BBVA | RESEARCH

# Economic Outlook

## Brazil

Third Quarter 2013
Economic Analysis

- **The global economy will grow 3.1% in 2013 and 3.8% in 2014.** The slowdown in emerging economies and the uncertainty regarding the withdrawal of monetary stimuli in the USA will be a source of stress to financial markets.
- **In Brazil, higher interest rates and a weaker exchange rate have emerged as key elements of the new macroeconomic environment.** The previous setup, based on lower interest rates, failed to drive growth up and ended up fueling inflation.
- **We have revised our GDP forecasts down to 2.3% in 2013 and 2.9% in 2014.** Higher interest rates – we expect the SELIC to reach 9.25% soon - and evidence of a sharper structural deterioration of the economy are the main reasons for this revision.
- **Currency depreciation will help keep inflation under pressure,** but at the same time it will open a door for the country to start to recover some of the competitiveness lost in recent years, which should help to prevent a further deterioration in the current account and also support growth in the medium term.
- **Public sector accounts are expected to worsen in both 2013 and 2014.**

# Index

1. Summary ........ 3

2. Global environment: deceleration in China and uncertainty about the withdrawal of the stimuli in the USA ........ 4

3. Brazil: weaker currency, higher interest rates and lower growth ........ 6

Box 1. How sensitive are Brazil and the Andean economies to a correction in commodity prices? ........ 14

4. Tables ........ 17

Closing date: August 8, 2013

# 1. Summary

**The global economy is showing cyclical weakness, above all in emerging markets, and is facing more difficult financial conditions.** The global economic situation is less favorable than it was three months ago and, therefore, we have revised down our global GDP growth outlook to 3.1% in 2013, 0.2 percentage points below the forecasts three months ago. For 2014, we maintain our expectations of continued expansion, in this case at 3.8%, 0.2 p.p. below the figure we forecast in the last quarter. At least two reasons lie behind this deterioration and the resulting revision of our forecasts. First, emerging markets (including China) are experiencing a sharper slowdown than expected. Second, the tightening of financial conditions at global level following the market reaction to the communication of the details given by the Fed about the reversion of the third round of its quantitative easing program.

**In Brazil, higher interest rates and a weaker than expected exchange rate have emerged as key elements of the new macroeconomic environment, due to domestic and external factors.** The macroeconomic setup implemented by the government through 2012, based on historically low interest rates and a relatively weaker exchange rate, failed to significantly restore Brazil's competitiveness and stimulate growth (GDP expanded only 0.9% in 2012). However, it added pressure on inflation, and forced the Central Bank to tight monetary conditions. The prospects of withdrawal of the monetary stimuli by the Fed and concerns about the deceleration in China have triggered a sharp depreciation of the currency since the end of May (around 12%) and reinforced the need for a tighter monetary policy. Accordingly, we expect the SELIC to be adjusted by 50bps and 25bps in August and October, respectively, and then to remain stable at 9.25% for the remainder of the year and in 2014.

**We have revised our GDP forecasts down to 2.3% in 2013 and 2.9% in 2014, from 3.4% and 3.8%, respectively.** The sharp negative surprise in 1Q13 GDP and preliminary evidence showing that growth remained relatively weak in 2Q13, in a context of supportive fiscal and monetary policies, have heightened concerns about the structural deterioration of the economy. In addition, higher than previously expected interest rates should impose a more significant moderation in labor and credit markets. Moreover, domestic and external uncertainty should continue to play a negative role, preventing a stronger recovery in investment. Finally, we expect external demand and the terms of trade to behave slightly worse than we expected before. All these factors limit the room for acceleration of economic activity in the future and determine a significant downward revision in our GDP forecasts.

**Currency depreciation will help keep inflation under pressure, but at the same time it will open a door for the country to start to recover some of the competitiveness lost in recent years.** Inflation, which reached 6.3% July , is expected to trend downwards in the next few months e to the moderation in food prices, the slowdown in labor markets, the more restrictive tone of monetary policy, and positive base effects. The moderation in domestic prices will provide only partial relief as inflation will remain within the upper range of the target (5.7% at the end of 2013 and 5.9% at the end of 2014, according to our estimations). Domestic prices will remain pressured by the expansionary tone of fiscal policy (especially in 2014) by a weaker currency. On the positive side, the depreciation of the exchange rate should support growth in the medium term and prevent a further deterioration in the current account (which we expect to peak at -3.3% in 2013).

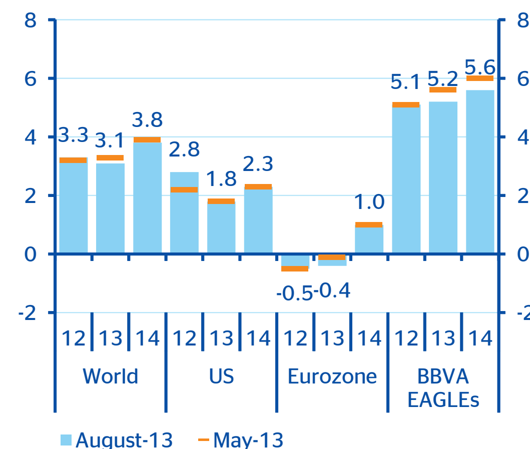
**Public sector accounts are expected to worsen in both 2013 and 2014 as fiscal policy will likely continue focused on supporting growth, and as interest payments will not decline as expected previously.** The recent pressure to rein in inflation and in public accounts was not sufficient to force the government to adopt a less expansionary fiscal policy. Moreover, elections to be hold at both national and regional levels should keep fiscal policy focused on driving growth up in 2014 as well. As a result, primary surpluses will fall short of the targets, which together with higher interest payments will increase the overall fiscal deficit to 2.8% in 2013 and 3.6% in 2014, from 2.5% in 2012. This increase, together with lower GDP growth, will reverse public debt's downward trend and could trigger the downgrade of the Brazil's sovereign rating.

# 2. Global environment: deceleration in China and uncertainty about the withdrawal of the stimuli in the USA

## The global economy is showing cyclical weakness, above all in emerging markets, and is facing more difficult financial conditions

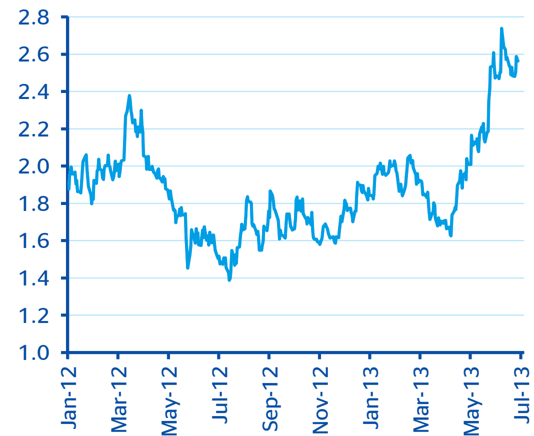
The global economic situation is less favorable than it was three months ago, when we issued our previous growth forecasts. We have therefore revised down our global GDP growth outlook to 3.1% in 2013, 0.2 percentage points below the forecasts three months ago. For 2014, we maintain our expectations of continued expansion, in this case at 3.8%, 0.2 pp below the figure we forecast in the last quarter. At least two reasons lie behind this deterioration and the resulting revision of our forecasts. First, the emerging markets are experiencing a sharper slowdown than expected, which is reflected in major downwards revision in its growth forecasts (Chart 1); above all, they include more moderate growth in China, which has a global impact beyond Asia, for example on the South American economies. Second, there has been an unexpected event, at least at the time when it occurred: the tightening of financial conditions at global level. This increased stress has basically been the result of market reaction to the communication of the details given by the Fed of its steady reduction and subsequent reversion of the third round of its quantitative easing program.

Chart 1
**GDP growth by region**




EAGLEs: Emerging and Growth-Leading Economies (China, India, Indonesia, Brazil, Russia, Korea, Turkey, Mexico and Taiwan).
Source: Haver Analytics and BBVA Research

Chart 2
**Interest rates on 10-year U.S. public debt (%)**




Source: Bloomberg and BBVA Research

## Making the market used to less liquidity: the greatest impact will be on emerging economies with larger short-term financing needs

Although the reasons for this may be varied, most of the shift in financing conditions at global level took place in mid-May, with the details announced by the Fed of its plans to limit and then put an end to its program of monetary expansion. The Fed has also reaffirmed its commitment to maintaining interest rates very low for an extended period and, perhaps more importantly, the whole process is conditional on recovery of the economy, i.e. on the economy continuing at “cruising speed”.

However, market reaction to this plan (even after being clarified in all its details) has been stronger than probably desired by the Fed. As can be seen in Chart 2, long-term interest rates increased by more than 100 basis points, while futures now discount the first rise in rates for the start of 2015, practically one year before expected two months ago. In our opinion, what is being seen on the financial markets is probably partly an over-reaction, as shown by recent downward moves in both long-term rates and expectations of shorter-term rates. Even so, the implementation of the mechanism has generated a process of restructuring of portfolios in the face of the end of abundant liquidity, and thus of extra demand for bonds that kept interest rates at exceptionally low levels. In our opinion, therefore, we are being faced with the start of a cycle of normalization of financial conditions, with higher interest rates and lower demand for risk assets.

Emerging markets have been the most affected by the recent upsurge of financial stress. The current situation has clearly reversed the positive funding conditions prevailing previously, with capital outflows from emerging markets (Chart 3). As well as falls in the stock markets and bond prices, there has also been a general depreciation in their currencies.

There are various factors behind these major capital outflows. As well as an immediate anticipation of the new global liquidity scenario through a restructuring of portfolios, the cyclical weakness of some large emerging markets and the growing risk of a steeper slowdown in China are factors pointing in the same direction. Moreover, monetary expansion in Japan has done little to generate capital flows to emerging markets in search of higher returns.

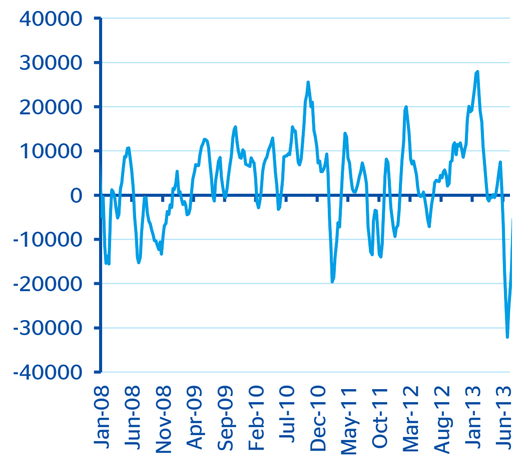
Overall, however, although the rate of capital outflow from emerging markets is very high, there are reasons for optimism. First, the most recent data on capital flows show more moderate outflows over recent weeks. Second, the profile of investors who have headed up the outflows is of a shorter-term investment horizon, compared with institutional investors with longer-term horizons. Finally, the portfolio reorganization has to take into account that if we are moving towards an environment of lower central-bank support for liquidity, this is because the global economic cycle is tending to improve. In addition, we should not forget the fundamentals that emerging markets have constructed in terms of their policy certainty and comparative advantages against the most developed countries with respect to their solvency ratios.

## Slowdown in China: sluggish external demand and steps to limit both indebtedness and the scope of shadow banking

The recent tightening of the Chinese interbank lending market is an example of the side effects of the authorities' efforts to limit financial risks associated with rapid credit growth in the official banking sector, and the credit generated within the so-called shadow banking, which is unregulated. Over the last year, the authorities have adopted a variety of measures aimed at restricting the growth of credit and curtailing shadow banking activities.

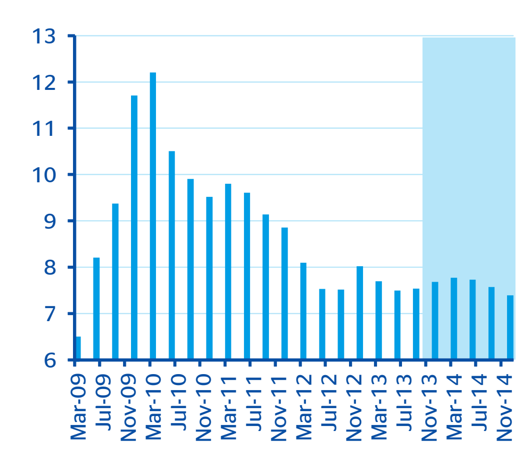
The baseline scenario continues to be one of a continued moderate slowdown (Chart 4). The measures taken to limit credit growth will act as a constraint on the room for stimulus measures to support growth. In addition, the Chinese authorities appear more comfortable with the current rates of GDP growth as they focus more on the quality of growth and medium-term sustainability. Even so, we still consider that the government has room for maneuver if the growth slips below the official targets. Moreover, we believe the authorities have resources to prevent financial risks from generating a hard landing in the near term.

Chart 3
Net flows to EM bond and equity funds (USD million, four-week moving average)




Source: Bloomberg, BBVA Research

Chart 4
China GDP growth (% YoY)




Source: Haver, BBVA Research

## More diversified global risk events, but with lower potential impact

This highly likely global baseline scenario still has some uncertainty ranges somewhat more tilted to the downside than to the upside, but with no high probability of disruptive events that would prevent an outlook of, at least, sustained global growth in 2013 and 2014 near 2012 levels. This diagnosis is a sign of a return to normality in the economic landscape.

The downside risks that could once again delay global recovery (relatively less likely than on other occasions) would basically be the persistence of events that complicated the outlook last quarter to the point of generating additional tensions in the conditions for accessing finance and a decline in the confidence of the economic agents. This could be: i) a new, intense and continued fall in the price of risk-less assets like the U.S. Treasury bond as a result of a market less compliant with the wishes of the Federal Reserve; ii) a resurgence of doubts about the progress towards the Banking Union and the "exceptional nature" of Greece; and iii) a sharper downturn in the Chinese economy, amid the necessary process of economic rebalancing and adjustment of the size of its financial system. Although it is true that the authorities have room for maneuver to prevent "tail" events, the process of change faced by China is notable and requires extensive, ongoing and decisive reforms.

# 3. Brazil: weaker currency, higher interest rates and lower growth

## Domestic and external factors have forced an adjustment of the mix of macroeconomic policies

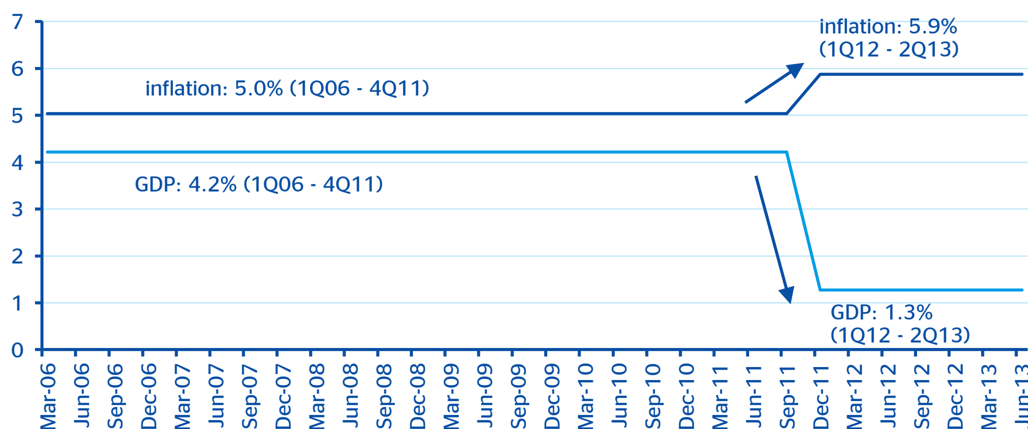
During most of 2012 and the beginning of this year, the government tried to implement a mix of macroeconomic policies centered on lower interest rates and a relatively weaker currency to try to restore part of the competitiveness lost in previous years and drive domestic growth up. In practice, the SELIC interest rate was driven down and maintained stable at 7.25% (around 1.0% in nominal terms), an all-time low, while the exchange rate converged to around 2.05 per dollar, a level 22% higher than the 2011 average, favored by series of interventions in foreign exchange markets.

However, the macroeconomic setup implemented by the government over 2012 failed to significantly restore Brazil's competitiveness and stimulate growth. Lowering interest rates and paving the way for a somewhat weaker currency was not sufficient to offset the series of structural problems faced by the economy (low investment, high tax burden, poor infrastructure…) and the natural limitations of a growth model excessively based on private consumption and credit. In addition, the implementation of this macroeconomic mix generated more concerns about excessive interventionism by the government in the economy, which helped to increase uncertainty up and to prevent domestic demand from recovering. In this context, GDP expanded only 0.9% in 2012 and growth at the beginning of 2013 was practically unchanged in comparison to the end of 2012 (see our 2Q13 Brazil Economic Outlook for more on this issue)..

In addition to a small impact on activity, the setup based on low interest rates and a weaker currency ended up fueling inflation, which remained close to 6.5%, the ceiling of the target range, during the first half of the year (see Chart 5).

Expansionary fiscal policy and a very robust increase in credit from public banks (not followed in this by private banks) did not prevent growth from moderating but contributed to add pressure on domestic prices (for more details on fiscal policy and credit markets, see our analysis below or check our previous publications).

Chart 5
**GDP and inflation: period averages (% YoY)***

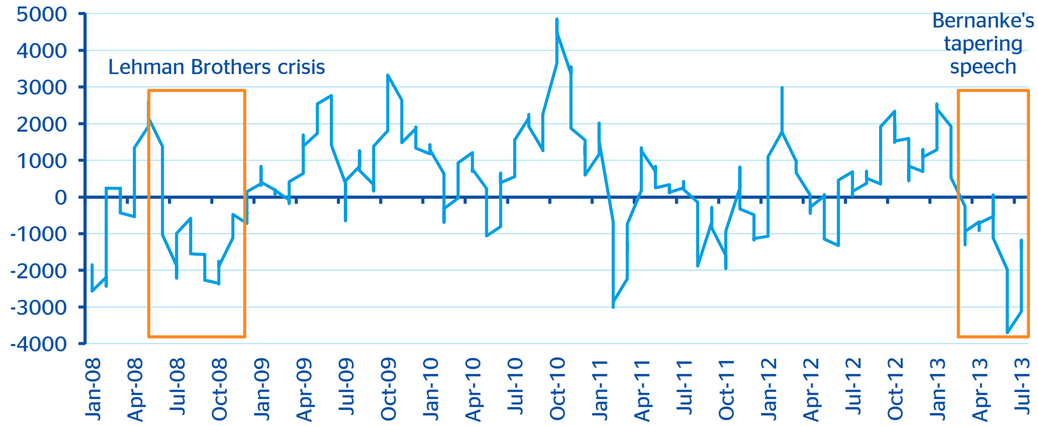



* 2Q13 GDP is the BBVA Research forecast.
Source: BCB and BBVA Research

Amid this semi-stagflation environment, the Central Bank of Brazil (BCB) decided to focus on inflationary risks and started to tighten monetary conditions in April as inflation was eroding household consumption. This slowed down growth and created a new source of political concerns for the President Dilma, only few months before generalized protests took the streets of Brazil's main cities to demand – among many other things- better public services.

Then, prospects of a withdrawal of monetary stimuli in the United States following Ben Bernanke's tapering speech on May 22 reinforced the capital outflow trend and spurred a sharp depreciation of around 12% in the Brazilian real (BRL) to around 2.30 per dollar (see Charts 6 and 7). Concerns about the deceleration in China, which hit commodity prices and consequently Brazil's terms of trade, also supported this depreciation (see Chart 8).

Chart 6
**Capital flows (monthly flows, USD million)***



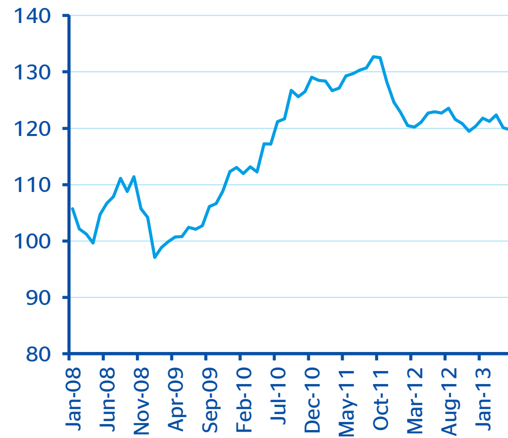

* 2Q13 GDP is the BBVA Research forecast.
Source: EPFR and BBVA Research

The sharp depreciation of the exchange rate reinforced concerns about inflation and increased the need for a sharper adjustment in interest rates (see the section about monetary policy below, for more details). It also triggered the removal of many capital barriers that had been adopted in the past to prevent an excessive appreciation of the currency (such as the IOF tax on foreign investment in fixed-income, the 1% tax on increases in USD short positions, the reserve requirements on short dollar and foreign exchange positions held by local banks).

Chart 7
**Exchange rate (BRL per USD)**

Source: BCB and BBVA Research

Chart 8
**Terms of trade (Index: 2006 average = 100)**




Source: IPEADATA and BBVA Research

Domestic and external factors thus forced some normalization of economic policies and an adjustment of the set of macroeconomic policies in Brazil. In Brazil, higher interest rates and a weaker than expected exchange rate have emerged as key elements of the new macroeconomic environment. The former helps to keep inflation under control, but adds to increasing concerns about the deceleration of the economy and forces a sharp downward revision of our GDP forecasts for both 2013 and 2014. The latter should maintain inflation under pressure but at the same time opens a door for the country to start to recover some of the competitiveness it lost in the last years, which could help to prevent a further deterioration in the current account and also support growth in the medium term.

Meanwhile, fiscal policy remains more focused on supporting growth (and meeting some of the demands revealed in the recent wave of protests) than on helping to control inflation. This should reverse the downward trend exhibited by public debt in the last years and, therefore, trigger a downgrade by rating agencies (see sections below for more on fiscal policy and public sector accounts).

## We have revised our GDP forecasts down to 2.3% in 2013 and 2.9% in 2014, as we see limited room for acceleration in economic activity in the future

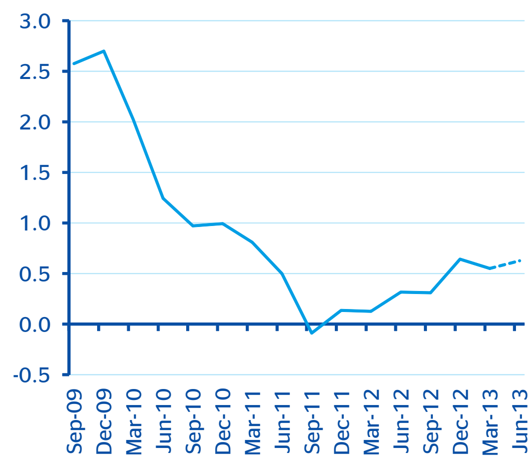
GDP expanded 0.6% QoQ in 1Q13, significantly less than expected (BBVA Research: 1.1% QoQ; consensus: 0.9% QoQ), and practically unchanged in comparison to the previous quarter (see Chart 9). The economy, therefore, did not pick up pace even though fiscal and monetary policies were exceptionally supportive.

Private consumption, which represents slightly more than 60% of GDP, slowed down and expanded only 0.1% QoQ in 1Q13, versus 1.0% QoQ in 4Q12. This deceleration reflects the moderation observed in credit and labor markets and the impact of rising inflation on household demand.

Exports declined 6.4% QoQ (-5.7% YoY) in the first quarter, among other reasons due to the lack of competiveness of the manufacturing sector. On the positive side, investment rebounded (4.6% QoQ) after exhibiting very weak prints since the middle of 2011 and to some extent due some one-off factors. This sharp expansion in investment helped to drive imports up by 6.3% QoQ in the period. In our view, the deceleration in private consumption and the decline in exports add to the evidence of exhaustion in the Brazilian growth model. Moreover, we remain skeptical about the sustainability of the pace of investment growth over the remainder of the year.

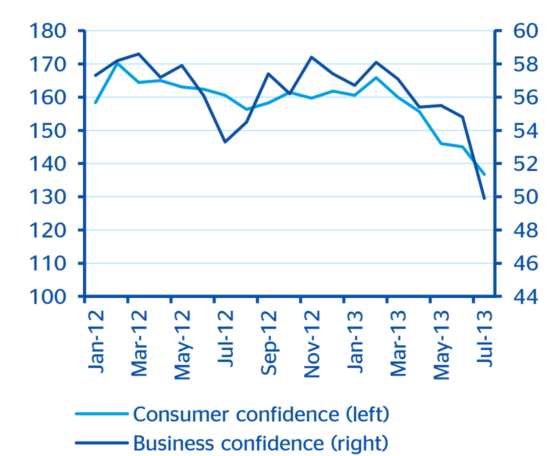
High-frequency data for the second quarter suggest that GDP will not grow significantly more than it did in 1Q13. Among other reasons, domestic and external uncertainty continues to weigh negatively on economic activity. Confidence data, for example, continued to trend clearly downwards during the second quarter (see Chart 10). All in all, we expect GDP to continue to grow at a relatively slow 0.6% QoQ pace in 2Q13 (which is practically half the average growth rate between 2006 and 2010).

Chart 9
**GDP (% QoQ)**




Source: IBGE and BBVA Research

Chart 10
**Consumer and business confidence***

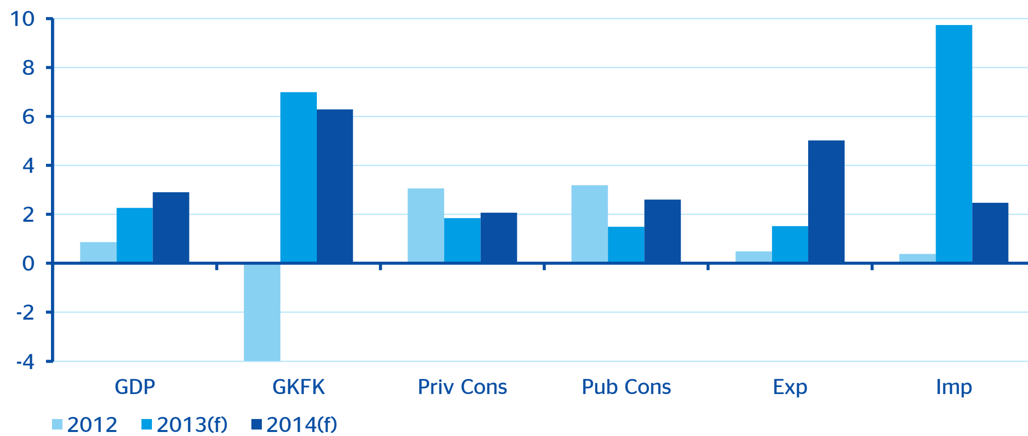



* Consumer confidence: from 0 to 200. Business confidence: from 0 to 100.
Source: FECOMERCIO, CNI and BBVA Research

The sharp negative surprise in 1Q13 GDP and preliminary evidence showing that growth has remained relatively weak favor a downward adjustment of our previous GDP forecasts for Brazil (3.4% and 3.8% in 2013 and 2014, respectively). If this were not enough, higher than previously expected interest rates should impose a more significant moderation in labor and credit markets. In addition, domestic and external uncertainty should continue to play a negative role, preventing a stronger recovery in investment. Among the external sources of uncertainty, we highlight the slowdown of the Chinese economy and the withdrawal of monetary stimuli by the Federal Reserve in the USA. With respect to domestic uncertainty, there is the increasing importance of next year's presidential elections on the political agenda against a new backdrop characterized by widespread popular protests and a significant decline in the President Dilma's approval ratings. Finally, we expect external demand and terms of trade to behave slightly worse than we expected, which will be partially offset by the positive impact of a weaker currency on net exports.

In our view, all these factors will limit the room for a future acceleration of economic activity. This makes it more likely that the economy will continue to grow at relatively sluggish pace. Therefore, we have revised our growth forecasts down to 2.3% and 2.9% in 2013 and 2014, respectively. Domestic demand will continue to be the main driver of growth, with the moderation in private consumption being partially compensated by a rebound in investment.Net exports will continue to contribute negatively to growth, at least in 2013 (see Chart 11).

Chart 11
**GDP and demand components (%)**




Source: IBGE and BBVA Research

Growth is expected to be slightly higher in 2014 than in 2013 as we expect investment to remain relatively supportive and exports to perform better next year. Investment should be backed by a more expansive fiscal policy (typical in a year with elections such as 2014) while exports will benefit from a weaker currency and from a moderation in domestic wages. In any event, structural problems will continue to be a burden and prevent a stronger recovery.

Recent evidence reinforces the perception that the lack of economic reforms to drive productivity up and insufficient changes in the consumption-centered growth model are in line with potential growth rates closer to 3.0% rather than 4.0%. In any event, the depreciation of the exchange rate, which we expect to continue in the future, opens a possibility for the country to move out of the lack of competitiveness in which it is gridlocked in the medium term, especially if the government that will emerge from the 2014 presidential elections is able to reduce the uncertainty hovering around the economy.

## Inflation is trending down, but it will continue to be a source of concerns

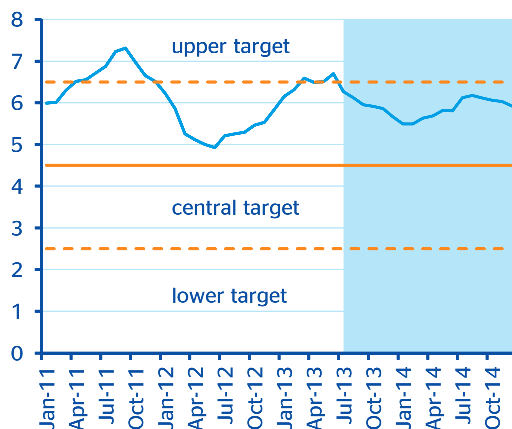
Inflation closed the first half of the year at 6.7% YoY, above the 6.5% target ceiling and the highest in almost two years (see Chart 12). Inflationary pressure came from the relative tightness of labor markets, the significant currency depreciation since the middle of 2012, increased food prices during the second half of the last year, and relatively low interest rates. Inflation could actually have been higher in the first half of the year if it were not for the positive impact of series of tax cuts introduced in the period (for more on this, see our 2Q13 Brazil Economic Outlook).

As commented before, inflation has become an important source of economic and political concerns. In our opinion, high inflation was also one of the triggers of the wave of protests we saw recently (it was not by chance that they started right after the announcement of an adjustment in public transport fares). This has forced the economic authorities to put inflation in the spotlight and increase interest rates. Inflation eased to 6.3% at the beginning of the second half of the year and is expected to trend downwards in the coming months following the moderation in food prices, the slowdown in labor markets, and the more restrictive tone of monetary policy. In addition, inflation will benefit significantly from positive base effects. Accordingly, we forecast inflation to remain close to 6.0% from August to November and then close the year around 5.7%.

The decline of inflation will provide only partial relief, as it will remain within the upper range of the target, not only in the second half of the year but also in 2014, when we expect fiscal policy to put more pressure on domestic prices and interest rates to not increase.

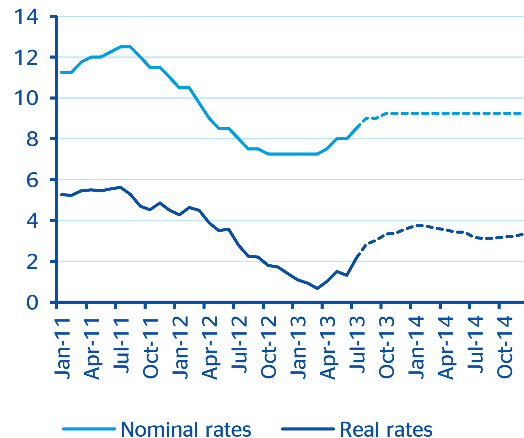
Our inflation forecasts assume the exchange rate will be within the 2.2 and 2.3 range. If the BRL ends up weakening more, this will create extra pressure on prices. We, therefore, see an upward bias on our inflation forecasts.

Chart 12
**Inflation: IPCA (% YoY)**




Source: IBGE and BBVA Research

Chart 13
**SELIC interest rates (%)**




Source: BCB and BBVA Research

## We expect the BCB to start soon to pave the way for the end of the current monetary tightening cycle, unless exchange rate risks materialize

Following a period where concerns about inflation were shared with worries about low growth, inflation took center stage during the second quarter of the year and the BCB had to change plans and start a monetary tightening cycle in April. From then to now, the SELIC rate was adjusted 125bps upwards, to 8.50%.

Continuing high inflation (both observed and expected), the sharp depreciation of the currency in the last two months and the fact that real interest rates are still below the levels considered neutral help understand the need for additional monetary tightening ahead. Accordingly, we expect the BCB to announce another +50 bp adjustment of the SELIC rate at the end of August and a final +25 bp adjustment in October (see Chart 13).

While we see little room for surprise in the August monetary decision (as supported by recent official communication), there is still a high degree of uncertainty regarding the last two decisions of the year, in October and November. However, as we expect i) inflation to trend down over the second half of the year, ii) activity to remain relatively weak, and iii) the exchange rate to be within the 2.2 – 2.3 range, we think that the BCB will have some room to put an end on the monetary tightening cycle with a 25 bp hike in October.

This expected adjustment is, in our view, insufficient to bring monetary policy to a neutral stance (i.e. to make real rates to reach 4.0-4.5%; see Chart 13), which contributes to inflation not converging at the 4.5% target.

From now on, and especially in 2014, political pressures can reduce the BCB's room for maneuver to increase interest rates. This also supports our call for a final adjustment in October and, in addition, makes us to think that the SELIC rate will remain stable at 9.25% during 2014. Therefore, we would not be surprised if the BCB falls behind the curve next year and then is forced to tighten monetary conditions again after presidential elections in October of 2014.

As there are non-negligible risks that the BRL weakens more than we are forecasting, we see an upward risk ahead in our forecast for the SELIC: a stronger depreciation of the currency should trigger more adjustments of the monetary conditions.

In any event, we do not see interest rates returning to the very high levels observed for most of the time before 2012.

## The sharp currency depreciation introduces additional pressure on inflation, but in the medium term it could help the country to address its problems of competitiveness

As commented before, the prospects of a withdrawal of the monetary stimuli by the Fed and the deceleration in China triggered a depreciation of the BRL of around 12% in the last few months, in spite of the BCB intervention in FX markets and the removal of most of the barriers to capital inflows introduced in the recent years.

We see almost no room for the BRL to strengthen significantly any time in the forecast horizon, but we also see reasons for the recent depreciation to lose steam in the short term. In our view, the main risks related to the withdrawal of the stimuli by the Fed and lower growth Chine will not materialize, so downward pressure on the BRL should lose steam. In addition, the removal of barriers to capital inflows and the upward adjustment of interest rates should provide some support to the currency. Accordingly, we forecast the BRL to continue within the 2.20 and 2.30 range for the remainder of the year and in most of 2014 (see tables with forecasts at the end this report).

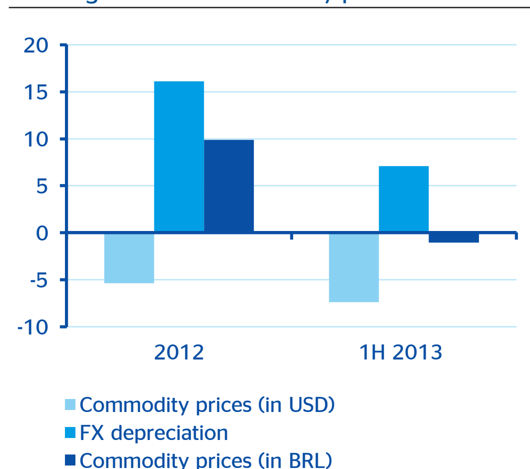
The recent depreciation of the currency adds pressure on inflation and supports our view that inflation will continue to be a source of concern. However, we expect this negative impact to be less than the impact of the currency depreciation observed last year: firstly, because the magnitude of the depreciation is lower this year than in 2012, at least until now (12% versus 18% last year); and secondly, because last year commodity prices measured in USD declined less than they did this year (see Chart 14).

The recent depreciation of the currency could potentially also introduce a significant cost for companies holding liabilities in USD, as has been shown by previous episodes of a sharp

weakening of the currency. However, the BRL depreciation observed last year somehow warned companies of this problem, reducing the risk of the recent depreciation taking agents by surprise and affecting them significantly. In addition, the foreign indebtedness of the private sector is largely concentrated in the long term (only 16% of the total foreign debt is due within one year) and relatively small (11.2% of GDP, which is less than BCB's international reserves, which amount to 16% of GDP and could be used by the government to address FX risks).

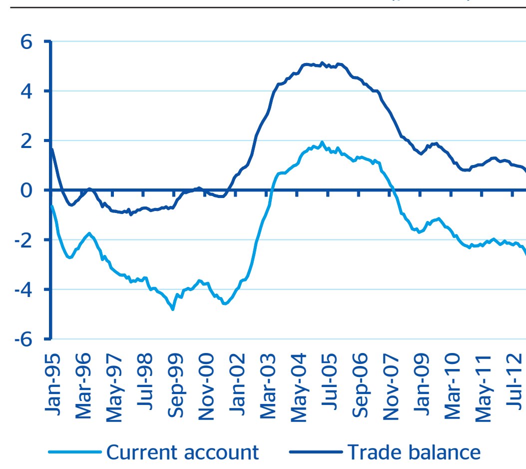
In spite of the costs involved in the weakening currency, it also opens a door for the country to recover part of the competitiveness it has lost in the recent years. This is particularly important as the capacity of domestic demand to support growth is reducing and as alternative ways to increase competitiveness (such as the adoption of economic reforms to increase productivity) seem very unlikely, at least in the current juncture.

Chart 14
**Exchange rate and commodity prices***




*Commodity prices: IC-BR, a basket of relevant commodities for Brazil.
Source: BCB and BBVA Research

Chart 15
**Current account and trade balance (% GDP)**




Source: BCB and BBVA Research

## We expect the current-account deficit to peak this year at 3.3% of GDP

Another symptom of the loss in competitiveness is the recent deterioration of the trade balance and of the current account in the last few years. The former currently stands around 0.4% of GDP and the latter at -3.2% of GDP. In both cases, the present figures are the worst in more than ten years (see Chart 15).

Part of this deterioration is related to strong domestic demand and the appreciation of the exchange rate in the period under analysis.

Looking forward, we expect the moderation of domestic demand and the weakening of the BRL to reduce the space for additional deterioration ahead. Accordingly, we expect the current account deficit to peak at 3.3% at the end of 2013 and then to decline to 3.0% in 2014. Similarly, we expect the trade surplus to close the year at 0.25% and then to recover very slightly and reach 0.40% in 2014.

A disorderly withdrawing of the stimuli in the United States or a sharper deceleration of the Chinese economy could force a less gradual and more painful adjustment. In any case, however, we expect the high level of international reserves and the resilience of foreign direct inflows, which remain strong (around 2.9% of GDP in June), to provide some support even under (unlikely) stress scenarios (see the Box 1 for a comparative analysis of the sensitivity of the Brazilian economy to a sharp drop in commodity prices).

## Box 1: How sensitive are Brazil and the Andean economies to a correction in commodity prices?

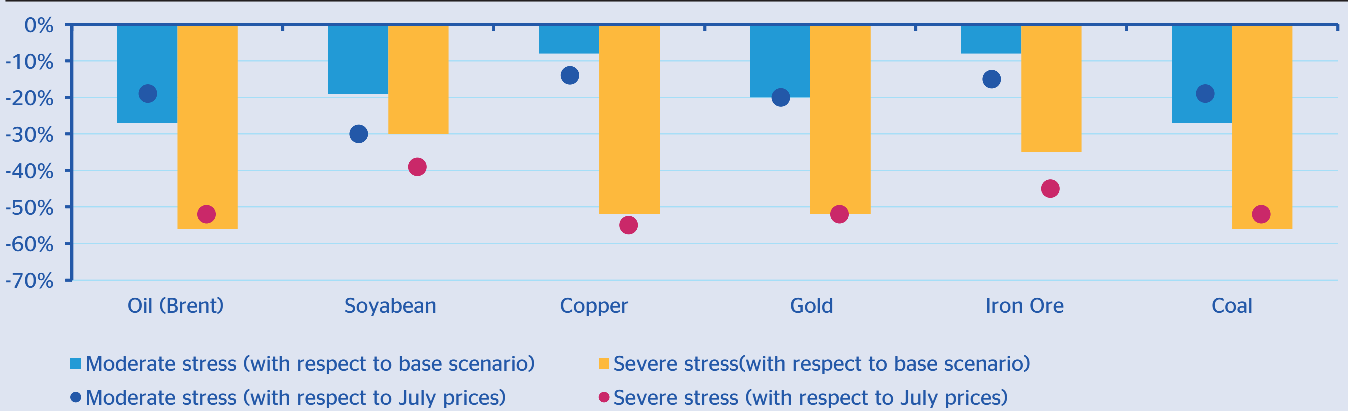
In recent years, Latin American countries have gone through a process of institutional and economic progress leaving them better placed to deal with internal and external shocks. The behavior of the region's economies after the collapse of Lehman Brothers supports this conclusion.

However, the significant weight of commodities in their productive structure and, above all, in their exports, remains a potential source of stress for countries in the region. In this regard, the recent slowdown in growth in Brazil and the Andean countries (i.e. Chile, Colombia and Peru) and the upturn in their current-account deficit could also be related to the recent slowdown in many commodity prices and in growth in China (see the discussion of this subject in our 3Q13 Latin America Economic Outlook).

Although our baseline scenario does not provide for a strong downward correction in commodity prices and we assign a low probability to such an event, in this box we will analyze the impact that a negative shock in commodity prices would have on current account balances and, above all, on economic growth in Chile, Colombia, Peru and Brazil. More specifically, we will quantify the impact of two commodity price scenarios on external deficit and GDP: i) a moderate stress scenario of a permanent fall in commodity prices of between 15% and 30% against the current price, starting in January 2014, to reach a level similar to the average for the period 2006-2012; ii) a severe stress scenario in which prices fall between 40% and 55%, starting in 2014, to reach similar levels in general to those of late 2008, right after the collapse of Lehman Brothers[1,2].

Chart 16 illustrates precisely the price assumptions used in our exercise.

Chart 16
Commodity price falls in the two stress scenarios (%)




Source: BBVA Research

Approximately 50% of exports from Chile and Peru will be affected by the price falls included in our exercise. In the case of Brazil, this ratio is slightly lower (about 45%), and in Colombia it is 65%[3].

The shocks impact on the Andean and Brazilian economies through various channels. Lower prices would lead to a deterioration in the terms of trade and would have a direct negative impact on exports. They would reduce the strength of sectors producing commodities, as well as sectors that depend directly or indirectly on them, due to the reduction of revenues and impaired financing conditions. This would lead to more moderate private consumption and investment (caused by, among other things, a slowdown in the labor market). At the same time, it would generate a fall in fiscal revenue, which would make it difficult to increase public spending. Deterioration in household and business confidence in the economy would certainly accentuate these negative impacts on growth.

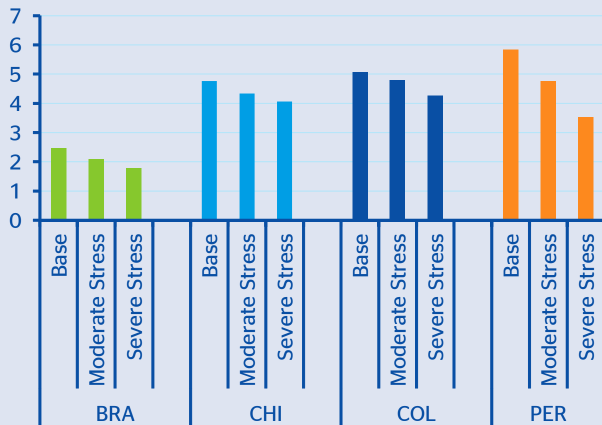
1: Exceptions to this pattern are copper and gold. In the moderate stress scenario, we assumes an ad-hoc drop in copper prices of 8% with respect to our baseline forecasts, which already incorporates a downward correction ahead (see our 3Q13 Latin America Economic Outlook) as current prices are already below the 2006-2012 average. With respect to gold, we assume a 20% decline in prices from 2014 on in the moderate stress scenario. In the severe stress scenario, we assume that gold prices drop about 50% instead of following the general correction pattern, as gold prices increased after the Lehman Brothers crisis.
2: The shocks considered do not incorporate a decline in the demand for commodities, but just a drop in prices.
3: In the case of Brazil, the size of falls in the price of copper and iron on the one hand, and soybeans on the other, were extended, in similar proportions, to other metal and agricultural commodities, respectively.

Although all the countries included in this exercise are net commodity exporters, the impact of lower prices of these products would be lessened by lower expenditure on commodity imports (which represent about 20% of total imports in Brazil and Peru, slightly more than 30% in Chile and more than 40% in Colombia).

We believe that the monetary authorities would react to the fall in commodity prices to reduce its impact on the economy. This reaction would be stronger in Chile and Peru, where there is more room to adopt countercyclical fiscal and monetary policies, and in the severe stress scenario, rather than the more moderate stress scenario.

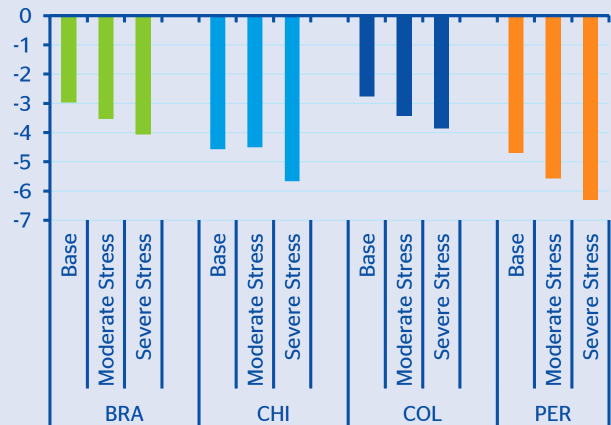
According to our estimates, the impact of the moderate stress scenario on GDP would be a decrease of about 120 basis points on average in 2014, and would fade away during 2015 and 2016. In the severe stress scenario the impact would be stronger (approximately a negative 250 points compared to our baseline scenario in 2014) and longer lasting (-50 points and -30 points on average in 2015 and 2016, respectively). Also, after a strong initial impact, the Andean economies would manage a robust recovery in 2016 (about 4.5% in the moderate stress scenario, and 4.0% in the severe stress scenario), while growth in Brazil – more affected by idiosyncratic problems – would not surpass the 3.0% barrier (see Chart 17 for more details of the impact of the two scenarios on GDP).

Chart 17
**GDP growth in the baseline and stress scenarios (average % in 2014-16)**




Source: BBVA Research

Chart 18
**Current account in the baseline and stress scenarios (average % of GDP in 2014-16)**




Source: BBVA Research

In both scenarios, and in all the countries analyzed, the current-account deficit would increase strongly in 2014: to about 4.0% in Brazil and Colombia and above 6.0% in Peru and Chile in the moderate stress scenario; and to about 5.0% in Brazil and Colombia and above 8.0% in Peru and Chile in the severe stress scenario. However, the depreciation in exchange rates and the slowdown in domestic demand would lead to a deficit reduction over 2015 and 2016. In both scenarios, the current-account deficit at the close of 2016 would not be very different from the levels we forecast in our respective baseline scenarios (see Chart 18 for more details of the two scenarios' impact on the current account)[4].

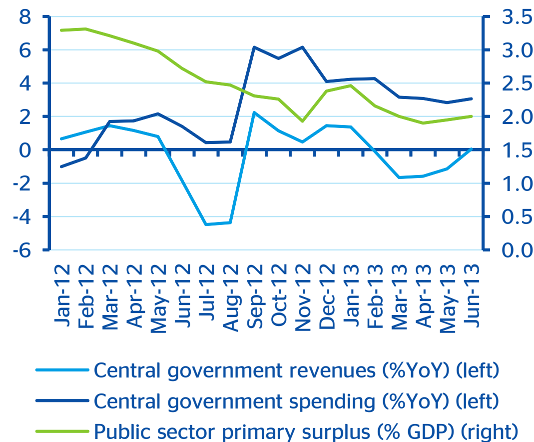
In general, our simulations suggest that the Andeans and Brazil would be heavily impacted by a correction in commodity prices. However, growth would continue at relatively robust levels, at least in the Andeans. In addition, the rise of the current account deficit would be largely temporary, since exchange rates would adjust to offset some of the impact of lower commodity prices.

4: The impact on both growth and on the external deficit would be higher in Peru than in the other countries. This is because i) Peru currently has a higher external deficit and thus a greater need for adjustment to bring it to more sustainable levels, ii) the more significant participation of foreign investors as holders of local assets, coupled with lower liquidity in financial markets than in the other three countries, lead to higher (and probably longer) corrections of asset prices, leading to further depreciation of the exchange rate, with further tightening of monetary conditions.

## Lower primary surpluses and higher interest payments will undermine the fiscal results

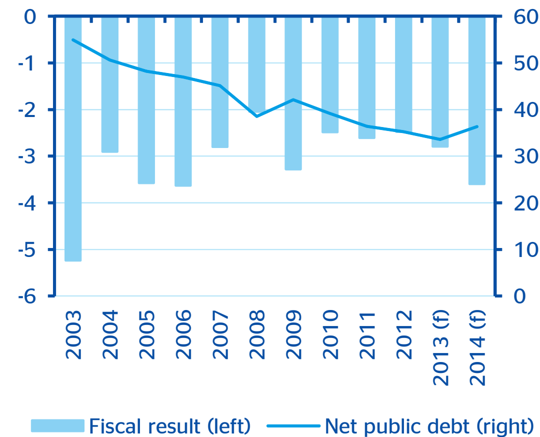
The support that public expenditure is providing to economic activity and the negative impact of the slowdown in domestic demand on revenues are both driving the primary surplus down (see Chart 19).

Chart 19
**Central government revenues and spending (% YoY, real terms) and public sector primary surplus (% GDP)**




* There are no updated revenue and spending data for regional governments and public-owned firms and therefore for the public sector as a whole. In this chart we use revenue and spending data for the central government instead.
Source: BCB and BBVA Research

Chart 20
**Public sector fiscal result and net public debt (% GDP)**




Source: BCB and BBVA Research

The recent pressure to rein in inflation and keep public accounts in check was not sufficient to force the government to adopt a less expansive fiscal policy. Accordingly, we expect the government to produce a 1.8% primary surplus this year. This figure will fall short of the latest 2.3% primary surplus target (the initial target for the year was 3.1% of GDP) and the 3.2% 2003-2011 average.

Presidential and regional elections held against a background of increasing popular demands should prevent the public sector from delivering a fiscal adjustment next year as well. In fact, we expect spending to pick up in 2014 and the primary surplus to decline further to 1.4% of GDP.

In addition to worse than expected primary surpluses, higher interest rates will create an extra fiscal burden, especially in 2014. According to our estimates, interest payments will reach 4.6% and 5.0% in 2013 and 2014. This contrast with previous estimations, based on lower SELIC rates, which pointed to an interest payment burden around 4.0%.

As a result, the overall fiscal deficit should increase from 2.5% in 2012 to 2.8% in 2013 and 3.6% in 2014. This increase, together with lower GDP growth, and in spite of the weakening of the BRL (which reduces the public debt as it increases the value in BRL of the international reserves), will reverse the downward trend in the public debt(see Chart 20) and could trigger a downgrade in Brazil's sovereign rating next year.

# 4. Tables

Table 1
## Macro Forecasts Yearly

| | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|
| GDP (% y/y) | 2,7 | 0,9 | 2,3 | 2,9 |
| Inflation (% y/y, eop) | 6,5 | 5,8 | 5,7 | 5,9 |
| Exchange Rate (vs. USD, eop) | 1,87 | 2,04 | 2,25 | 2,30 |
| Interest Rate (%, eop) | 11,00 | 7,25 | 9,25 | 9,25 |
| Private Consumption (% y/y) | 4,1 | 3,1 | 1,8 | 2,1 |
| Government Consumption (% y/y) | 1,9 | 3,2 | 1,5 | 2,6 |
| Investment (% y/y) | 4,8 | -4,0 | 7,0 | 6,3 |
| Fiscal Balance (% GDP) | -2,6 | -2,5 | -2,8 | -3,6 |
| Current Account (% GDP) | -2,1 | -2,4 | -3,3 | -3,0 |

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 | 1,9 | 6,6 | 2,02 | 7,25 |
| Q2 13 | 2,1 | 6,7 | 2,26 | 8,00 |
| Q3 13 | 2,4 | 6,0 | 2,21 | 9,00 |
| Q4 13 | 2,7 | 5,7 | 2,25 | 9,25 |
| Q1 14 | 2,8 | 5,6 | 2,24 | 9,25 |
| Q2 14 | 2,9 | 5,8 | 2,24 | 9,25 |
| Q3 14 | 3,1 | 6,1 | 2,25 | 9,25 |
| Q4 14 | 2,8 | 5,9 | 2,30 | 9,25 |

Source: BBVA Research

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