BBVA RESEARCH

ECONOMIC OUTLOOK

BRAZIL

4th QUARTER 2016

We continue to expect the Brazilian economy to contract by 3.0% in 2016. Most recent activity data suggest the risks to this forecast are tilted to downside.

We are also maintaining our 0.9% GDP growth forecast for 2017. Recovery will be favored by factors such as reduced political uncertainty, lower inflation and the easing of monetary conditions.

Some recent advances make the adoption of a ceiling for public expenditure more likely. Its approval by the Congress would limit fiscal risks and further spur growth from 2017 on. However, in order to implement this ceiling effectively, the government will need to approve a social security reform.

GLOBAL

4th QUARTER 2016

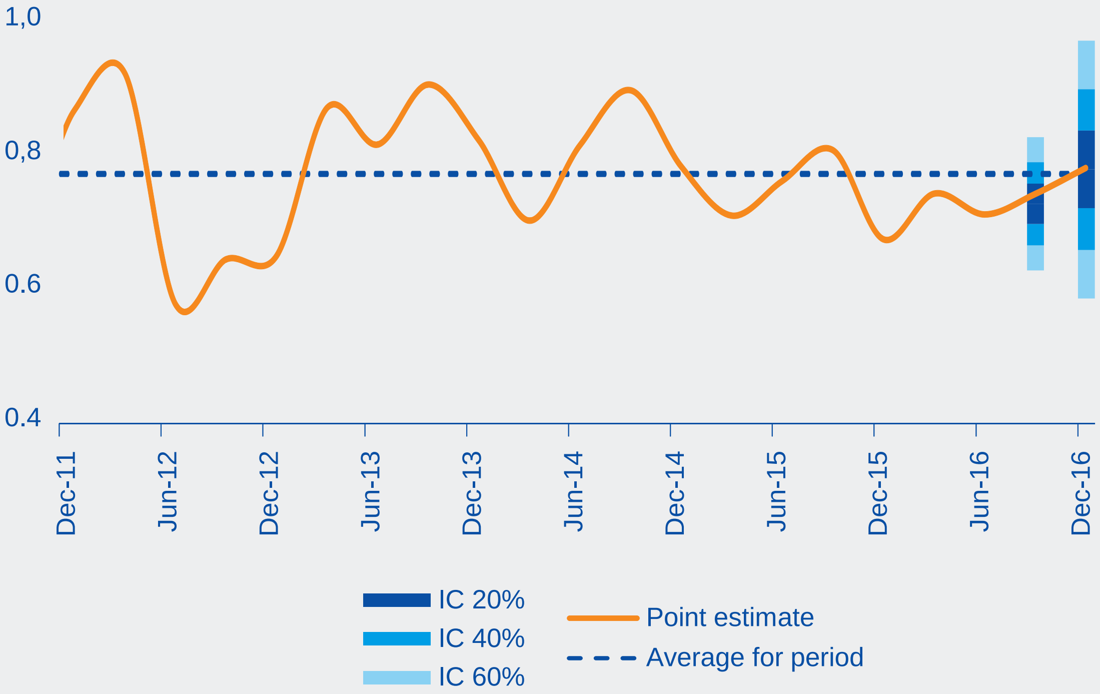
GLOBAL GROWTH

Global GDP growth will accelerate slightly in 2H16

- **The slowdown in goods exports seems to be bottoming out** and showing signs of improvement
- Retail sales indicate that **consumption continues to show strength**
- Mixed signals on confidence indicators, **although with signs of recovery** in many countries

GLOBAL GDP GROWTH

Forecasts based on BBVA-GAIN (%, QoQ)

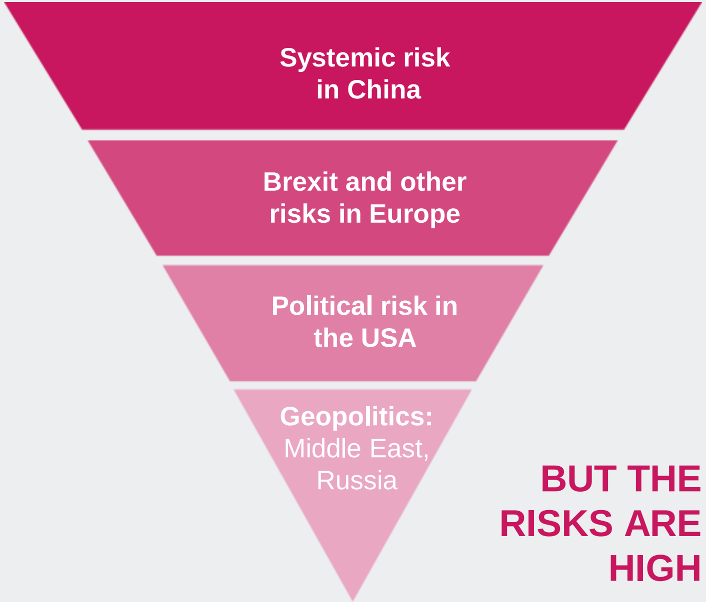


Source: BBVA Research

GLOBAL FACTORS

Positive data, but risks still high

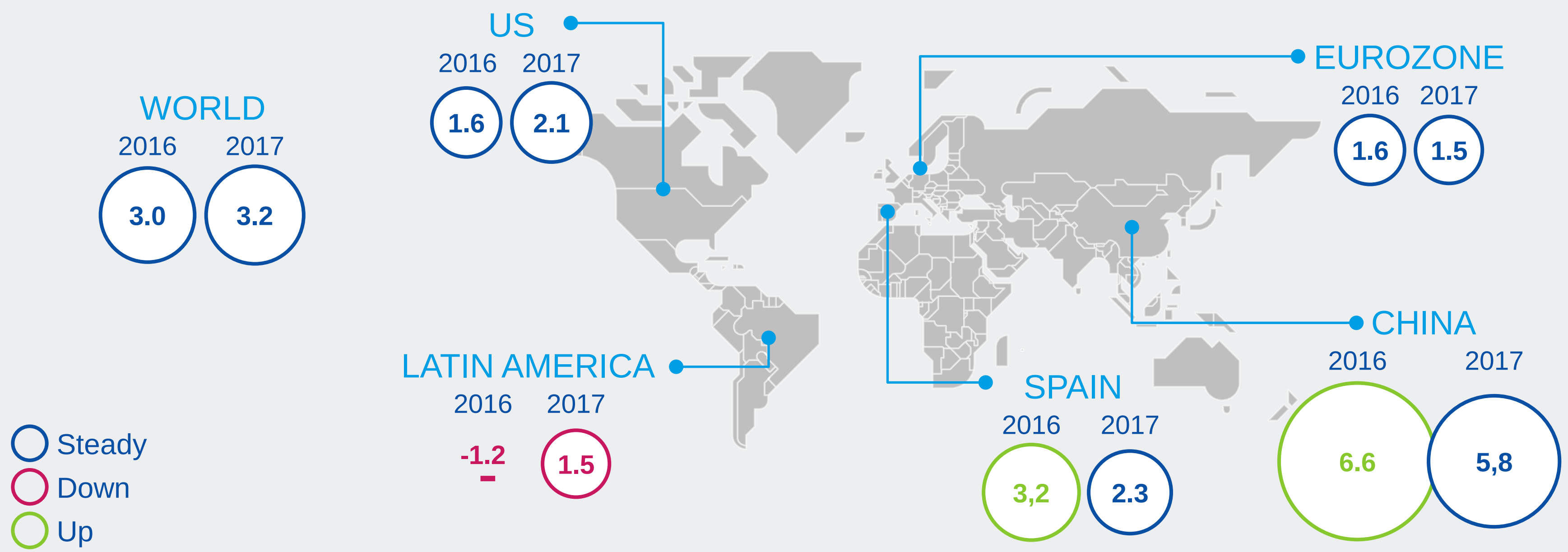
POSITIVE FACTORS



BUT THE RISKS ARE HIGH

GLOBAL SCENARIO

Slight downward revision of growth in Latin America in 2016-17



Source: BBVA Research. Latin America includes: Argentina, Brazil, Chile, Colombia, Mexico, Paraguay, Peru, Uruguay and Venezuela

WORLD GROWTH

Factors that affect the recovery

Central banks and low interest rates

Low interest rates are here to stay, because of cyclical and structural problems, but not at such low levels as those of today

Monetary **policies** are approaching their limits and are beginning to outweigh the costs

Coordination of different policies

Fiscal and structural policies should complement monetary ones

The USA and Germany have room for expansionary measures, which are more likely in the US

Other countries have scope to modify the **composition of public expenditure**

Global trade

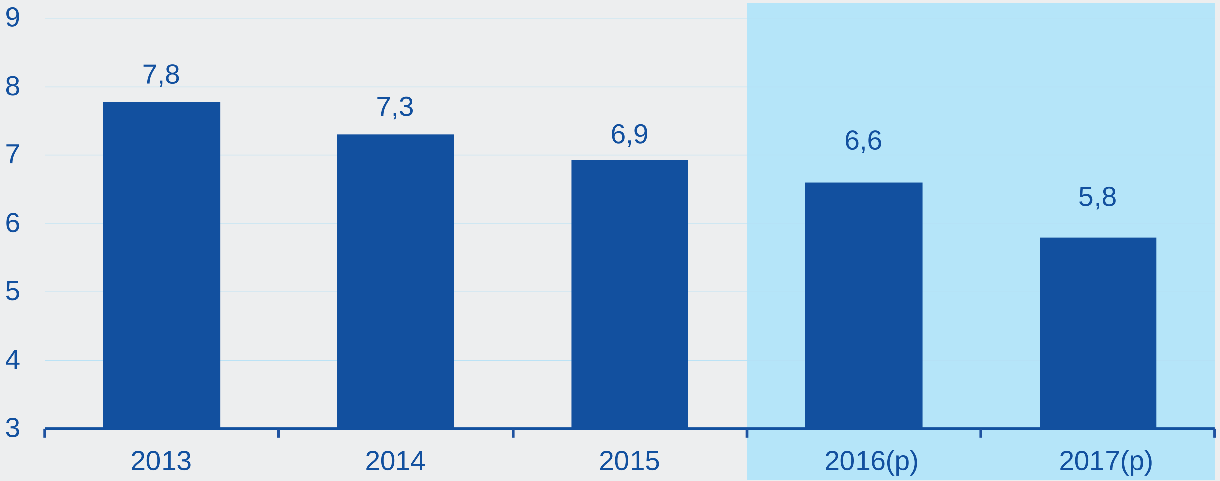
The **slowdown in global growth** affects trade

The **elasticity of trade** to GDP growth **is lower than before the crisis**

CHINA

Slight upward revision of growth in 2016

GDP GROWTH
(YoY, %)



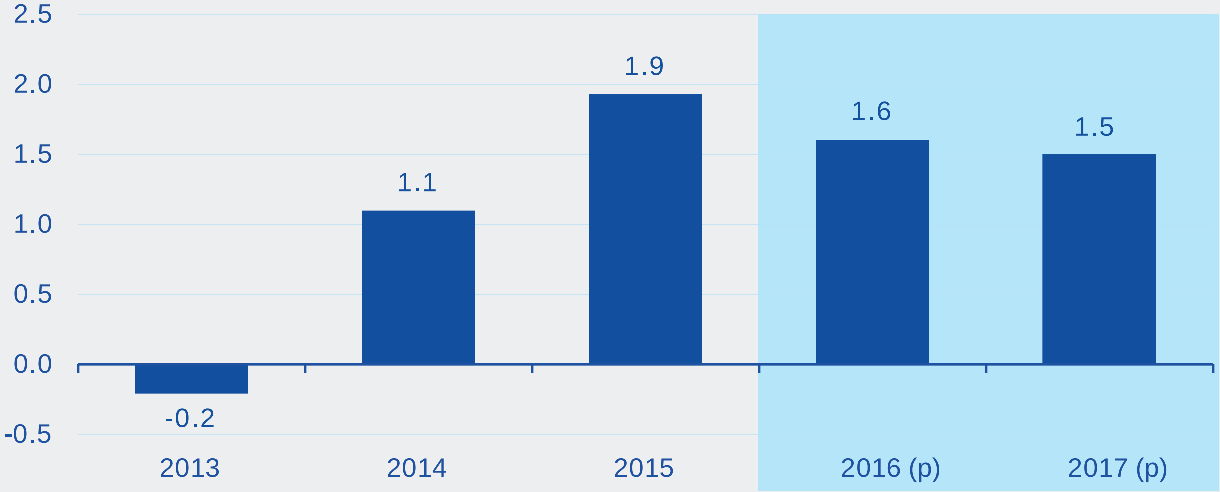
- **Domestic demand** strengthened by new monetary and fiscal stimulus
- The authorities have postponed any additional monetary measures with a view to curbing the real estate bubble, while continuing to move ahead with macroprudential measures
- Risks remain over **the medium term**:
  - Indebtedness of private companies and lack of reforms in public ones
  - Real estate market
  - Capital outflows and exchange rate
  - Shadow banking

Source: BBVA Research and IMF

EURO ZONE

Unchanged forecasts for 2016 and 2017

GDP GROWTH
(YoY, %)



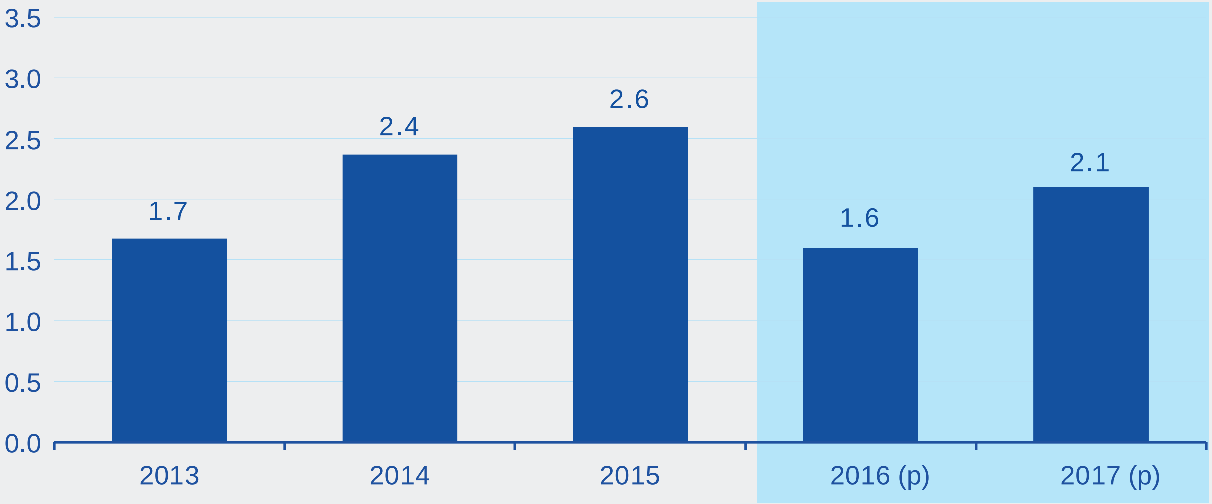
- Support of domestic demand, despite the uncertainty
- **End of year downward bias:** uncertainty regarding politics, the banking system and Brexit, despite the support of monetary policy
- **The ECB has little room for manoeuvre**: QE will most likely be extended and adjusted

Source: BBVA Research and Eurostat

UNITED STATES

Growth for 2016 revised downwards

GDP GROWTH (%)
(YoY, %)



- **Reasons**:
  - The indicators suggest insufficiently strong growth in 2H16 following the weak first half
  - Persistently low productivity
- **Fed**: we expect a rate increase in December 2016 and two in 2017 up to 1.25%
- **Political risk** following the presidential election

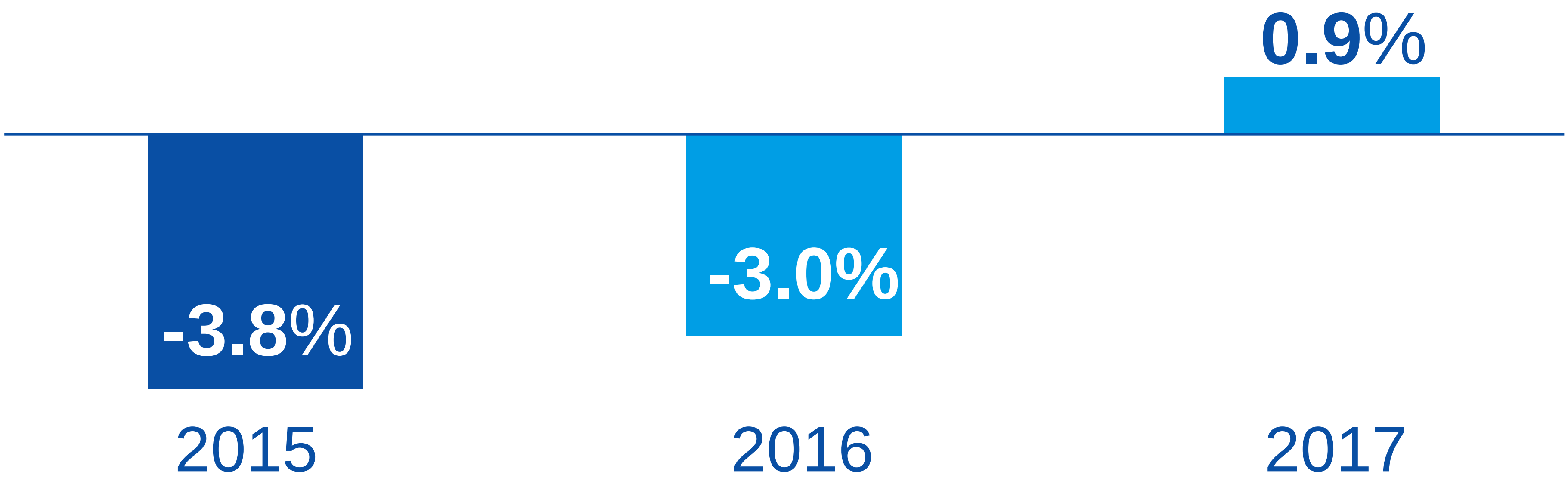
Source: BBVA Research, BEA

BRAZIL

4TH QUARTER 2016

GROWTH PROSPECTS

Unchanged forecasts, but with downside risks for 2016 and upside risks for 2017

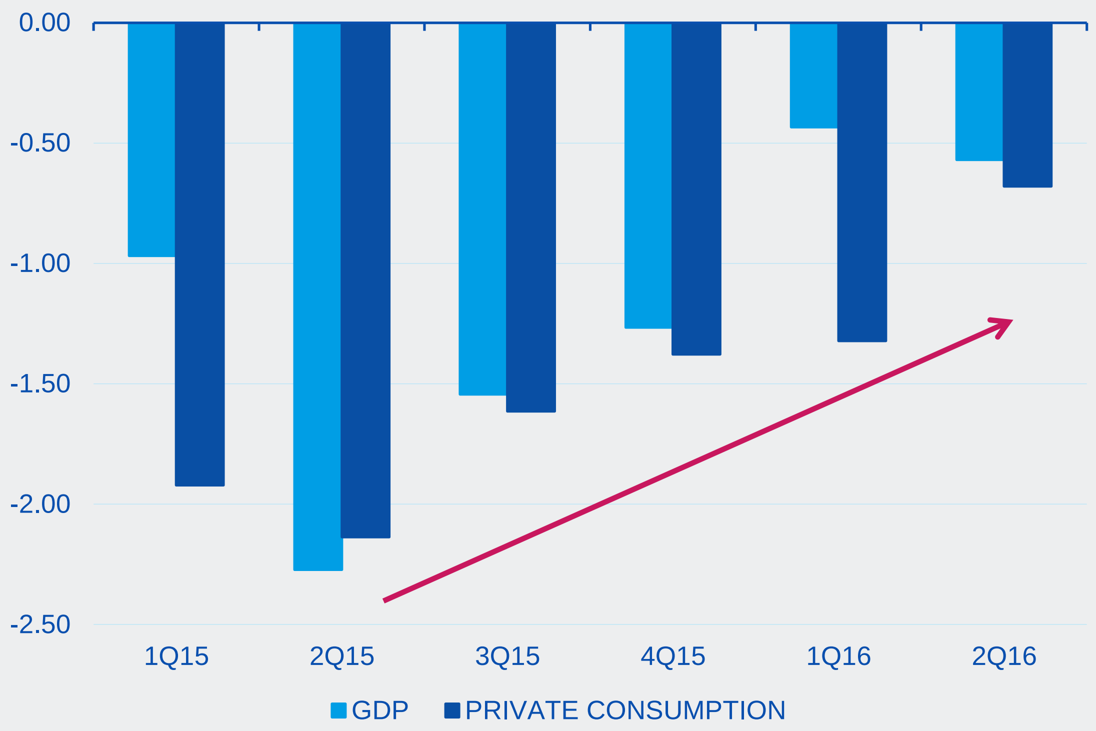


SHARP GDP CONTRACTION IN 2016

Further growth deterioration in 1H16

- GDP continued to contract in the first half of the year, but at a slower pace than it did during 2015
- The **main contributor to GDP contractions in 1H16 was private consumption,** which offset the positive contribution to growth of fixed investment (in 2Q16 but not in 1Q16, thanks to somewhat lower uncertainty) and mainly of net exports (thanks to a weaker currency)

GDP AND PRIVATE CONSUMPTION GROWTH
(% QoQ)

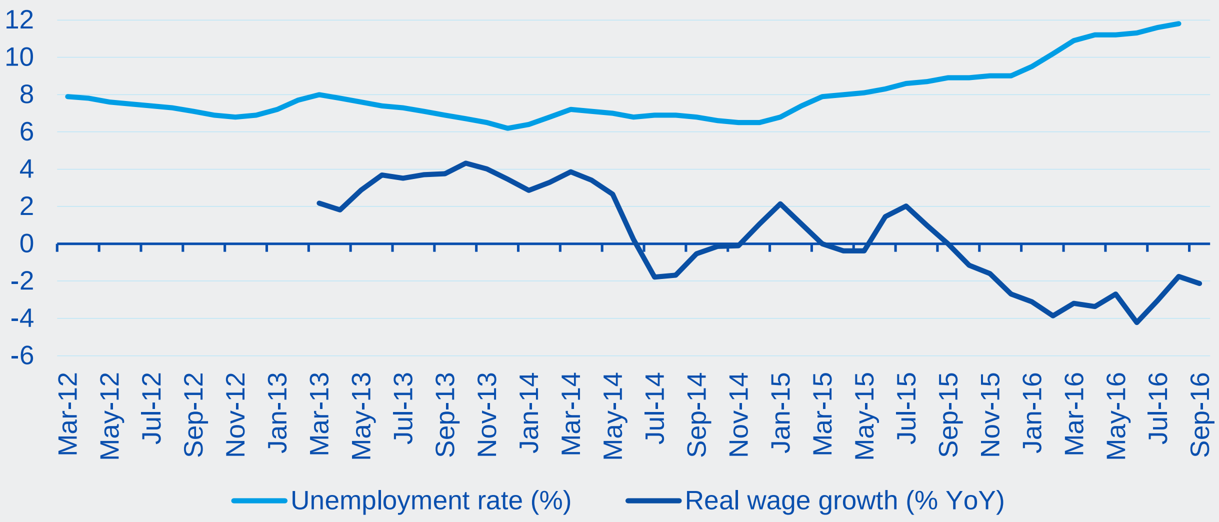


Source: BBVA Research and IBGE

SHARP GDP CONTRACTION IN 2016

Negative consumption dynamics: mainly driven by labor market

LABOR MARKET: UNEMPLOYMENT RATE AND REAL WAGE GROWTH



- **Other drivers**:
  - Credit markets slowdown
  - Relatively high indebtedness
  - High inflation (although lower than a few months ago)
  - Tight monetary policy
  - Cuts in public expenditure
  - Low confidence (although higher than a few months ago)
  - High uncertainty (although lower than a few months ago)

Source: BBVA Research, IBGE and IPEADATA

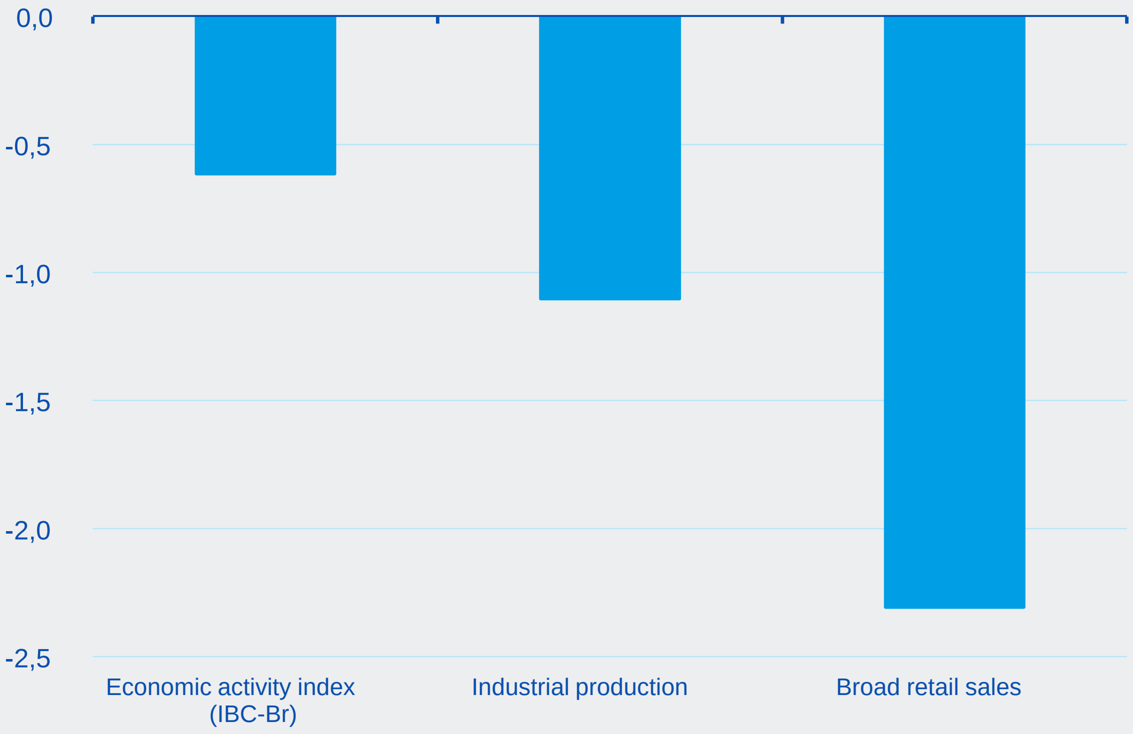
SHARP GDP CONTRACTION IN 2016

GDP to fall again in 3Q16, stabilize in 4Q16

- Available data suggest that **economic activity contracted again in quarterly terms (QoQ) in 3Q16** and that no robust recovery should be expected in 4Q16
- In fact, recently released indicators show that 2H16 growth could be weaker than we are forecasting. Thus, **risks to our -3.0% GDP forecast for 2016 are tilted to the downside**

ECONOMIC ACTIVITY INDICATORS: GROWTH IN 3Q16*

(% QoQ)

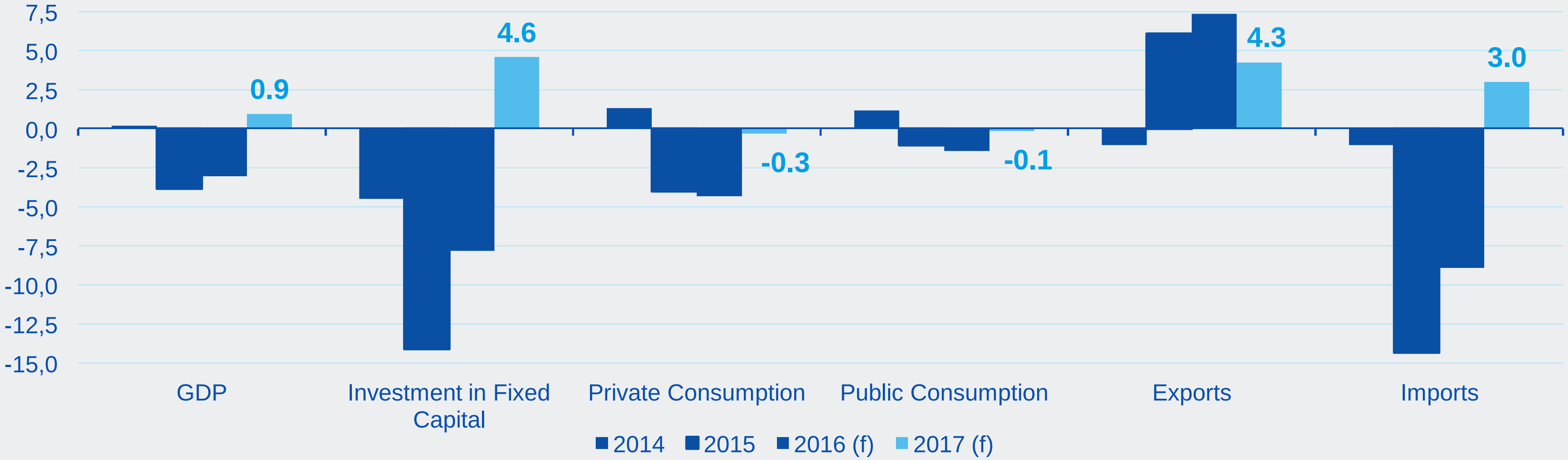


* Data until September in the case of industrial production and until August in the other two cases.
Source: BBVA Research and IBGE

POSITIVE GDP GROWTH IN 2017

2017 growth: better than in the three previous years, but still modest

GDP GROWTH
(%)

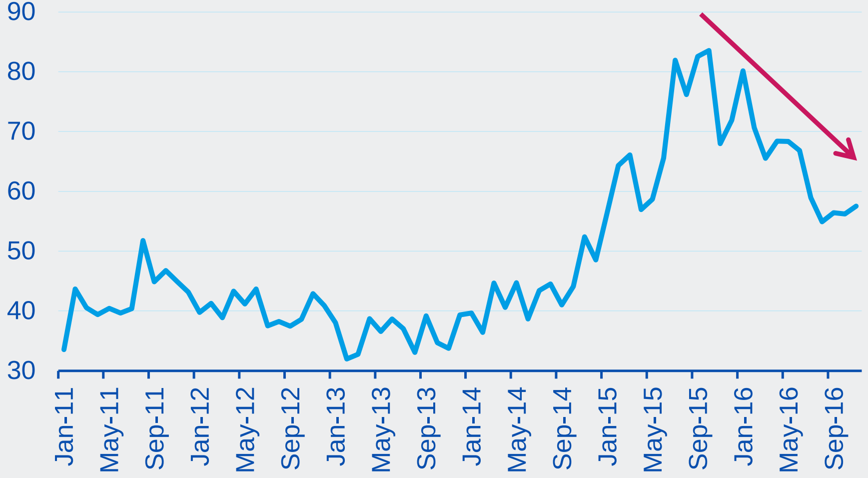


(f): forecast
Source: BBVA Research and IBGE

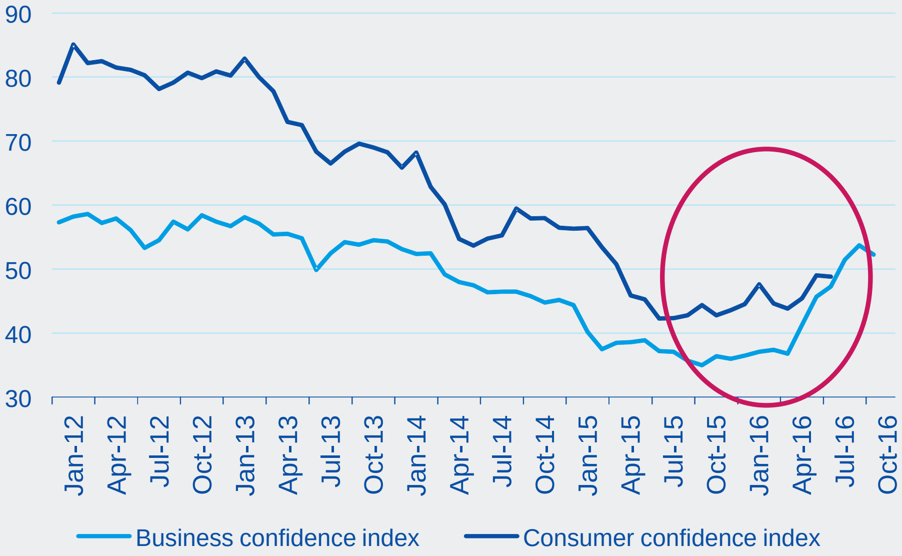
POSITIVE GDP GROWTH IN 2017

Activity to benefit from lower political uncertainty, higher confidence

BRAZIL'S CRISIS INDEX
(based on web searches)*



CONFIDENCE INDEXES



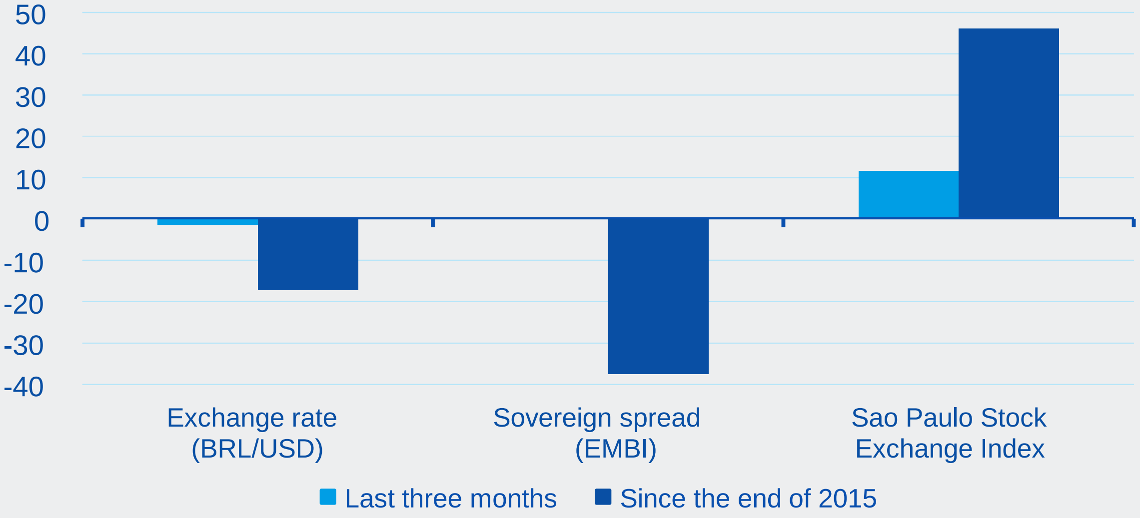
* Seasonally-adjusted index built on the interest about the term "crise" (crisis in Portuguese) in Brazil.
Source: BBVA Research and IBGE

Source: BBVA Research, FECOMERCIO and CNI

POSITIVE GDP GROWTH IN 2017

Financial markets’ rebound also supports recovery view

BRAZILIAN FINANCIAL ASSETS
(% changes)*



- Financial markets continued to recover from previous losses in the last three months
- On the one hand, these gains are **related to external factors: lower concerns on China, higher commodity prices and mainly the gradualism in the normalization of monetary conditions in the US**
- On the other hand, **the ongoing rebound in asset prices is related to the reduction of the “political noise”** (which remains high) **and the generalized perception that the worst of the domestic crisis is behind us**

* Data until November 3, 2016. Positive variations represent exchange rate depreciations.
Source: BBVA Research and HAVER Analytics

POSITIVE GDP GROWTH IN 2017

The approval of the fiscal reform should help to pave the way for activity recovery in 2017

Fiscal reform to be approved soon

Somewhat surprisingly, the government has been able to get the **Congress to support the bill that imposes a cap on fiscal expenditure for 20 years** (by ensuring that it will remain constant in real terms)

It was approved by the Chamber of Deputies and will likely be approved by the Senate soon

It should reduce fiscal risks and spur growth

Getting the fiscal reform approved would be an **important step towards ensuring the stabilization and eventual reduction of public debt in the long term**

In fact, **the approval of the fiscal reform could prompt a faster-than-expected recovery of activity from 2017 on**

However…

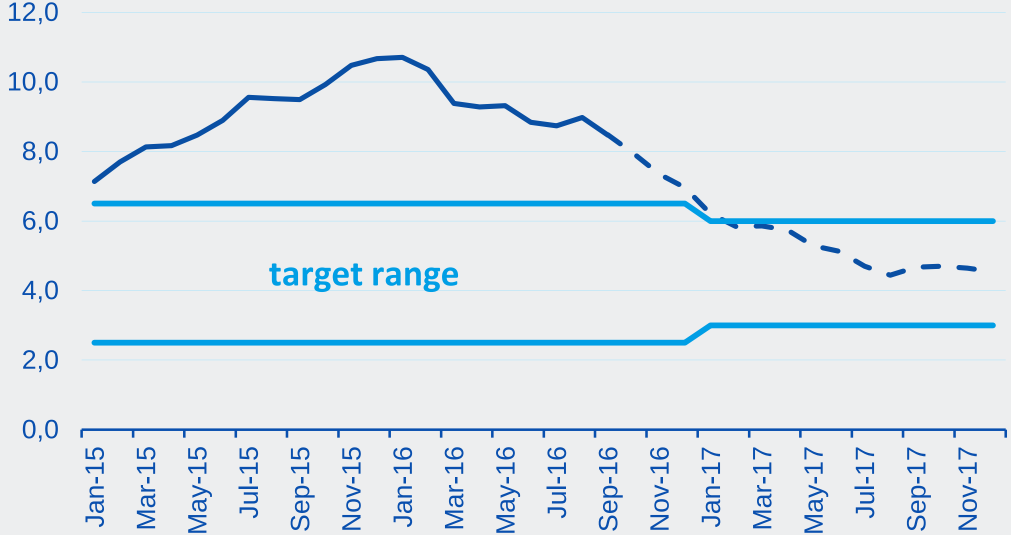
To be able to implement the new fiscal rule, **the government will need to approve a social security reform**. A bill will likely be sent to Congress in the next few months

Even if fiscal and social security reforms are approved, **fiscal accounts will continue to worsen significantly in the short-term** (see the forecast table at the end of this report)

POSITIVE GDP GROWTH IN 2017

Inflation will continue to trend downwards moving forward

INFLATION (IPCA)
(% YoY)



- We expect inflation to reach **7.0% at the end of 2016** and **converge to the 4.5% target in 2017** (our previous forecasts were 6.8% and 4.5%, respectively)
- Main drivers of the slowdown:
  - Recent currency appreciation
  - Lack of demand pressures
  - Smaller adjustments in regulated prices
- The reduction of inflation will have a positive impact on disposable income. Moreover, it will create room for an easing of monetary conditions which should further push economic activity next year

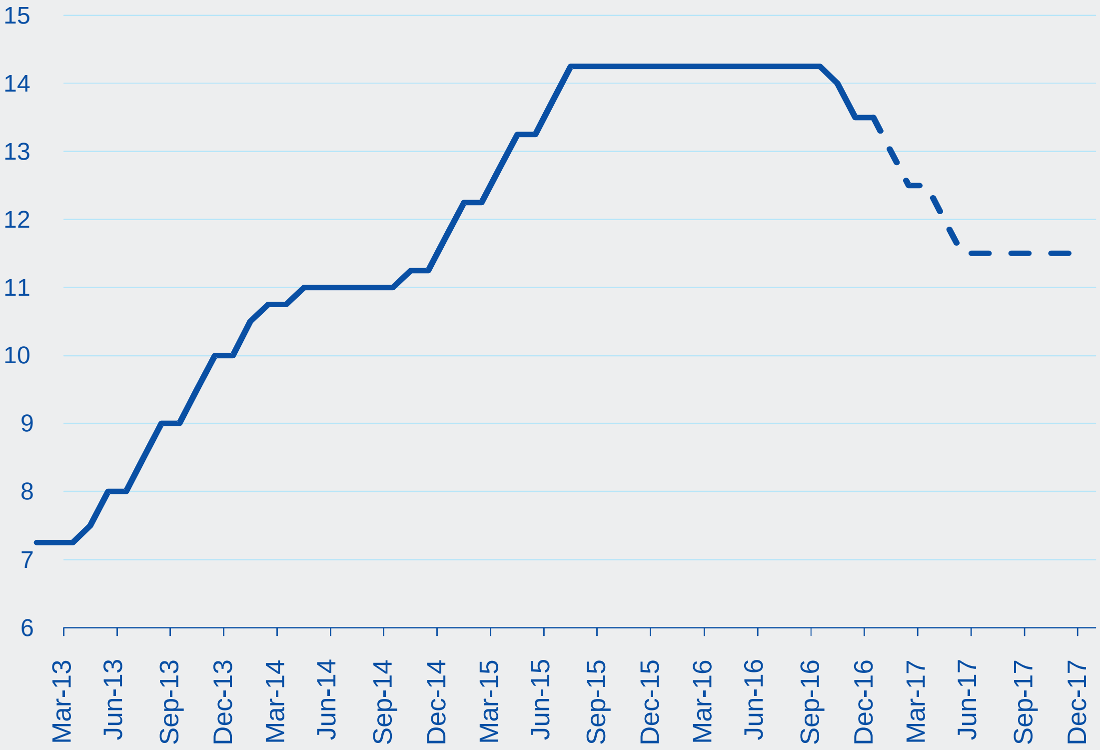
Source: BBVA Research and IBGE

POSITIVE GDP GROWTH IN 2017

A moderate monetary easing cycle ahead

- **The BCB cut the Selic by 25 bps to 14.0% in Oct/16**, after maintaining it unchanged since Jul/15. The decision, which occurred somewhat earlier than we expected, followed the inflation slowdown and the anchoring of expectations (now around 5.0% for 2017 and 4.5% for the following years)
- We expect a **50 bp cut in Nov/16** (but another 25bp cut should not be ruled out) and the Selic to reach 11.50% in 1H17
- The BCB commitment to keep inflation around 4.5% and the tightening of the US monetary conditions should help to prevent a more sizable easing cycle

SELIC RATE
(%)



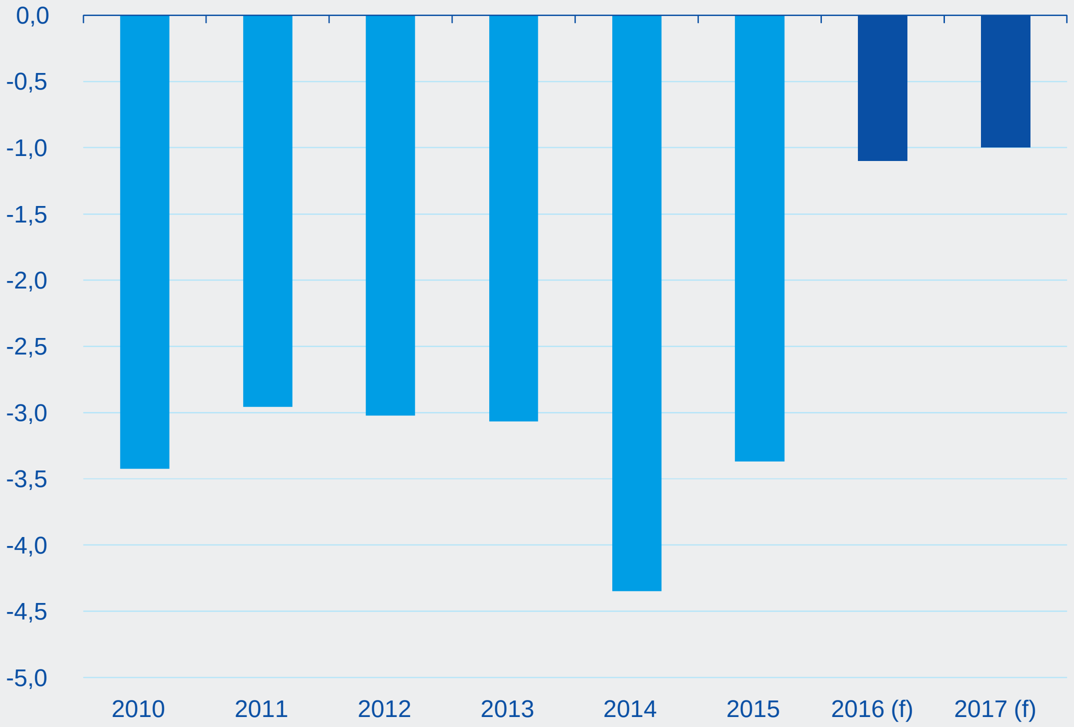
Source: BBVA Research and BCB

POSITIVE GDP GROWTH IN 2017

The external adjustment is mostly over

- We expect **the current account to remain relatively stable from now on**, after the sharp adjustment it went through (from -4.4% of GDP in Dic/14 to -1.3% of GDP in Sep/16)
- That would contribute to the stabilization of the Brazilian real (BRL), which however we expect to depreciate somewhat going forward (thus favoring exports) as the spread between domestic and foreign interest rates will decrease
- More precisely, **we expect the BRL to close 2016 at 3.34 and average 3.43 in 2017** (vs. 3.49 in 2016)

CURRENT ACCOUNT
(% GDP)



(f): forecast
Source: BBVA Research and BCB

Forecasts Table

	2014	2015	2016 (f)	2017 (f)
GDP (%)	0.1	-3.8	-3.0	0.9
Private consumption (%)	1.3	-4.0	-4.3	-0.3
Public consumption (%)	1.2	-1.0	-1.4	-0.1
Fixed capital investment (%)	-4.5	-14.1	-7.8	4.6
Exports (%)	-1.1	6.1	7.3	4.3
Imports (%)	-1.0	-14.3	-8.9	3.0
Unemployment rate (average)	6.8	8.3	11.3	11.7
Inflation (eop, YoY %)	6.4	10.7	7.0	4.5
Selic interest rate (eop, %)	11.75	14.25	13.50	11.50
Exchange rate (eop)	2.66	3.80	3.34	3.49
Fiscal result (% of GDP)	-6.1	-10.2	-9.7	-8.7
Gross public debt (% of GDP)	57.2	66.2	72.1	76.9
Current account (% of GDP)	-4.3	-3.3	-1.1	-1.0

(f): forecast; (eop): end of period
Source: BBVA Research