

## 4 The Brazilian economy will contract sharply in 2015 and stagnate in 2016; inflation will remain under pressure

### A sharp contraction in domestic demand pushes the country into a recession

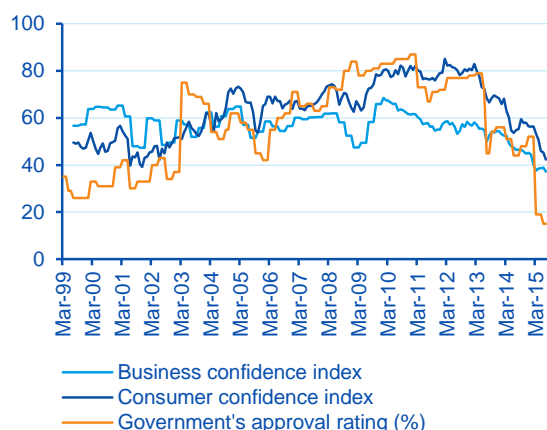
The economy contracted sharply in the second quarter of 2015, following a moderate decline in the first quarter, according to most indicators.

The confidence indices, which were already at very low levels at the beginning of the year, deteriorated further in the last months, especially since March. Both business and consumer confidence are now at the lowest levels in more than ten years. To some extent, the worsening of confidence is related to the negative political dynamics (corruption scandals spilling over the public and private sectors, government's increasing problems in dealing with the Congress, etc.) described in the previous section, especially in the last few months. The government's approval rating has dropped from 40% at the end of 2014 to only 9% in June, by far the worst in many years (Figure 4.1).

The negative trends exhibited by confidence and the government's approval indicators are certainly linked to the performance of economic activity. In this sense, it is worth noting that after displaying an impressive resilience in the past years, labour markets have started to deteriorate significantly in the last few months (Figure 4.2). If the former strength was a sign of optimism regarding the future of the economy, the recent worsening can be used to support the opposite view, i.e. that the optimism regarding the country has waned.

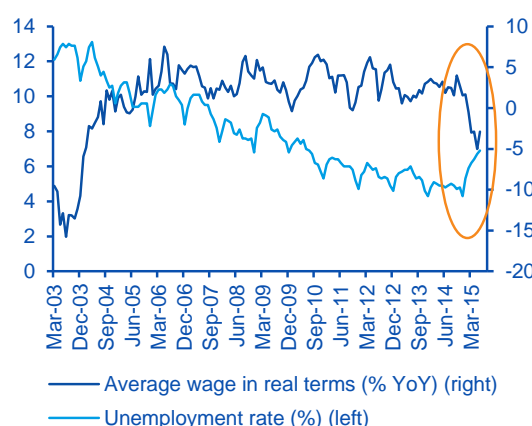
The unemployment rate, which averaged 4.8% in 2014, jumped to 6.9% in June. Average wages, which expanded around 2.7% in real terms in 2014 (and even more in previous years), started to grow at negative rates in real terms in February (Figure 4.2).

Figure 4.1  
**Confidence indices and government's approval rating**



Source: CNI, IPEADATA and BBVA Research

Figure 4.2  
**Labour markets: unemployment rate and real wages**



Source: IBGE and BBVA Research

With respect to credit markets, where the moderation trend started some years ago (due to private credit deceleration which was only seen in public banks from the middle of 2014), the recent evolution also supports the view that economic activity is deteriorating. Not only is the stock of credit's growth pace now running below the inflation rate, but also lending rates are increasing, among other reasons due to the aggressive monetary tightening that the Brazilian central bank has been implementing (Figure 4.3).

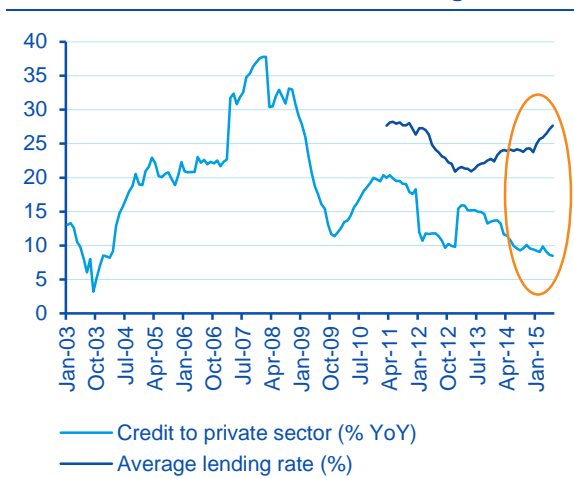
Even though the government is currently being forced to adopt a tightening of both monetary and fiscal policy (see Section 5), which is certainly one of the main factors behind the current slowdown of the economy, it announced in the last few months a couple of measures to try to provide some partial relief to labour and credit markets. At the beginning of July the government announced [a measure to try to reduce lay-offs by increasing the flexibility in the number of hours worked](#), and a few days later it raised to 35% from 30% the cap of payroll loans as a share of personal income.

Still regarding domestic factors that are currently driving growth down, we note that the rising inflation and the exchange rate depreciation have been representing a costs shock for both consumers and producers. On the positive side, there are the reduced risks of an energy blackout, due to increased rainfall and a contraction of consumption.

Even though the domestic environment is playing a very significant role in the ongoing deceleration of the Brazilian economy, we have to note that the external environment is not being supportive either, mainly because of the negative impact of the moderation of the Chinese economy and, consequently, of commodity markets.

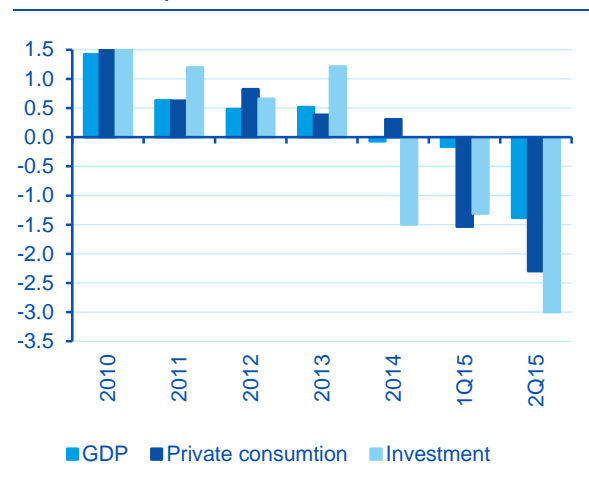
Considering all these factors, we expect the economy to contract by 1.4% QoQ in the second quarter, in comparison to a 0.2% QoQ contraction in the first. A second consecutive quarter of negative quarterly growth would mean that the country is technically in recession.

Figure 4.3  
Credit markets: credit stock and lending rate



Source: BCB and BBVA Research

Figure 4.4  
GDP, private consumption and investment (average quarterly growth for 2010-14, 1Q15 and 2Q15, % QoQ)\*



\* BBVA Research forecast for 2Q15.  
Source: IBGE and BBVA Research

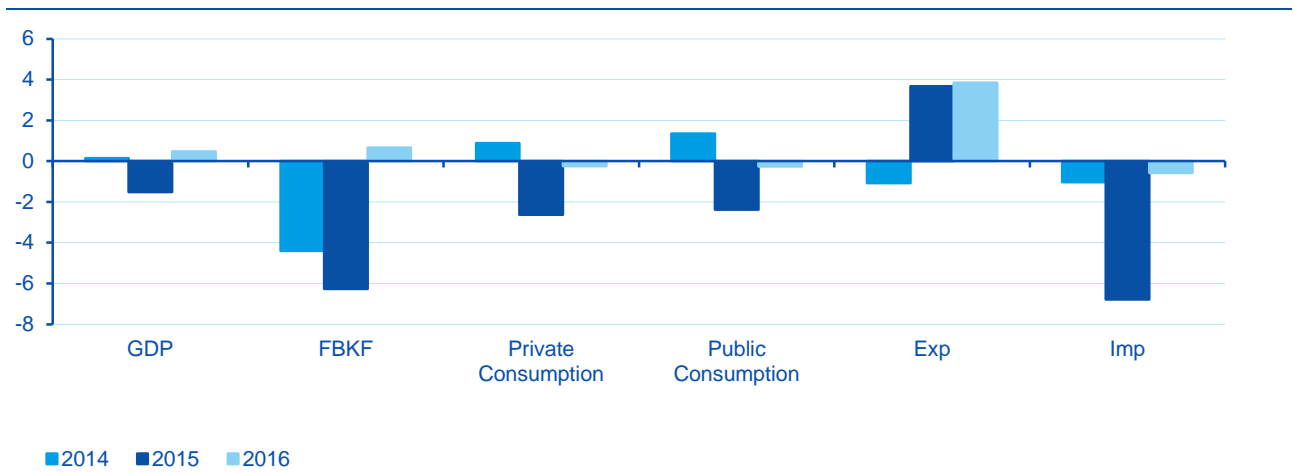
In terms of GDP components, the main drivers of the contraction in the first two quarters of the year were investment and private consumption (Figure 4.4). The latter, which actually accounts for two-thirds of GDP, declined 1.5% QoQ in the first quarter and our forecasts point to a more significant drop in the second quarter, mainly reflecting the deterioration in the labour market. If our estimate proves to be correct, this will be the most significant contraction in private consumption since 1995. Regarding investment, it is expected to contract for the eighth consecutive time in the second quarter. Among other reasons, the expected contraction of investment is due to the impact of low confidence and heightened uncertainty, as well as of the reduction in investments by Petrobras following the recent financial problems faced by the company on private investment; and the impact of the ongoing fiscal adjustment on public investment. In contrast with the very negative contribution of domestic demand components to GDP growth, we expect external demand to contribute positively in the second quarter, as it did in the first, mainly due to a contraction in imports.

GDP is expected to drop 1.5% in 2015, and to grow only 0.5% in 2016

Up to now, there are still neither clear signs nor strong reasons to think that the economy will recover in the second half of 2015 after the sharp deceleration in the first part of the year. Therefore, the most likely outcome is that the economy will continue in recession, at least during the third quarter. The turbulence observed in both the political and financial arenas at the beginning of the second half of the year and the leading indicators (such as confidence) for the period reinforce the view that the economy will deteriorate further in the remainder of the year. Nonetheless, we do not expect GDP to contract as sharply in any of the two following quarters as it probably did in the second.

Based on these prospects, we estimate that GDP will contract 1.5% in 2015 (Figure 4.5). Therefore, we now expect the economy to go through a more significant correction than we did three months ago when we held a -0.7% forecast, even though growth surprised to the upside in the first quarter (observed: -0.2% QoQ; forecast: -0.6% QoQ), and in spite of the perspectives of a less intense fiscal adjustment this year (see Section 5 for more on fiscal policy). The main factor behind this downward revision is a larger-than-expected fall in domestic demand – mainly due to the worsening of confidence and the sharp deterioration of the labour market – although a less positive evolution of the world economy, especially in China, also contributed to it.

Figure 4.5  
GDP and components (%)



Source: IBGE and BBVA Research

The worst of the current crisis should be left behind in 2016, at least if the political situation stops deteriorating and if the government manages to prevent a further worsening of the fiscal prospects (more negative political or fiscal dynamics are the main downward risks to our baseline scenario). Even though we do not expect a sharp turnaround of the economy next year, there are some factors that support the emergence of a less negative scenario, in which confidence stops worsening. Among them, we highlight: i) the fall in inflation, that we expect to occur from the beginning of next year; ii) the likely end of the monetary tightening cycle in July of 2015 and an eventual easing cycle next year; iii) the lagged impact of the ongoing exchange rate depreciation on net exports; iv) the increase of world growth to 3.8% in 2016 from 3.4% in 2015 (Section 2); and v) the expected stabilisation of commodity prices and, consequently, of Brazil’s terms of trade (Figure 4.6).

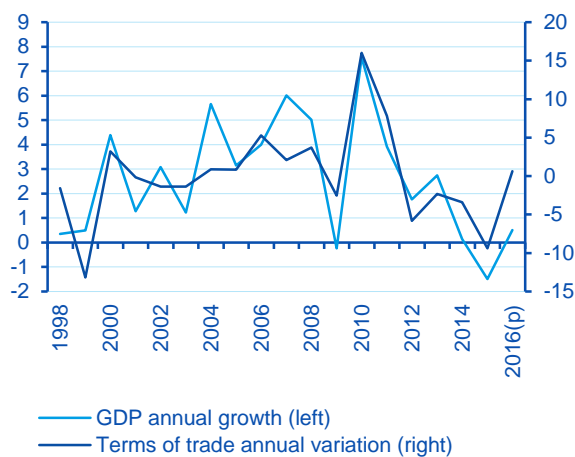
We have revised our forecast for growth in 2016 down to 0.5% from 1.8% previously, as we expect the aforementioned factors to be less supportive than we had expected and as the fiscal adjustment will be more gradual than forecasted, which means that part of the expenditure control and revenue increase will be done

in 2016 rather than in 2015, and mainly because it will make the government’s task of recovering the credibility of economic policy more difficult (see Section 5 for more details). Finally, it is important to highlight that carry-over statistical effects will be negative in 2016: taking into account our 2015 forecasts, GDP will contract by 0.5% in 2016 if GDP remains stable (0.0% QoQ) in every quarter of the next year.

We expect private consumption to decline by around 0.3% in 2016, as the ongoing labour market slowdown should continue next year, as it usually reacts with some lags to the economic cycle (we forecast an increase of the average unemployment rate from 4.8% in 2014 to 6.7% in 2015 and 8.2% in 2016). However, this contraction would be not as significant as the one expected to happen this year (-2.6%). We expect public consumption to exhibit a similar growth pattern (Figure 4.5) and investment to remain broadly unchanged after a sharp contraction in 2015 (around -6.0%). Therefore, after contributing very negatively to growth in 2015 (-2.7pp), domestic demand will contribute slightly negatively (-0.1pp) to growth in 2016. Regarding net exports, they will contribute significantly (+1.2pp) to growth this year, mostly due to the contraction in imports, and to a lesser extent in 2016 (+0.6pp) due to a smaller contraction in imports, and in spite of the better performance of exports.

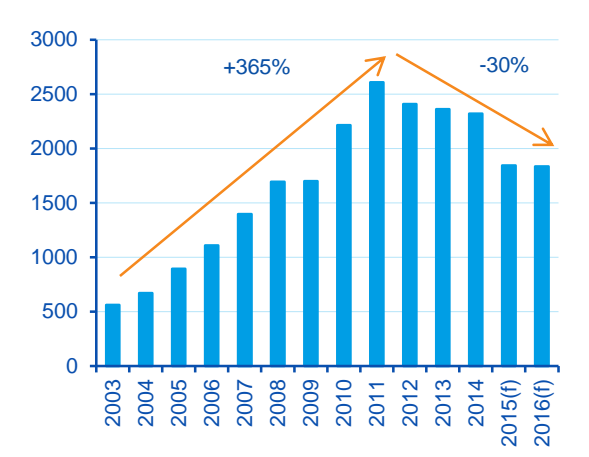
At the end of 2016, according to our estimates, the Brazilian GDP measured in dollars will be around USD1,834bn, 30% lower than in 2011 when it peaked at USD2,607bn thanks to five years of poor growth and a weakening currency (Figure 4.7). Not surprisingly, given the macroeconomic performance in recent years, the lack of a national agenda to increase productivity and investment and the gradual aging of the Brazilian population, long-term potential growth is around 2.2%, lower than in the previous years and than expected some time ago (see Box 1 for more on potential GDP estimates for Brazil and other Latin American countries).

Figure 4.6  
**GDP and terms of trade (% growth)**



Source: IBGE and BBVA Research

Figure 4.7  
**GDP (USD bn)**



Source: IBGE and BBVA Research

## Inflation is expected to remain under pressure, at around 9.0% in 2015 and 6.0% in 2016, in spite of the contraction in domestic demand

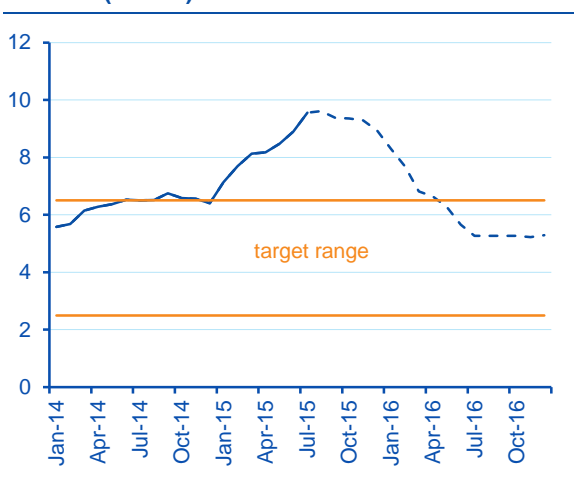
In spite of the benign impact on prices of the slowdown in domestic demand, overall inflation has clearly been trending upwards (Figure 4.8). In July it increased for the seventh consecutive month and reached 9.6%, the highest rate since 2003, 3.2pp above the level observed at the end of 2014.

The main factor behind the vertiginous rise of inflation in the last few months is the upward adjustment in administered prices, i.e. in the prices of those services and goods regulated by the government, which represent around 24% of the consumption basket. After remaining for some time at artificially low levels, administered prices started to be adjusted at the beginning of the year, given the lack of fiscal room to manoeuvre. Other factors, such as the cost pressures on energy companies due to climate shocks in the first months of the year, also contributed to the upward revision in regulated prices. Therefore, administered-price inflation jumped to 15.9% in July from 5.5% at the end of 2014 (and 1.5% in December 2013).

Although the main culprit of the recent inflationary skyrocketing is administered-price inflation, tax increases implemented at the beginning of the year, the impact of higher costs (mainly water and electricity tariffs) on food markets and the effects of a weaker exchange rate have also contributed (for more on the latter, including a discussion about the degree of exchange rate pass-through into domestic prices, see Box 2). According to our calculations, more than 80% of inflationary deviations from what we expected a year ago are due to larger-than-expected adjustments in administered prices.

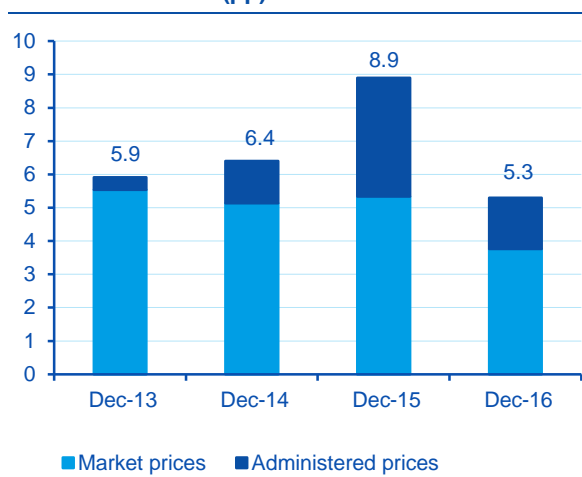
With respect to non-administered prices, they have remained broadly stable lately (7.7% in July, compared to 7.1% and 7.9% in July 2014 and July 2013 respectively), in spite of the sharp deceleration of domestic demand and the recent deterioration of domestic labour markets.

Figure 4.8  
Inflation (% YoY)\*



\* BBVA Research forecasts from August 2015 onwards.  
Source: IBGE and BBVA Research

Figure 4.9  
Contribution from market and administered prices to annual inflation (pp)



\* BBVA Research forecasts for Dec-15 and Dec-16.  
Source: IBGE and BBVA Research

As most of the realignment process of regulated prices is now over, we expect inflation to lose some steam from September onwards and to close the year at 8.9%. The inflation rate should then decelerate more significantly during the first half of 2016, when the effect of the adjustment in regulated prices implemented at the beginning of 2015 will start to fade away. Moreover, the contraction of domestic demand and the sharp slowdown in labour markets should drive down market inflation to 5.3% at the end of 2016. However, the effects of the sharp exchange rate depreciation and the strength of inertial factors should play against the moderation of inflation next year. Regarding the latter, it is worth reminding that the minimum wage, which is still an important reference for local labour markets, will be revised around 9% up at the beginning of 2016<sup>2</sup>. Taking all these factors into account, we expect inflation to reach 5.3% at the end of 2016, much lower than 2015 inflation, but still above the 4.5% inflation target (Figure 4.9).

2: The law establishes that minimum wage adjustment in a given year is equal to inflation in the previous year plus GDP growth two years ago. With inflation expected to reach 8.9% in 2015 and taking into account that GDP grew 0.1% in 2014, one arrives at the 9.0% figure.

**DISCLAIMER**

This document has been prepared by BBVA Research Department, it is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

In regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions in the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

The content of this document is protected by intellectual property laws. It is forbidden its reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process, except in cases where it is legally permitted or expressly authorized by BBVA.

This report has been produced by the LatAm Unit

Enestor Dos Santos  
 enestor.dossantos@bbva.com

With the contribution of:

Cecilia Posadas  
 c.posadas@bbva.com

Alejandro Faci  
 alejandro.faci@bbva.com

Julián Cubero  
 juan.cubero@bbva.com

Rodrigo Falbo  
 rodrigo.falbo@bbva.com

## BBVA Research

**BBVA Group Chief Economist**  
 Jorge Sicilia Serrano

**Developed Economies Area**  
 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@bbva.com

**Emerging Markets Area**

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

**Asia**  
 Le Xia  
 le.xia@bbva.com

**Mexico**  
 Carlos Serrano  
 carlos.serranoh@bbva.com

**LATAM Coordination**  
 Juan Manuel Ruiz  
 juan.ruiz@bbva.com

**Argentina**  
 Gloria Sorensen  
 gsorensen@bbva.com

**Chile**  
 Jorge Selaive  
 jselaive@bbva.com

**Colombia**  
 Juana Téllez  
 juana.tellez@bbva.com

**Peru**  
 Hugo Perea  
 hperea@bbva.com

**Venezuela**  
 Oswaldo López  
 oswaldo.lopez@bbva.com

**Financial Systems and Regulation Area**  
 Santiago Fernández de Lis  
 sfernandezdelis@bbva.com

**Financial Systems**  
 Ana Rubio  
 arubiog@bbva.com

**Financial Inclusion**  
 David Tuesta  
 david.tuesta@bbva.com

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

**Recovery and Resolution Strategy**  
 José Carlos Pardo  
 josecarlos.pardo@bbva.com

**Global Coordination**  
 Matías Viola  
 matias.viola@bbva.com

**Global Areas**

**Economic Scenarios**  
 Julián Cubero  
 juan.cubero@bbva.com

**Financial Scenarios**  
 Sonsoles Castillo  
 s.castillo@bbva.com

**Innovation & Processes**  
 Oscar de las Peñas  
 oscar.delaspenas@bbva.com

## Contact details:

**BBVA Research**  
 Azul Street, 4  
 La Vela Building - 4 and 5 floor  
 28050 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