BBVA Research

Brazil
Economic Outlook
4Q19

October 2019

Creating Opportunities

Mensajes clave

The global environment, marked by the growth slowdown and high uncertainty, will further complicate the process of recovery of Brazilian economic activity. Thus, after growing 1.1% in 2018, GDP is expected to expand only 0.9% in 2019 and the growth forecast in 2020 is revised downwards by 0.2 p.p. to 1.6%.

In addition to a more unfavorable global context, the lack of fiscal stimulus actions will weigh negatively on economic performance. After the imbalances accumulated over the last years, the room for countercyclical fiscal policies will remain limited and the priority will be to guarantee the sustainability of public debt.

Monetary policy, in contrast, will support economic growth, even more than expected. The more expansive tone displayed by central banks around the world and the fact that inflation will remain under control (3.6% in 2019 and 4.0% in 2020) will pave the way for the central bank to cut the SELIC interest rate to 4.75% and keep it at this historically-low level until the end of 2020.

The social security reform, which will most likely be implemented soon, will also support economic activity, mainly because of its effect through the confidence channel. Other structural changes currently discussed, such as the tax reform and the opening of the economy, if approved, would allow -in the medium-term- GDP to grow above the 2.0% - 2.5% range, which is the currently estimated potential growth rate.

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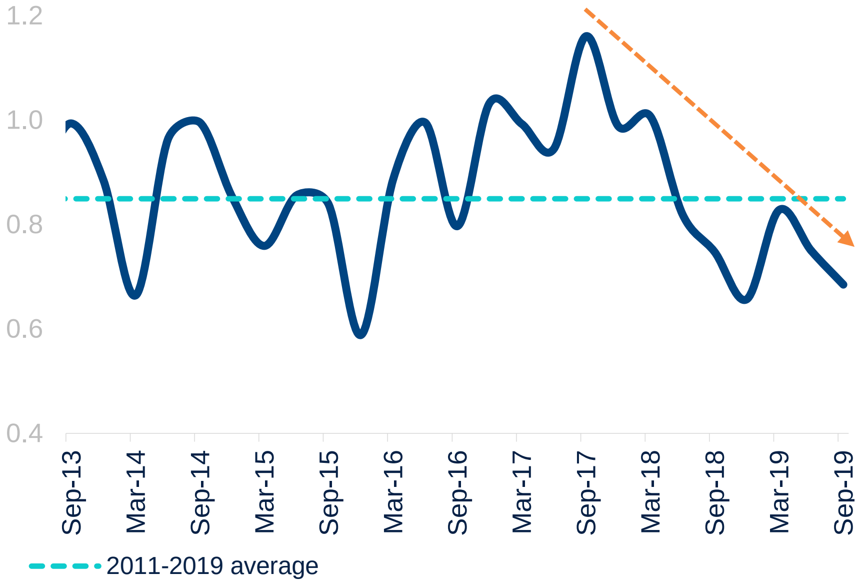
01

Global environment: slowdown and uncertainty

Global growth continued to weaken

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

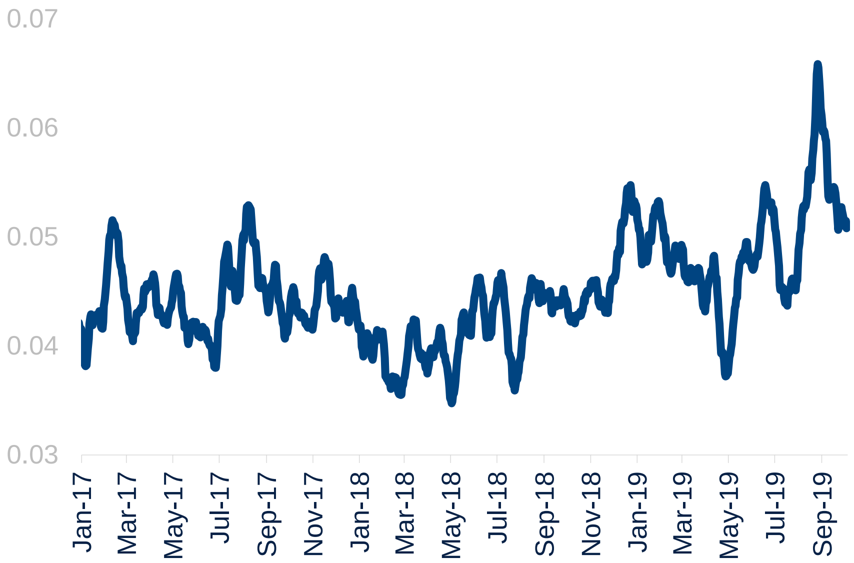


Source: BBVA Research

- Recent evidence confirms that uncertainty and protectionism are negatively affecting growth.
- The ongoing growth slowdown has been sharper than expected, especially in China and Europe.
- Exports and the manufacturing sector remain particularly weak…
- ... and there are signs that this weakness is beginning to affect the service sector.

Uncertainty has increased sharply in August and remains high despite the recent moderation

ECONOMIC UNCERTAINTY INDEX
(TONE OF THE NEWS ON ECONOMIC UNCERTAINTY WEIGHTED BY COVERAGE, 15-DAY MOVING AVERAGE)

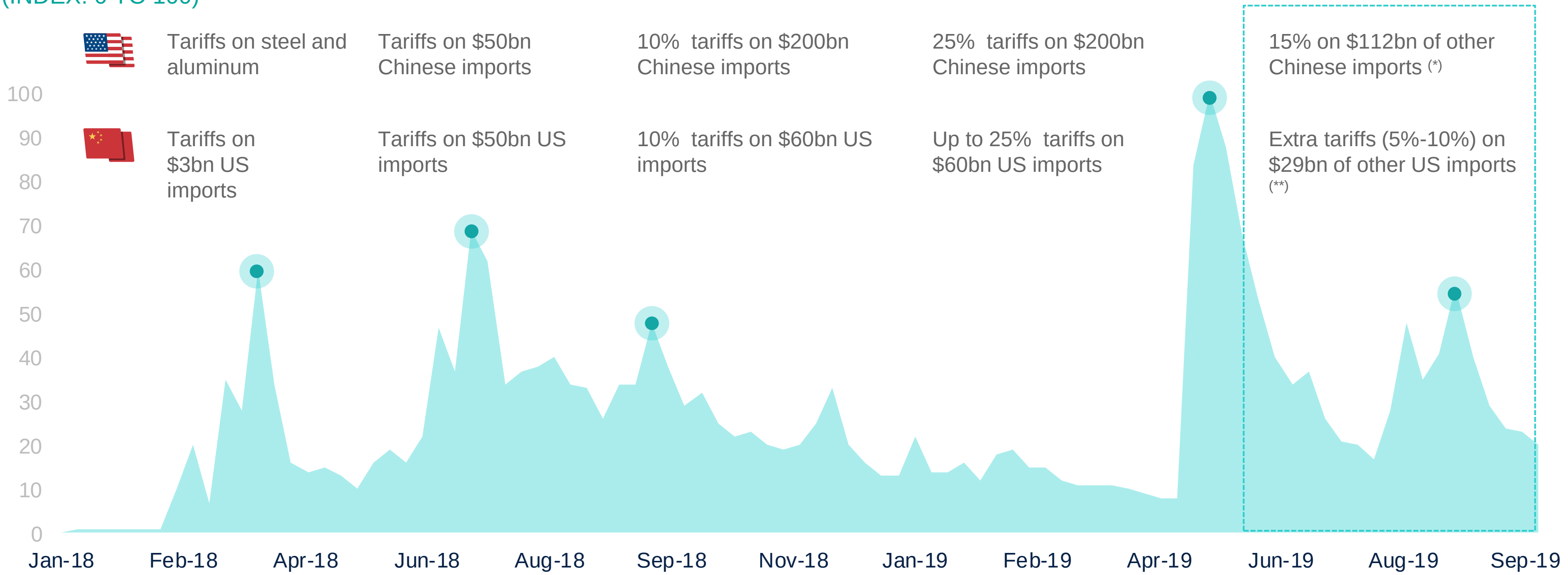


Source: BBVA Research and GDELT

- High uncertainty due to:
  - trade and technological tensions
  - Brexit
  - Political and geopolitical turbulences
- The impact on confidence adds to the effects of the structural slowdown in China and the cyclical moderation of the US economy.

The new protectionist measures have fueled trade tensions

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

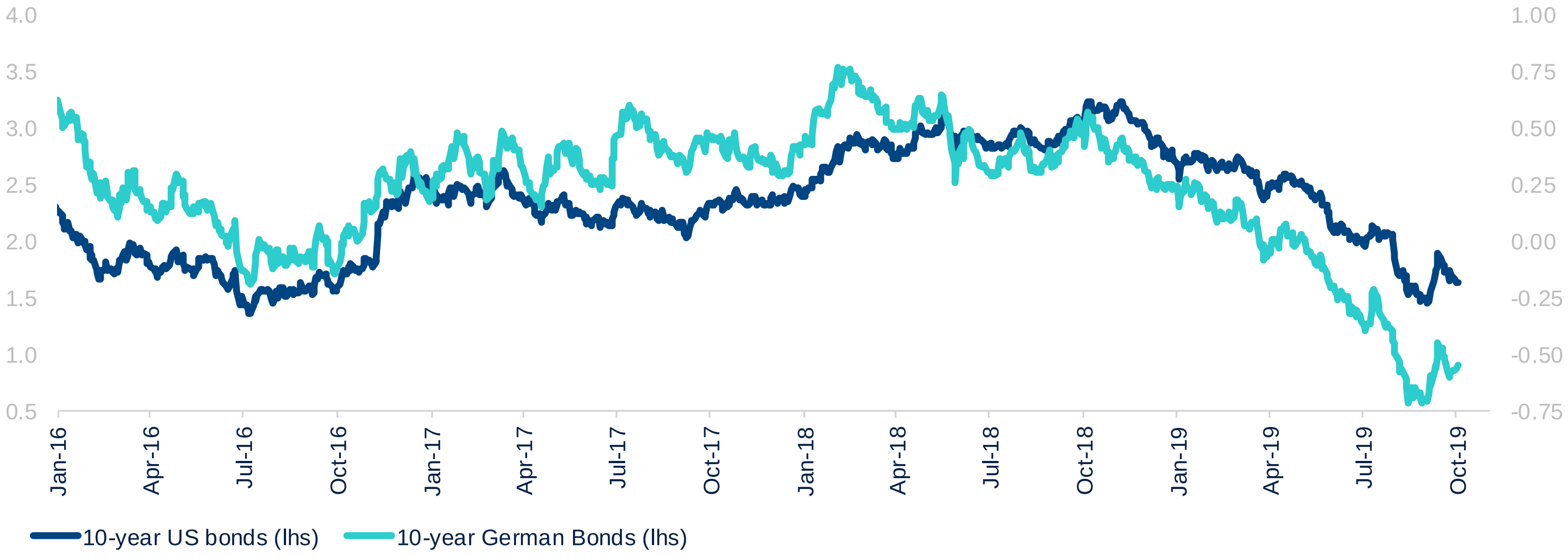


(*) And till Dec-19: a further 5% tariff (to 30% from 25%) on USD250bn and 15% on the rest of Chinese imports. (**) And till Dec-19: extra tariffs (5%-10%) on $46bn of other US imports.
Source: BBVA Research and GDELT

In financial markets, the flight-to-safety mood continues to prevail

SOVEREIGN DEBT YIELDS

(%)



Source: BBVA Research, Bloomberg

Counter-cyclical policies will help to keep financial tensions under control, but will not prevent a global slowdown

COUNTERCYCLICAL POLICIES

Monetary policy:

- Will continue to lead countercyclical actions…
- … despite its lower effectiveness in the actual context.
- More measures will be announced moving forward.

Fiscal policy:

- Should play a bigger role…
- … but political issues and high debt will limit its use.
- More measures in Europe and mainly in China.

A global coordination of policies is now less likely.

GLOBAL UNCERTAINTY

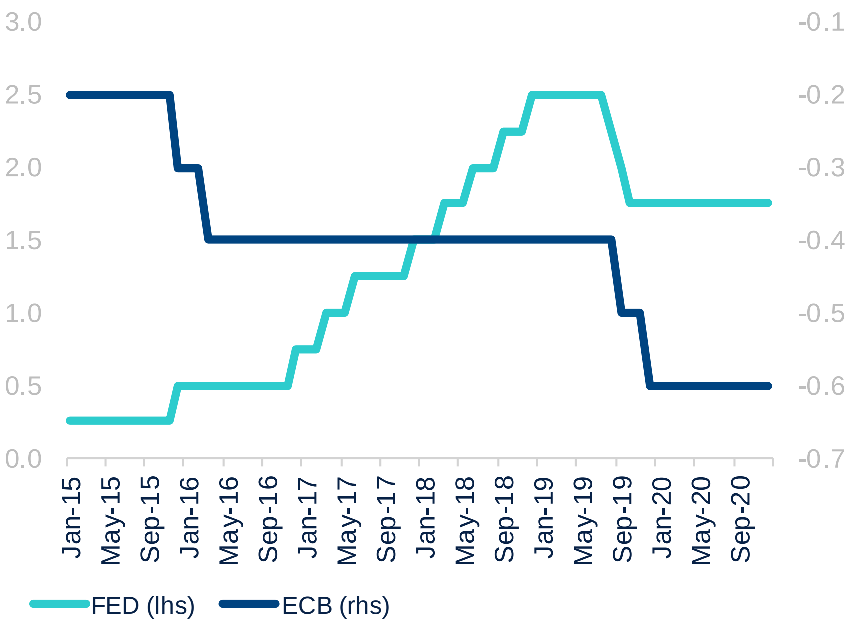
US – China tensions will remain in place:

- A partial trade agreement between both countries is likely.
- Tariffs will hardly return to the levels exhibited a few months ago.
- Structural and technological issues will continue to generate turbulence.

The Brexit issue, as well as political and geopolitical tensions in certain regions, will continue to fuel uncertainty.

The central banks have announced further monetary stimuli in the last few months

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



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

- Fed: a 50bps reduction in rates in recent months and at least an additional 25bps cut in October.
- ECB: an aggressive monetary package
  - a 10bps cut in deposit rates
  - a two-tiered system for bank deposits
  - a new quantitative easing program
  - a more favorable TLTRO-III
- In Europe, another 10bps cut in deposit rates is likely.
- China and other emerging countries: more aggressive reduction in interest rates.

A sharper slowdown of the world economy

	USA	Latam	Eurozone	China	World
2019	2.3	0.7	1.1	6.0	3.2
2020	1.8	N.A.(*)	0.8	5.6	3.1

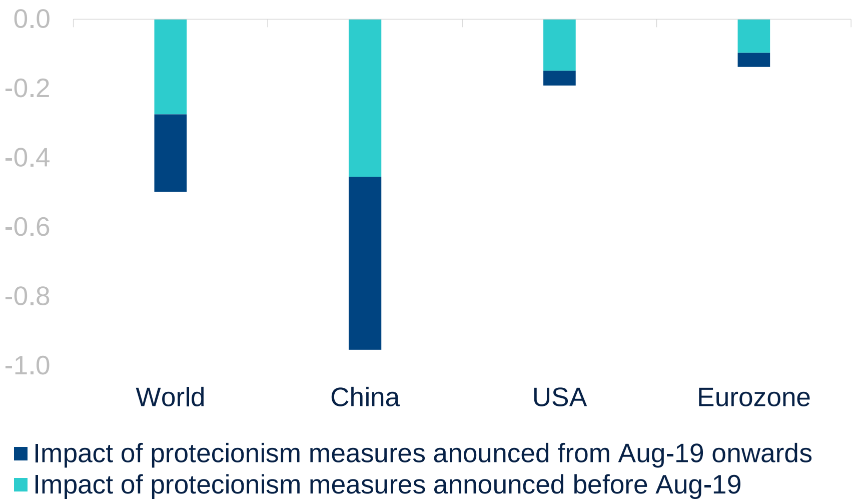
- Upward revision
- Unchanged forecast
- Downward revision

(*) Non available as there is not yet a definitive forecast for Argentina.
Source: BBVA Research

This sharper slowdown is to some extent related to persistent protectionist tensions

IMPACT ON GDP OF THE PROTECTIONISM

(IMPACT ACCUMULATED IN TWO YEARS, PP)

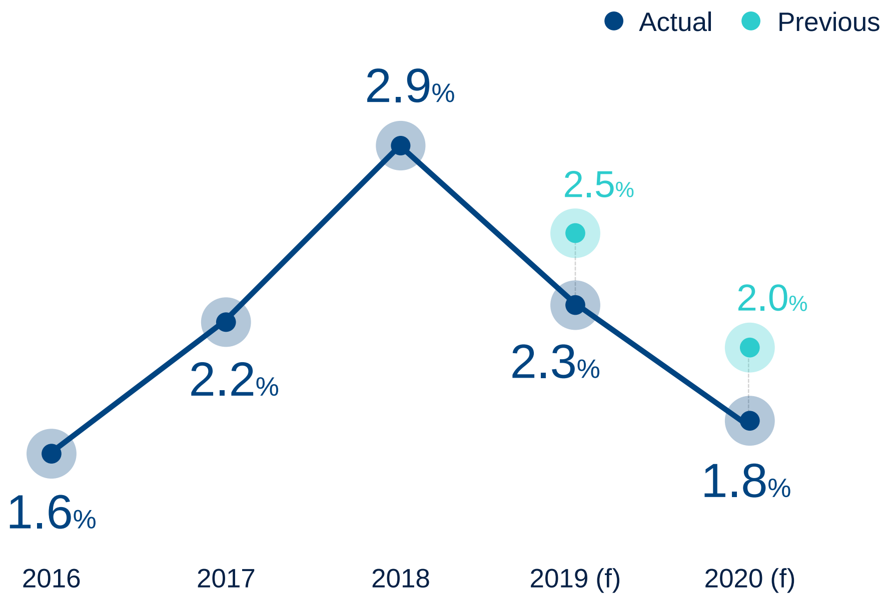


(*) Direct and indirect impact. **Protectionism measures announced before Aug-19**: US: 25% tariff increase on steel, 10% on aluminum, 25% on $250bn China imports. China: 25% on USD110bn US imports **Protectionism measures announced from Aug-19 on** (to be implemented, in case of no trade agreement, till Dec-19): US: a 5% extra tariff on $250bn and 15% on $300bn China imports. China: extra tariffs (5%-10%) on $75bn US imports.
Source: BBVA Research

- The revisions in GDP forecasts are broadly in line with the estimated impact of adopted protectionism measures.
- Specially in China, the impact has been smoothed by countercyclical policies.
- In the Eurozone the deterioration has been even larger thanks to lower export to the United Kingdom (Brexit) and problems in the automobile sector.
- Risks: if the US and China don't reach a trade agreement and the protectionist escalation continues, there would be an additional negative effect on the global economy.

USA: lower growth due to the global slowdown and uncertainty about domestic policies

GDP GROWTH
(%)

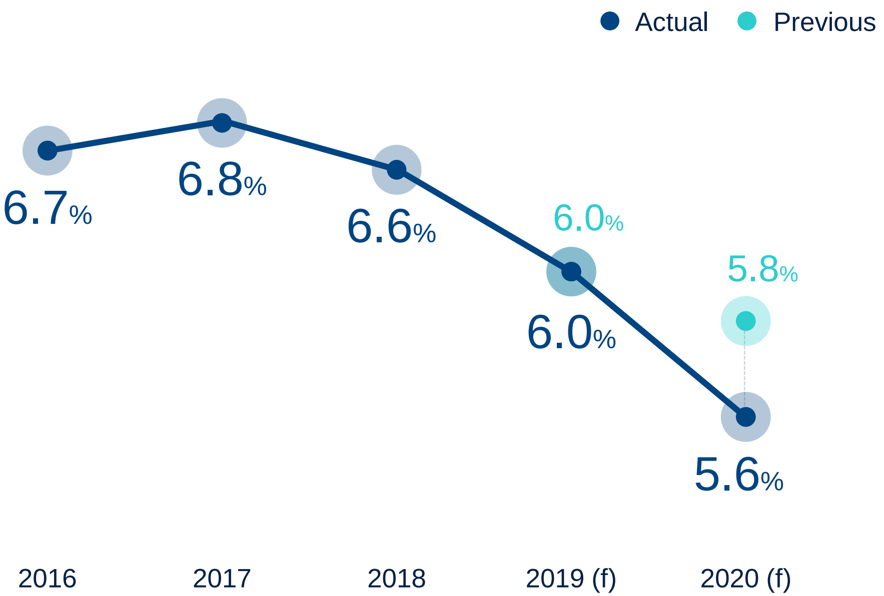


(f) Forecast.
Source: BBVA Research

- Growth will converge to the potential rate faster than expected.
- Inflation will remain close to the 2% target.
- The probability of a recession has increased.
- Trump's impeachment process increases uncertainty and reduces the likelihood of additional fiscal stimuli.

China: trade tensions add to the downward structural trend

GDP GROWTH
(%)

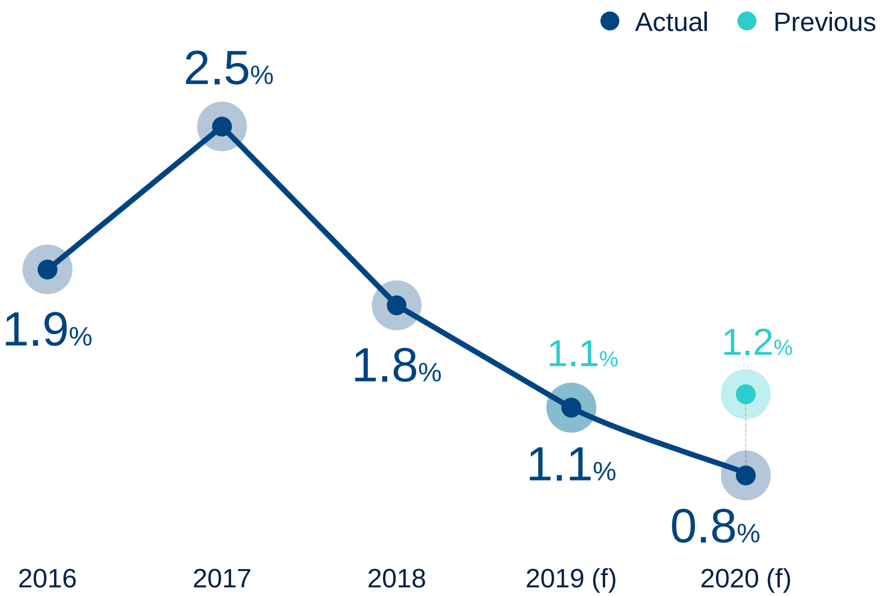


(f) Forecast.
Source: BBVA Research

- There are increasing signs of widespread moderation of the economy.
- Fiscal and monetary stimulus measures will prevent a sharp slowdown, but may increase financial vulnerabilities.
- The exchange rate will remain at a more depreciated level, to partially to offset the effects of higher protectionism.

Eurozone: worse growth prospects due to the most negative global environment and high uncertainty

GDP GROWTH
(%)

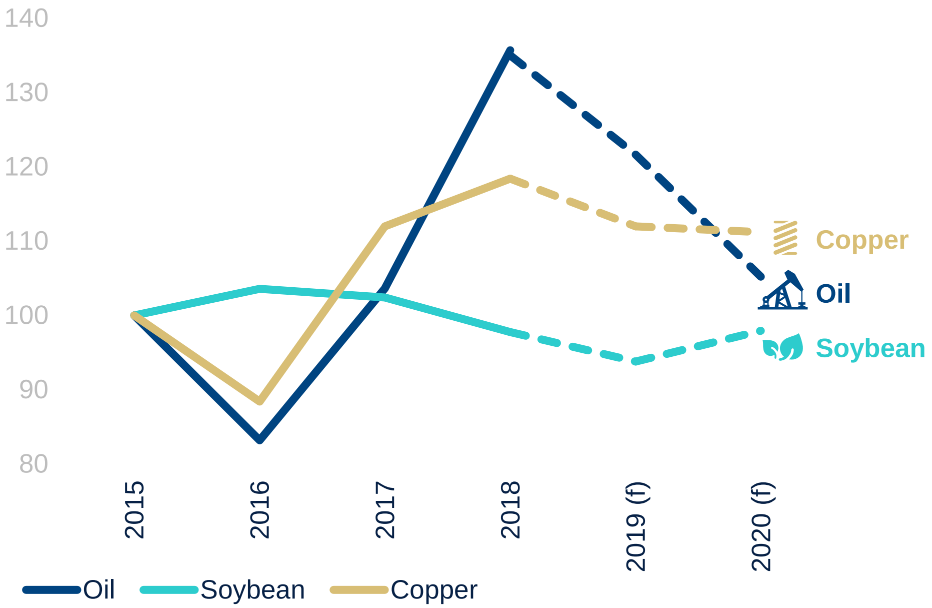


(f) Forecast.
Source: BBVA Research

- The Brexit and the problems in the auto sector, on top of trade tensions, have affected economic activity…
- … and have contributed to a particularly large fall of exports to the rest of Europe and UK.
- Increasing divergence in growth performance across countries depending on their exposure to the external sector.
- Inflation will remain low (1.2% in 2019; 1.1% in 2020).
- The risk of recession has increased.

Prospects for weaker growth pressure commodity prices downwards

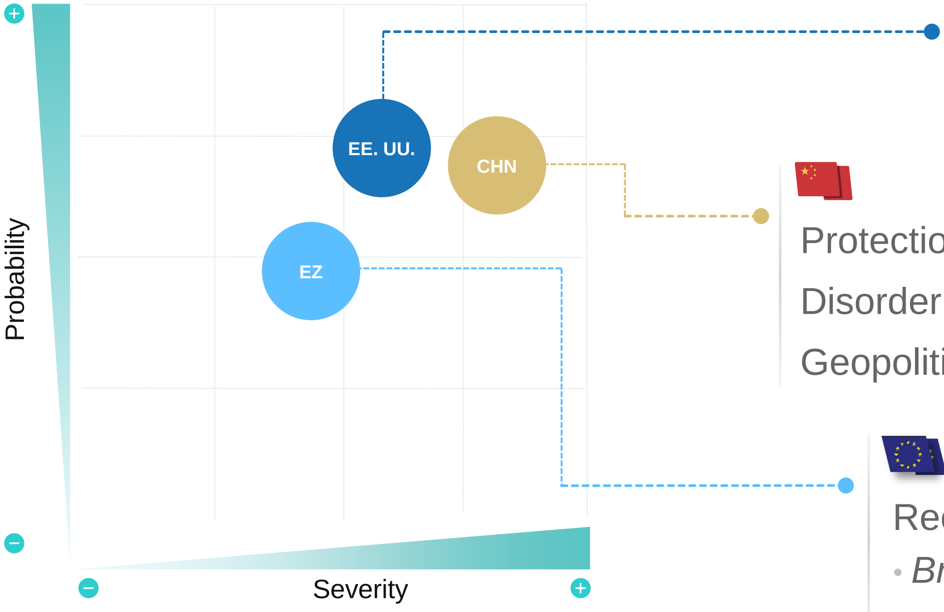
MATERIAS PRIMAS: PRECIOS ANUALES PROMEDIOS
(ÍNDICE: PROMEDIO DE 2015 = 100)



(f) Forecast.
Source: BBVA Research

- Oil: Slight upward revision of short-term forecasts and risk that an escalation of tensions in the Middle East will end up driving oil prices up.
- In any case, prospects for price moderation going forward are maintained, given the relative strength of supply in an environment of lower demand.
- Soybean and copper: price forecasts revised downwards.

Global risks continue to increase, mainly due to tensions between China and the US



Source: BBVA Research

Economic recession: higher

Protectionism: high

Protectionism: high

Disorderly deleveraging: higher

Geopolitical tensions

Recession: higher

- *Brexit*, Italy

Protectionism: still contained but increasing

The risk of geopolitical turbulence in the Middle East has also increased.
Financial vulnerabilities can amplify the severity of risks.

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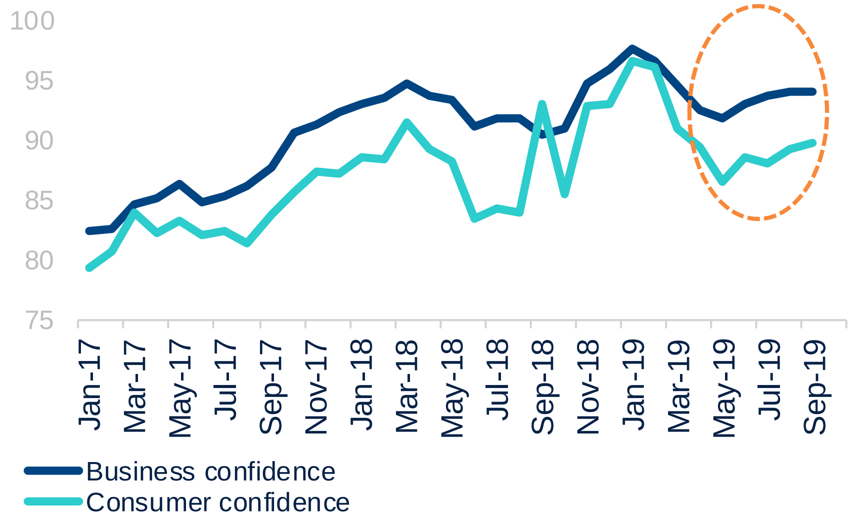
02

Brazil: the global environment will make the domestic recovery more difficult

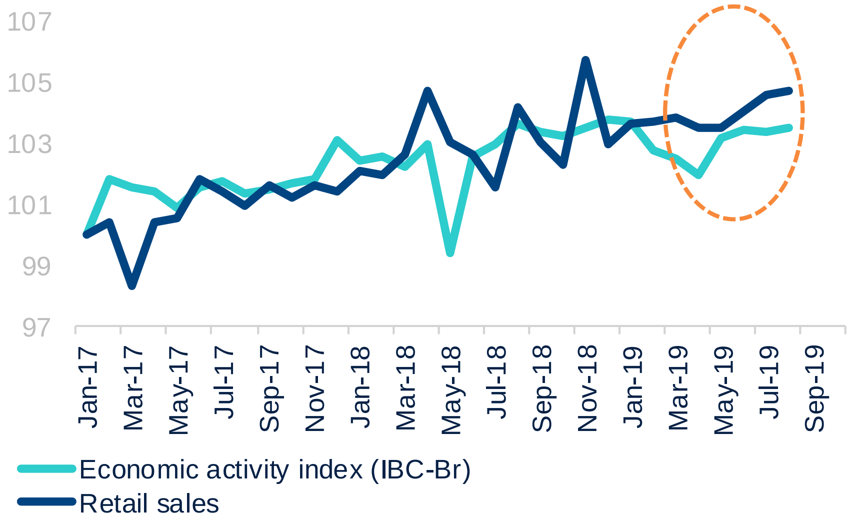
Economic indicators show that economic activity improved somewhat in the last few months...

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



Source: BBVA Research, FGV

ACTIVITY INDEXES
(JAN/17 = 100)

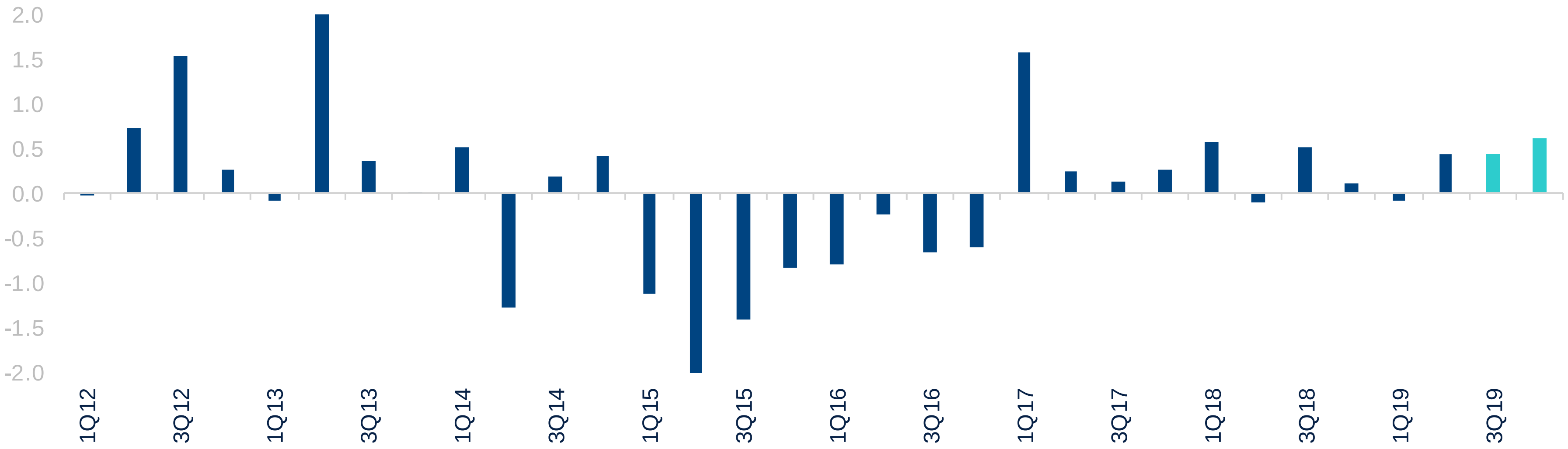


Source: BBVA Research, IBGE, BCB

Although most of the indicators support the perception of a gradual increase in economic dynamism since the beginning of the year, the manufacturing sector continues to show signs of stagnation.

... which supports the prospects for a slight recovery of growth in the second half of 2019

GDP GROWTH (*)
(QOQ %)



(*) Forecast : 3Q19 and 4Q19.
Source: BBVA Research

After contracting 0.2 % QoQ in the first quarter of the year, partly due to a supply shock that affected the extractive industry, GDP grew 0.4% QoQ in the second quarter, above expectations (BBVA Research: 0.2% QoQ).

Expansive monetary policy and the approval of the social security reform, among other factors, will support the economy ...

Growth recovery will be boosted by a number of factors:

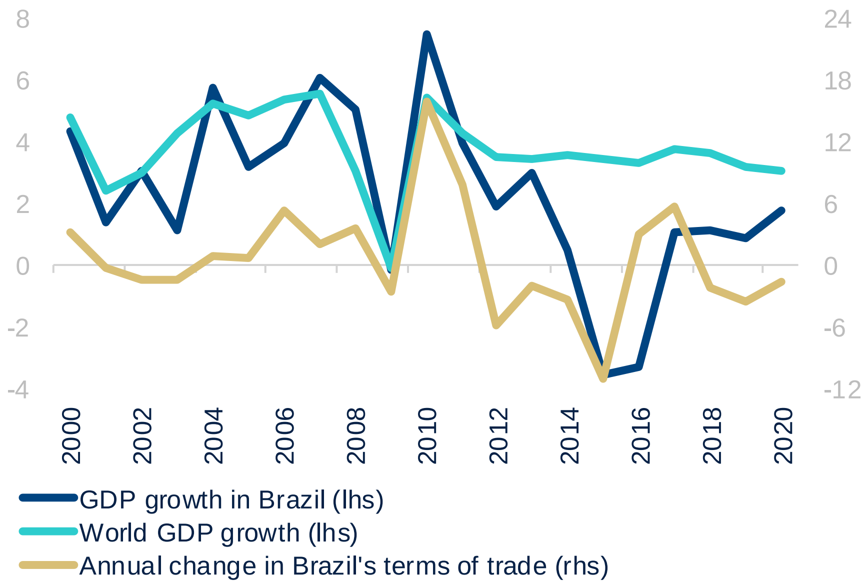
- Relatively low inflation
- Expansive monetary policy
- Low level of capacity utilization creates room for GDP to grow more without generating sizable
- Structural reforms (if finally adopted):
  - social security reform
  - trade openness, tax reform, privatizations, etc: recent news show that these structural changes are increasingly likely; if approved, they could result in GDP growing more than currently expected (2.0%-2.5%).

Social security reform: a key step for growth acceleration

- The reform will most likely be implemented in the remainder of 2019: after its approval by the Chamber of Deputies and the final backing by the Senate, the reform is about to be enacted.
- It will have an impact of around BRL 750 billion over the next 10 years: that is roughly equivalent to a reduction of fiscal spending by 2 p.p. of GDP (70% of the savings included in the original proposal sent by the government to congress).
- The reform reduces, without eliminating, the fiscal risks: it is key for debt sustainability, but complying with fiscal rules will require additional measures.
- It will stimulate to the economy, mainly through the confidence channel; it will also take some pressure out of monetary policy, helping interest rate to remain low.

... but the less favorable global environment and some domestic factors will prevent a more robust recovery

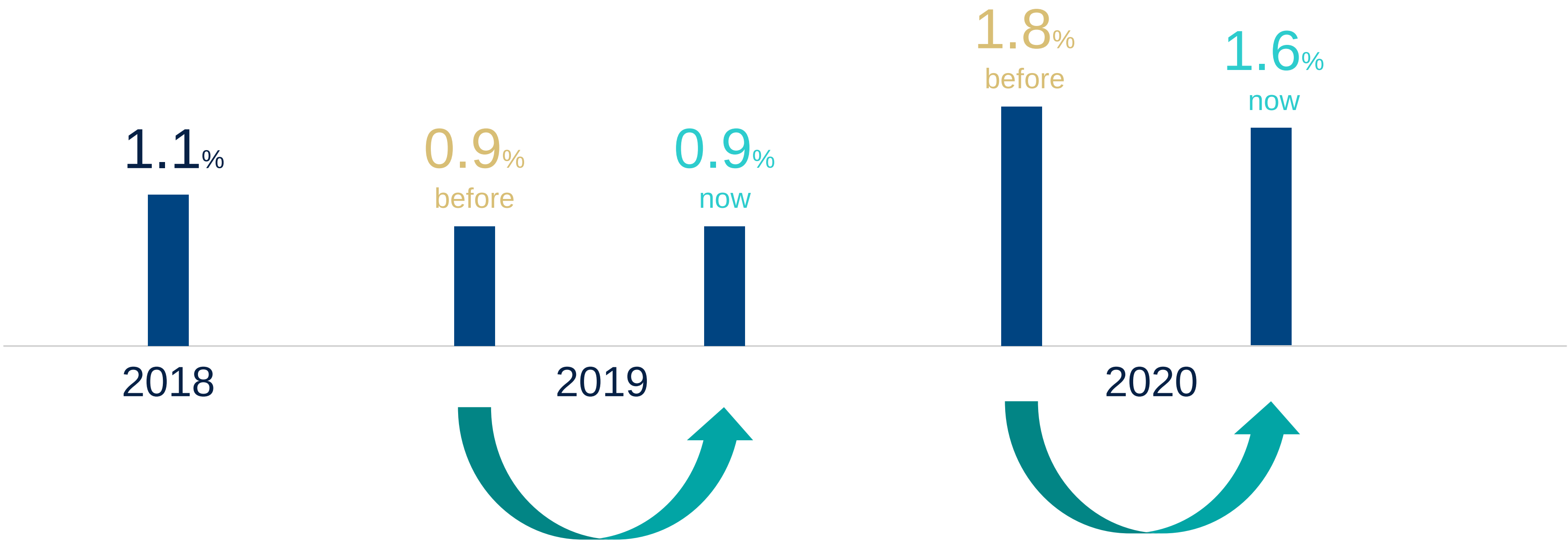
WORL GDP GROWTH AND BRAZIL'S GDP GROWTH AND TERMS OF TRADE (*)
(% ANNUAL CHANGE)



(*) Forecast: 2019 and 2020.
Source: BBVA Research

- The deceleration in global growth and relatively low commodity prices will make the acceleration of domestic growth more difficult.
- The crisis in Argentina will also weigh negatively, mainly due to its effects on Brazilian exports.
- There will be little room for countercyclical fiscal policies, even after the approval of the social security reform.
- The risk that activity recovery derails due to political tensions continues to exist.

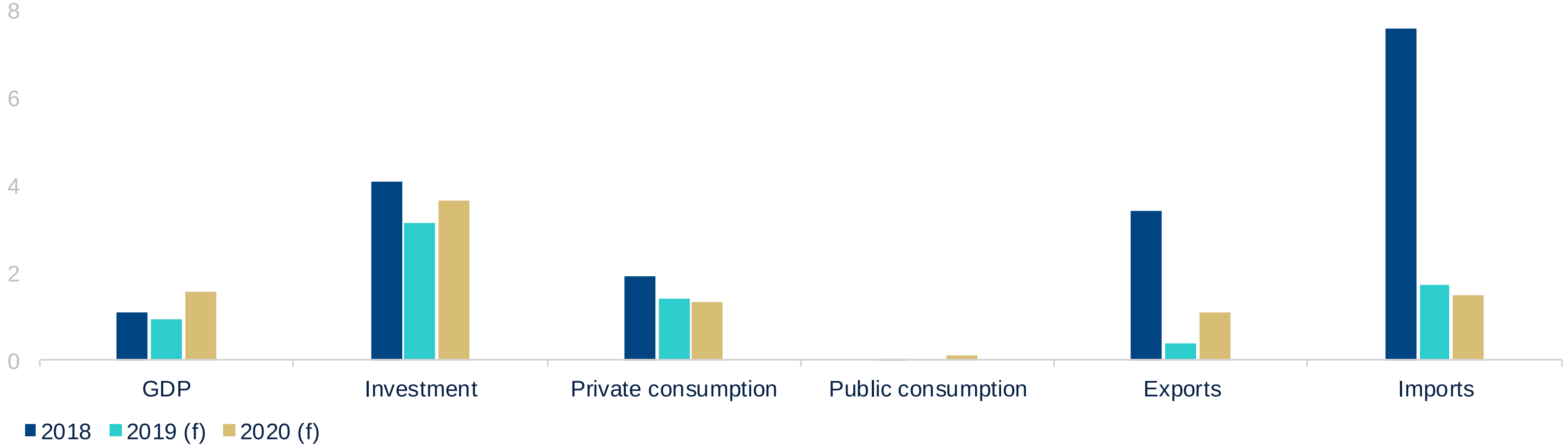
GDP growth is expected to reach 0.9% in 2019 and 1.6% in 2020



Growth will likely increase somewhat during the second half of the year, but less than previously expected, to a large extent thanks to a the less favorable global environment. Therefore, the GDP forecast for 2020 is revised downwards, while the upside surprise in 2Q19 GDP avoids a downward revision in the forecast for 2019.

Investment will continue to be the most dynamic component of GDP

GROWTH OF GDP AND ITS COMPONENTS (*)
(%)

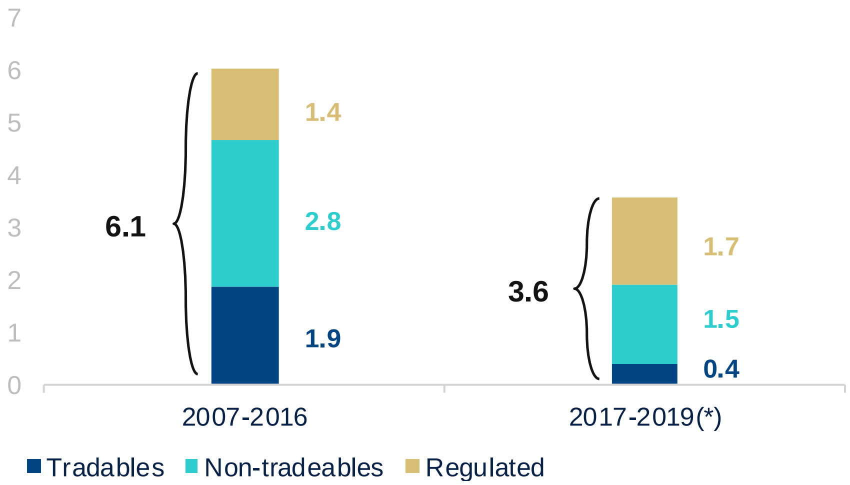


(*) (f) = Forecast.
Source: BBVA Research, IBGE

Investment was the main driver of the upward surprise in 2Q19 GDP growth. The margin of recovery for this component of GDP is higher given that it is still 21% below the level of 5 years ago. In comparison, private consumption and exports are, respectively, 3% lower and 11% higher than in 2Q14; GDP is still 3.6% below the pre-crisis level.

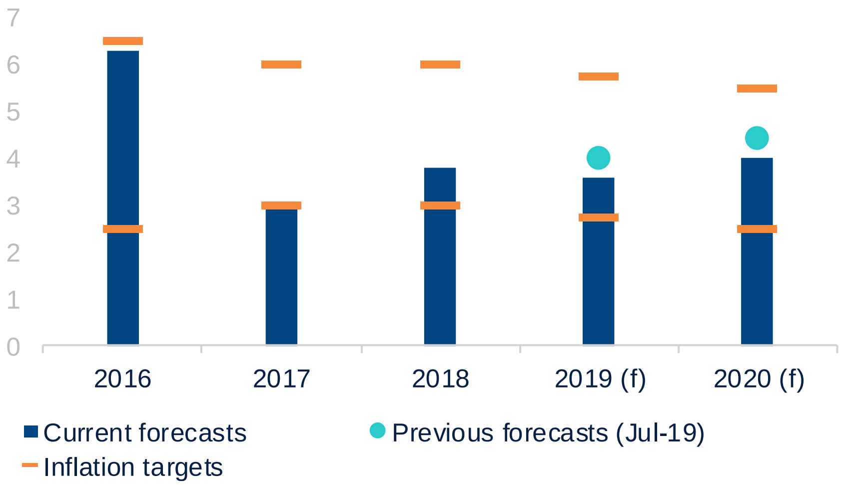
Inflation is expected to remain under control, to some extent due to low global inflation rates and relatively weak domestic demand

INFLATION: AVERAGE CONTRIBUTION BY TYPES OF PRODUCTS
(PP, 2007-16 AND 2017-19 AVERAGES)



(*) Until Sep-19.
Source: BBVA Research, BCB

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

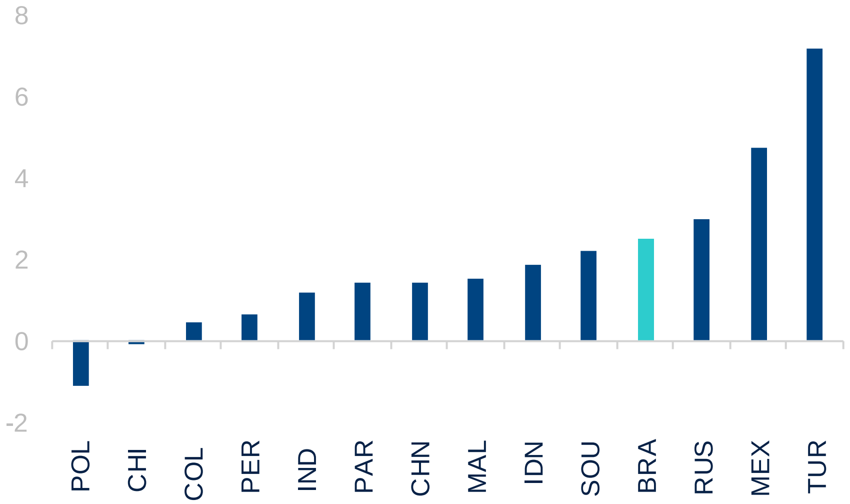


(*) (f) Forecast.
Source: BBVA Research, BCB

Inflation, which has reached 2.9% YoY in Sep-19, will gradually increase moving forward as demand gradually recovers and a more depreciation exchange rate ends up affecting domestic prices. Inflation is forecast to converge to 3.6% and 4.0%, respectively, at the end of 2019 and 2020 (slightly less than expected three months ago).

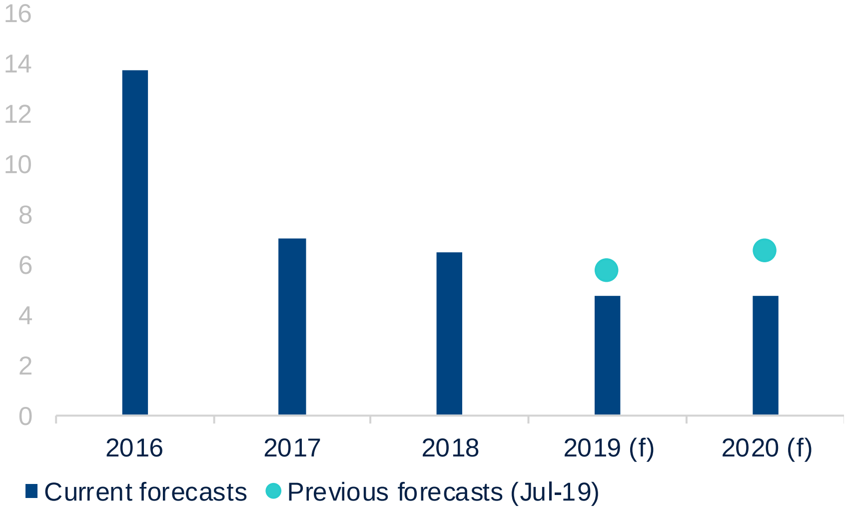
Unexpected interest rate cuts in the US have created room for more aggressive cuts in the SELIC interest rate

REAL INTEREST RATE: CURRENT VALUE
(%, EX-ANTE REAL RATE)



Source: BBVA Research , BCB

SELIC INTEREST RATE (*)
(Y/Y % ; END OF PERIOD)

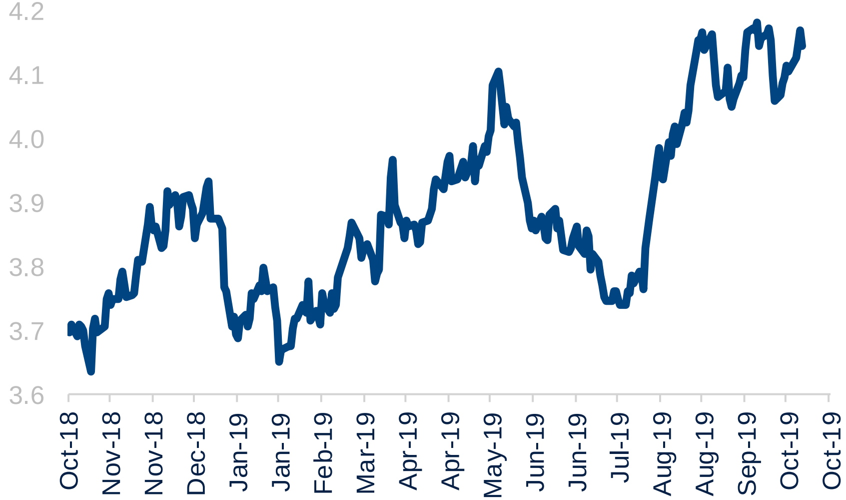


(*) (f) Forecast.
Source: BCB, BBVA Research

The global and the local macroeconomic contexts have enabled the central bank to reduce monetary policy interest rates to 5.5% in Sep-19 (still among the highest in the world in real terms). Additional cuts are likely over the newt few months: the SELIC is likely to be taken down to 4.75% and to remain at that low levels until the end of 2020.

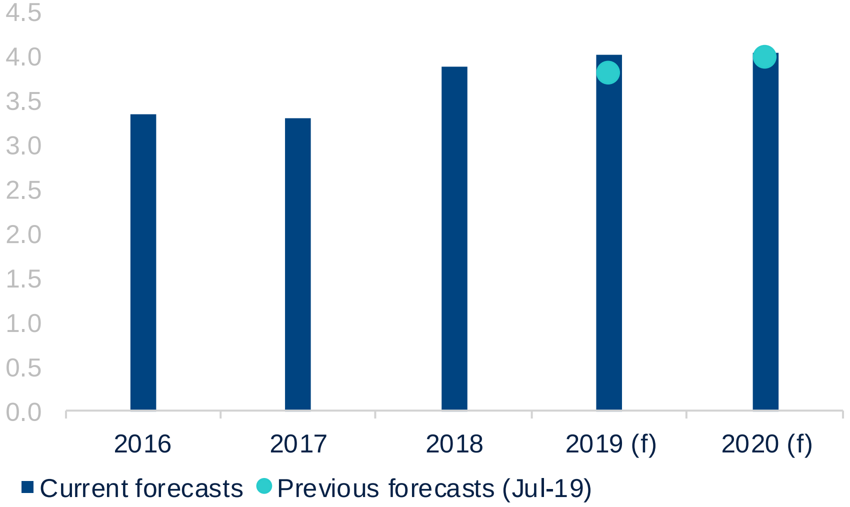
The high uncertainty and risk-aversion prevailing in global markets have paved the way for an exchange rate depreciation

NOMINAL EXCHANGE RATE
(BRL/USD)



Source: BBVA Research, BCB

NOMINAL EXCHANGE RATE
(BRL/USD, END OF PERIOD)

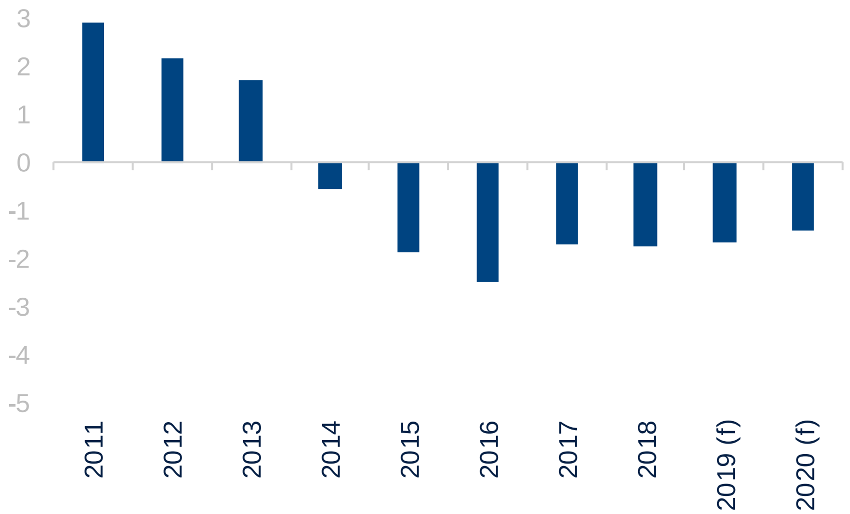


(f) Forecast.
Source: BBVA Research, BCB

Since mid-August, the BRL/USD exchange rate has remained around 4.1. In addition to global uncertainty and augmented risk-aversion, relatively low commodity prices and more aggressive SELIC cuts have weighed on the exchange rate. The expected gradual improvement of the domestic macroeconomic environment would allow a slight appreciation of the Brazilian real ahead.

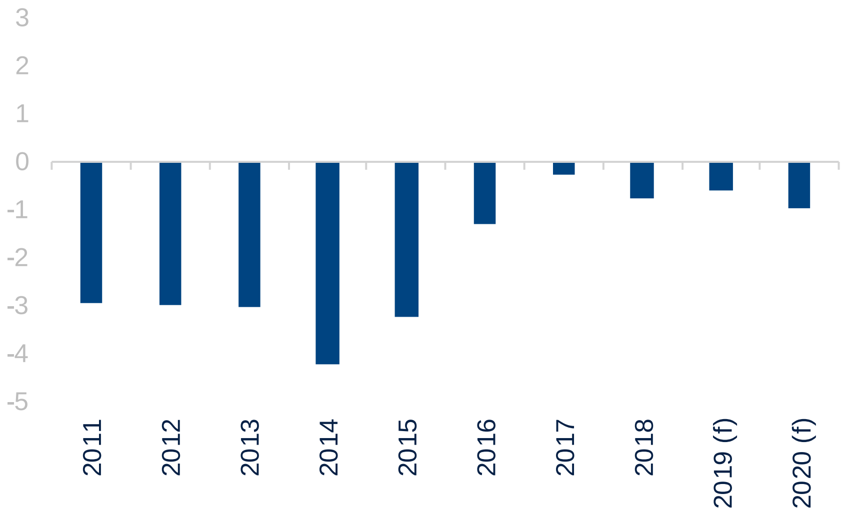
A weak domestic demand will make a reduction of the fiscal deficit more difficult, but will help to keep the external deficit under control

PRIMARY FISCAL BALANCE (*)
(% OF GDP)



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

CURRENT ACCOUNT BALANCE (*)
(% OF GDP)

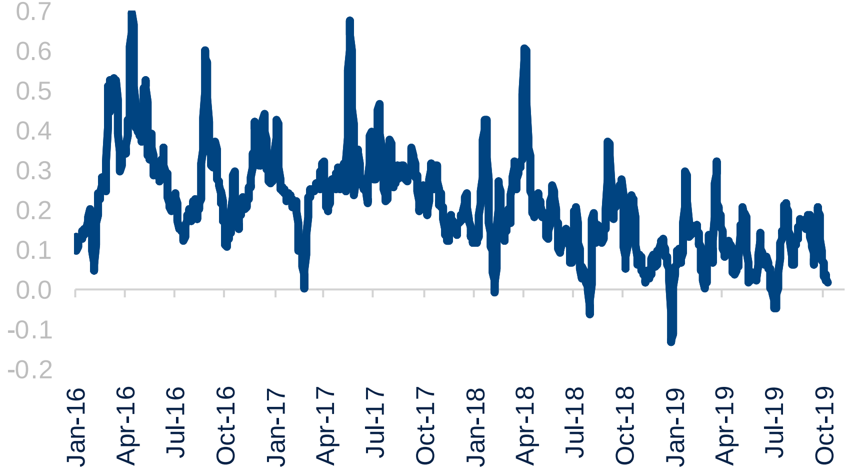


(*) (f) Forecast.
Source: BBVA Research

Even after the approval of the social security reform, reducing the primary deficit will be challenging; additional fiscal adjustments are needed for the country to generate a primary fiscal surplus again. The current account deficit will remain low, close to 1% of GDP, in 2019 and 2020.

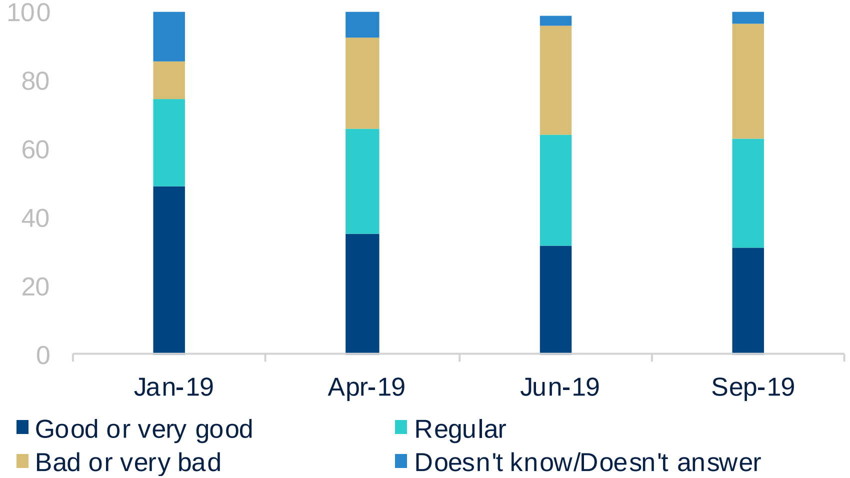
Implementing structural reforms in a context of political polarization continues to be among the main challenges

INDEX OF POLITICAL TENSIONS



(*) Tone of the news on politics in the local press, weighted by media coverage.
Source: BBVA Research

OPINION POLLING: THE BOLSONARO ADMINISTRATION
(Q: WHAT IS YOUR ASSESSMENT OF THE ACTUAL GOVERNMENT?)



Source: BBVA Research, CNI/IBOPE

The government of Jair Bolsonaro has managed to get the support of the congress for its social security reform, but the parliamentary and popular support for other needed reforms (tax reform, trade openness, privatization, etc.) should not be taken for granted.

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03

Brazil: forecast table

Brazil: forecasts

	2017	2018	2019(f)	2020(f)
GDP (%)	**1.1**	**1.1**	**0.9**	**1.6**
Private consumption (%)	1.3	1.9	1.4	1.3
Public consumption (%)	-0.9	0.0	-0.3	0.1
Investment in fixed capital (%)	-2.6	4.1	3.2	3.7
Exports (%)	5.7	3.4	0.4	1.1
Imports (%)	5.5	7.6	1.7	1.5
Unemployment rate (average, %)	**12.7**	**12.3**	**12.0**	**11.0**
Inflation (end of period, YoY %)	**2.9**	**3.8**	**3.6**	**4.0**
SELIC interest rate (end of period, YoY %)	**7.00**	**6.50**	**4.75**	**4.75**
Exchange rate (end of period)	**3.30**	**3.88**	**4.02**	**4.00**
Current account (% of GDP)	**-0.3**	**-0.7**	**-0.7**	**-1.0**
Public sector primary fiscal balance (% of GDP)	**-1.7**	**-1.6**	**-1.6**	**-1.4**

(f) Forecast.
Source: BBVA Research