BBVA | RESEARCH

Economic Outlook

Brazil

Second Quarter 2013

Economic Analysis

- **The world economy continues to grow, but there is an increasing unevenness between the different areas,** especially within developed countries.
- **In Brazil, growth should accelerate to 3.4% in 2013 and 3.8% in 2014 from only 0.9% last year.** In spite of this cyclical recovery, which is still subject to high risks, we see a structural deterioration of the domestic macroeconomic environment.
- **Inflationary pressures forced the Central Bank of Brazil to start a monetary tightening cycle,** which we expect to bring the SELIC rate to 8.75%, still relatively low for Brazilian standards. However, there is practically no room for a significant deceleration in inflation.
- **Fiscal policy is now more focused on supporting activity.** Meeting targets and reducing the public debt are now secondary goals. This worsens the fiscal accounts and adds a burden to monetary policy.
- **The current-account deficit is expected to widen,** in line with the appreciation of the exchange rate in real terms and the loss of competitiveness of the economy.

Index

Closing date: May 22, 2013

1. Summary

The world economy continues to grow, but there is increasing unevenness between the different areas, especially within developed economies, where the recovery in Europe is once more lagging behind in comparison to the US and even Japan. In turn, emerging economies will continue to lead global growth. We expect world growth to reach 3.3% in 2013, just 0.1 percentage point above the estimated growth for 2012. In 2014 growth should reach 3.9%, but the balance of risks continues tilted to the downside.

The Brazilian economy grew only 0.9% in 2012, due to idiosyncratic, structural factors. In recent years, the economy lost competitiveness due to increasing wages, the appreciation of the exchange rate and the lack of reforms. The model based on credit growth and expanding consumption appeared exhausted. This implies that the sharp expansion observed in the last decade in these markets will not be repeated in the next few years. We see some structural deterioration of the Brazilian economy, but this should not prevent growth from recovering from the abnormally low rate observed in 2012.

GDP growth should accelerate to 3.4% in 2013 and 3.8% in 2014. The gradual recovery of the economy gained momentum at the beginning of the year. Growth should remain higher than in 2012 this year due to the expansive tone of economic policies, lower inventory levels, the improvement in the global environment and the fading effects of some negative shocks that hit the economy in 2012. The recovery of the economy in 2013 will put the country on track for growing 3.8% in 2014.

Inflation will not decelerate significantly and converge to the 4.5% target anytime soon. Increasingly since the last year, the government has been managing tax cuts and administered prices to try to keep inflation under control. However, inflation continued to surprise to the upside and to trend upwards. It should soon breach the target ceiling again, and remain above these levels until the beginning of the third quarter, when we believe it will start to converge towards 5.6% y/y by the end of the year. In 2014, we expect it to remain at around 5.5%.

Inflationary pressures forced the Central Bank to start a monetary tightening cycle. It abandoned its plans to maintain stable monetary conditions and adjusted the SELIC rate up by 25bps to 7.50% in April. This monetary tightening cycle should continue in the months ahead. We expect the SELIC to reach 8.75% in August and remain constant thereafter. Domestic and external uncertainties as well as our perception that this tightening cycle is aimed at anchoring inflation expectations, rather than forcing inflation to converge to target, support our view that this tightening cycle will be relatively soft.

Fiscal policy is focused on supporting economic activity. Meeting targets and reducing the public debt are now secondary goals. Fiscal policy has been made more expansive to support growth and, accordingly, fiscal targets have been eased permanently. This easing will prevent public debt from trending downwards as we expected before. It will also increase uncertainty regarding the future fiscal performance and could imply the need to adopt a more tightened monetary policy, precisely as it is happening now.

The exchange rate is expected to remain relatively stable and the current-account deficit to widen. Even though the government is more willing to use the exchange rate to increase competitiveness than to keep prices anchored, we expect the exchange rate to remain relatively stable within the 2.o-2.10 range in 2013 and 2014. However, an appreciation in real terms due to high domestic inflation, together with less favorable terms of trade, the recovery of domestic demand and no prospects of reforms to improve competitiveness, will drive the current-account deficit up to 3.0% in 2013 and 3.3% in 2014. This widening trend is a warning of the increasing risks related to the impact of a sudden change in the mood of global markets.

2. A more uneven global scenario

Global growth continued its gradual recovery in 1Q13, but more varied prospects for the main economies have slowed the expected pace of improvement in GDP in 2013 and 2014. Quarterly global GDP growth, estimated by BBVA Research at 0.7% at the beginning of the year, was slightly above the 0.6% of the last quarter of 2012. However, available indicators point to a growing unevenness of economic growth, particularly within the advanced economies, where the Eurozone is once more lagging behind the US and even Japan. At the same time, emerging economies will continue to lead global economic growth. All in all, the expected growth for 2013 (3.3%) is just 0.1 percentage points above the estimated growth for 2012 (see Chart 1). The rate will be close to 4% in 2014, although the balance of risks continues tilted to the downside.

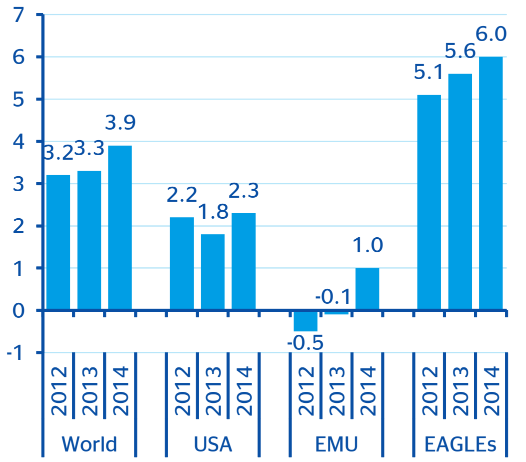
In the euro area, recovery is being delayed to 2014, despite the role of the ECB as a firewall against financial tensions, helped by the boost given to banking union. The ECB has surprised positively by its effective role as a guarantor of the euro against shocks such as the disordered bailout of Cyprus, the political situation in Italy and the Constitutional Court ruling in Portugal. This is in fact reflected in the low response of the markets and the financial tensions to such events (see Chart 2). On the negative side, indicators of the economic situation show a general cyclical weakness that goes beyond the European periphery. That justifies the recent cut in rates by the ECB. This is a positive measure, although it is unlikely by itself to reduce a financial fragmentation that is already having less impact on sovereign issuers and even large corporations, but continues affecting households and companies due to the uneven operation of the banking channel. The bank lending conditions in the area as a whole continue to tighten while in peripheral countries demand for credit is still falling. The Eurozone needs to go beyond the extension of liquidity support for banks and should implement measures to boost lending to firms with the participation of institutions such as the European Investment Bank.

Overall, our scenario involves a downward revision of growth forecasts for the Eurozone. We estimate a fall of 0.1% in GDP in 2013 and a rise of 1% in 2014, 0.4 and 0.3 percentage points, respectively, below the forecasts in our January publication. In any event, the risks continue tilted to the downside. The key point is that Germany should not remain as the only source of growth in the area because of its easy access to finance, high level of competitiveness and greater exposure to the best performing sources of global demand.

One additional consequence of the weakening of the European cycle is the growing debate on the appropriate level of fiscal consolidation to achieve a credible path of a falling deficit without such a severe short-term deterioration in growth that it makes the adjustment effort a failure. The support offered by the European Commission to the delay in achieving the public deficit targets in some European countries is in line with paying more attention to quality and the composition of the fiscal adjustment, and emphasising structural reforms over short-term objectives. What is wrong in Europe? There is a need for a more decisive move towards banking union, to take the debate on deficit targets to structural measures and provide a firmer commitment to reforms in the peripheral countries.

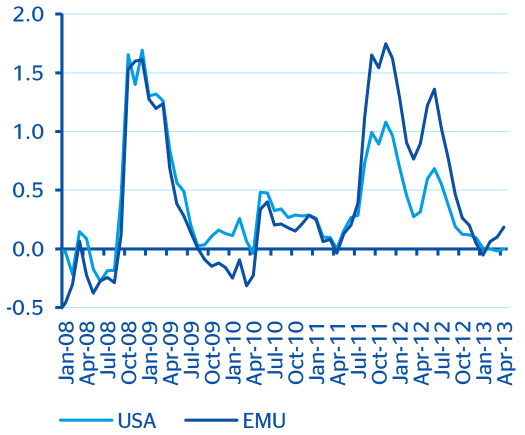
In the US the strength of private demand, against a backdrop of fiscal adjustment, is sustaining growth prospects. Uncertainty on fiscal policy in the short term has eased compared with scenarios that included the closure of government offices. However, the US still lacks credible fiscal-consolidation measures. The removal of some tax breaks and the entry into force of spending cuts have not triggered the alarm in financial markets (see Chart 2) and did not finally cause a significant halt to private expenditure, thanks to monetary expansion that maintains very favourable financing conditions and helps increase income and wealth. It is therefore reasonable to maintain the growth forecasts despite the downside surprise in GDP in the last two quarters in its public demand component.

Chart 1
GDP Growth



Source: BBVA Research

Chart 2
BBVA Financial Stress Index



Source: BBVA Research

The Chinese economy has lost some of its strength in the first quarter of 2013, when investment was weak, despite increased external demand. However, growth that remains in line with the government target of 7.5% for 2013. The measures implemented to tackle the financial fragility appear to have contributed to the slowdown. However, the change in the growth model towards a more consumption-oriented economy continues. With inflation also lower than expected, pressure for tighter monetary conditions has eased. As a result, the authorities have room for manoeuvre, given their commitment to sustainable growth. In all, our forecast for growth in China remains unaltered at 8% for 2013 and 2014.

Sustaining monetary expansion over time, in which the Central Bank of Japan is now also involved, is a challenging prospect. The aim that investors searching for returns should move to higher risk assets may in some markets favour valuations that are far from their long-term fundamentals, and this may lead to disorderly adjustments as the stimuli are withdrawn. This risk is growing given the lack of coordination between the different central banks with quantitative easing policies, each of them looking out for its respective domestic objectives of anchored inflation and sustainable growth. The emerging economies are coping well with inflows, but it is essential to maintain a vigilant stance over the possibility of domestic excesses.

3. Brazil: cyclical recovery, structural deterioration

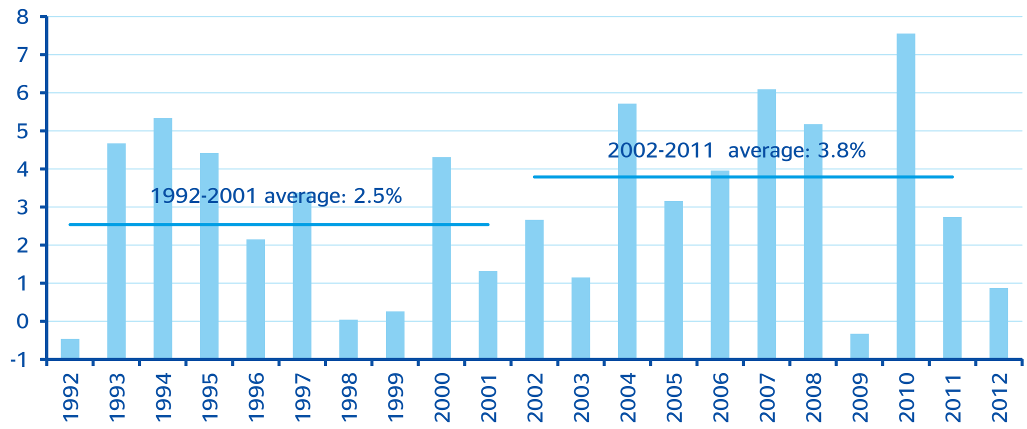
The economy grew only 0.9% in 2012. This is due to idiosyncratic, structural factors that also determine a worsening of the long-term prospects for the country

2012 was not a good year for the Brazilian economy. GDP expanded by 0.9%, the lowest figure since 2009 when the country was hit by the effects of the Lehman Brothers and the economy contracted 0.3%, and well below the 3.8% average growth of the ten previous years (Chart 3).

Therefore, the process of growth deceleration that started in 2011 as a natural consequence of the excessive growth of 7.5% observed in 2010 continued into 2012. The deceleration was, however, much sharper than most anticipated.

Even though the problems faced by developed economies continued to be a source of turbulence, and global GDP growth slowed to 3.2% in 2012 from 3.9% in 2011 and 5.0% in 2010, the main drivers of the sharp slowdown of the Brazilian economy were domestic.

Chart 3
GDP growth (%)



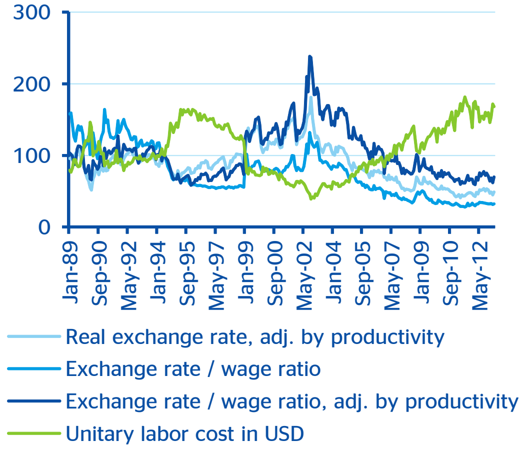
Source: IPEADATA

This view is supported by the evidence from other emerging economies, in particular in Latin America, which continued to grow at high rates in spite of the deterioration in the external environment. Excluding Brazil, Latin America grew 4.0% in 2012, a slowdown in comparison to the 5.4% growth recorded in 2011, but still a very robust pace. Of all the main countries in the region, growth in Brazil was higher only than in Paraguay, where supply shocks drove GDP growth down (for more details on the region, see our Q2 2013 Latin America Economic Outlook).

To the list of "old", well-known domestic weaknesses, such as poor infrastructure, low human capital levels and high tax burden, the expansion of the economy in the last decade added new problems. First, as a consequence of both the sharp increase in domestic wages (due to a tightening of the labor market) and the appreciation of the exchange rate, labor costs in dollars increased sharply (more than 300% since the end of 2002), matching productivity gains and then eroding Brazil's competitiveness (Chart 4). Second, credit expansion in the last ten years drove up the household debt burden and debt service costs, reducing the room for additional credit growth ahead and therefore reducing the contribution of credit markets to domestic demand. The reduction in lending rates and banking spreads seems to have worked in the same direction, as it potentially discourages the supply of credit, even though it has a positive effect on helping to reduce household debt (Chart 5).

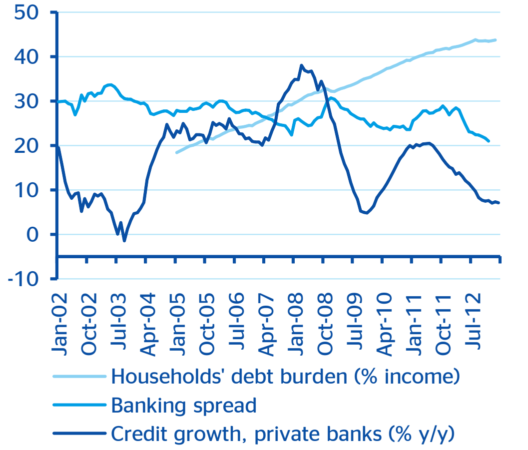
Therefore, the deceleration of the economy in 2012 is to some extent the consequence of a certain exhaustion of the economic model based on credit growth and consumption expansion observed in recent years. This exhaustion, as well as some other factors, supports our view that the strong expansion observed in the last decade in these markets will not be repeated anytime soon. More precisely, we think the following factors will prevent the economy from growing was much as in the recent past ahead: i) the distortions generated over recent years (increase in household debt and erosion of competitiveness due to steep wage growth); ii) household credit/GDP is now much higher than some years ago (16% versus 6% in 2003) and the unemployment rate, much lower (5.5% versus 12% in 2003) which makes additional expansion more difficult; iii) demographics are now less favorable (the working-age population is currently expanding at less than 1.0% in yearly terms versus around 2.0% in 2003); and iv) a comparable expansion in the future would create additional pressure on the current account (which is currently around -2.9% of GDP, while in 2003 it was +0.75%).

Chart 4
Competitiveness measures (Indexes Jun 1994 = 100)



Source: BCB

Chart 5
Credit market measures



Source: BCB

The general perception of increasing interventionism by the government in the economy is also another factor behind the recent slowdown. Examples of such interventionism abound: the excessive expansion of public banks, the new regime for oil exploration in the pre-salt region, the perception that the government is having a say in the conduct of monetary policy, interventions in exchange rate markets, the management of tax cuts and administered prices to try to control inflation and some reluctance in attracting private investments into infrastructure projects.

In our view, this interventionism (and the uncertainty it creates) is one of the reasons behind the 4.0% drop in overall investment in 2012, which compares to an expansion of 21.5% and 4.0%, respectively, in 2010 and 2011.

Even though the government has announced some positive measures to try to rebalance Brazil's growth model and make it less dependent on consumption/credit expansion (such as the concession of infrastructure projects to the private sector, the reduction of energy costs and some tax cuts), they have been insufficient so far and plagued of implementation problems. Up to this point, there is no enough evidence to say that the government is committed to a significant twist in the growth model. Any advance in this direction is especially unlikely before the 2014 presidential elections.

In this environment, we see now a lower potential GDP for the Brazilian economy, certainly below 4.0% and getting closer to 3.0%. The perception that long-term growth is now lower is accompanied by the deterioration in inflation expectations and by prospects of higher external and public deficits than expected before (for more details about this, see the sections below). In short, we see some structural deterioration of the Brazilian economy in recent years, which, however, should not prevent growth from recovering from the abnormally low rate observed in 2012.

Our reduced optimism for the Brazilian economy implies some worsening of our baseline scenario forecasts for the country, which are presented in the sections below, and also that this baseline scenario is subject to higher domestic risks. Examples of such risks are: i) inflation may continue surprising to the upside and ending up running out of control; ii) growth may not recover due to lack of adjustment in the current, partially exhausted growth model or due to the negative impact from monetary tightening; iii) excessive public interventionism may drive private investment even lower; iv) credit from public banks may continue expanding heavily, with risks to financial stability. The recent prominence of domestic risks may offset the improvement regarding external risks.

Ongoing recovery should open the way for growth of 3.4% this year

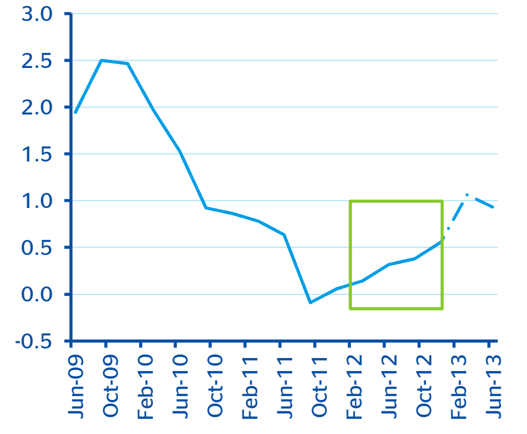
GDP growth remained at very low levels over 2012. However, quarterly data show a slight upward trend throughout the year (Chart 6).This very gradual recovery of economic activity (from 0.1% q/q in 1Q12 to 0.6% q/q in 4Q12) was driven by the increasing fiscal and monetary incentives provided by the economic authorities, the gradual reduction of industrial inventories and a slight improvement of the global environment.

From a different perspective, growth recovered due to the increasing resilience of private consumption. More precisely, private consumption growth averaged 0.8% q/q in the first half of the year and 1.1% q/q in the second. The relative strength of private consumption, which relied on the strength of labor markets, contrasted with the weakness of investment, which nonetheless eased over the year (investment declined in the first three quarters and then grew by 0.5% in 4Q12).

Activity data for the first quarter of 2013 suggest that growth picked up at the beginning of the year (Chart 7). We expect GDP to expand by 1.1% q/q in the period, the highest growth in practically the last three years. This acceleration is related to the maintenance of relatively robust private consumption and by an upturn in investment. The latter is to some extent due some one-off factors such as the sharp expansion in the fleets of trucks, which follows a strong downward correction last year due to the adoption of a new, anti-pollution technology.

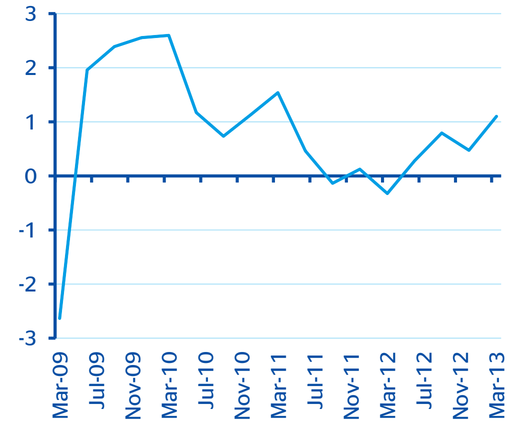
We expect GDP to continue to grow over the year at a quarterly pace around 1.0% q/q, significantly more than the rates recorded in 2012, and 2013 growth to reach 3.4%.

Chart 6
GDP growth (% q/q)



Source: IPEADATA and BBVA Research

Chart 7
Economic Activity Index: IBC-Br



Source: BCB

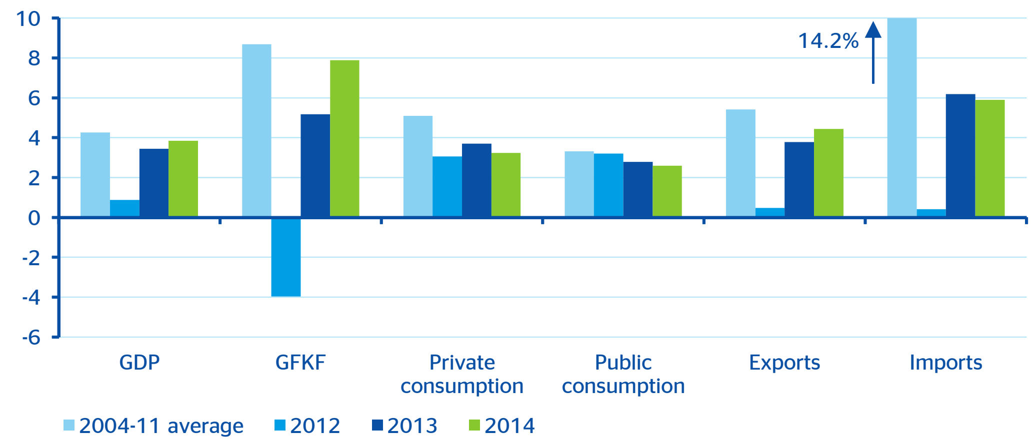
The acceleration of economic activity in comparison on 2012 levels will be driven by the factors cited above (expansive economic policies, lower inventory levels and some improvement in the global environment) as well as by the fading effect of some negative shocks that hit the economy in 2012. Regarding the latter, we highlight that this year better climate conditions will drive domestic harvest significantly up (12% according to official estimates) and growth in Argentina will pick up pace (which should boost manufacturing exports, at least if import restrictions are not tightened). However, structural weaknesses pointed to at the beginning of this report, as well as the external situation, will prevent GDP growth from reaching the high rates observed in previous years.

By demand components, we expect private consumption to grow 3.7% in 2013, slightly more than in 2012 (3.1%) but below the 2004-2011 average (5.1%). Private consumption will, therefore, remain as one of the main contributors to GDP growth (in 2012, it was practically the only contributor to growth). Its contribution, however, will not be as high as in the 2004-2011 period, as the room for additional support from both labor and credit markets is now more limited (see the section above for more details on this issue).

Investment is expected to recover from a 3.9% drop last year and grow 5.2% in 2013. This will be due to the expansion in public investment (by federal and regional governments), the advance in the implementation of some infrastructure projects (some of them related to the organization of the soccer World Cup) and series of incentives provided by the government to the private sector. In spite of this expansion, the investment / GDP ratio will continue at low levels (19% by the end of the year).

Triggered by these prospects for consumption (especially private consumption as public consumption is expected to grow 2.8% this year in comparison to 3.2% in 2012) and investment, the contribution of domestic demand to GDP should jump to 4.1% this year from 0.9% in 2012 (5.3% on average between 2004 and 2011). Stronger domestic demand will drive imports of goods and services up and, consequently, reduce the net contribution of external demand to GDP growth from 0.0% in 2012 to -0.7% in 2013 (-1.1% on average between 2004 and 2011).

Chart 8
GDP growth by demand components (%)



Source: IPEADATA and BBVA Research

Economic drive will continue in 2014, when GDP should grow 3.8%

In our view, the recovery of the economy in 2013 will put the country on track for growing 3.8% in 2014. In addition, the combination of presidential elections, scheduled for October, and the organization of the soccer World Cup in June/July should create incentives for some acceleration in domestic demand (especially in investment). More precisely, our estimates point to an expansion of 4.4% in domestic demand, with private consumption growing 3.1% and investment 7.9% (Chart 8).

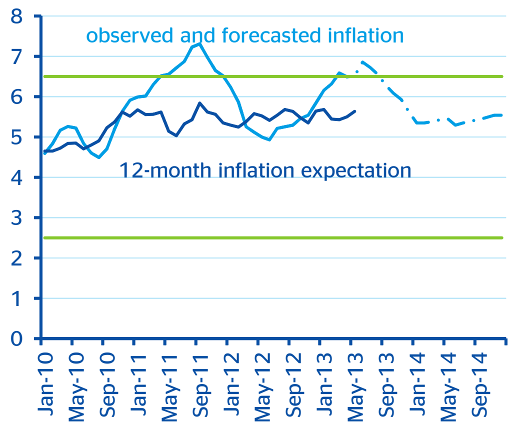
As part of the boost generated by these events will be transitory, and in line with the perception that the sustainable growth rate of the Brazilian economy is now lower than in the past, growth will lose momentum after 2014 and be closer to 3.0% than to 4.0%.

Inflation: high and with no prospect of significant deceleration

In line with our expectations, since last year the government has increasingly been managing tax cuts and administered prices to try to keep inflation under control. Among the main measures announced this year are: i) the decision to adopt a larger than expected cut in electricity tariffs; ii) the postponement of the adjustment in transport tariffs in some regions; iii) the reduction of the taxes on food products with an important weight on inflation and other sectors; and iv) the decision to postpone the return to normal (i.e. increase) of taxes on vehicles produced locally. Together these measures took off at least 100bps from 2013 inflation.

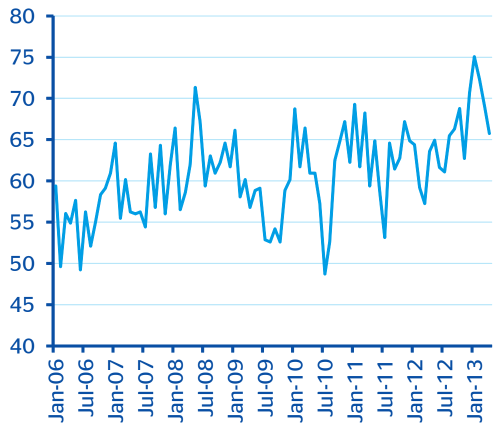
In spite of these measures, inflation continued to surprise to the upside and to trend upwards lately. It breached the target range (2.5%-6.5%) in March but, due to favorable base effects, returned temporarily within this range in April (Chart 9).

Chart 9
IPCA inflation (% y/y)



Source: IBGE and BBVA Research

Chart 10
IPCA diffusion index* (%)



* Share of goods with positive monthly inflation.
Source: BCB

In addition to the deterioration in observed figures, expectations have also deteriorated lately and long-term forecasts are now not only above the 4.5% official target, but also above the 5.5% "implicit" inflation target (at least according to market perception).

Other indicators also reveal increasing inflationary pressures. In particular, the diffusion index (which has been explicitly pointed out by the BCB in its official statements) shows that the share of goods with positive inflation has increased this year, revealing that pressures are widespread (Chart 10).

Worsening inflation is due to multiple reasons: i) strong private consumption and a tight labor market; ii) supply shocks that impacted the economy during the second half of 2012 (driving food prices up); iii) the 17% average exchange rate depreciation in 2012; iv) increases in import tariffs; v) an expansive fiscal and monetary stance; and vi) inflation inertia.

Looking ahead, we see room for a gradual slowdown in monthly inflation over the next few months due to the moderation in food prices and some seasonal factors. Nevertheless, unfavorable base effects should offset the impact of this deceleration and push yearly inflation above the target ceiling until the beginning of the third quarter, when we believe a convergence will begin towards a level of 5.6% y/y by the end of the year.

This deceleration will be favored by the tightening of monetary policy (see more in the section below), the relative stability of the exchange rate (in comparison to the sharp depreciation in 2012), and reduced pressures from food prices.

In 2014, we expect prices to remain around 5.5% (Chart 9). We see no reasons to expect inflation to decelerate more significantly and converge to the 4.5% target any time soon.

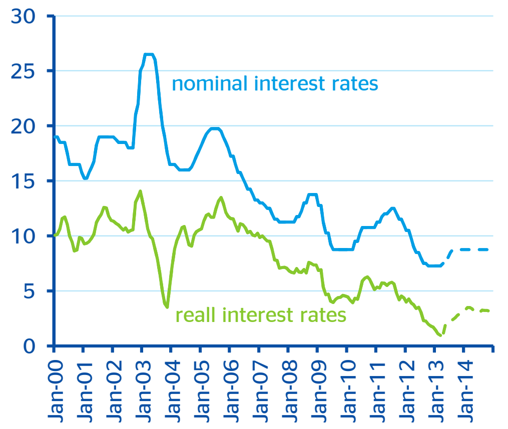
Increasing inflationary pressures forced the BCB to start a monetary tightening cycle, which we expect to bring the SELIC up to 8.50%

The increased perception that inflation was running out of control forced the Central Bank of Brazil (BCB) to abandon its plans to maintain the SELIC stable. It then adjusted the SELIC interest rate up by 25bps to 7.50% in April and declared that "the high level of inflation and the dispersion of price increases, among other factors, contribute to the resilience of inflation and require a monetary policy response."

This adjustment followed a six-month period of stable interest rates at 7.25%, when the BCB proclaimed continuously that "the stability of monetary conditions for a sufficiently prolonged period of time is the most adequate strategy to guarantee the convergence of inflation to target".

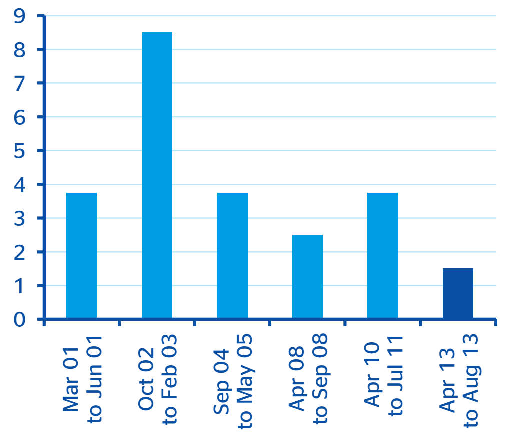
We expect the monetary tightening cycle started in April to continue in the months ahead and the SELIC rate to be hiked by 50bps in the next two monetary policy meetings (in May and July) and finally by 25bps in August. Afterwards it would remain constant at 8.75%. In spite of this adjustment, real and nominal interest rates would continue at relatively low levels for Brazilian standards (Chart 11).

Chart 11
Interest rates (%)



Source: BCB and BBVA Research

Chart 12
Monetary tightening cycles (%)



Source: BCB and BBVA Research

In our view, therefore, the current monetary tightening cycle will be softer than any other cycle adopted since the inflation target system was implemented in 1999 (Chart 12).

In the communiqué on the decision to hike the SELIC by 25bps in April, the BCB also highlighted that it "considers that domestic and principally external uncertainties surround the prospective inflation outlook and requires monetary policy to be managed with caution."

By "domestic uncertainties" the BCB was probably referring to the fact that activity remains relatively weak and that the process of recovery is only incipient. And by "external uncertainties", basically to low growth and the potential for turbulence in developed economies as well as to abnormally high liquidity levels which potentially could leave the exchange rate and the price of other domestic assets under increased pressure.

These uncertainties (partially downplayed by the BCB recently) and our perception that that this monetary tightening cycle is aimed at anchoring medium-term inflation expectations and not at forcing inflation to converge to the 4.5% target support our view that this monetary tightening cycle will be relatively soft. However, the risk that a more prolonged cycle ends up being implemented is now higher than before as inflation risks are also higher now.

We think that any tightening of monetary policy needed to keep inflation under control will be done this year in order to avoid this type of unpopular adjustment during an electoral year such as 2014. We therefore expect interest rates to be left unchanged throughout the next year.

Fiscal policy is focused on supporting economic activity. Meeting targets and reducing the public debt are now secondary goals.

The public sector's primary surplus is currently running at around 2.0% of GDP, well below the 3.1% target and the 3.6% average from 2003 to 2008 (Chart 13).

That is a consequence of maintaining public expenditure strong (around 3.0% y/y in real terms) while revenues remain relatively weak (around -1.0% y/y, also in real terms). The former follows a decision to provide a countercyclical stimulus to economic activity and the latter is due to both the negative impact from the moderation in domestic demand and the series of tax incentives introduced lately. In other words, the reduction in the primary surplus is to a large extent the result of the adoption of a more expansive fiscal policy.

As we noted in a previous section, the decision to cut taxes, which is now at the core of fiscal policy, is not only aimed at supporting domestic activity, but also at preventing inflation from running out of control.

Taking into account that the tax burden is one of the main structural problems faced by the private sector in Brazil, we think the decision to cut taxes should be welcomed. Nonetheless, the reduction of taxes should be more focused on driving production costs down and less on cutting consumer prices, as increasing the competitiveness of the manufacturing sector is still one Brazil's big challenges, while private consumption remains robust (this would be more in line with the need to adjust the country's growth model as discussed above). In addition, incentives for example, to staple food, vehicles and home appliances, introduced at least in part to drive inflation down could end up generating higher demand pressures and therefore higher inflation in the future. Finally, we think that the country would benefit more from tax cuts across the board instead of cuts applied only to some selected sectors.

In any event, tax cuts adopted in recent months as well those we expect to be adopted in the future should cause a permanent deterioration in Brazilian fiscal accounts as a significant reduction in public expenditure is not expected to be announced anytime soon.

Accordingly, the government has been lately easing the primary surplus target of 3.1% of GDP. From this year on the government will be allowed to exclude from its target not only 0.9% of GDP on public investment projects included in the PAC (the Acceleration Growth Program) but also 0.4% on tax breaks. These exclusions make the fiscal target more flexible and, in practice, reduce it to 1.8% of GDP.

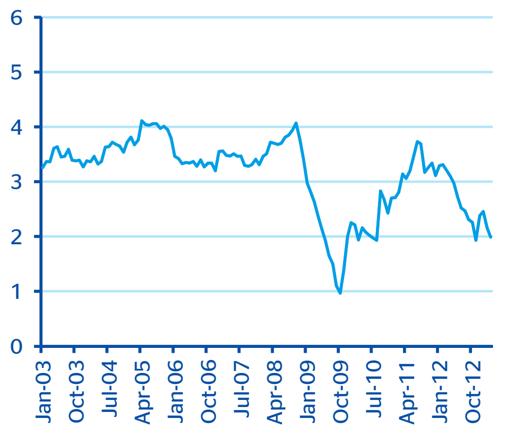
In addition, from now onwards the central government will not be forced to generate a larger surplus if regional governments do not fulfill their part of the surplus target (0.95% of GDP). As we expect regional governments to continue missing their targets in the years ahead, this measure also represents a source of fiscal deterioration.

We expect the public sector's primary surplus to be close to 1.8% of GDP in the years ahead and the total fiscal result, which includes interest payments, to be around -2.7% of GDP.

According to our estimations, these results are in line with a public debt / GDP ratio of around 34% in 2013 and 2014, practically the same as the 35.2% of GDP rate at the end of 2012.

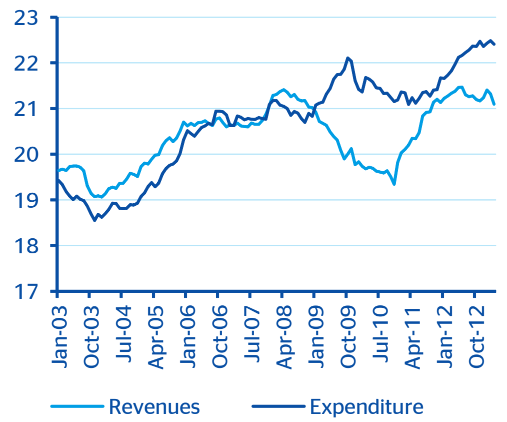
Therefore, the easing of the fiscal target will prevent public debt from trending downwards as we expected before. It also increases the uncertainty regarding the fiscal performance, in particular with respect to the government's ability/willingness to drive the primary surplus up any time in the future when GDP is growing above potential. Finally, the more expansive fiscal stance could imply the need to adopt a tighter monetary policy, precisely as it is happening now.

Chart 13
Public sector primary surplus* (% GDP)



* The public sector includes Central Government and regional governments.
Source: BCB and BBVA Research

Chart 14
Central government: revenues and expenditure* (% a/a)



* Central government includes the National Treasury, Social Security System and BCB. Revenues include tax and contribution revenues as well as social security and BCB revenues. They exclude dividends from state-owned companies and one-offs (such as the revenues generated in 2010 due to the capitalization of Petrobras). Expenditure excludes any related to the capitalization of Petrobras.
Source: BCB and BBVA Research

The exchange rate is expected to remain relatively stable and the current account deficit to widen

In our view, the government is more willing to use the exchange rate to increase the competitiveness of the economy than to keep domestic prices anchored. Nonetheless, we expect increasing concerns about inflation, the recovery of economic activity and abundant global liquidity to prevent the Brazilian real (BRL) from depreciating significantly.

On the other hand, we also consider it unlikely that the BRL will appreciate and move below the 1.90 mark. If a renewed global appetite for Brazilian assets resulted from, say, either the current monetary tightening or the recovery of the domestic economy, the government and the BCB would certainly intervene to prevent a sharp appreciation of the BRL.

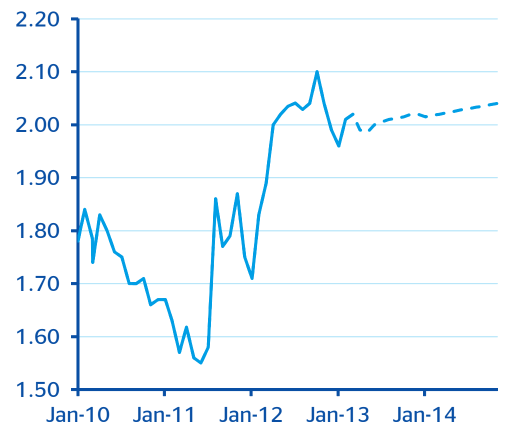
We therefore expect the BRL to remain relatively stable, within the 2.0-2.10 range, where it has been most of the time since the second quarter of 2012 (Chart 15).

The stability of the nominal exchange rate combined with the positive inflation differential between domestic and external rates (i.e. higher inflation in Brazil than in the United States) imply that the BRL /USD exchange rate will appreciate in real terms (2% on average in 2013 and 2% in 2014, according to our estimations). The same logic lies behind an expected appreciation of the real effective exchange rate (which is a multilateral exchange rate, in real terms).

An additional appreciation of the BRL in real terms is one of the reasons why we expect the current-account deficit to widen to 3.0% in 2013 and 3.3% in 2014 (see Chart 16 for the historical relationship between the real effective exchange rate and the current account). Other drivers of this widening are slightly less favorable terms of trade (-3% and -6% in 2013 and 2014, respectively, compared with 2012), the recovery of domestic demand and no prospects of reforms that could significantly increase domestic productivity and therefore improve Brazil's competitiveness.

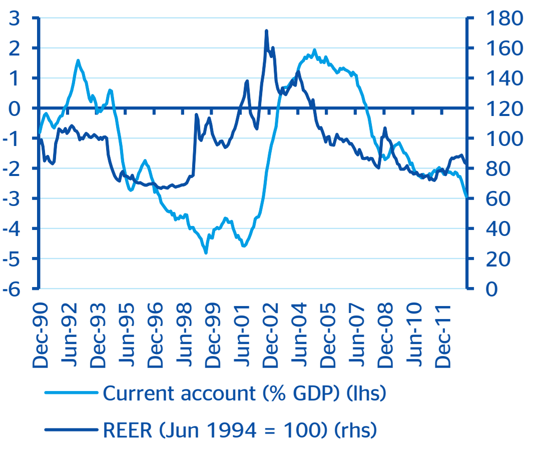
The current-account deficit is expected to remain at manageable levels. Moreover, FDI and international reserves should continue high, providing some cushion: FDI is expected to be around 2.5% of GDP in 2013 and 2014 and international reserves are forecasted to reach 16.7% of GDP in 2013 and 16.1% in 2014. However, the widening in the current-account deficit warns against the increasing risks related to the possible impact of a sudden change in the mood of the global markets.

Chart 15
Exchange rate (BRL/USD)



Source: BCB and BBVA Research

Chart 16
Current account (% GDP) and real effective exchange rate (index Jun 1994 = 100)



Source: IPEADATA and BCB

4. Tables

Table 1
Macro Forecasts Yearly

	2011	2012	2013	2014
GDP (% y/y)	2.7	0.9	3.4	3.8
Inflation (% y/y, eop)	6.5	5.8	5.6	5.5
Exchange Rate (vs. USD, eop)	1.87	2.04	2.02	2.04
Interest Rate (%, eop)	11.00	7.25	8.75	8.75
Private Consumption (% y/y)	4.1	3.1	3.7	3.2
Government Consumption (% y/y)	2.0	3.2	2.8	2.6
Investment (% y/y)	4.8	-4.0	5.2	7.9
Fiscal Balance (% GDP)	-2.6	-2.5	-2.7	-2.8
Current Account (% GDP)	-2.1	-2.4	-3.0	-3.3

Source: BBVA Research

Table 2
Macro Forecasts Quarterly

	GDP (% y/y)	Inflation (% y/y)	Exchange Rate (vs. USD)	Interest Rate (%)
Q1 12	0.8	5.3	1.83	9.75
Q2 12	0.5	4.9	2.02	8.50
Q3 12	0.9	5.3	2.03	7.25
Q4 12	1.4	5.8	2.04	7.25
Q1 13	2.3	6.6	2.01	7.25
Q2 13	3.0	6.7	1.99	8.00
Q3 13	3.8	6.3	2.01	8.75
Q4 13	4.6	5.6	2.02	8.75
Q1 14	4.3	5.4	2.02	8.75
Q2 14	4.1	5.4	2.03	8.75
Q3 14	3.7	5.4	2.03	8.75
Q4 14	3.2	5.5	2.04	8.75

Source: BBVA Research

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This report has been produced by the Emerging Economies Unit:

Enestor Dos Santos
enestor.dossantos@bbva.com

BBVA Research

Group Chief Economist
Jorge Sicilia

Emerging Markets:
Alicia García-Herrero
alicia.garcia-herrero@bbva.com.hk

Cross-Country Emerging Markets Analysis
Álvaro Ortiz Vidal-Abarca
alvaro.ortiz@bbva.com

Asia
Stephen Schwartz
stephen.schwartz@bbva.com.hk

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Latam Coordination
Juan Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Alejandro Puente
apuente@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@grupobbva.com.pe

Venezuela
Oswaldo López
oswaldo_lopez@provincial.com

Developed Economies:
Rafael Doménech
r.domenech@bbva.com

Spain
Miguel Cardoso
miguel.cardoso@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

United States
Nathaniel Karp
nathaniel.karp@bbvacompass.com

Global Areas:

Economic Scenarios
Julián Cubero
juan.cubero@bbva.com

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

Innovation & Processes
Clara Barrabés
clara.barrabes@bbva.com

Financial Systems & Regulation:
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Pensions
David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy
María Abascal
maria.abascal@bbva.com

Contacts details:

BBVA Research
Paseo Castellana, 81 – 7th floor
28046 Madrid (Spain)
Tel.: +34 91 374 60 00 and +34 91 537 70 00
Fax: +34 91 374 30 25
bbvaresearch@bbva.com
www.bbvaresearch.com