BBVA | RESEARCH

Brazil
Economic Outlook

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01
The prospects for the Brazilian economy continue to worsen. The ongoing crisis is still far from being over

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GDP is now expected to fall 3.0% in 2016 after having decreased sharply in 2015

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Inflation will lose steam moving forward, but will remain above the target range in 2016

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Fiscal accounts will deteriorate further, undermining recovery and heightening domestic risks

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Closing date: 26 February 2016

1 Overview

The global economy will continue to grow, albeit at a slower pace and with higher risks. Global GDP is expected to grow by just 3.2% in 2016 (exactly as in 2015), postponing recovery to 2017 when it should reach rates of around 3.5%. Risks to these forecasts are tilted to the downside and concentrated in the emerging block, although the expected recovery in developed economies is also fragile. Indeed, the volatility which flared up in international markets in January and February 2016, appears to have been triggered by the increased probability of a risk scenario with lower growth in China and emerging economies as well as a further slide in oil prices, with negative impacts on oil sector companies and exporter countries.

The prospects for the Brazilian economy continue to worsen. The ongoing crisis is still far from being over. The effects of a less supportive external environment are being exacerbated within Brazil especially by the impact of fiscal deterioration. As a consequence, the country is now going through an economic crisis, which has been fueling -and being fueled by- a political crisis. Looking forward, there are no elements to think that the worst is behind us. Economic and political problems will likely continue to feed each other. As a turnaround in the external environment is unlikely, and as a solution to Brazil's fiscal problems seems distant, economic activity is set to weaken further, which should contribute to maintaining political tensions well alive. Moreover, the congressional proceedings to decide whether to impeach President Dilma Rouseff and the ongoing investigations on the recent corruption scandals will continue in the spotlight. Among other things, these non-economic events will keep uncertainty very high and will complicate the adoption of the needed fiscal adjustment, negatively impacting economic activity.

Economic activity will decrease sharply again and inflation will remain above the target range in 2016. We expect GDP to fall 3.0% in 2016 after having dropped around 3.8% in 2015. A decrease in both private consumption and fixed capital investment will be the main factors behind the GDP decline this year, as in 2015. On the other hand, net external demand should continue to contribute positively to activity growth in 2016. Prospects for 2017 are less negative, as uncertainty should decline once the congress takes a decision (whatever it is) regarding the impeachment of President Dilma Rousseff, which could happen in the middle of 2016. Moreover, terms of trade are expected to increase somewhat in 2017 after two years of severe drops. With respect to inflation, it should moderate gradually going forward after having peaked at 10.7%. However, relatively high indexation, among other factors, will prevent it to converge to within the target range in 2016.

Concerns on activity deceleration, and political factors, are playing a more important role in the definition of economic policies. Fiscal indicators continued to worsen sharply in 2015 and this negative trend will likely persist in 2016 and 2017, as the main fiscal problem - the structural upward trend of public expenditure- is expected to remain unaddressed, undermining recovery and heightening domestic risks. On top of that, we are skeptical regarding the recently announced measures to increase credit from public banks, as they should have a limited impact on activity while bringing along non-negligible risks. With respect to monetary policy, once the idea of delivering another dose of monetary tightening was abandoned, the BCB is expected to keep the Selic unchanged until the end of the year and then start an easing cycle in 2017. All in all, even though maintaining inflation under control and adopting a fiscal adjustment seem to be among the government's main objectives, there is a risk that these goals may not be properly prioritized, which in our view, would increase macroeconomic distortions and extend the crisis even longer.

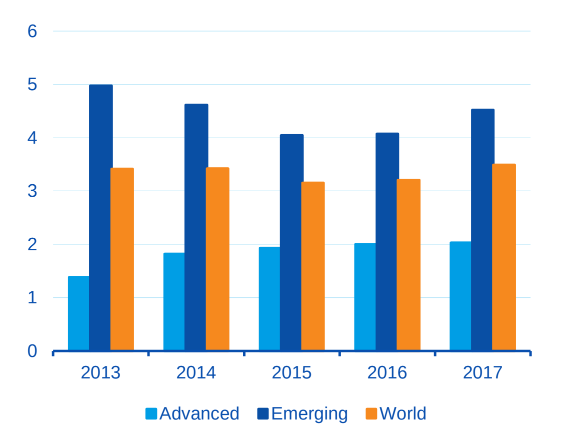
Turbulent financial markets, weaker currency and lower current account deficit. Turbulence spread over financial domestic markets in the last few months, imposing another round of downward correction in the prices of local financial assets. The exchange rate continued to depreciate and is expected to weaken further going ahead, although future losses are not expected to be as sharp as those recorded in 2015. The weakening of the currency and mainly the decrease of domestic demand are allowing the current account deficit to adjust quickly, to the point that it is already fully covered by FDI inflows. In any case, the ongoing external adjustment is mostly cyclical rather than structural.

2 Global environment: anaemic and more fragile growth

The intensification during the last quarter of 2015 of some of the risk clusters with a global impact led to a further downward revision of world economic growth forecasts for this year. The transition to a lower growth pattern in China, with economic reforms and changes to key objectives such as the exchange rate, is being accompanied by bouts of intense financial volatility and falling commodity prices. All this leads to a much less favourable global panorama for large commodity-exporting economies, but also for those perceived as more vulnerable financially.

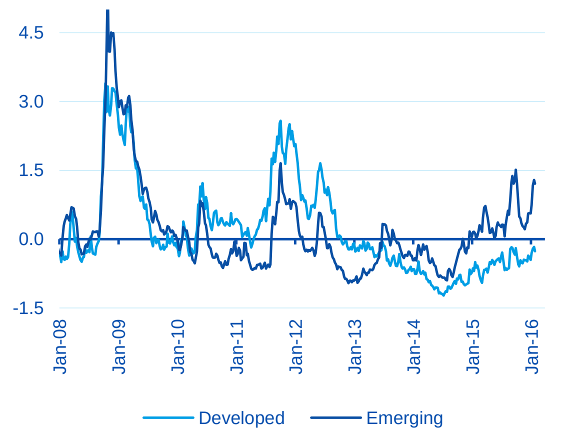
In fact, the leading indicators (confidence indices) and the increase in financial stresses point to more moderate growth in early 2016 than as foreseen three months ago. Therefore, world GDP will grow by just 3.2% in 2016, repeating the advance of 2015 and postponing recovery to 2017 when it should reach rates of around 3.5% (figure 2.1). This lower growth rate reflects slackening demand in emerging economies. Recovery in developed economies is still fragile and highly dependent on the possible impact of the slowdown in world trade and the increase in financial instability on industrial output, capital investment and consumer spending. With the US growing at 2.5% and the Eurozone by less than 2%, the tenuous improvement in activity in developed economies as a whole will not be enough to offset emerging markets' deceleration.

Figure 2.1
World GDP, % YoY



Source: BBVA Research and IMF

Figure 2.2
BBVA index of financial tensions (normalized values)



Source: BBVA Research and Bloomberg

The recent behaviour of the financial markets is largely explained by doubts about the strength of the world economic cycle. Activity indicators continue to show the greatest degrees of deterioration concentrated in manufacturing and trade. Activity in services, which until now had benefited from the recovery of private consumption in major developed economies, is also starting to show signs of less dynamism. Then, the BBVA Research's Financial Stress Index for emerging countries has climbed back up to the levels seen in July and August of 2015 (first wave of the Chinese stock exchange crisis), reaching the stress levels of 2011 (Figure 2.1). Volatility remains contained in developed economies, in a context in which capital seeks refuge in financial assets with a lower risk profile such as sovereign bonds of countries like Japan, the US and Germany.

All the same, the world economy faces a 2016 of limited growth and with a balance of risks showing a negative bias and concentrated in the emerging bloc. How China's economy evolves, both as regards the degree of slowdown in activity and how the authorities manage the financial imbalances that exist, will continue to have a significant influence on capital flows and commodity prices in general, not just oil. The level of corporate indebtedness in emerging countries most vulnerable to the external environment constitutes an additional source of instability, in a context of lower profits and higher funding costs (risk premia). Allied to this, geopolitical tensions in certain parts of the world and the risk of a scenario of low growth and low inflation in major developed economies complete the outlook for the world economy in 2016.

USA: moderate growth and dependent on consumer spending

In the second half of 2015, US economic growth steadied at around 2.5%, the level we estimate it to grow this year and next. However, activity deceleration in the fourth quarter, as well as the leading signals from business confidence signals, increase the chances of a lower-than-expected growth this year. Meanwhile, the Federal Reserve has repeatedly stressed that the path of interest rate increases will be gradual and subject to the continuation of the dynamic of domestic demand and inflation. In a context of relatively low inflation and considering the recent fall in oil prices, we expect at most two interest rate hikes in 2016.

China: the challenge of eliminating financial instability

Doubts about China's ability to successfully manage the transition to a more moderate and balanced economic growth model resurfaced in the last quarter of 2015 following a new bout of financial instability deriving, as last August, from the stock and currency markets.

While maintaining financial stability is crucial in order to avoid any repetition of episodes of risk aversion such as the recent one, the growth dynamic shown by China in the short and medium term continues to be of decisive importance for the world economic cycle. For the time being, growth continues to gradually moderate and to recompose itself, as has been occurring since 2011. Our base scenario holds GDP growth for 2016 at 6.2% and at 5.8% for 2017. Additional monetary stimulus measures during 2016 in the form of key interest rate cuts cannot be discounted, although they will be constrained by the impact they might have on capital flows. Finally, it is quite likely that this scenario will lead to a situation of greater risk given the doubts about the pace of rebalancing of the economy and the authorities' room for manoeuvre for managing it smoothly.

Eurozone: no changes to expected growth

If the recent recovery dynamic is maintained, the Eurozone could grow this year by 1.8% and 2.0% in 2017, the same figures as forecast last quarter. The positive effect of the fall in energy prices, a more expansionary fiscal policy and the continuation of loose monetary conditions would be partly offset by the negative impact of the slowdown in international trade on the export of goods and of increased financial and political instability on investment decisions.

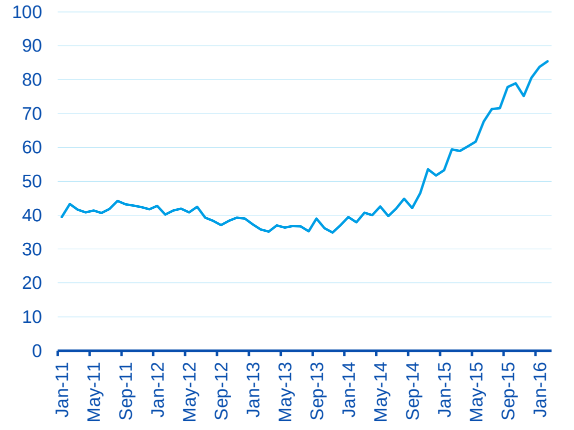
3 Brazil: economic activity will decrease sharply again and inflation will remain above the target range in 2016

The crisis is not over and the prospects for the economy continue to worsen

The effects of a less supportive external environment, characterized by a significant fall in commodity prices, anaemic growth, financial turbulence and high uncertainty, are being exacerbated within Brazil especially by the impact of the sudden deterioration of fiscal accounts. As a consequence, Brazil is now going through an economic crisis, which has been fueling -and being fueled by- a political crisis. Therefore, on the economic front, activity is decreasing severely while inflation is running above 10%. On the political front, the beginning of the proceedings to impeach President Dilma Roussef and a series of corruption scandals are some of the factors behind the ongoing turmoil.

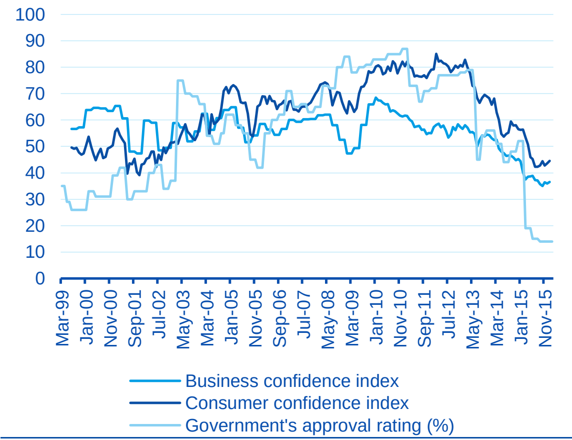
Therefore, it is not surprising that concerns about the crisis have widespread (Figure 3.1) and that both the government's approval rating and confidence indicators are at extremely low levels (Figure 3.2).

Figure 3.1
Brazil's crisis index (based on web searches)*



* Seasonally-adjusted index built on the interest about the term "crise" (crisis in Portuguese) in Brazil.
Source: Google Trends and BBVA Research

Figure 3.2
Government's approval and confidence indices



Source: CNI, Fecomercio and BBVA Research

Looking forward, there are no elements to think that the worst was left behind. Economic and political problems will likely continue to feed each other. As a turnaround in the external environment is unlikely, and as a solution to Brazil's fiscal problems seems distant, economic activity in general –and labor markets in particular- are set to weaken further, which should contribute to maintaining political tensions well alive. Moreover, the congressional proceedings to decide whether to impeach President Dilma Rouseff, and the ongoing investigations on the recent corruption scandals, such as –but not only- the "Car Wash" Operation conducted by the Federal Police on corruption at the state-controlled oil company Petrobras, will continue in the spotlight. Among other things, these non-economic events will keep uncertainty very high and will complicate the adoption of the needed fiscal adjustment, negatively impacting economic activity.

Taking all that into consideration, the prospects for the Brazilian economy have continued to worsen, which is clearly reflected in our updated forecasts detailed below. Moreover, there are now larger risks that the situation may deteriorate even more than envisaged in our baseline scenario for the country and, therefore, that the crisis may end up being sharper and longer than expected.

GDP to contract 3.0% in 2016 after having contracted around 3.8% in 2015

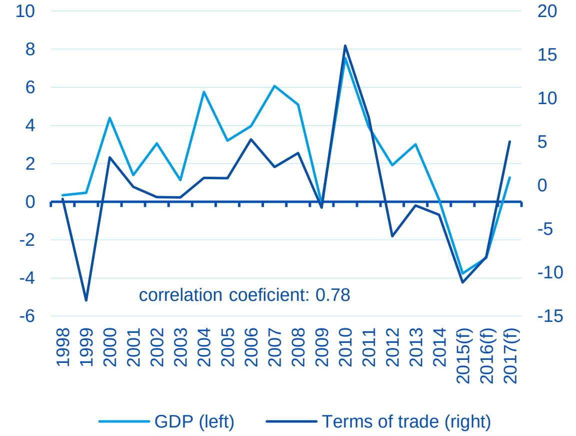
Activity indicators suggest that GDP decreased again in the last quarter of 2015, although not as much as in the previous quarters. Based on that evidence, we estimate that GDP declined 1.1% QoQ in the fourth quarter, in comparison to 2.1% QoQ and 1.7% QoQ respectively in the second and third quarters. If our forecast proves to be correct, then GDP will have decreased 3.8% last year, after having stayed practically unchanged in 2014 (0.1%). That would be the worst result since 1991, when the country was still fighting hyperinflation.

By components, the main contributors to the large decrease in economic activity in 2015 were likely investment and private consumption, which we estimate to have dropped 13.7% and 3.9%, respectively. Taking into account that we expect public consumption to have decreased slightly last year, 0.4% precisely, domestic demand probably contributed with -6.5 percentage points (p.p.) to 2015's GDP. Therefore, the GDP contraction was not even larger than currently forecast because net exports contributed positively to growth last year, with around 2.7 p.p.. Anyway, the latter was mainly due to a contraction in imports than to the performance of exports (forecast table in section 6 and Figure 3.5).

Figure 3.3
World GDP and Brazil's trade partners GDP (% growth)*

* Brazil's trade partners GDP is the GDP of Brazil's trade partners weighted according to their share as a destination of Brazil's total exports as of 2015. Growth data comes from the IMF's WEO. Source: IMF and BBVA Research

Figure 3.4
Brazil's GDP and terms of trade (% growth)



Source: IBGE, Funcex and BBVA Research

The relatively weak performance of exports, and to some extent the correction in domestic demand, is related to the evolution of the global environment, in particular to a moderation in global growth and a fall in commodity prices (in the last three months oil, iron ore and soybean prices fell around 22%, 1% and 2% respectively)[1]. Regarding the former, it is worth to note that not only has global growth decelerated lately, but also that the deceleration in GDP of Brazil's main trade partners has been somewhat more intense. In fact, GDP of the main importers of Brazilian goods has not grown more than world GDP since 2014, in contrast with what used to occur previously (Figure 3.3). With respect to commodity prices, their decline is the main factor behind the 11% decrease in Brazil's terms of trade (i.e. the ratio between export and import prices), and therefore, one of the main drivers of Brazil's ongoing recession (Figure 3.4).

It is noteworthy that the Brazilian economy is usually negatively affected not only by lower agricultural and metal prices, such as soybeans, iron ore, sugar, meat, coffee, corn, etc., but also by lower oil prices. Even though Brazil roughly imports the same amount of oil that it exports, a decline in its prices have a negative

1: For an analysis of commodity markets, including our forecasts, see BBVA Research's 1Q16 Latin America Economic Outlook.

impact on Petrobras, one of the biggest Brazilian companies, and reduces the potential wealth related to Brazil's oil reserves, which to some extent remain unexploited.

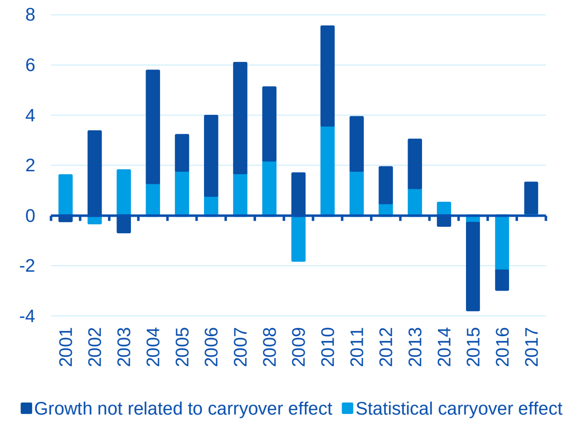
Looking forward, both world GDP and GDP of Brazil's main trade partners are not expected to accelerate significantly in 2016, although some improvement is likely in 2017. Moreover, we forecast Brazil's terms of trade to decrease around 8% in 2016 and then to rebound 5% in 2017.

The prospects for the global economy support the view that the Brazilian economy will decrease again in 2016 and then recover slightly in 2017, at least if our scenario of soft landing in China and gradual recovery of the US economy proves to be correct.

Our assessment of Brazil's internal situation reinforces the view that recession will continue in 2016 and will come to an end in 2017. The main domestic factors that helped to drive GDP growth down in 2015, namely the fiscal deterioration, the lack of room to adopt countercyclical measures, rising costs faced by consumers and businesses (due to the exchange rate depreciation and high inflation), the impact of corruption scandals (especially on Petrobras and construction companies) and the political turmoil, will continue to play a negative role in 2016. Even though we do not expect fiscal problems to be addressed this year, the abnormally high uncertainty regarding the economy could ease somewhat once the Congress takes a decision (whatever it is) about the impeachment of President Dilma Rousseff, which could happen in the middle of the year. Taking that into account, as well as the perspectives of lower inflation, more stable exchange (at a more depreciated level), and less tight monetary policy, we think that there will be some room for improvement in terms of economic activity in 2017.

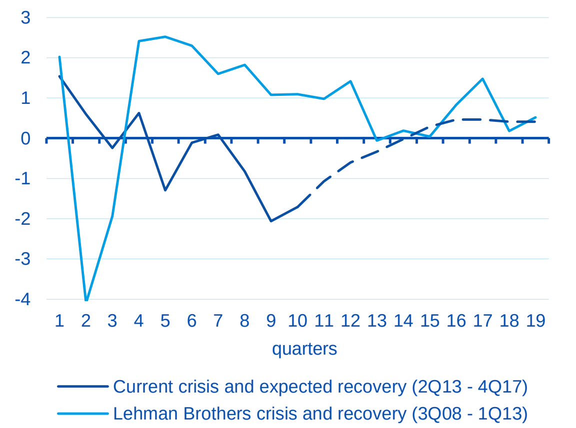
Consolidating the expected impact of both foreign and domestic drivers, we now forecast GDP to decrease 3.0% in 2016 and then to increase 1.3% in 2017. These forecasts are respectively 2.5 p.p. and 0.2 p.p. lower than our previous figures. These adjustments are in line with the sharper than expected deterioration of economic activity in the second half of 2015, as well as with the worsening of the prospects for both the Brazilian and the world economy.

Figure 3.5
GDP growth and contribution to it of statistical carryover effect*



* BBVA forecasts for GDP from 4Q15 to 4Q16 were used to calculate contribution of carryover effects in 2016 and 2017.
Source: BBVA Research

Figure 3.6
Economic activity cycles: recession and recovery now and after the Lehman Brothers crisis (GDP QoQ)*

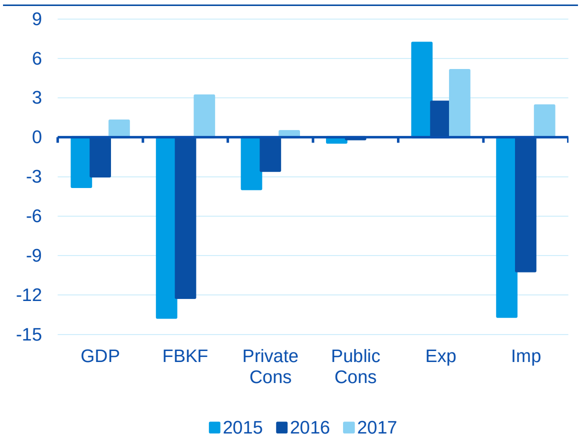


* BBVA forecasts from 4Q15 to 4Q17.
Source: CNI, IPEADATA and BBVA Research

It is important to note that part of the expected GDP decrease in 2016 will likely be due to statistical carryover effects. Quarterly GDP's downward trend over 2015 means that if it stays unchanged (0.0% QoQ) during the four quarters in 2016, then GDP will decline 2.2%. We forecast this statistical carryover effect to be around 0% in 2017 (Figure 3.5).

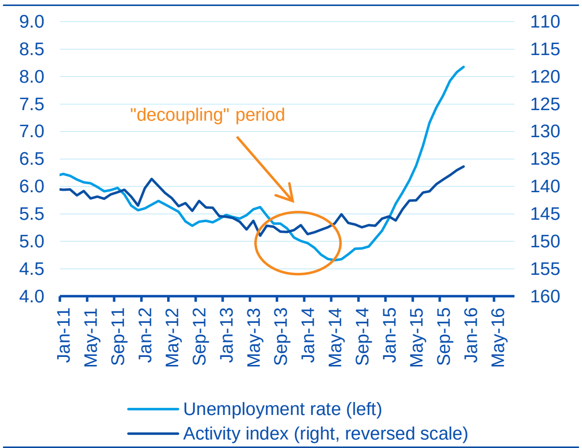
Anyway, we expect quarterly GDP growth to remain in negative territory until the third quarter of the year and then grow slightly, but still below the potential rate, after that (Figure 3.6). In comparison to the previous recession, when the country was hit at the end of 2008 by the Lehman Brothers crisis, the current one is not only larger but also sharper. Moreover, we should note that a positive growth rate in 2017 would not mean that the crisis is over. It would be more a punctual economic activity correction following a severe downward adjustment in the previous years with respect to the beginning of a new sustainable growth cycle. The latter would require at least addressing fiscal problems, something we do not expect to occur soon.

Figure 3.7
GDP and components (%)



Source: IBGE and BBVA Research

Figure 3.8
Economic activity index (IBC-Br) and unemployment rate (%)*



* Both series are seasonally adjusted. In the right axis the scale is reverted: higher values mean lower levels of economic activity
Source: IBGE, BCB and BBVA Research

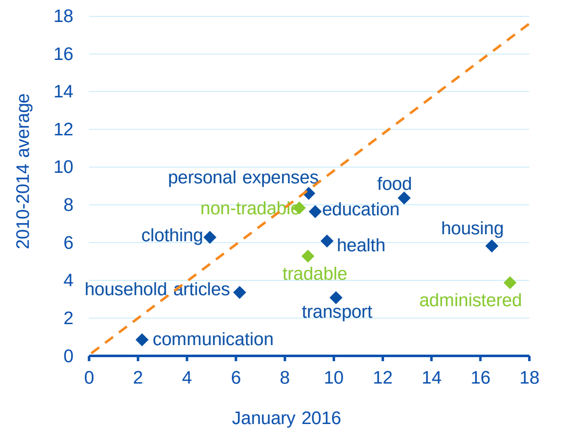
In terms of components, we forecast the 2016 GDP decrease to be again driven by domestic demand components, while net exports should contribute positively to growth, although mainly due to a sharp decrease in imports (Figure 3.7 and forecast table in section 6). The likely, but still uncertain, recovery in 2017 would be supported by some improvement in exports and by a (limited) rebound in investment.

Private consumption, which represents around two thirds of GDP, will likely continue to be hit by high inflation (although not as much as in 2015), high uncertainty, non-supportive credit markets, and mainly by the labor market deterioration, which is expected to continue moving forward. The unemployment rate, which had declined in 2013 and 2014 in spite of the weakness of economic activity in the period, started to increase at the end of 2014 putting an end to the "decoupling" (Figure 3.8). We forecast it to average around 8.8% in 2016 and then to remain broadly unchanged in 2017, in comparison to 4.8% in 2014 and 6.9% in 2015.

Inflation will remain above the 6.5% target ceiling over 2016

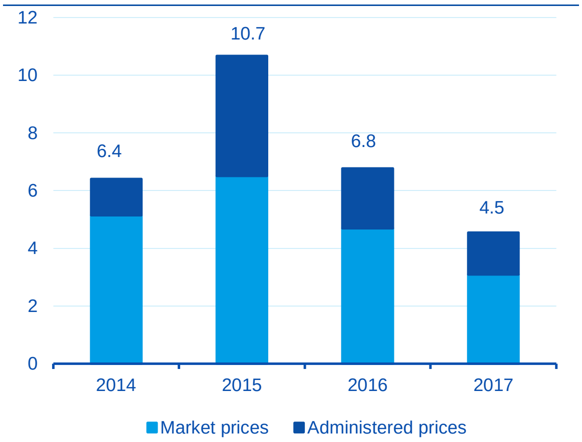
Annual inflation reached 10.7% in January, remaining broadly stable in comparison to the end of 2015 rather than decline as expected. Even though the main pressure is currently from administered and food prices, the latter due to supply shocks such as the "El Niño" weather phenomenon, high inflation is widespread across sectors. Figure 3.9 shows that current inflation is higher now than in the 2010-2014 period, when inflation averaged 5.9%, in practically all groups of products. Even non-tradable products, which are not directly affected by the exchange rate depreciation, such as tradable products, and are freely determined in markets, in contrast with administered prices, are higher now than they were some years ago when the economy was still growing at positive rates. The main reason behind that apparent paradox is that indexation mechanisms continue to play an important role in the processes of price formation in Brazil. Our estimated Phillips curve, which relates inflation to past inflation, expected inflation, foreign inflation and output gap, shows that the parameter relating past inflation to current inflation, which works as a proxy for inertia, is currently around 0.7, broadly unchanged in comparison to the previous years, but higher than usually found in advanced economies (less than 0.5).

Figure 3.9
Inflation: January 2016 vs. 2010-2014 average (YoY %)



Source: IBGE, BCB and BBVA Research

Figure 3.10
Contribution from market and administered prices to annual inflation (pp)



Source: IBGE and BBVA Research

In spite of the existence of important indexation mechanisms (minimum wages were adjusted by 11.6% this year largely thanks to the 10.7% inflation in 2015, for example) and of additional pressure due to the exchange rate depreciation, we expect inflation to have peaked in December and January and to gradually lose steam from now onwards. The two main reasons that support this view are the perspectives that the sharp activity recession will end up constraining further price adjustments and that regulated prices will not be adjusted so significantly this year as in 2015. Regarding the latter, we expect administered price inflation to decline from 18% last year to 9% in 2016, as most of the misalignments in regulated prices are now corrected.

Our forecast is that inflation will decline gradually in 2016 and 2017. It will likely remain over the 6.5% target ceiling in 2016, averaging 8.8% and reaching 6.8% in December. In 2017 the most likely is that it will converge to 4.5%, BCB's central target (Figure 3.10). However, we attach an upward bias to our 2017 forecast as there is a risk that economic policies will focus on driving growth up more than expected and end up being somewhat more tolerant with inflation.

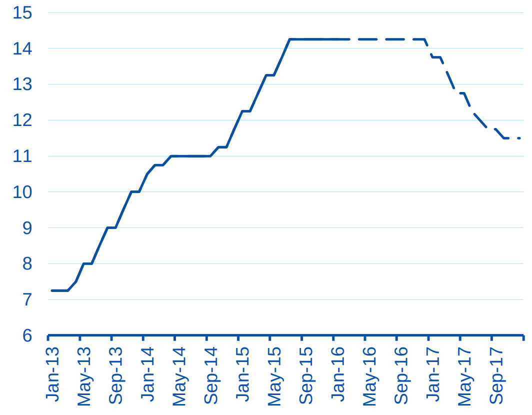
4 Concerns on activity deceleration start to play a more important role on the definition of economic policies

Recent decisions by local economic authorities show that increasing concerns about the sharp decrease in economic activity, and also political pressure, are starting to have a more important role in the setting of monetary, fiscal and quasi-fiscal policies. Even though maintaining inflation under control and adopting a fiscal adjustment seem to continue to be among the government's main objectives, there is a risk that, as other moments in recent years, these goals are not properly prioritized, which in our view would increase macroeconomic distortions and extend the crisis even longer.

Monetary policy: stable rather than increasing interest rates

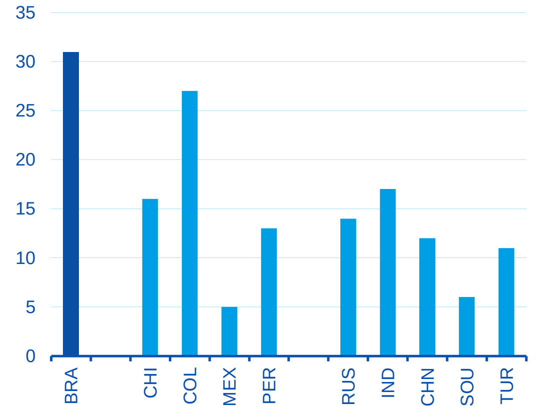
After having tightened monetary policy sharply since the beginning of 2013 until July 2015, the Central Bank of Brazil (BCB) decided to leave the Selic policy interest rate unchanged at 14.25% during last year's second half (Figure 4.1). However, the higher than expected increase in inflation and especially the deterioration of expectations for the end of both 2016 and 2017[2], to some extent due to the fiscal deterioration and the exchange rate depreciation, forced the monetary authority to suggest, at the end of 2015 and beginning of 2016, that another dose of monetary tightening would be soon delivered. Nonetheless, in contrast with this previous signaling, the BCB finally decided to leave the Selic rate unchanged in January. As we expected, the concerns with domestic economic activity, in particular with the effects of the global environment on it, ended up weighing more, preventing the beginning of a new tightening cycle.

Figure 4.1
Reference interest rate: Selic rate (%)



Source: BCB and BBVA Research

Figure 4.2
Number of changes in the reference interest rate since January 2011*



* BRA=Brazil. LATAM: CHI=Chile, COL=Colombia, MEX=Mexico, PER=Peru. Other emerging economies: RUS=Russia, IND=India, CHN=China, SOU=South Africa, TUR=Turkey.
Source: Bloomberg and BBVA Research

Inflation expectations deteriorated further following January's monetary policy decision[3] and the most likely is that the goals that the BCB announced at that moment –making inflation converge to within the 2.5%-6.5% target range in 2016 and to 4.5% in 2017- will not be fully achieved. However, the most likely is that the worries about the global environment and the local recession will continue to play a more important role in

2: Market expectations for inflation at the end of 2016 and 2017 were 5.5% and 4.5% at the beginning of September and then increased to 6.9% and 5.2% respectively in December.
3: They moved up from 7.0% at the end of 2016 and 5.40% at the end of 2017 to 7.6% and 6.0% respectively at the end of February.

the definition of the monetary policy. We then expect the Selic rate to remain unchanged for the remainder of the year and the beginning of a monetary easing cycle in the first months of 2017 when we forecast inflation to converge to within the target range, which by then will be narrowed to 3.0%-6.0% following last year's decision.

Even though we expect interest rates to be left stable at 14.25% for a prolonged period, the recent record of the BCB shows that there is a non-negligible likelihood that it will act earlier than expected. Since the beginning of January 2011, the monetary authority has adjusted, either upwards or downwards, the reference interest rate in 31 of its 41 monetary policy meetings. The Selic was only left unchanged in the three meetings at the end of 2012 - beginning of 2013, in the three meetings that preceded the presidential elections of 2014 and in the last four meetings. As we show in Figure 4.2, the BCB has been one the most "active" central banks in emerging countries.

Fiscal policy: deterioration continues as problems remain mostly unaddressed

The measures adopted in 2015 to cut expenditure and increase revenues were insufficient to allow an improvement of fiscal accounts, especially because the decrease in economic activity had a significant negative impact on public revenue and also because the government paid last year around 1.2% of GDP in expenses from previous years (locally known as "pedaladas"). Therefore, the public sector showed a primary deficit of 1.9% of GDP, even worse than the 2014 result, -0.6% of GDP (Figure 4.3). On top of that, interest payments increased substantially last year, to 8.3% of GDP from 5.5% in 2014. The heavier interest burden was a consequence of the increase in the public debt and mainly of higher interest rates (in line with a higher Selic rate and higher country-risk). Moreover, interest payments were driven up in 2015 by 1.7 % of due to the expenses generated by the more than USD100bn in exchange rate swaps maintained by the BCB[4].

As a consequence of the worse primary result and higher interest payments, as well as of GDP decrease, general government public debt jumped again in 2015, to 66.2% of GDP, from 57.2% in 2014 and 51.7% in 2013 (Figure 4.3).

In a few words, Brazil's main fiscal problem is that the federal government's primary expenses have been displaying an upward trend for many years while the primary revenues trend has been declining since the aftermath of the Lehman Brothers crisis (Figure 4.4). As Brazil's fiscal burden is already high, the best way to address this problem would be keep expenditure under control through i) a reform in the social security system to adapt it to increasingly less favorable demographic conditions and ii) a reduction in the rigidity of primary expenses (currently only around of 20% of total expenditure is potentially subject to be adjusted).

Even though the government, especially the new minister of finance Nelson Barbosa, has been talking lately about a social security reform and the creation of a ceiling to public expenditure, we are skeptical about their implementation. Creating a consensus about these measures and approving them at the congress is a challenging task for the government taking into account the ongoing political and economic situation.

The current environment complicates not only the implementation of structural reforms, but also the adoption of other adjustment measures, such as the recreation of the CPMF financial transactions tax (which could potentially generate more than 1% in extra revenues), the augment in some taxes that do not require approval by the congress (such as the IOF financial tax and the CIDE fuel tax), and further expenditure cuts. Regarding the latter, the government recently announced the freezing of around 0.3% of GDP in budgeted

4: By providing exchange rate swaps, the BCB reduces the private sector's exposure to an exchange rate depreciation but increases its own. The 1.7% of GDP costs were therefore the consequence of holding up a sizeable stock of these swaps in a moment when the currency weakened. Even though these swaps are referred in USD dollars, they are paid in Brazilian reais. Finally, it is worth to note that if on the one hand the government loses with an exchange rate depreciation by maintaining these swaps, on the other hand it benefits from a currency weakening because its international reserves, amounting to almost USD370bn, make the government an external creditor. However, these benefits do not impact the public sector's annual result (they do impact the public sector's debt).

expenses, which is less than the freezing announced last year and clearly insufficient to change recent negative trends.

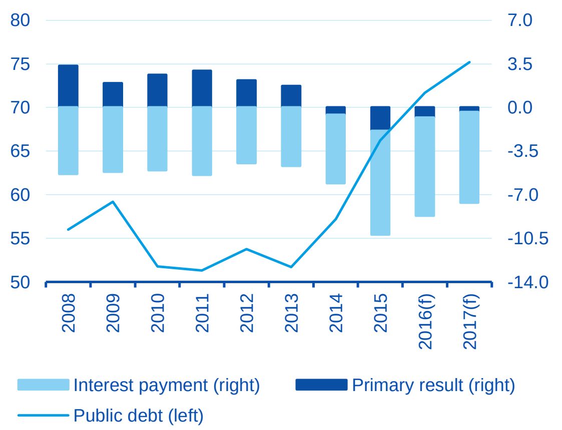
Therefore, given the negative prospects for the adoption of a significant fiscal adjustment, and considering that activity decrease will continue to weigh on public revenues, we expect the fiscal deterioration to persist over the next few years, at least until the government can create a consensus about the need of fiscal reforms and be able to implement them.

We forecast the primary result to remain in negative territory in both 2016 in 2017, around -0.8% and -0.4% of GDP respectively, which would contribute to maintaining the total fiscal result at very high levels, around -8.7% in 2016 and -7.6% in 2017. Therefore, the central government's public debt would reach 72% in 2016 and 75% in 2017 (Figure 4.3). And it would probably break the 80% of GDP mark moving forward, as the government will likely be unable to generate primary surpluses around 2.5% of GDP, which is needed to stabilize the debt-to-GDP ratio.

Taking into account these prospects for fiscal accounts, the recent sovereign rating downgrades cannot be seen as surprising (in the last few weeks S&P and Moody's placed Brazil's sovereign rating two levels below the investment grade range while Fitch downgraded the country to the highest level within the high-yield zone in December).

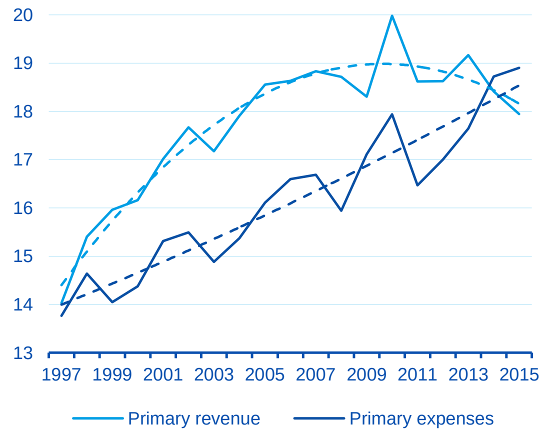
If for some reason investors become significantly more risk-averse or if fiscal prospects worsen furthermore to the point that debt solvency starts to be an issue, a "fiscal dominance" scenario could end up emerging. In said risk scenario, which we see as relatively unlikely, the stabilization of the public debt would be favored by a low interest rates / high inflation environment. We see other responses to a debt crisis, such as a sovereign default or an IMF rescue package, as less likely outcomes, among other reasons because most of the Brazilian public debt is denominated in local rather than in foreign currency (in fact, Brazil is a net external creditor as its international reserves correspond to 21% of GDP while the public sector's external debt is 7% of GDP).

Figure 4.3
Fiscal indicators: primary balance, interest payment and gross public debt* (% of GDP)



* Primary result + interest payment = total fiscal result. Primary result and interest payment refer to the consolidated public sector while the gross public debt refers to the general government, which excludes the BCB and stated-owned companies.
Source: BCB and BBVA Research

Figure 4.4
Federal government's primary accounts: observed and trend* (% of GDP)



* Observed figures: solid lines. Trend: dashed lines. Primary revenues exclude transfers to regional governments.
Source: BCB and BBVA Research

Quasi-fiscal policy: the suggested higher supply of public credit should have a limited impact on activity and could bring along non-negligible risks

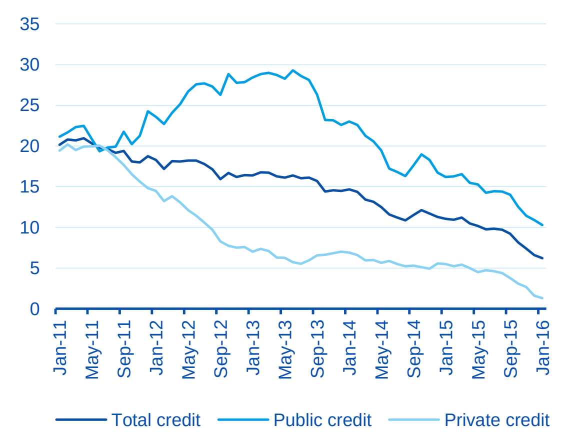
Credit markets continue to lose steam thanks to the deceleration of economic activity, the monetary policy restrictive tone and heightened risks, among other factors. The credit stock is currently growing at 6.2% YoY pace, below the pace recorded in the recent past and below the current rate of inflation. Even though credit from public banks has also been moderating, it continues to grow more than credit from private banks, 10.3% YoY the former vs. 1.3% YoY the latter (Figure 4.5).

Not surprisingly given the current juncture, non-performing loans (NPL) continue to trend upwards: they reached 3.5% of total loans in January in comparison to 2.7% at the end of 2014 (Figure 4.6). In the last few months, the household debt burden as a share of the income has been declining, as the slowdown in household loans has been offsetting the decrease in household income. As the latter will likely continue to adjust downwards, we see a risk that the debt burden stops falling. Anyway, in our view, NPL will continue to trend up going forward.

Given the increasing concerns about the deceleration of the economy, the government has recently announced some proposals to increase the supply of credit by public banks to some specific sectors (such as agriculture, real estate, infrastructure, exporters and payroll credit) by an amount equivalent to 1.4% of GDP (2.6% of the credit stock).

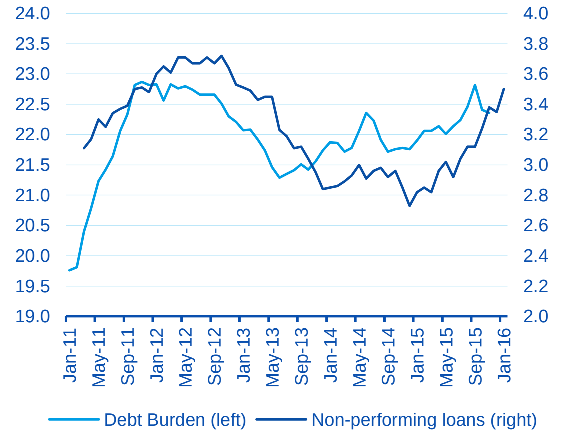
Even though these measures could eventually have a positive impact in some sectors, we expect their overall effect on economic activity to be modest. We also think Brazil needs more structural reforms, especially those that could increase domestic productivity, rather than a new round of credit-driven growth. Moreover, using public credit to try to revitalize credit markets at the same time as domestic demand decreases sharply entails additional risks for these banks, and therefore for public accounts.

Figure 4.5
Credit stock: from public and private banks (YoY % nominal growth)



Source: BCB and BBVA Research

Figure 4.6
Credit markets indicators: household debt burden (% of their income) and non-performing loans (% of total loans)



Source: BCB and BBVA Research

5 Turbulent financial markets, weaker currency and lower current account deficit

Prices of domestic financial assets declined sharply in the last few months

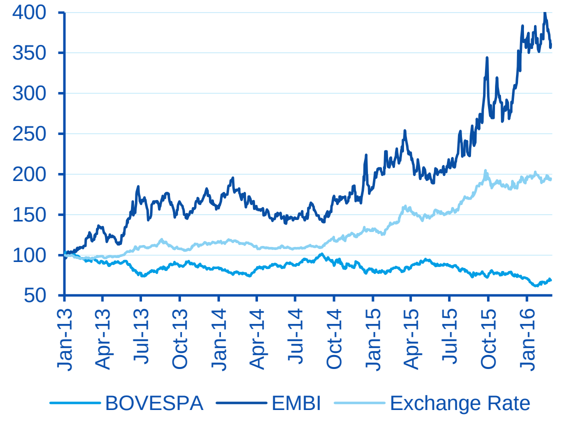
After a short period of relative stability before the end of 2015, turbulences started to spread over financial markets again. The concerns about the Chinese economy and the significant decline in oil markets seem to be behind the most recent bout of financial tension in global markets (see Chapter 2 for more details).

The recent rebound in the global risk aversion, the fall in commodity prices and the deepening of the local crisis, including the deterioration of Brazil's sovereign ratings[5], favored further declines in the prices of local financial assets (Figure 5.1). Brazil's main equity market index, the IBOVESPA, lost around 10% in the last three months, while the country's sovereign spread increased by 24% (or 97 b.p.) in the period. The Brazilian real (BRL) lost around 6% and was around 3.98 per dollar at the end of February.

The recent corrections in local equity markets and sovereign spreads were on average higher than the losses recorded in other emerging markets (Figure 5.2). In fact, they were in general even sharper than the corrections observed in oil producer countries, such as Mexico, Colombia and Russia, which are more exposed to the ongoing decline in the prices of the commodity. However, the BRL depreciation in the last three months was on average milder than the depreciation of other emerging currencies. The latter is to some extent due the fact that the depreciation accumulated over the last one or two years is much higher in Brazil, which implied that the BRL is already trading above its equilibrium level.

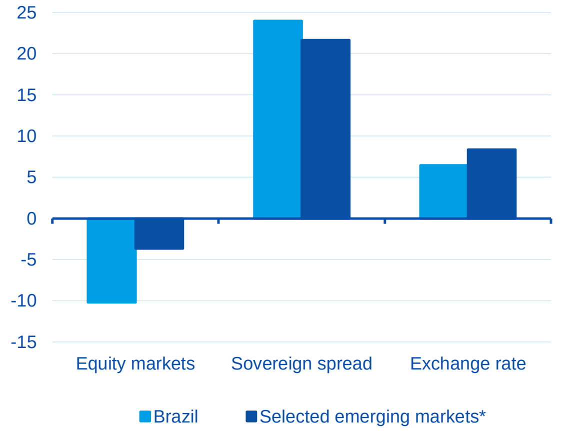
Looking forward, the most likely is that Brazilian financial markets will remain turbulent. This is not only because they should continue to reflect the volatility created by the process of recovery of the US economy (and therefore of the speed of normalization of its monetary policy) and to the transition process which the Chinese economy is currently going through, but also because they should respond to the evolution of the domestic crisis, which is still far from its end.

Figure 5.1
Equity markets (BOVESPA), sovereign spreads (EMBI +) and exchange rate (USD/BRL). Indexes Jan-2013=100 *.



* Higher values represent a weaker Brazilian real, a higher BOVESPA index and a higher sovereign spread. Data until February 26.
Source: Datastream and BBVA Research

Figure 5.2
Equity markets (BOVESPA), sovereign spreads (EMBI +) and exchange rate (USD/BRL). Changes in the last three months (%) *



* Selected emerging economies: Colombia, Mexico, China, Russia, Turkey and South Africa. Variations calculated between February 26, 2016 and November 26, 2015.
Source: Datastream and BBVA Research

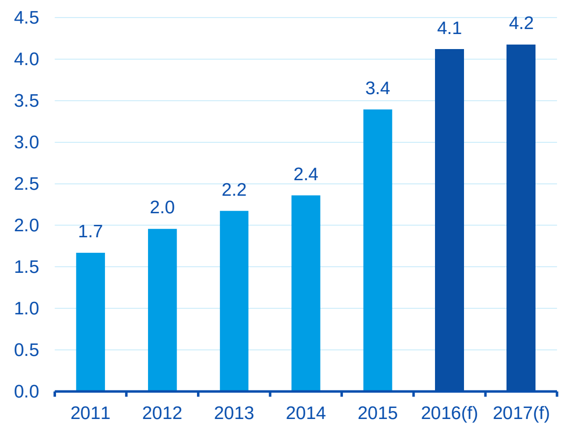
5: As highlighted in section 4, in the last few weeks S&P and Moody's placed Brazil's sovereign rating two levels below the investment grade range while Fitch downgraded the country to the highest level within the high-yield zone in December.

The exchange rate is likely to depreciate further going forward

After weakening around 6% in the last three months, the Brazilian real (BRL) has accumulated a depreciation of 38% in the last 12 months and of 70% in the last 24 months. We expect the depreciatory trend to continue over 2016 and 2017, although at a slighter pace than in the recent past. More precisely, we forecast the BRL to converge to around 4.15 at the end of 2016 and to 4.20 at the end of 2017. On average, it would be around 21% weaker in 2016 than in 2015 and broadly unchanged in 2017 (Figure 5.3).

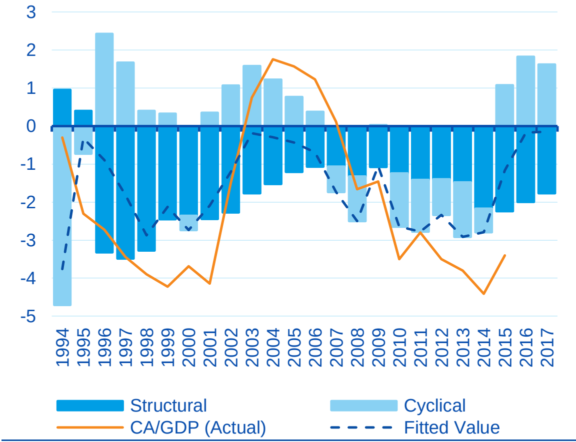
In our view, the expected deepening of both the economic and the political crisis, especially in 2016, will work as a trigger for an additional weakening of the BRL. The fact that financial tensions in global markets should continue at relatively high levels also support our expectation of additional depreciation of the Brazilian currency. On the other hand, the stability and perhaps even a slight rebound of commodity prices, and the fast reduction of the current account deficit should help to avoid BRL from depreciating as significantly in 2016 and 2017 as it did in 2015.

Figure 5.3
Exchange rate (annual average, Brazilian real per USD dollar)



Source: BCB and BBVA Research

Figure 5.4
Current account (CA) deficit and importance of cyclical and structural on its dynamics (% of GDP)



Source: BCB and BBVA Research

A weaker currency and a decrease in domestic demand will continue to determine a (cyclical) reduction of the current account deficit

The 12-month current account deficit reached USD52bn in January, half of the amount recorded in December 2014 when it peaked. 53% of this decline is explained by the improvement in the trade balance, from a deficit of USD6.7bn at the end of 2014 to a USD 21.2bn surplus in 2015 (which is to a large extent due to a decline in imports). 25% of the reduction in the annual current account deficit is due to a reduction in the deficit of the services account, especially due to a decline in travel expenses. Finally, 22% of the recent correction of the current account deficit is a consequence of a decline in the deficit in the income account.

In terms of GDP; the annual current account deficit dropped from 4.3% in December 2014 to 2.9% in January. It is important to note that the sharp decrease in GDP measured in dollars prevented a more significant fall in the current account deficit to GDP ratio in the period.

As the main determinants of the faster-than-anticipated adjustment of the current account deficit, i.e. the exchange rate depreciation and mainly the weakening of domestic demand, will likely persist to play an important role in the external adjustment, the current account deficit will likely decline further in the next few years. More precisely, we expect the current account deficit to reach around USD41bn (2.7% of GDP) at the end of 2016 and then USD18.2bn (1.1% of GDP) at the end of 2017. However, our models suggest that the downward correction of the current account deficit is a cyclical rather than a structural phenomenon, meaning that it will likely rebound when the country starts to grow more significantly again (Figure 5.4).

Foreign direct investment (FDI) into the country has been showing resiliency. It declined, from USD96.9bn (4.0% of GDP) at the end of 2014 to USD74.8bn (4.3% of GDP) in January 2016, but at a much slower pace than the current account deficit. As a consequence, FDI inflows are currently higher than the country's external financing needs, reducing the country's exposure to short-term capital flows (since June 2015, there have been portfolio capital outflows in each month, with the exception of November).

We expect FDI inflows to continue to trend downwards, but the most likely is that they will continue to exceed the current account deficit.

Finally, even though the non-financial corporate sector has been in general able to manage the costs related to the impact of the exchange rate depreciation on its external debt, which according to the BCB is around 19% of GDP and heavily concentrated in the long-term, this is an issue that should continue to be monitored, as there is a risk that it can hit the private sector further moving forward.

6 Forecast table

Table 6.1
Macroeconomic forecasts

	2014	2015	2016	2017
GDP (% growth)	0.1	-3.8	-3.0	1.3
Inflation (% YoY, end of period)	6.4	10.7	6.8	4.5
Exchange rate (BRL/ USD,end of period)	2.66	3.96	4.15	4.20
Interest rate, SELIC (%, end of period)	11.75	14.25	14.25	11.50
Private consumption (% growth)	1.3	-3.9	-2.5	0.5
Public consumption (% growth)	1.2	-0.4	-0.1	0.0
Fixed capital investment (% growth)	-4.5	-13.7	-12.2	3.2
Exports (% growth)	-1.1	7.2	2.7	5.1
Imports (% growth)	-1.0	-13.6	-10.2	2.4
Fiscal result (% GDP)	-6.1	-10.2	-8.7	-7.6
Current account (% GDP)	-4.3	-3.4	-2.7	-1.1

Source: BBVA Research

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