

2nd QUARTER
2016

Economic Outlook

Brazil

Main messages

Economic activity will continue to weaken while the political environment should remain turbulent

GDP will fall around 3.0% in 2016, driven by a contraction of around 6% in the domestic demand

We expect positive GDP growth in 2017, but activity recovery will be slow, in line with our estimates showing potential growth of just 1%

Inflation slowdown and current account improvement will bring some relief, while fiscal concerns will continue

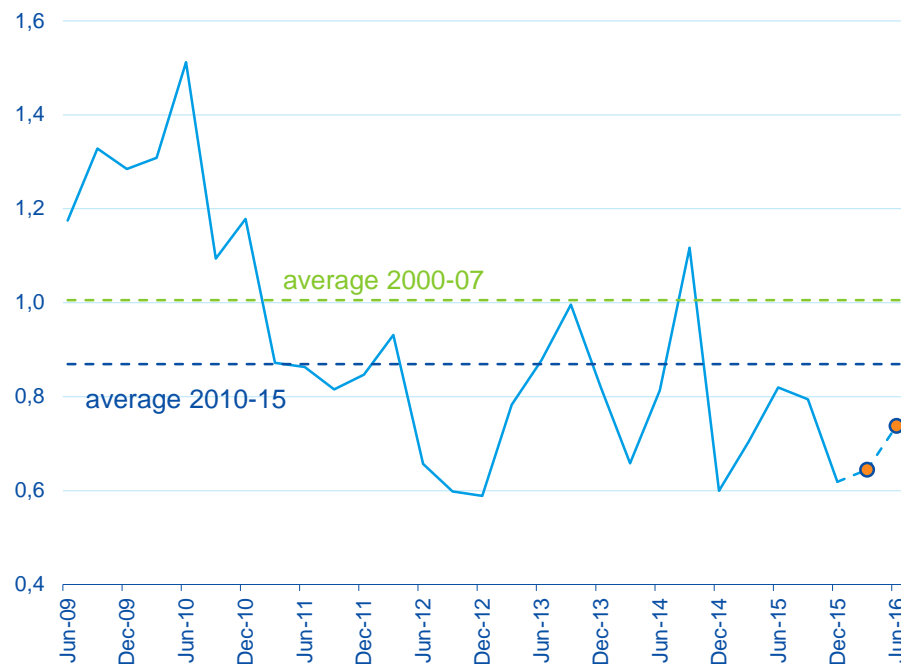
The background of the slide is a photograph of the Earth as seen from space. The horizon of the planet is visible, with a thin layer of white clouds and a bright blue glow from the sun. The rest of the image is a deep, dark blue, representing the void of space.

Global

Global environment: fragile and China-dependent growth

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World GDP (QoQ%). Forecasts for 1Q16 and 2Q16 based on BBVA-GAIN



Source: BBVA Research

World GDP accelerated somewhat and financial tensions eased in the last few months...

...as concerns about China and US monetary policy lessened.

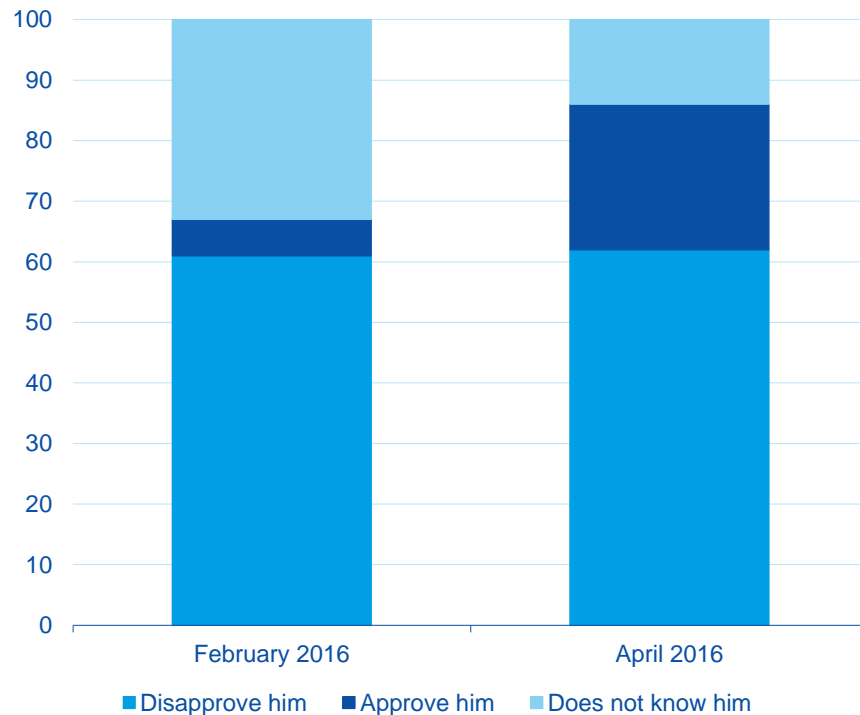
World growth is expected to continue to accelerate gradually, but to remain fragile and dependent mainly on the evolution of China

Brazil

Economic activity will contract sharply in 2016 and recover timidly in 2017

The political environment is expected to remain turbulent

Michel Temer's approval rating (%)



Source: Ipsos

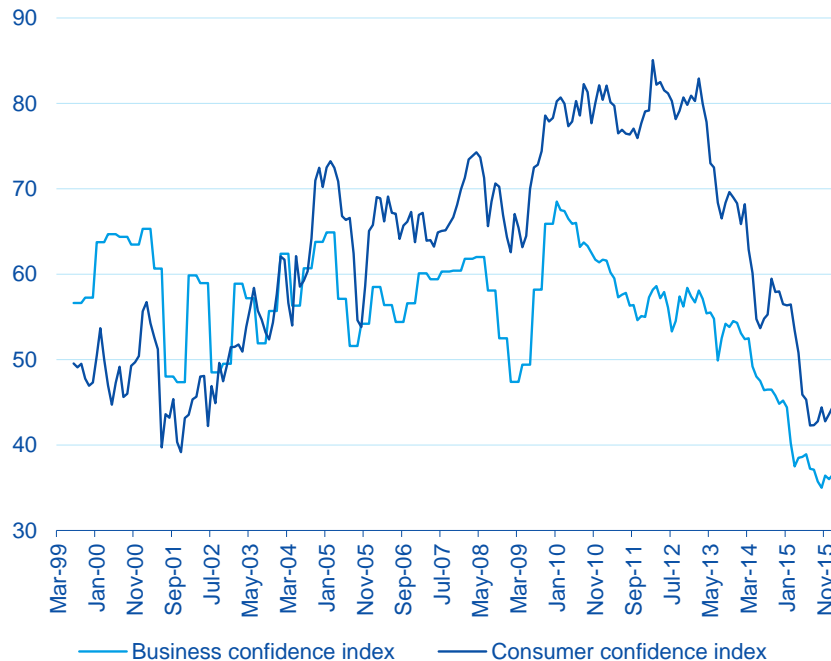
Following recent decision by the Congress, President Rousseff stepped aside and Vice-President Michel Temer assumed presidential duties.

Once the doubts about who will govern the country have been mostly cleared up, we see some room for domestic uncertainty to fall.

However, we expect political tensions to remain high for many reasons: i) it is not clear whether the new administration will have the needed support to govern, ii) ongoing corruption scandals, iii) economic crisis, iv) fierce opposition, etc.

Economic recovery is likely to be slow, as political turbulence and fiscal concerns will continue

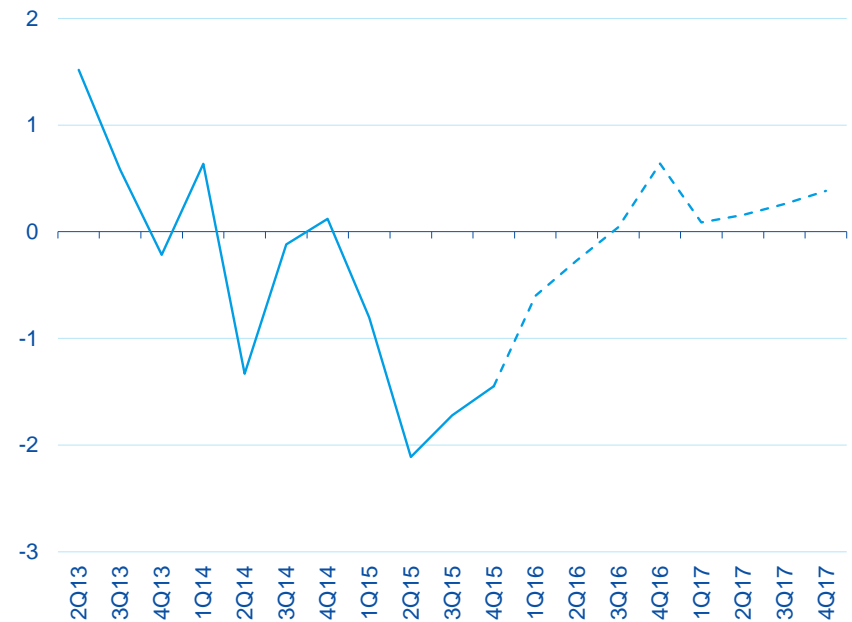
Confidence indices



Confidence levels could increase, but are expected to remain at low levels

Source: CNI, Fecomercio and BBVA Research

GDP growth (QoQ%)

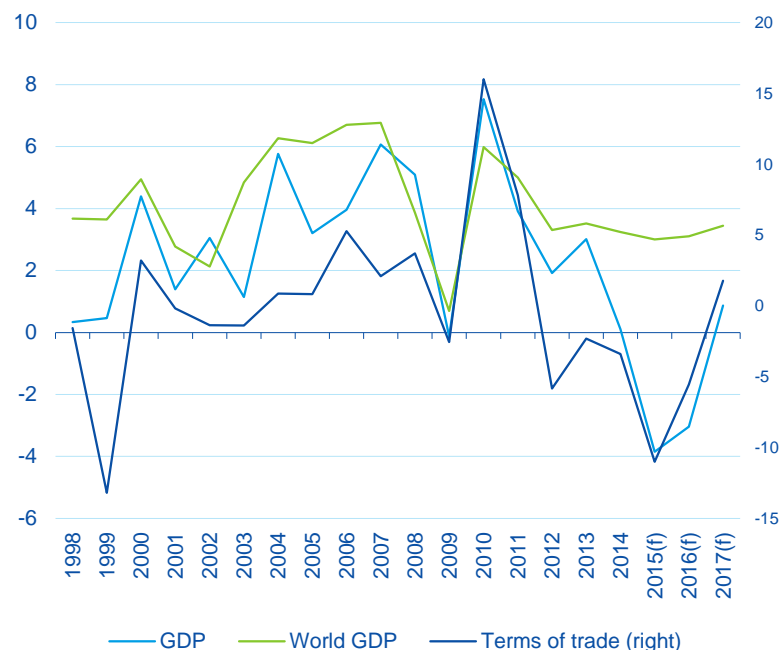


GDP to contract in 1H16 (not as much as in 2H15), stabilize in 2H16 and be back into positive territory in 2017

Source: BBVA Research

GDP is expected to decrease 3.0% in 2016 and grow by 0.9% in 2017

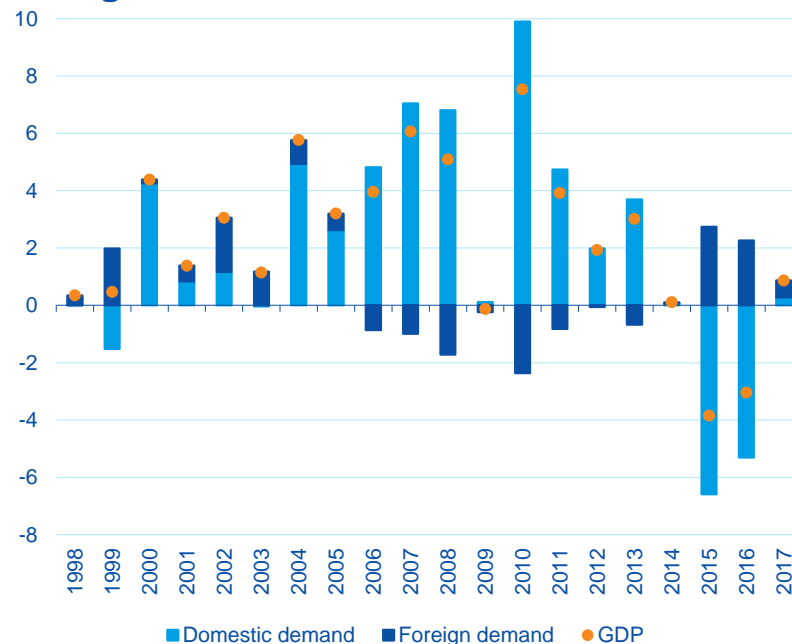
Brazil's GDP, terms of trade and world's GDP
(% growth)



Global environment is likely to be more supportive in 2017

Source: IMF and BBVA Research

GDP growth: contributions of domestic and foreign demand

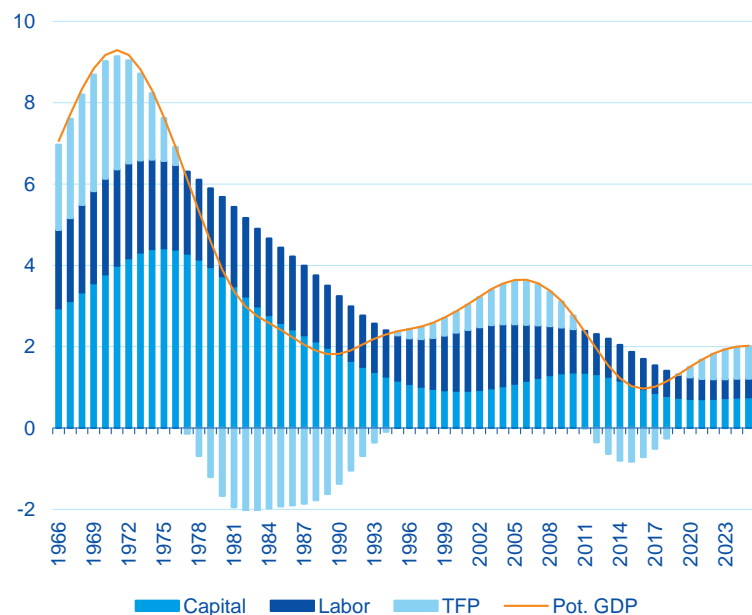


Moreover, the economy will benefit from a mild decline in domestic uncertainty, a slowdown in inflation, a less contractive monetary policy, etc

Source: IBGE and BBVA Research

Low growth scenario is reinforced by estimates showing that potential GDP has fallen to just 1.0%

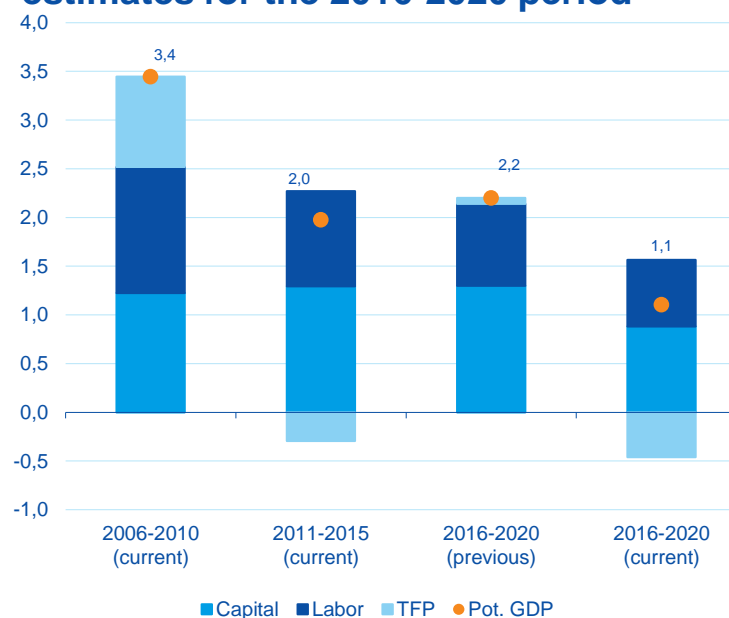
Potential output by contributors



Due to lower contributions from capital, labor and productivity, potential GDP has fallen significantly.

Source: BBVA Research

Current potential GDP estimates for 2006-2010, 2011-2015 and 2016-2020 and previous (2015) estimates for the 2016-2020 period

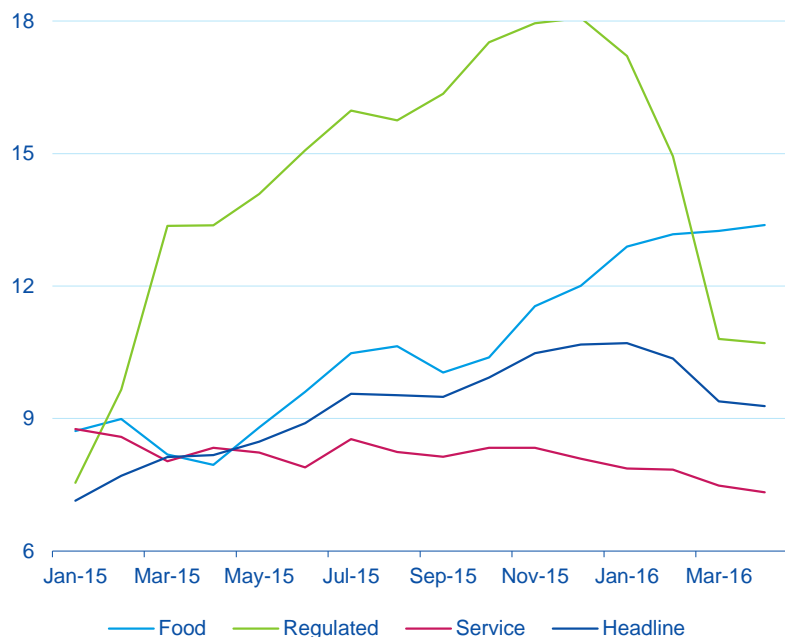


Reforms (tax system, labor system, social security, trade liberalization, political system, etc) could trigger a faster than expected recovery of potential GDP

Source: BBVA Research

Domestic demand deceleration is finally affecting inflation more significantly

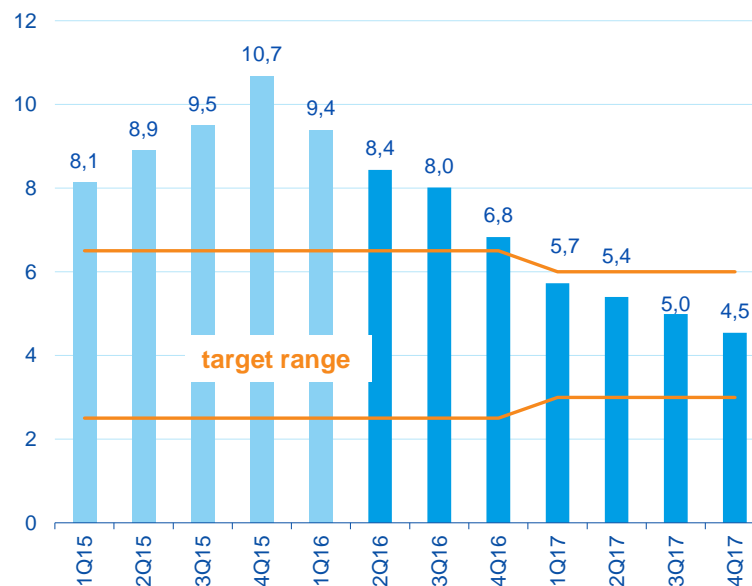
Inflation: headline, food, regulated and service (YoY %)



The main drivers of the slowdown are (and will continue to be) the smaller adjustments in regulated prices and the contraction of domestic demand.

Source: BCB and BBVA Research

Headline inflation: observed and forecasts (YoY %, end of quarter)

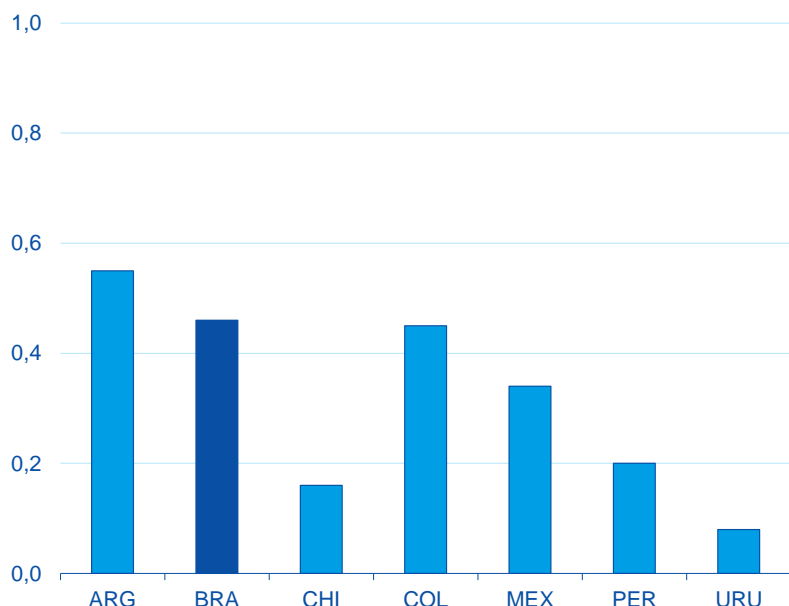


Recent inflation moderation reinforces our forecasts that inflation will fall to 6.8% in 2016 and 4.5% in 2017.

Source: BCB and BBVA Research

Relatively high inertia in Brazil is one of the obstacles for inflation to slow down more significantly

Persistence of headline inflation: based on the estimation of a Phillips curve (Jan/04-Mar/16)*

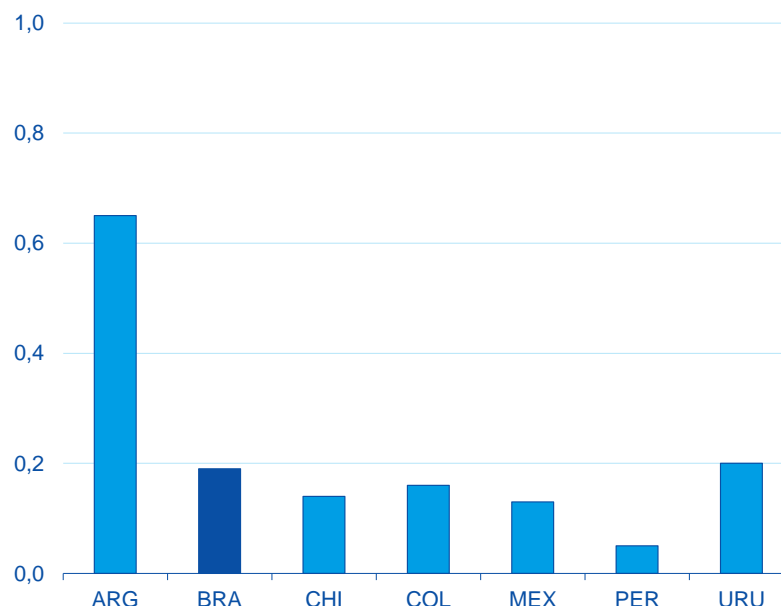


Different inertia measures show that inertia in Brazil is relatively high...

* Due to data issues, the sample for Argentina starts in August 2006. The results are significant at a 5% level for Argentina, Brazil, Colombia, Peru and Mexico and at 10% for Chile.

Source: BBVA Research

Persistence of core inflation: based on the estimation of a Phillips curve (Jan/04-Mar/16)*



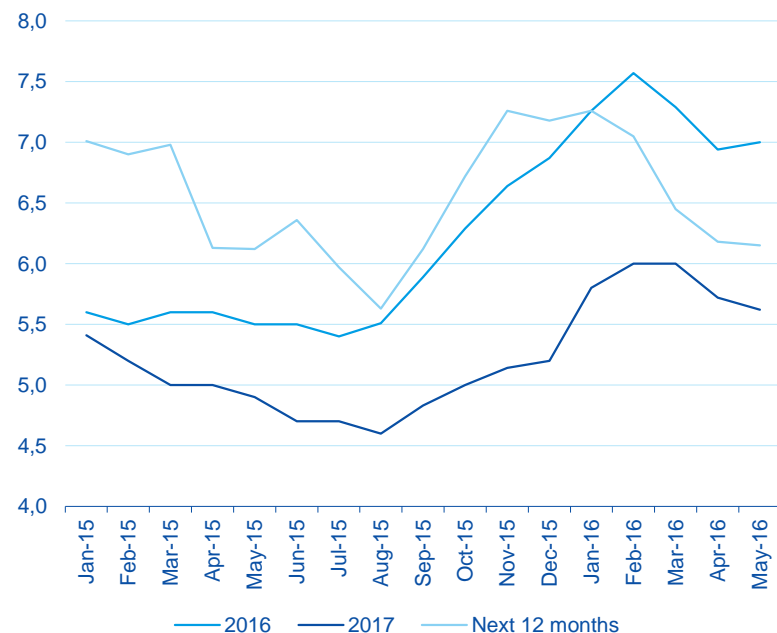
...reinforcing our view that inflation will only converge to the targets next year.

* Due to data issues, the samples for Argentina and Uruguay start in April 2008 and January 2011, respectively. The results are significant at a 5% level for Argentina, Brazil, Colombia and Mexico and at a 10% level for Peru and Uruguay.

Source: BBVA Research

Inflation slowdown brings some relief, but the time for a monetary easing has not arrived yet

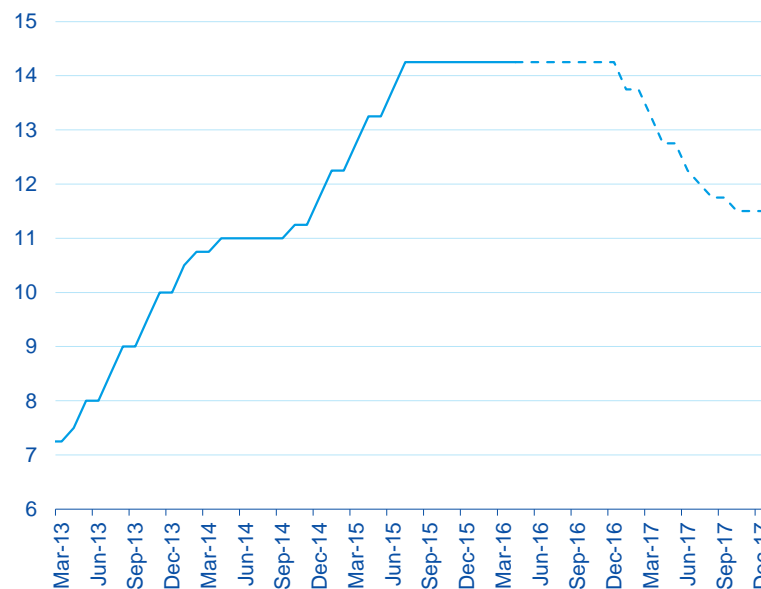
Inflation expectations: market consensus for next 12 months, end of 2016 and end of 2017 (YoY %)



Inflation expectations have fallen lately, but a further decline is needed for the BCB to start to cut the Selic rate

Source: BCB and BBVA Research

Selic interest rate (%)

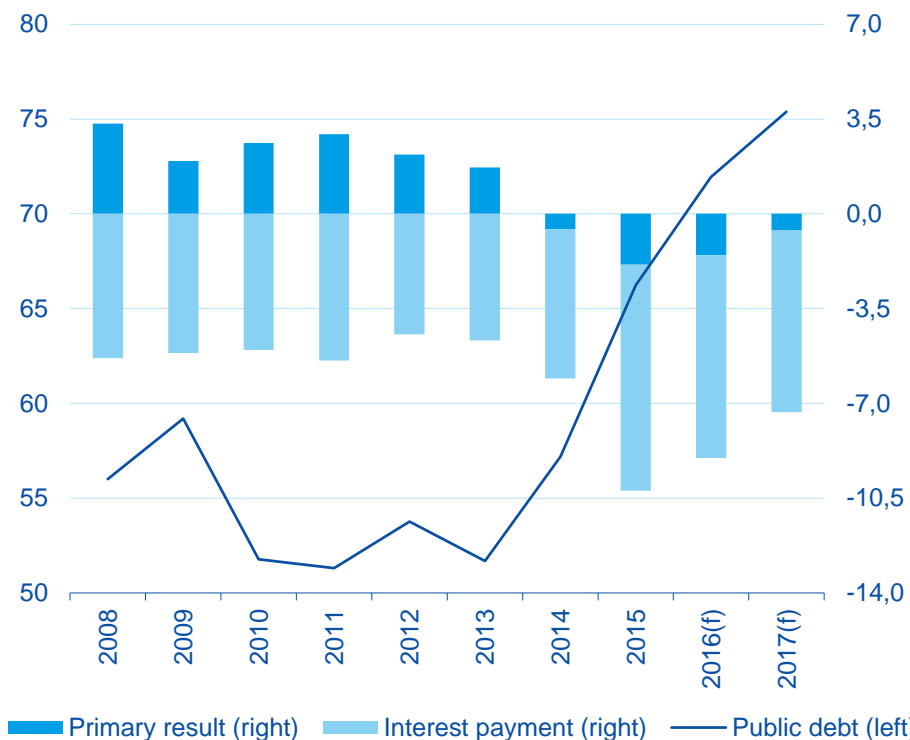


Although the possibility of a new BCB governor being appointed soon increases uncertainty, we expect monetary easing to begin only next year

Source: BCB and BBVA Research

We remain skeptical about a short-term solution to the fiscal crisis

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



Source: BCB and BBVA Research

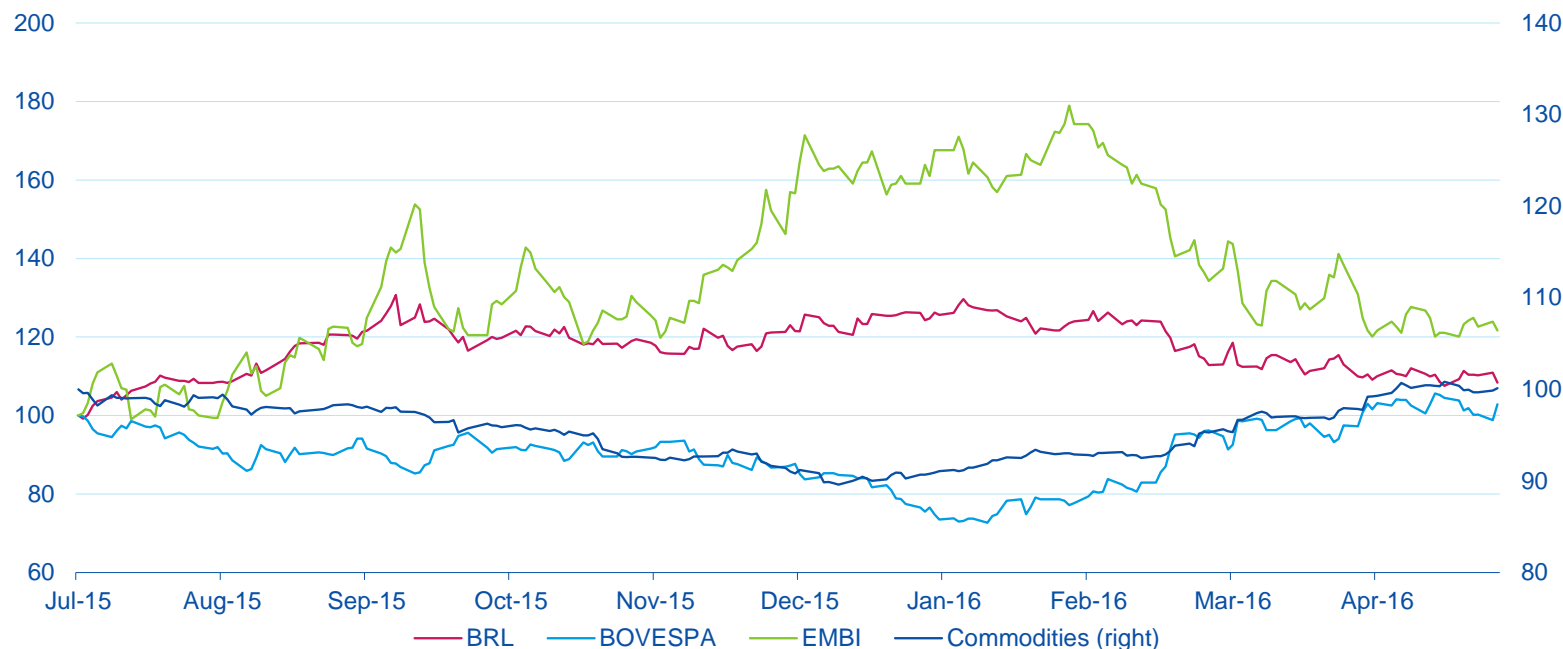
Although the new administration seems willing to address fiscal matters, we are skeptical about its ability to approve a significant social security reform and to effectively reduce the degree of rigidity of public expenses

Therefore, we expect public accounts to continue to worsen and fiscal risks (debt crisis, fiscal dominance, etc) to remain in place

The gross public debt is forecast to jump from 66% of GDP in 2015 to 72% in 2016 and 75% in 2017.

Financial markets: after the storm comes the calm; and then another storm?

Commodity prices (CRB index), equity markets (BOVESPA), sovereign spreads (EMBI +) and exchange rate (USD/BRL). Indexes: figures as of July 20, 2015 =100.

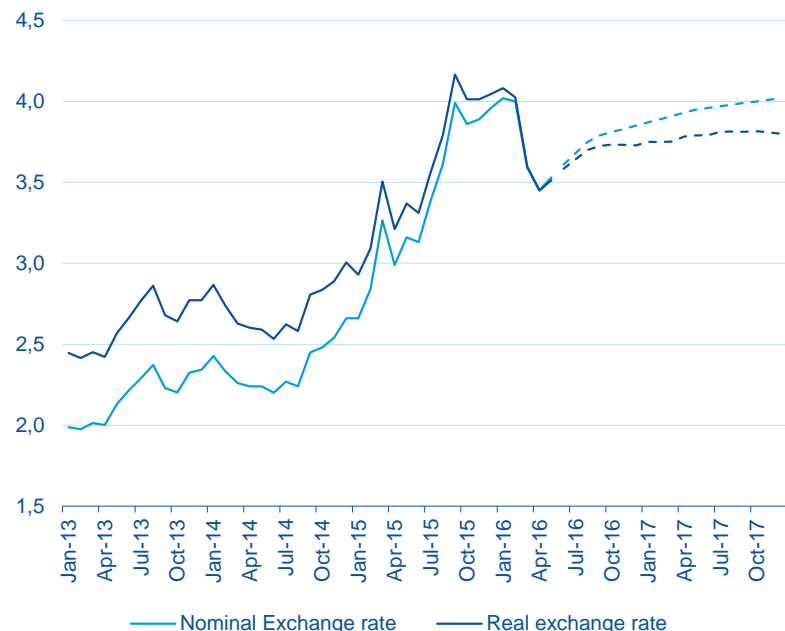


Local financial assets recovered in the last months the losses recorded during the second half of 2015, in line with commodity prices dynamics. We expect financial turbulence to remain high.

* Higher values represent a weaker Brazilian real, a higher BOVESPA index and a higher sovereign spread. Data until May 11.
 Source: Datastream, CRB and BBVA Research

The exchange rate is likely to depreciate and the current account deficit is expected to ease furthermore

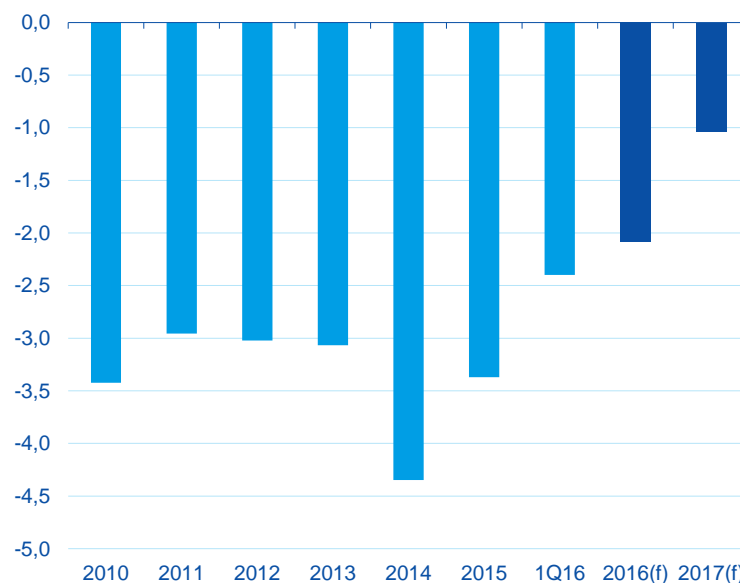
Exchange rate: Brazilian real per USD dollar (nominal and real rates)



Global volatility due to concerns on China and US monetary policy and our view that fiscal and political issues will continue to weigh negatively...

Source: BCB and BBVA Research

Current account (% of GDP)



...support the view that the BRL will weaken, helping CA deficit to decline, which will further reduce the risk of a balance-of-payments crisis.

Source: BCB and BBVA Research

Main messages

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GDP will fall around 3.0% in 2016, driven by a contraction of around 6% in the domestic demand

We expect positive GDP growth in 2017, but activity recovery will be slow, in line with our estimates showing potential growth of just 1%

Inflation slowdown and current account improvement will bring some relief, while fiscal concerns will continue

A hand holding a tablet computer against a blurred city skyline background. The image is dominated by blue tones, with a white diagonal line running from the top right corner towards the center. The word "Annex" is written in a large, bold, blue font in the lower right quadrant.

Annex

Forecasts

Macroeconomic forecasts

	2014	2015	2016	2017
GDP (% growth)	0.1	-3.8	-3.0	0.9
Inflation (% YoY, end of period)	6.4	10.7	6.8	4.5
Exchange rate (BRL/ USD,end of period)	2.66	3.96	3.85	4.02
Interest rate, SELIC (% , end of period)	11.75	14.25	14.25	11.50
Private consumption (% growth)	1.3	-4.0	-3.3	-0.1
Public consumption (% growth)	1.2	-1.2	-1.0	-1.6
Fixed capital investment (% growth)	-4.5	-14.1	-12.6	1.6
Exports (% growth)	-1.1	6.1	3.2	4.8
Imports (% growth)	-1.0	-14.3	-14.2	0.7
Fiscal result (% GDP)	-6.1	-10.2	-9.0	-7.3
Current account (% GDP)	-4.3	-3.4	-2.1	-1.0

Source: BBVA Research