasts

	2017	2018	2019 (f)	2020 (f)
GDP (%)	1,1	1,1	0,9	1,8
Private consumption (%)	1,3	1,9	1,5	1,5
Public consumption (%)	-0,9	0,0	0,8	0,4
Investment in fixed capital (%)	-2,6	4,1	1,0	3,5
Exports (%)	5,7	3,4	3,3	1,9
Imports (%)	5,5	7,6	1,1	1,5
Unemployment rate (average, %)	12,7	12,3	12,0	11,0
Inflation (end of period, YoY %)	2,9	3,8	4,0	4,4
SELIC interest rate (end of period, YoY %)	7,00	6,50	5,75	6,50
Exchange rate (end of period)	3,30	3,88	3,81	4,00
Current account (% of GDP)	-0,3	-0,7	-0,7	-1,1
Public sector primary fiscal balance (% of GDP)	-1,7	-1,6	-1,6	-1,3

(f) Forecast.
Source: BBVA Research