BBVA | RESEARCH

ECONOMIC OUTLOOK
BRAZIL
1ST QUARTER 2017

Economic activity surprised to the downside and political tensions increased somewhat in 2H16. We have thus revised our 2016 GDP forecast to -3.5% from -3.0%

We expect growth to recover moving forward and therefore maintain our forecasts for 2017 and 2018 at 0.9% and 1.2%, respectively

The approval of a fiscal reform, lower inflation, declining interest rates, among other reasons, should pave the way for the recovery. However, political tensions and failing to approve the needed social security reform could derail growth

GLOBAL

1ST QUARTER 2017

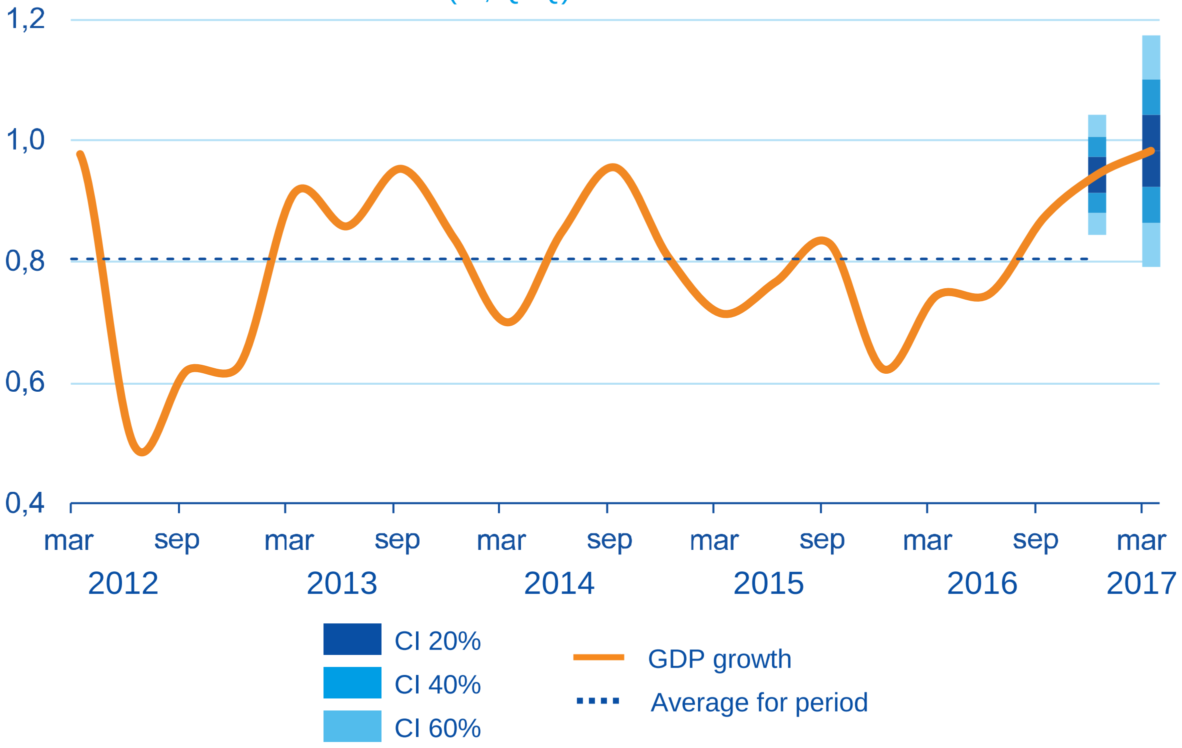
ACTIVITY

Global growth is accelerating

- Better-than-expected data for 3Q in the US, China, and the euro zone
- **Recovery of the industrial sector and world trade**
- Confidence indicators on the rise

GLOBAL GDP GROWTH

Forecasts based on BBVA-GAIN (%, QoQ)



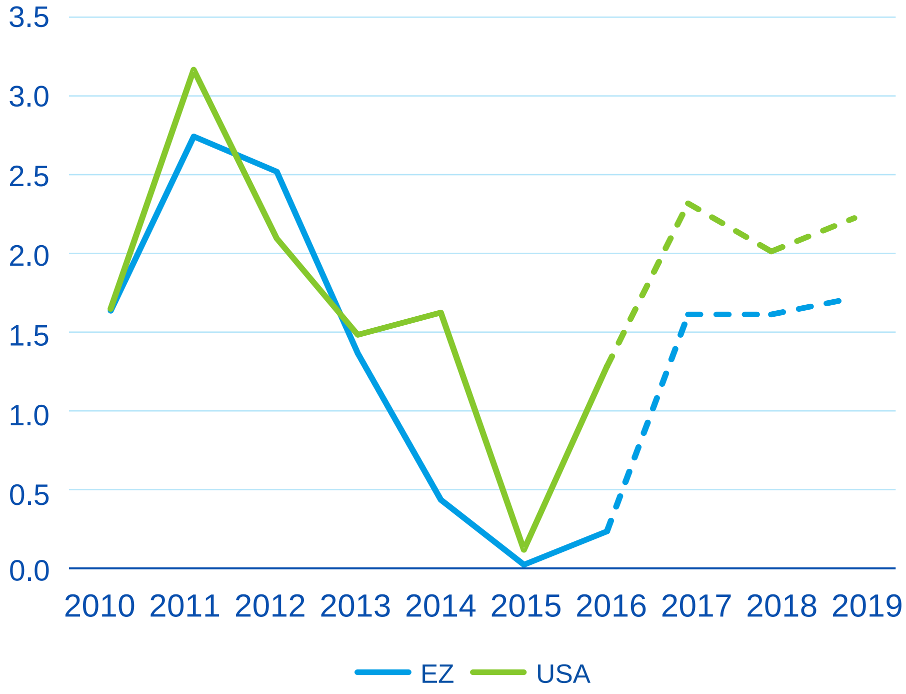
Source: BBVA Research based on data from Haver

INFLATION

The increase in commodity prices opens the way to normalisation of inflation

- **Inflation in the advanced economies has recovered** due to the base effect of energy prices and the increase in the price of crude oil
- **Core inflation** remains at **moderate rates**
- The recovery of inflation increases the chances of **normalisation of interest rates**

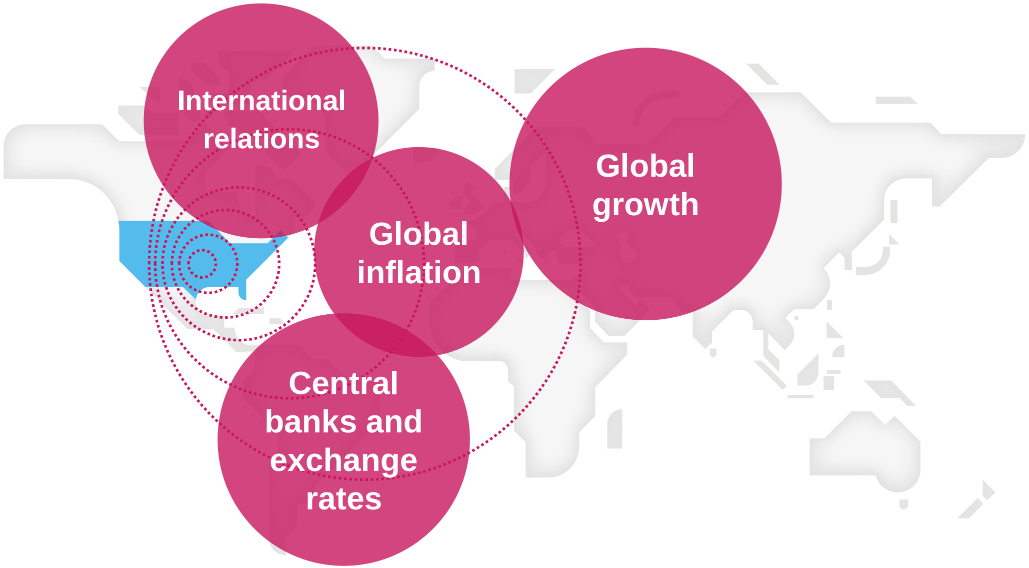
GLOBAL HEADLINE INFLATION
(%, YoY)



Source: Haver and BBVA Research

A FEW UNKNOWNS

US economic policy and its global effects



Priorities of fiscal policy?

Impact of fiscal stimulus on growth and inflation in an economy with full employment?

What impact will Trump have on potential growth?

What will the protectionist measures be? When will they be applied? What will their impact be?

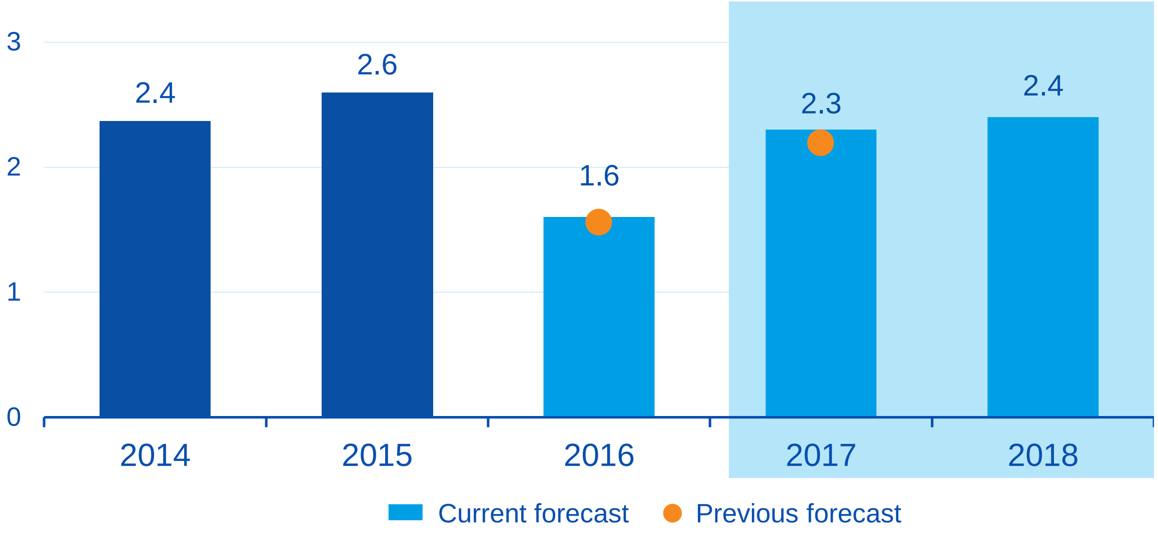
What will be the reaction of other countries (such as China)?

Which sectors will be deregulated, and how?

UNITED STATES

Boost in the short term, but with a high degree of uncertainty

GDP GROWTH
(YoY, %)



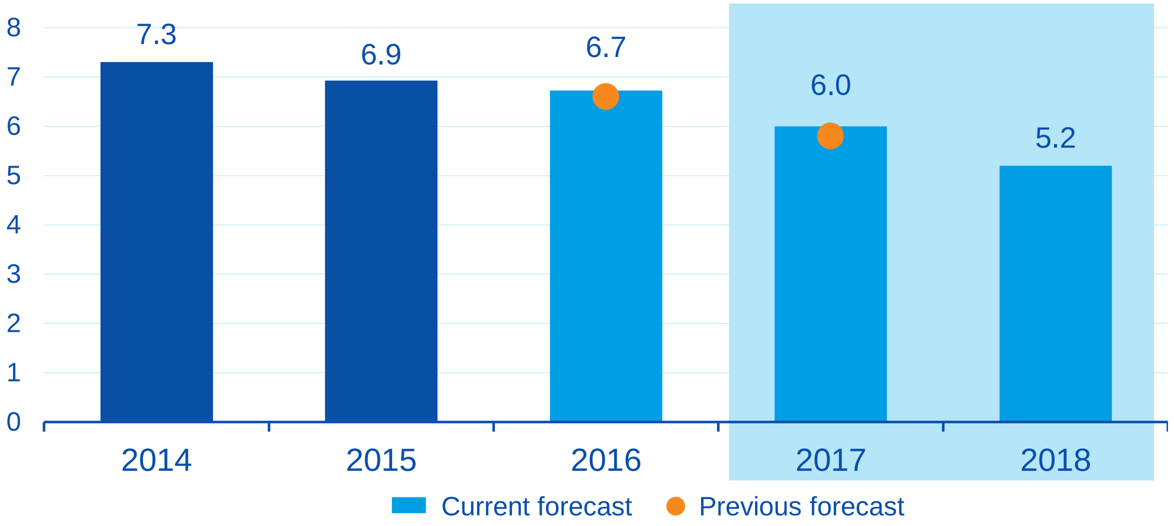
Source: BBVA Research based on BEA (Bureau of Economic Analysis)

- **Slight upward revision in 2017 pending concrete decisions**
  - Less downward pressure from mining, oil and construction
  - Solid employment situation and rising wages together with recovering corporate earnings
  - Improvement in confidence indicators and market expectations
- **Monetary policy: forecast of rate hikes**, although the Federal Reserve will remain cautious (two hikes in 2017 and 2018, to 1.75%)
- **Risks**: economic policy; inflation, dollar exchange rates and interest rates

CHINA

Stability takes priority over growth

GDP GROWTH
(YoY, %)



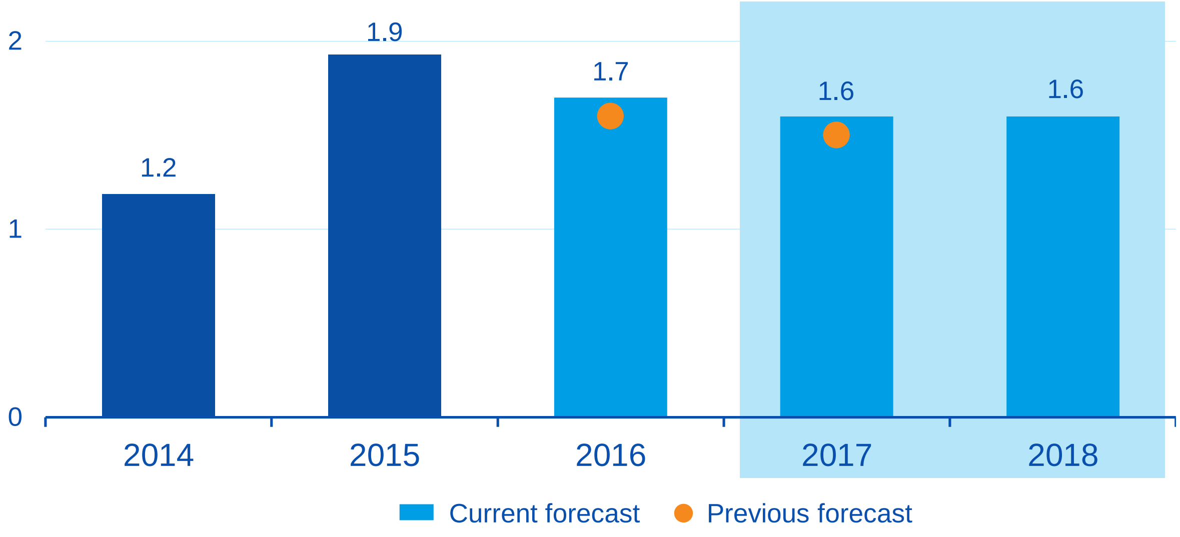
- **China continues to stimulate its economy** in order to ensure a high rate of growth in the short term
- **Monetary stimulus measures have been postponed** (real estate bubble), but macroprudential measures continue and **fiscal policy continues to support activity**
- **Significant medium-term risks:**
  - US trade policy
  - Real estate market
  - Capital outflows and exchange rate
  - Corporate debt and lack of reforms in state-owned enterprises

Source: BBVA Research based on CEIC data

EURO ZONE

Slight upward revision, high degree of political uncertainty

GDP GROWTH
(YoY, %)

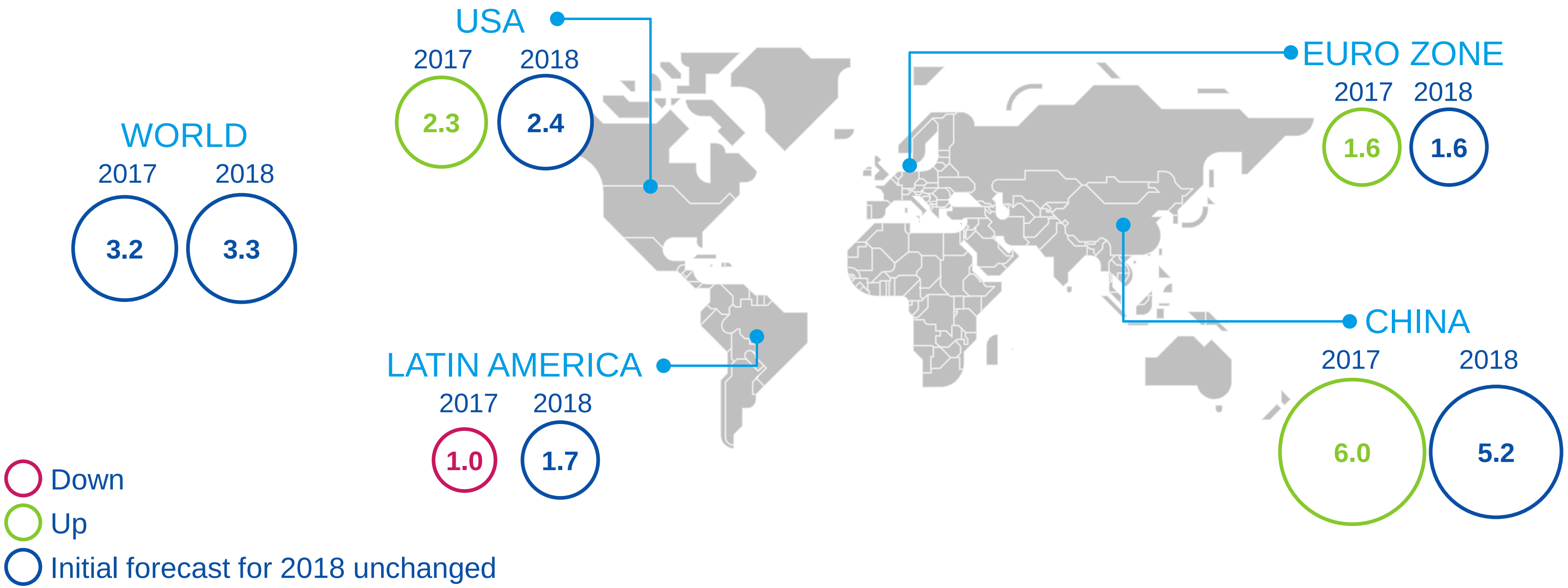


- The **positive factors** supporting activity remain in place, despite the overall uncertainty: **recovery of world trade and weak euro**
- **Pressure on the ECB will increase in line with inflation:** withdrawal of QE during 2018 and first interest rate hike towards the end of that same year
- **Risks mainly political:** “hard” Brexit, electoral cycle, banking system, programme of assistance to Greece, geopolitical risks

Source: CEIC and BBVA Research

GLOBAL SCENARIO

The economy will accelerate in 2017 and 2018



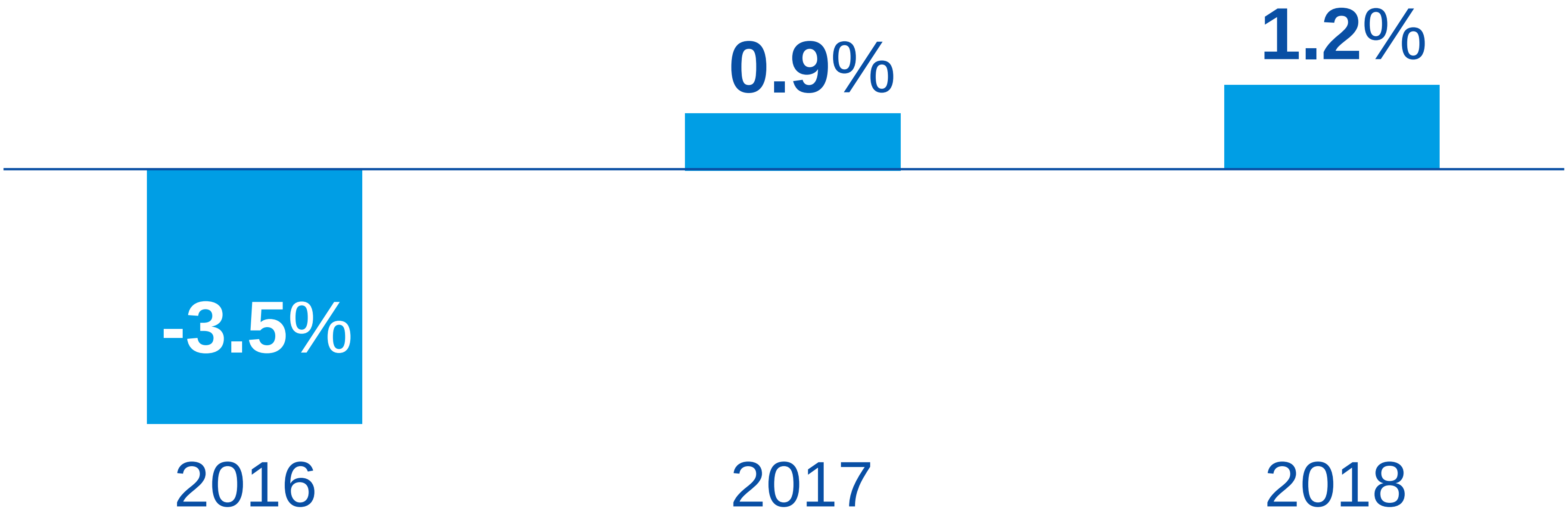
Source: BBVA Research. Latin America comprises: Argentina, Brazil, Chile, Colombia, Mexico, Paraguay, Peru, Uruguay and Venezuela

BRAZIL

1ST QUARTER 2017

GROWTH PROSPECTS

Economy on track for a gradual recovery, in spite of worse than expected performance in 2H16

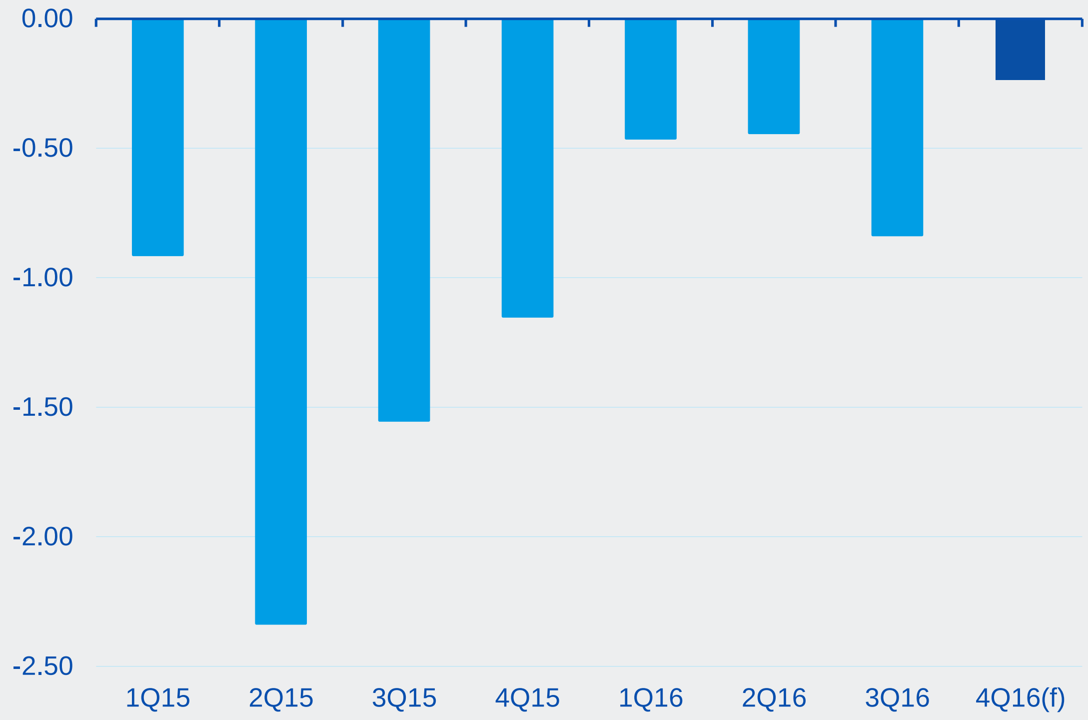


NO RECOVERY IN ACTIVITY IN 2H16

We revise our GDP forecast down to -3.5%

- 3Q16 GDP fell 0.8% QoQ, more than in the two previous quarters and more than expected
- Preliminary data suggest that GDP declined again in 4Q16
- Private consumption continued to weaken in 2H16, in line with still high inflation, rising unemployment, credit slowdown, etc.
- Political tensions helped to hold investment down in 2H16
- Net exports contributed positively to GDP, but not enough to offset other factors
- All in all, we revise our 2016 GDP forecast from -3.0% to -3.5%

GDP GROWTH
(% QoQ)



(f): forecast
Source: BBVA Research and IBGE

ON TRACK FOR A GRADUAL RECOVERY

Many factors favor a recovery, while some suggest caution

Stabilization of terms of trade

Lower inflation

Declining interest rates

Negative growth surprises in 2H16

Global uncertainty

Higher global growth

Rebound of financial markets

Lower uncertainty

Labor market to remain unsupportive

Adoption of some micro-reforms

Approval of fiscal reform

Sharp adjustment in 2015-16

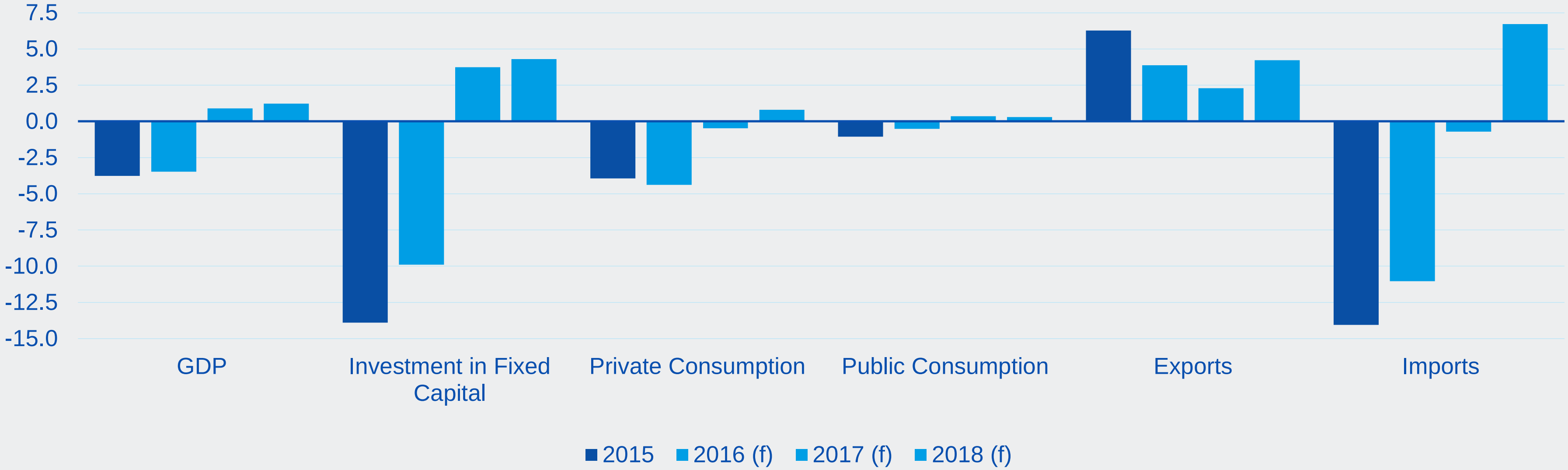
Political tensions remain well-alive

Approval of social security reform not assured

ON TRACK FOR A GRADUAL RECOVERY

We continue to expect GDP to grow by 0.9% in 2016 and 1.2% in 2017

GDP GROWTH
(%)



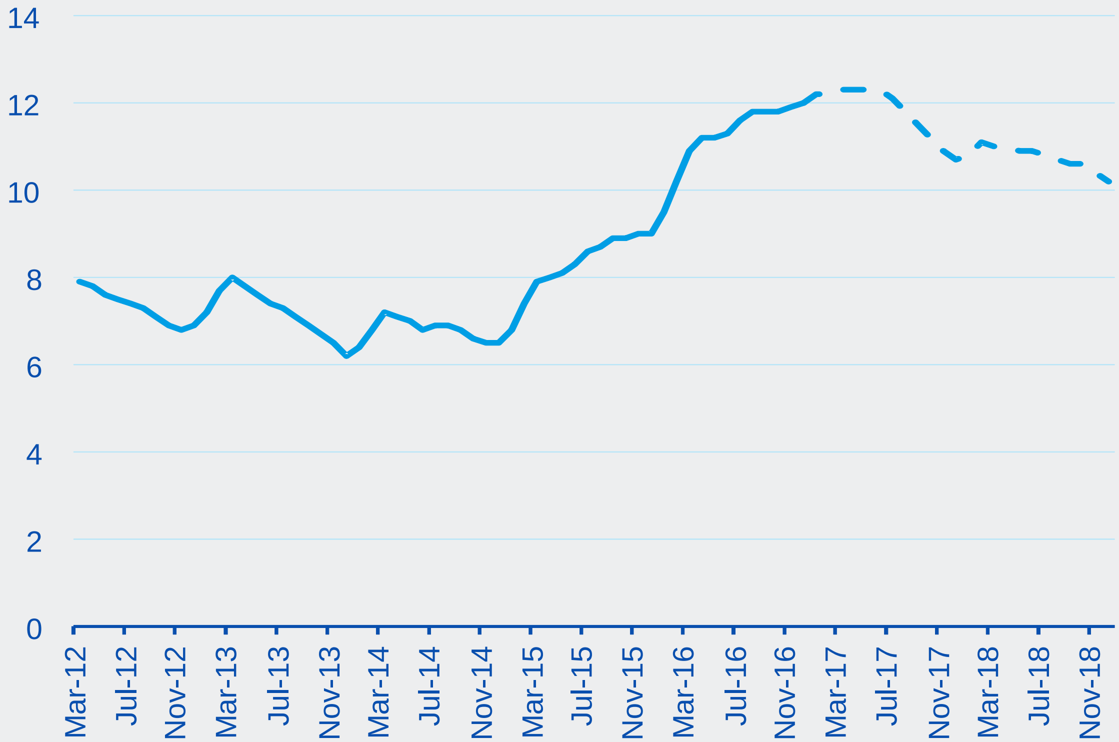
(f): forecast
Source: BBVA Research and IBGE

ON TRACK FOR A GRADUAL RECOVERY

Weakness in consumption to hold down GDP growth

- We expect investment to expand around 4% in both 2017 and 2018 as policy uncertainty declines
- Exports will contribute positively to growth, but imports recovery will offset part of that effect
- Private consumption to remain broadly stable in 2017 and 2018. Although lower inflation, higher confidence and some improvement of credit markets will provide support, the labor market will continue weighing down (unemployment will fall from 2H17 onwards, but will remain high)

LABOR MARKET: UNEMPLOYMENT RATE
(forecasts from Jan-17 on; %)

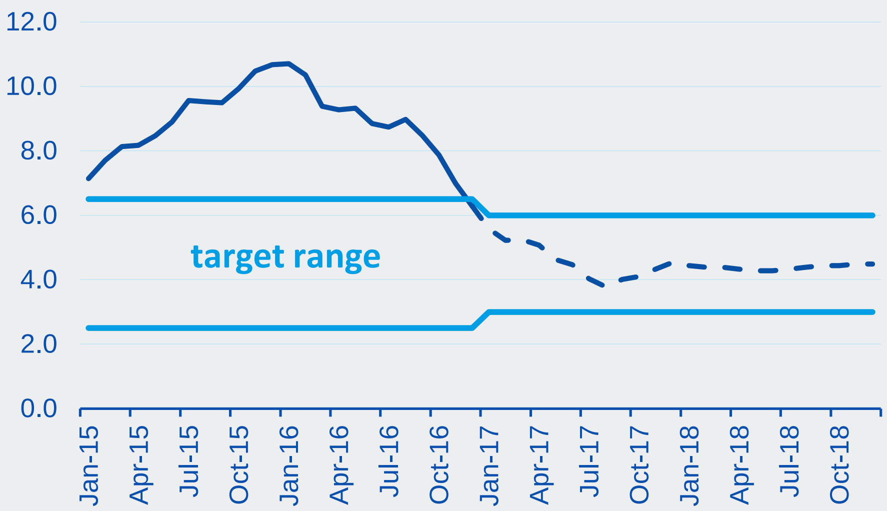


Source: BBVA Research and IBGE

ON TRACK FOR A GRADUAL RECOVERY

Recent downward surprises reinforce our view that inflation will converge to the 4.5% target this year

INFLATION (IPCA)
(% YoY)



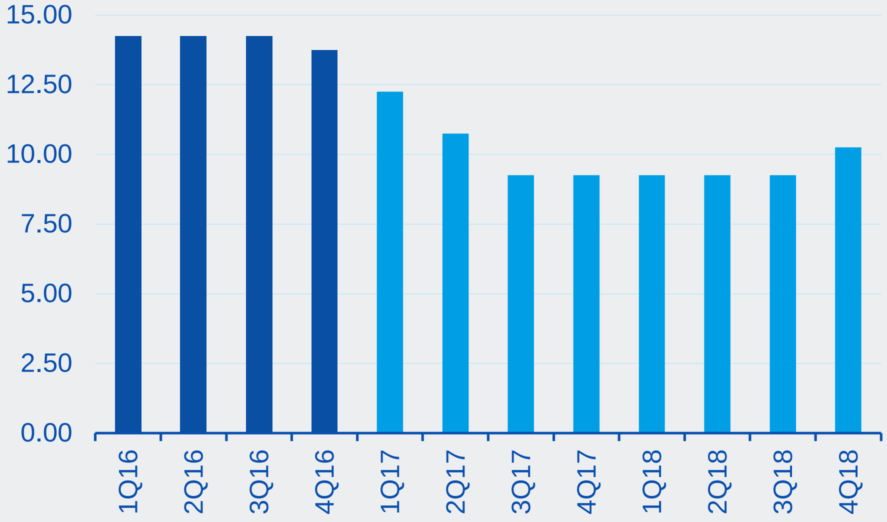
- Inflation closed 2016 at 6.3%, within the target range and significantly less than expected
- The worse-than-expected performance of activity in 2H16, the recent appreciation of the exchange rate and the moderation of food prices all contributed to the recent dynamics of domestic prices
- Inflation will continue to slowdown in the future. We continue to expect it to converge to 4.5% by the end of 2017 and remain around that level in 2018

Source: BBVA Research and IBGE

ON TRACK FOR A GRADUAL RECOVERY

Inflation slowdown is paving the way for reductions in the Selic rate

POLICY INTEREST RATE: SELIC RATE
(end-of period; forecasts from 1Q17 on)



- After cutting the Selic rate by 25bp in each of the two previous meetings, the BCB surprised markets by cutting it by 75bp to 13.00% (rather than by 50bp to 13.25%) in January
- The decision was built on i) the sharper-than-expected recent slowdown in inflation and ii) forecasts that inflation will be close to the target from 2017 onwards (consensus: 4.6% in 2017 and 4.5% in 2018; BCB forecasts, assuming constant FX and Selic rates: 4.0% in 2017 and 3.4%)
- We expect the BCB to continue to cut the Selic at a pace of 75bp in the next months until it reaches 9.25% in Sep-17. We see some tightening from the end of 2018 on due to a weaker exchange rate, stronger activity and higher global rates
- There is a chance that during 1H17 the BCB reduces the inflation target for 2019 to 4.0% from its current 4.5%

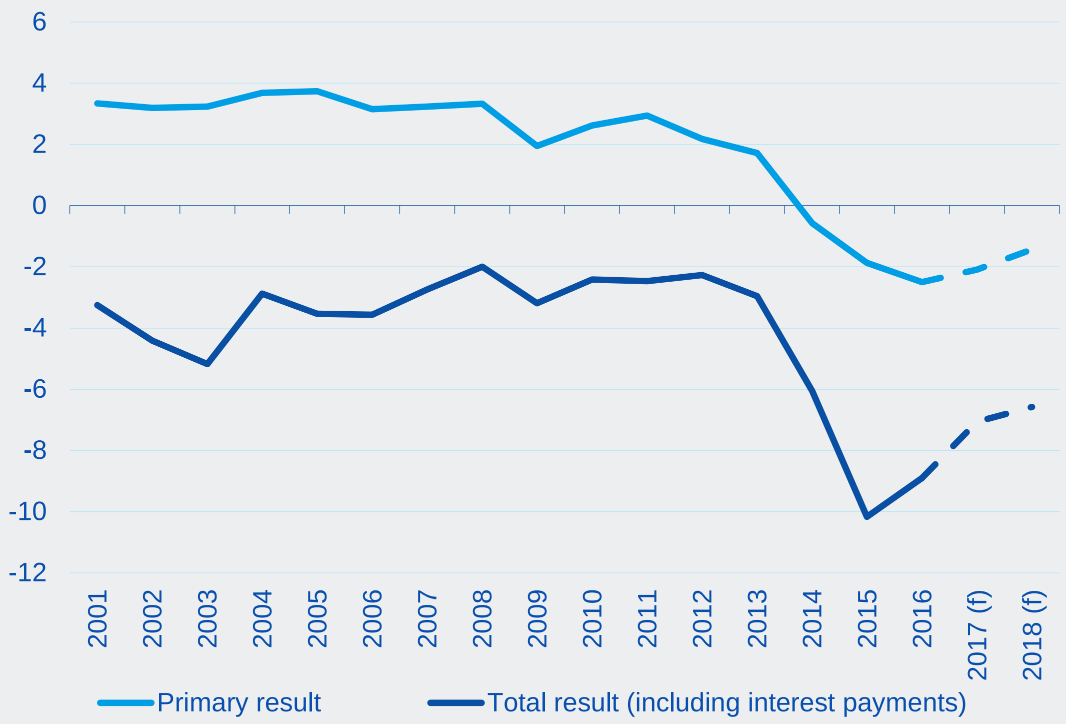
Source: BBVA Research and IBGE

ON TRACK FOR A GRADUAL RECOVERY

Public accounts worsen, but reform reduces risks

- The primary deficit reached 2.5% of GDP in 2016 as GDP contraction continued to hit fiscal revenues and given the lack of measures to cut expenditure in the short-term
- The nominal result reached 8.9%, somewhat less than in 2015 as the FX appreciation in 2016 generated gains due to the BCB's holding of FX swaps
- The gross public debt hit 69.5% of GDP (65.5% in 2015 and 56.3% in 2014)
- The fiscal reform approved in 4Q16 limits expenditure growth to 0.0% in real terms for 20 years, reducing solvency risks
- To comply with that rule the government needs to approve social security reform, something we expect to happen in 1H17

FISCAL ACCOUNTS: PRIMARY AND TOTAL RESULTS
(% GDP)



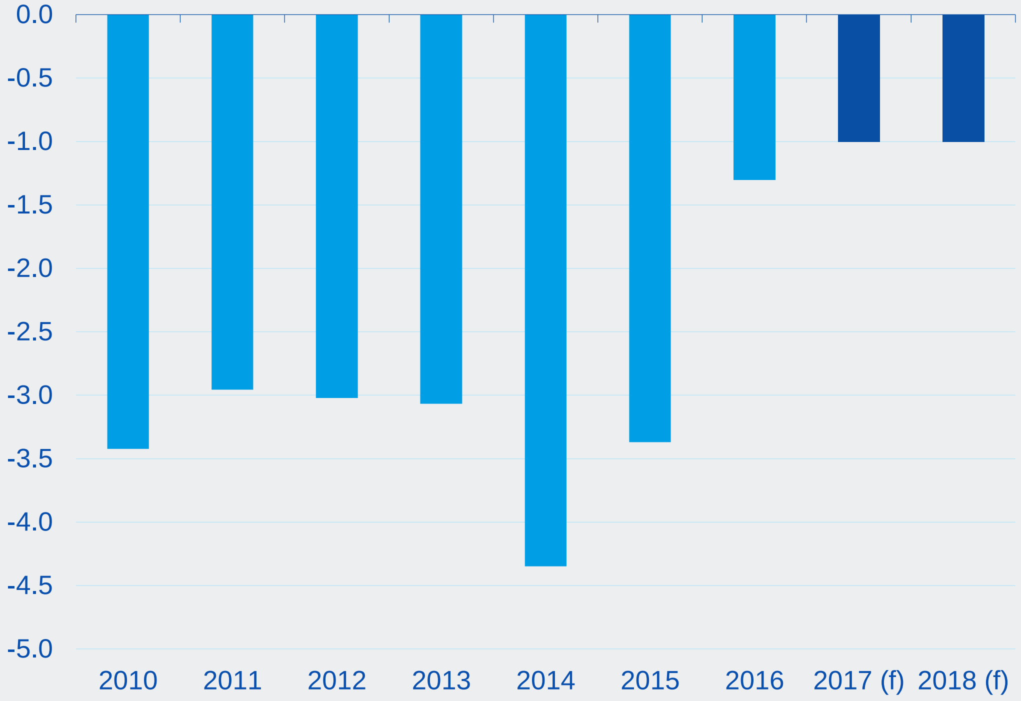
(f): forecast
Source: BBVA Research and BCB

ON TRACK FOR A GRADUAL RECOVERY

The CA deficit declined to 1.3% of GDP in 2016

- The fast adjustment of the current account (CA) is mostly cyclical and a result of the sharp contraction of domestic demand.
- Lack of strong demand pressures should help to maintain the current account deficit around 1% in 2017 and 2018.
- In spite of the turbulence, the FDI remained strong, totaling 4.4% of GDP in 2016.
- International reserves reached 20.6% of GDP.
- CA-related risks remain low, but a new depreciation in the exchange rate could generate problems for some companies

CURRENT ACCOUNT
(% GDP)



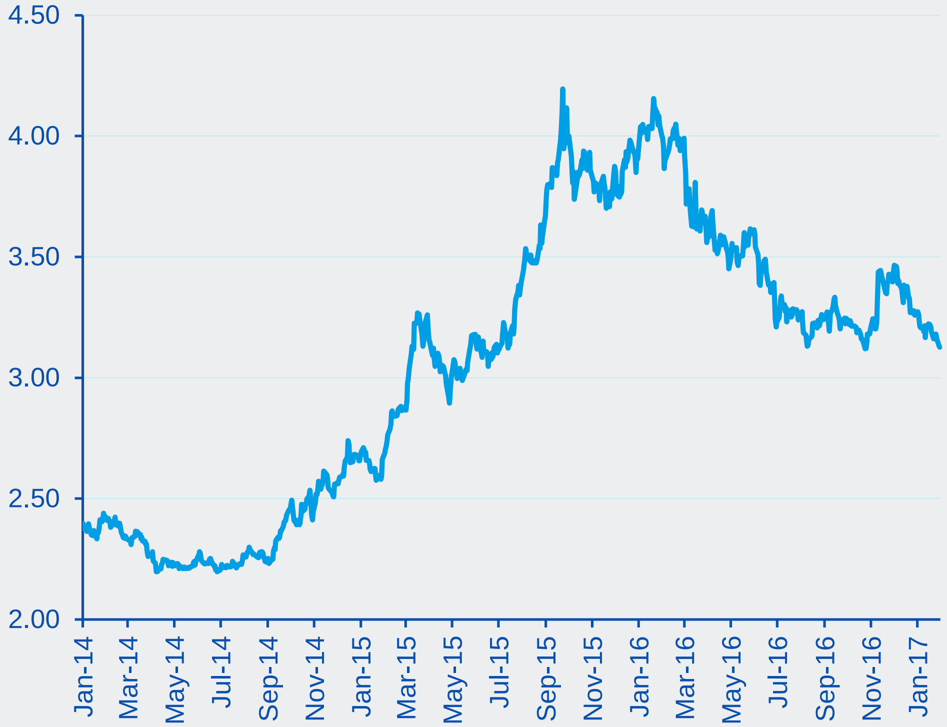
(f): forecast
Source: BBVA Research and BCB

ON TRACK FOR A GRADUAL RECOVERY

Not much room for a further FX appreciation

- The Brazilian real (BRL) reached 3.13 at the end of Jan-17, accumulating a 23% appreciation over the last 12 months.
- That was favored by a reduction of domestic uncertainty, the sharp reduction in the CA deficit and some improvement in Brazil’s terms of trade (due to higher commodity prices).
- We expect the BRL to depreciate going forward, among other reasons because interest rate differentials will fall significantly.
- We forecast the BRL to average 3.3 in 2017 and 3.5 in 2018 (vs. 3.5 in 2016)

EXCHANGE RATE
(Brazilian real per US Dollar)

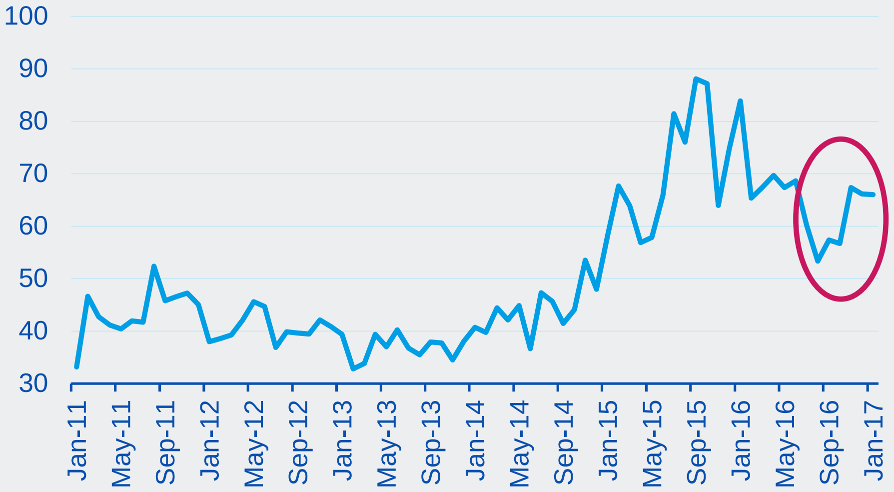


(f): forecast
Source: BBVA Research and BCB

RISKS

There still exists a risk that political tensions undermine the recovery in economic activity

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



- The results of the "Car Wash" investigation and new corruption scandals have caused some increase in political tensions since the end of 2016
- That could potentially drive up uncertainty, reducing confidence levels and making it more difficult for activity to recover
- Moreover, it would also make it more difficult for a proper reform of social security to be approved in 1H17 and, therefore, for the concerns about Brazil's fiscal situation to fade away
- Michel Temer's approval ratings remain at low levels, around 13%

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

Forecasts Table

	2015	2016	2017 (f)	2018 (f)
GDP (%)	-3.8	-3.5	0.9	1.2
Private consumption (%)	-3.9	-4.4	-0.5	0.4
Public consumption (%)	-1.1	-0.5	0.4	0.8
Fixed capital investment (%)	-13.9	-9.9	3.7	4.3
Exports (%)	6.3	3.9	2.3	4.2
Imports (%)	-14.1	-11.0	-0.7	6.7
Unemployment rate (average)	8.3	11.5	11.8	10.8
Inflation (eop, YoY %)	10.7	6.3	4.5	4.5
Selic interest rate (eop, %)	14.25	13.75	9.25	10.25
Exchange rate (eop)	3.80	3.26	3.42	3.55
Fiscal result (% of GDP)	-10.2	-8.9	-7.1	-6.6
Current account (% of GDP)	-3.3	-1.3	-1.0	-1.0

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