Brazil Economic Outlook
FIRST QUARTER 2018
Brazil: recovery gains momentum, but risks do not recede

1. The growth of the Brazilian economy has surprised upwards during 2017. That and the improvements in the global environment, especially the acceleration of global growth, reinforce the prospects for a (cyclical) recovery of the activity. We have thus revised upwards our growth forecasts Brazil. **We now estimate growth to have reached 1.0% in 2017 and expect it to increase to 2.1% in 2018 and 3.0% in 2019.**

2. **Inflation has already bottomed out, but its acceleration from now on will be gradual, allowing the Central Bank to keep SELIC interest rates at historically low levels.** Specifically, inflation should reach 4.3% in 2018 and 4.7% in 2019, after having closed 2017 at 2.9%, while SELIC rates should soon reach 6.75% and remain at this level for a long time.

3. Although in our baseline scenario the economy will continue to recover and the fiscal problem will be addressed with a reform of the social security and other measures at the beginning of the next government to be elected in Oct-18, **we can not rule out an alternative scenario where political and fiscal risks materialize, bringing the recovery to an end and perhaps even generating a new economic crisis.**
GLOBAL

Global growth confirmed and short-terms risks moderated
Global growth confirmed

01 Improved forecasts for the US, China and the Eurozone
   There is less short-term uncertainty

02 More positive perspectives for emerging countries
   Greater global demand and increase in commodity prices

03 More caution in the financial markets
   Expectations of lower liquidity may reduce flows to emerging markets

04 Contained core inflation
   Although the downward pressure factors are disappearing

05 Central banks continue their paths towards normalization
   The reasons for withdrawing stimuli are materializing

06 Global risks
   Lesser in the short term; no changes in the medium and long term
Reasons for optimism in large areas, although with caution

**UNITED STATES**
- Growth revised upwards
- Improvement in the labor market
- Approval of the tax reform
- Continuistic changes in the Fed

**CHINA**
- Moderate deceleration
- Some reforms already underway
- Positive conclusions at the XIX Congress of the CPC
- Greater potential growth

**EUROZONE**
- Greater growth than expected
- More robust domestic demand
- Lower political uncertainty
- Plans for greater integration
Robust and sustained global growth

World GDP growth
(Forecasts based on BBVA-GAIN, % QoQ)

- The global economy continues to grow, supported by the recovery of the industrial sector.
- Confidence indicators continue to improve, and anticipate that the outlook will continue to be positive.
- Private consumption continues to sustain growth in advanced economies and gains momentum in emerging economies.

Source: BBVA Research
The outlook for emerging economies improves

The increase in oil prices reflects a greater global demand, which would account for 60% of such increase.

But this is also due to supply factors, linked to geopolitical risks and the correction of inventories.

Positive and significant impact on emerging economies that produce raw materials.

However, we still expect prices to converge to $60 per barrel in the medium term, due to increased competition and structural changes in the energy sector.

Source: BBVA Research
Caution in financial markets, with moderation of flows to emerging markets

Risk appetite indicator
(Factor 1 (global), EPFR flow analysis)

Greater appetite for risk
Less appetite for risk

Investors appetite for emerging (EM) vs developed (DM)
(Inflows in EM vs. DM in % of assets under management)

Source: BBVA Research, EPFR
Contained core inflation

Production gap and core inflation (% GDP potential, % YoY)

- Reduction of the idle capacity of the economy, but with room to grow without strong inflationary pressures
- Less reaction of prices to the increase in activity, for several reasons:
  - Globalization
  - Increased flexibility of the labor market
  - Low inflationary expectations
  - Reduced productivity growth
- The increase in the price of oil will push up inflation in the short term, facilitating the normalization of central banks in developed economies

Source: BBVA Research and the OCDE
Withdrawal of non-conventional monetary policy measures

**Pre-crisis**
- **Tightening**

**Crisis**
- **Easing**
  - Reducing of purchasing of bonds
  - Reinvestment of maturities

**Normalization**
- **Tightening**
  - Hike in interest rates
  - Partial reinvestment

**Central Banks**
- **Fed**
- **BoJ**
- **ECB**
Monetary policy normalization: accelerated in the case of the Fed, gradual in the case of the ECB

**Tightening cycle and reduction of the balance in progress**
- Estimated rise of 75pbs in 2018 to 2.25% and reduction of the balance by 500,000 million dollars

**QE reduction, but extension until September 2018**
- No rate hikes are expected until 2019

*Focus: gain room for manoeuvre*

*Focus: avoid sudden acceleration of long-term rates*

**Elements of uncertainty:**

**Politics:** changes in government ministries (Fed, ECB)

**Macro:** possible surprises in inflation

**Markets:** Long-term rates and slope of the curve
Generalized revision of the upward growth

Source: BBVA Research
Global risks: Fewer in the short term

- Containment of risks associated with high leverage in the short term
- Potential negative effect of increased protectionism
- Political tensions still high, but more contained
- Negotiation of trading relations (NAFTA)
- Signs of over-valuation of certain assets
- Reduced risk of rapid normalization by the Fed, but uncertainty persists
- Reduced political uncertainty, but significant question marks remain in several countries:
  - Brexit: fewer doubts about future trading relations
  - Germany: functioning of the “grand coalition”
  - Italy (elections in March 2018): risk of a government opposed to the European project
  - Management of the normalization of monetary policy

* US: United States; EX: Eurozone; CHN: China. Source: BBVA Research
BRAZIL

Recovery gains momentum, but risks do not recede
Political tensions must increase again as the presidential elections of October approach

- Political tensions have fallen again in recent months. On one hand, uncertainty about the continuity of president Temer in office was reduced and, on the other hand, there are still several months left for the presidential elections.

- Lula, who can still be prevented from being a candidate due to a possible conviction for corruption, as well as the right-wing Jair Bolsonaro lead voting intentions, according to the polls.

- It is not clear yet whether Lula or Bolsonaro would support orthodox economic policies and reforms (in particular, the social security one), which feeds political risks.

- In any case, the most likely is that they moderate their speech in case of victory or that a more centrist candidate emerges in the next few months and ends up winning the elections.

Source: BBVA Research and GDELT. * Index of political tensions = share of news about politics * (1 - average tone of news about politics)
The economic recovery has gained momentum throughout 2017

- The recession has been left behind. GDP has been growing at positive rates for some quarters.
- In particular, growth reached 1.4% YoY (0.1% MoM) in 3Q17.
- Exports and private consumption have been contributing positively to GDP since the beginning of the year.
- In 3Q17 they grew 10.8% YoY (4.1% MoM) and 2.1% YoY (1.1% MoM), respectively.
- Investment in fixed capital, which lost 30% since the second half of 2013, grew positively in the second half of 2017 (in 3Q17 in quarterly terms and in 4Q17 in annual terms).

Source: BBVA Research and IBGE
Robustness of exports and recovery of private consumption and investment sustain the cyclical recovery of the economy

- Exports are supported by the global environment, as well as by favorable terms of trade and exchange rate.
- Private consumption, which represents two thirds of GDP, has been accelerating due to the moderation of inflation and improvements in the labor market, and despite the weakness of the credit market.
- Unemployment reached 12.0% in Nov-17 (13.70% in Mar-17) helping the real wage bill to grow over 4% in recent months.
- With respect to investment, it has been stimulated by the recovery of consumption, expansive monetary policy and the reduction of political uncertainty.
- Both public consumption and expansion of imports continue to contribute negatively to GDP.

Source: BBVA Research and IBGE
Growth prospects for Brazil improve, mainly due to a more positive global environment

The greater strength of the recovery of activity in Brazil since the beginning of 2017 and, mainly, the better perspectives for global growth (particularly in China) have caused an upward adjustment in our forecast for the country.

The approval of an ambitious social security reform during the final year of the Temer government is unlikely. Unaddressed fiscal problems and the political noise that the October elections must generate should together prevent a more robust economic recovery.
In 2017 private consumption has started to grow positively again and in 2018-19 investment must do so; net exports will contribute less to GDP.

Consumption and investment forecasts have been revised upwards, in line with the improved tone exhibited by recent data and improvement in the global environment.

Exports must also grow more than previously expected, stimulated by further growth in the global economy. The expansion of domestic demand will support imports, reducing the net contribution of external demand to GDP.
Inflation has already hit bottom

- Inflation closed 2017 at 2.95%, slightly below the target range and in line with our forecast.
- We maintain our forecast that inflation will close 2018 at 4.3% and 2019 at 4.7%.
- The acceleration of domestic demand, the expected (moderate) depreciation of the exchange rate and the view that food prices will exert ahead more pressure than in 2017, when they fell 1.9%, will all contribute for an acceleration of inflation throughout 2018 and 2019.

Source: BBVA Research and IBGE.
Monetary policy will remain exceptionally loose in 2018

- The Monetary policy easing cycle, started on Sep-16 when the SELIC interest rates was at 14.25%, is about to come to an end.

- Specifically, we anticipate that the BCB will announce a 25 bp cut of the SELIC rate, bringing it to 6.75%, at its next monetary policy meeting in February, and that from then onwards it will keep it stable at this historically low level until the end of 2018.

- In 2019, as inflationary pressures increase and interest rates in the developed economies are hiked, the SELIC rate would be adjusted upwards to 9.50%.

(f) = forecasts  Source: BBVA Research and BCB.
Fiscal situation: there is still no light at the end of the tunnel

- The economic recovery will drive tax collection up, benefitting public accounts. In particular, the recent recovery in public revenue will allow the government to meet the 2017 fiscal target (primary deficit of -2.5% of GDP)

- Anyway, even if activity growth surprises upwards, a strong additional fiscal adjustment will be needed so that - in the medium term - the spending ceiling rule will be met and - in the long term - the unsustainability of public debt will be avoided.

- In this sense, a reform of the social security and other complementary measures are needed

- One of the biggest problems is that the current government will hardly manage to pass an ambitious social security reform and, while we continue to wait for the next president to do so at the beginning of his government, it is still not clear whether he will be willing or able to do so

Source: BBVA Research and BCB.
The current account will deteriorate moderately, but the deficit will remain at low levels

- The trade balance has been exceptionally high in 2017. On one hand, exports have grown robustly due to the global environment and a relatively depreciated exchange rate. On the other hand, imports remained relatively low, due to weak domestic demand.

- Thus, the commercial balance of 2017, of around 3.3% of GDP, will contribute for driving down the current account deficit to historically low levels (close to 0.3% of GDP).

- The strengthening of domestic demand and the stability of the terms of trade should generate an increase in the current account deficit to around 0.6% of GDP in 2018 and 1.9% of GDP in 2019.

(f) = forecasts  Source: BBVA Research and BCB.
Financial markets continue to display a very positive tone, stimulated by the global environment and, in a certain way, downplaying local risks.

At the start of Jan-18, the Sao Paulo Stock Exchange reached historical maximum levels (in nominal terms), while the risk premium was around 220 bp, close to the values observed before the crisis, when the country still exhibited an investment grade.

The exchange rate has appreciated 1% in real terms in 2017 (a nominal depreciation of 2%). The normalization of monetary policy in the US and the stability of the terms of trade will contribute for the Brazilian real to depreciate from 3.30 in Dec-17 to 3.35 in Dec-18 and 3.45 in Dec-19.

Stock exchange and risk premium (% variation in 2017 and in the last three months*)

Nominal exchange rate (BRL / USD)

* Variations in the last three months: from October 10, 2017 to January 10, 2018
Source: Datastream and BBVA Research.
Political and fiscal risks remain high, feeding each other

Political risks
(turbulence in the presidential race, heterodox policies, populist government, political polarization, government without sufficient support in the congress, etc.)

Fiscal risks
(no approval of the social security reform, breach of the spending ceiling rule, unsustainability of public debt, inflation, etc.)

In our baseline scenario, the economy will continue to recover and the fiscal problem will be addressed with a reform of social security and other measures at the beginning of the next government, to be elected in October.

However, it can not be ruled out that political and fiscal risks materialize, slowing down the recovery and even generating a new economic crisis, especially if the global environment stops being so positive.
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FORECASTS
### BBVA Research forecasts for Brazil

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2017(f)</th>
<th>2018(f)</th>
<th>2019(f)</th>
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<tr>
<td><strong>GDP (%)</strong></td>
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<td>Private consumption (%)</td>
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<td>Gross fixed investment (%)</td>
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<td>Exports (%)</td>
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<tr>
<td>Imports (%)</td>
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<td>Unemployment rate (average)</td>
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<td>Inflation (end of period. YoY %)</td>
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<td>SELIC rate (end of period. YoY %)</td>
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<td>Public sector’s total fiscal result (% of GDP)</td>
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<td>Gross public debt (% of GDP)</td>
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*f = forecasts*