BBVA | RESEARCH

Economic Outlook

Brazil

First Quarter 2014
Economic Analysis

- **Global expansion will continue in 2014 and 2015,** this time with a greater contribution from developed economies.
- **Brazil will have another bumpy year ahead.** Growth will remain low and inflation will continue on the upper boundary of the target range amid more volatile and more sceptical financial markets.
- **The current environment requires fiscal and monetary policies to have a more restrictive stance.** Failing to do will make the country more vulnerable to the Fed tapering.
- **The exchange rate depreciation process has continued and still has some way to go.** This adjustment will add pressure to inflation, but will favour the transition towards a growth model more centred on exports and less dependent on consumption.

Index

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1. Summary

The global cycle is improving, with stronger growth and more balanced risks. Global GDP growth will accelerate from 2.9% in 2013 to 3.6% in 2014 and 3.9% in 2015. This improvement has been supported by the acceleration in the developed economies, above all the US, which we expect to continue in the next two years. This cyclical improvement in the US has given the Fed space to start the tapering of monetary stimulus. The emerging economies have been the worst-affected by this, with reductions in capital inflows and currency depreciation, although more by idiosyncratic events in the large emerging economies than by the start of tapering itself.

Financial markets: more volatility and more scepticism on Brazil. Global events helped to increase the volatility of local markets, which were already stressed by domestic issues such as weak growth, high inflation, deterioration in fiscal and external accounts, policy uncertainty, etc. Financial markets are now more volatile and more sceptical on Brazil in an environment where countries should increasingly be differentiated according to their fundamentals.

The exchange rate depreciation process has continued, and still has some way to go. The weakening of the Brazilian real (BRL) in the last 12 months was sharper and the perspectives regarding its evolution in the next 12 months are more negative than in other emerging countries in the region. The ongoing exchange rate depreciation in Brazil is a realignment after many years of currency appreciation. It is also related to the need to recover the competitiveness lost in the manufacturing sector in recent years. We expect the BRL to depreciate on average 12% and 5% in 2014 and 2015 respectively.

Inflation will remain around 6.0% in 2014. The pressure of the exchange rate on tradable inflation and higher administered-price inflation will offset the impact of tighter monetary conditions and a less robust labour market on non-tradable inflation. Price pressures could diminish somewhat in 2015 following the tightening of fiscal and monetary policies.

The current environment requires the BCB to maintain a tighter monetary policy. We expect the monetary authority to hike the Selic rate by 25bp (rather than by 50bp) at the end of February. In our view, the February hike will be the final one and the Selic rate will be maintained unchanged at 10.75% over the remainder of 2014. In 2015, we expect a new tightening cycle, as part of a more general adjustment to tackle inflation. The risk is that the 2015 adjustment may need to be frontloaded and adopted in 2014.

External and fiscal accounts worsened significantly in 2013. External accounts should improve somewhat, but the fiscal deterioration is likely to continue in 2014. The current account deficit reached 3.7% of GDP in 2013 and the public sector's primary surplus reached 1.9% of GDP, in both cases the worst figure since 2001. In spite of this deterioration, fiscal and external accounts are not as weak in Brazil as in other emerging economies. In our view, it is economic policies - and not external or fiscal weaknesses - that are making Brazil more vulnerable. We expect an important adjustment of fiscal policy to be adopted only in 2015. External accounts should start to improve this year due to the impact of a weaker currency and the acceleration in global growth.

Growth will remain around 2.0% in 2014 and 2015. In spite of some indicators suggesting that the economy could have entered recession at the end of 2013, we estimate that the economy grew 0.4% QoQ in 4Q13, and therefore 2.2% in 2013. We expect GDP growth to reach 2.5% in 2014 due to higher exports and less buoyant imports, thanks to a moderation in domestic demand. The bias to our 2014 forecast is to the downside because of the recent turbulence in financial markets, the risk of a lower than expected growth in 4Q13 and the impact of Argentina. Looking further forward, we expect GDP growth to slow to around 1.9% in 2015 following the impact of more restrictive policies.

Private consumption will contribute less to growth in the longer-term. The performance of exports and especially investment will not be enough to prevent a slowdown in GDP growth. We expect potential growth to be around 2.5% - 3.0%.

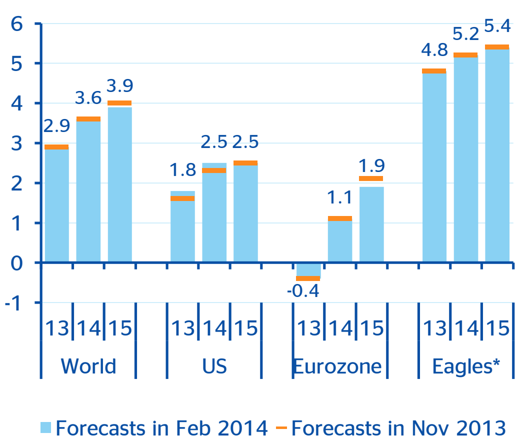
2. External environment: more growth and more balanced risks

The global economic cycle is improving and we now have clarity on some economic policy uncertainties

The global economic cycle strengthened during the latter months of 2013. According to our estimates, during the second half of 2013, global GDP accelerated to a rate close to 1% QoQ, leaving behind the moderation with its roots in 2012 and its low at the beginning of 2013, when growth was barely 0.5%. This improvement was driven by the acceleration of the developed economies – particularly the US, but also the eurozone, which started to see moderate growth. In the emerging markets, the situation is more diverse, but some of them (e.g. China) are posting relatively stable rates of growth.

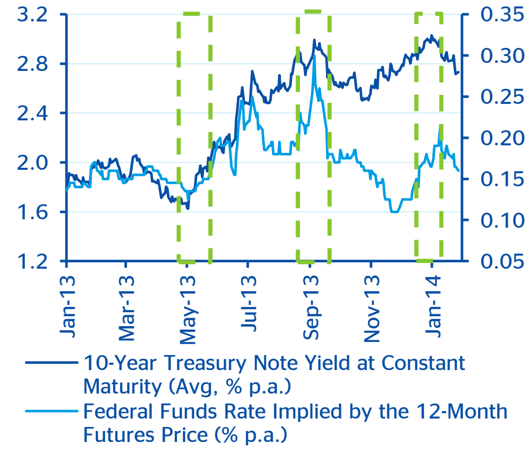
Our improved assessment of the global scenario is also the result of the developments in economic policy, inasmuch as this helps to reduce uncertainty. First, the US reached a more far-reaching agreement on fiscal policy than we expected. Meanwhile, the improvement in activity allowed the Fed to start tapering its expansive monetary policy at the beginning of 2014. In Europe, further steps have been taken towards the construction of banking union, which together with the ECB's determination to keep risks under control, should eliminate the hobble represented by financial fragmentation. The global outlook would be clearer if it were not for the effect that the tapering is having on financial markets in the EMs, and which could eventually affect economic growth in some of the countries included in this category.

Chart 2.1
GDP growth forecasts (%)



EAGLES is the group of emerging economies that will make the biggest contribution to global GDP in the next 10 years. The group comprises China, India, Indonesia, Brazil, Russia, Korea, Turkey, Mexico and Taiwan.
Source: BBVA Research and IMF

Chart 2.2
EU: Federal funds futures and long-term interest-rates (%)



Source: BBVA Research and Bloomberg

Thus, global GDP growth, which in 2013 had decelerated to 2.9%, will increase to 3.6% and 3.9% in 2014 and 2015, respectively (Chart 2.1), almost the same as our forecasts three months ago. The expected increase in global growth does not detract from the existence of downside risks to our forecasts. Although these risks are a long way from having the systemic nature that they had in the past, some recent events such as the fall in asset prices and currency depreciation in EMs have made themselves felt.

The US starts to unwind its monetary stimulus

US GDP growth has been accelerating through 2013, which by year-end allowed the Fed to take the first steps towards withdrawing monetary stimulus. Furthermore, in December, an agreement was reached that represents an important step forward in eliminating the uncertainty regarding the funding of the government's activity in 2014-15, as well as reducing the fiscal adjustment initially forecast for that period.

The outlook for monetary policy has also clarified recently, in line with our expectations. As a consequence of an acceleration in activity with well-anchored inflation expectations, the Fed decided to start to taper its monthly purchases of financial securities. All in all, in the fourth quarter of 2014, the central bank will have stopped expanding its balance sheet. Our base scenario also assumes that the first increase in interest rates will take place in the second half of 2015, although the FED will continue to use its forward guidance to anchor interest-rate expectations. In fact, the Fed's efforts to explain its exit strategy have been relatively successful in avoiding episodes of volatility like we saw last summer. Both long-term interest rates and expectations regarding Fed funds remain at levels no higher than the beginning of the summer (Chart 2.2). This is significant because part of the US recovery was due to interest-rate sensitive sectors such as real estate.

In this context, we have revised upwards our forecast for US growth in 2014 to 2.5%, the same as our estimate for 2015 (Chart 2.1). This adjustment reflects both the strength of the US economy in the second half of 2013 and the additional momentum contributed by the reduced fiscal drain thanks to the agreement reached at the end of last year. Note that there are also upside risks to our forecast if the improvement in confidence results in additional corporate investment and hiring.

The withdrawal of monetary stimulus in the US could cloud the outlook for some emerging economies

The change of direction in US monetary policy has, as usual, had a global impact. The emerging economies are being subjected to reduced capital inflows and currency depreciation, intensified in some cases by domestic events that have increased uncertainty regarding the management of their respective economic policies. In addition, there continues to be a differentiation between economies depending on their fundamentals: higher external deficits and more dependence on short-term and foreign-currency funding are associated with greater vulnerability to capital outflows and currency depreciation (Chart 2.3).

The recent tensions have not changed our growth forecasts for the EMs as a whole, but they do represent a significant downside risk. This risk is higher in the economies that have a higher weighting in global investment portfolios and that have the above-mentioned vulnerabilities: Turkey, Brazil, Indonesia and India in particular. The monetary tightening being introduced by some of these countries to control currency depreciation and inflation expectations will inevitably have a negative impact on growth. All in all, the diversity within the EM group means that our outlook remains favourable for some parts of South America, such as the Andean economies, emerging Asia and Mexico, some of which are benefiting from the cyclical momentum of the US economy (Chart 2.4).

Growth in China remains at around 7.5%, but the vulnerabilities are more evident

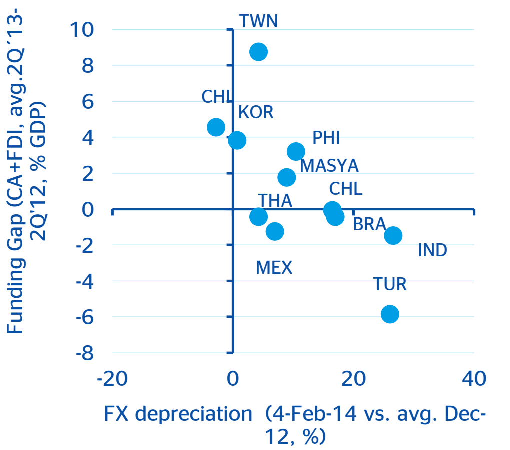
The fourth quarter was a clear example of the duality of China's economy as both a support for the global economy and a potential risk factor. The uncertainty at the beginning of the last year regarding the sustainability of its growth and the possibility of a hard landing dissipated in the short term. The economy recovered in the second half of 2013 (Chart 2.4) and maintains a good tone, although some of the more recent data on confidence and expectations of manufacturing activity are once again below market expectations.

Fundamental changes in economic policy have also been announced. At the Third Plenum of the Chinese Communist Party, the authorities reiterated their commitment to maintaining high rates of growth, while proposing measures that will strengthen the role of the market in allocating resources and a rebalancing from a model of investment and exports towards increasing household consumption. These announcements are steps in the right direction, but their effectiveness will depend on their execution, and they are not without risk.

For example, as regards the financial sector, the authorities are continuing to demonstrate their commitment to tackle the current vulnerabilities, fundamentally linked to the rapid growth of credit. This is being reflected in liquidity tensions in the interbank market which are above all affecting the so-called shadow banking sector[1], although the authorities have not managed to moderate the rate of growth in credit.

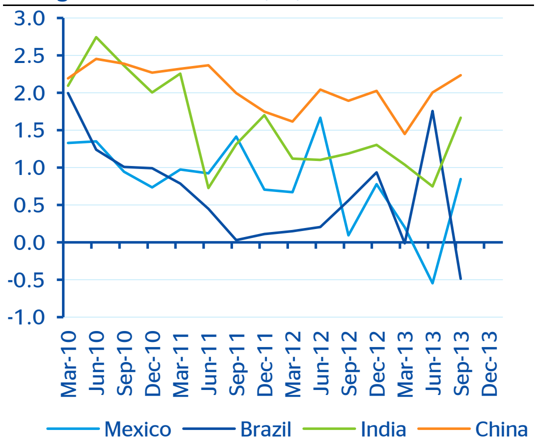
In any case, our 2014 and 2015 growth forecasts for China's economy remain unchanged (at 7.6% and 7.5% respectively), based on our confidence in the authorities' scope and ability to take action.

Chart 2.3
Exchange-rate depreciation (%) vs. external funding gap (CA + FDI, % GDP)



Source: BBVA Research and Haver Analytics

Chart 2.4
GDP growth in EMs (% QoQ sa)



Source: BBVA Research

The gradual recovery in the eurozone continues, with the support of the ECB and with banking union in its sights

After starting the year in recession, the eurozone managed to sustain moderate expansion throughout the second half of the year, in line with our forecast. Thus the fourth quarter data indicate YoY growth of 0.4%, which although only slight, is its best since the end of 2011. The driver of this slight improvement was the prospect of an increasing role played by domestic demand and the sustained improvement in credit financial conditions, favoured by the determination and commitment of the ECB to an expansive monetary policy. Nonetheless, the engine of European growth in 2013 and 2014 was, and will continue to be, the export sector.

In any case, we cannot rule out periods of instability as we approach events that could alter the panorama of progress in banking union and of strengthening the monetary union in Europe in general. The events to watch in this context include the European Parliamentary elections, and developments on the conditions and results of the stress test and asset quality review of the banking sector.

All in all, we reiterate our forecast for eurozone GDP growth at 1.1% for 2014. For 2015 we estimate 1.9%. However, given our projection of continued cyclical weakness, we are also maintaining as a risk event to our forecast horizon a scenario of significant deflation, although we assign a low probability to this risk.

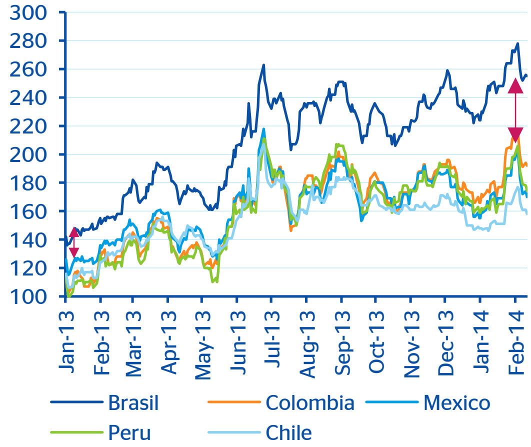
1: The group of financial institutions and vehicles that fall outside the regulation of the banking system, but that carry out the same intermediary functions between the economic agents with surplus liquidity and those with insufficient savings to take consumption or investment decisions.

3. Brazil: another bumpy year ahead

Financial markets: more volatility and more scepticism on Brazil

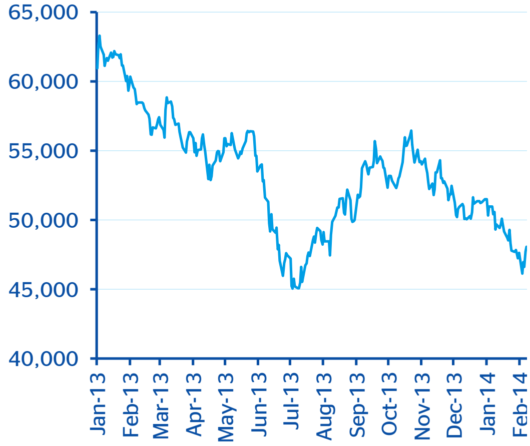
The beginning of the tapering by the Fed in the USA and, especially, the turbulence in emerging markets caused by events such as the depreciation of the peso in Argentina, political and economic tensions in Turkey and worries of a slowdown in China's growth contributed to drive up the volatility of financial markets in Brazil. That helps to explain the recent increase in Brazilian sovereign spreads and the losses in domestic equity markets, among other corrections (see Charts 3.1 and 3.2).

Chart 3.1
Sovereign spread, EMBI (bp)



Source: Datastream

Chart 3.2
Equity markets: BOVESPA index



Source: Datastream

The external environment clearly contributed to increase the volatility in domestic financial markets, which were already stressed by domestic issues such as growth weakness, high inflation, increasing external deficit, fiscal weakening, economic policy uncertainty, etc. (see below for more on each of these issues).

Markets are increasingly less optimistic on Brazil. That is being reflected, for example, in the increasing difference in sovereign spreads between Brazil and other Latin American economies (see Chart 3.3). That difference has increased from 20-30bp a year ago to 60-100bp at the beginning of 2014. In the same line, the losses in domestic equity markets (-21% since the beginning of 2013) were more significant than in Mexico (-7%), Colombia (-17%) and Chile (-18%), although less sharp than in Peru (-25%).

Further signs of the worsening mood on Brazil are last year's downgrades of the rating outlook and the recent comments by the main rating agencies, suggesting that a sovereign downgrade could be announced soon unless the government decides to fix fiscal policy. These moves contrast with the very recent upgrade of the Mexican sovereign rating by Moody's and the upgrade of Colombia by Fitch at the end of 2013.

In this environment, it comes as no surprise that balance of payments data - as well as high-frequency indicators - show net portfolio outflows since the end of 2013.

All in all, financial markets are now more volatile and more sceptical of the Brazilian economy, due to both external and domestic factors.

The turbulence in Argentina, Turkey and other emerging regions could wane, but markets are expected increasingly to segregate economies with robust fundamentals from those with inherent vulnerabilities, in an environment marked by the Fed's tapering. Considering this, financial volatility could result in imposing a larger-than-expected cost on Brazil, making more difficult the needed transition from a private consumption-centred economy to one more dependent on investment and exports (see below for more on this).

The exchange-rate depreciation process has continued; and it still has some way to go

The Brazilian real (BRL) has lost 3.7% since the Fed confirmed the tapering on 18 December. This depreciation was similar to the correction observed in other emerging countries in the region (Mexico: 2.7%; Chile: 5.2%; Peru: 2.0%; Colombia: 5.5%). However, the weakening of the BRL in the last 12 months was sharper, and the perspectives regarding its evolution in the next 12 months are more negative, than in other Latin American countries. More precisely, the BRL has lost 22% in the last 12 months, while the losses faced by other currencies in the region were around 10% (Mexico: 5%; Chile: 17%; Peru: 10%; Colombia: 14%). In addition to that, markets expect the forthcoming correction to be more significant in Brazil: the depreciation implicit in 12 months forward exchange rates is currently 10% in Brazil, as opposed to no more than 5% in other comparable countries in the region (around 5% in Mexico, 4% in Chile and 3% in Peru and Colombia).

From one perspective, the ongoing exchange rate depreciation in Brazil -and in other emerging markets- is a realignment after many years of excessive currency appreciation driven by the reduction of global liquidity and better perspectives on advanced economies, together with concerns about some emerging markets, in particular China (which implies reduced optimism about commodity prices).

However, as well as other financial market indicators, the scale of the exchange rate corrections in Brazil in comparison with other markets also suggests the existence of factors other than global behind the BRL weakening.

In our view, the adjustment of the BRL is also part of a slow and probably painful transition from a growth model based on private consumption to another potentially more dependent on exports and investment. In other words, the exchange rate adjustment process is related to the partial exhaustion of private consumption and the need to recover the competitiveness lost in the manufacturing sector in past years (see Box 1). The private consumption slowdown requires other GDP components, such as exports and investment, to gain momentum in order to prevent economic activity from plummeting. The lack of domestic reforms to improve productivity, and the lack of strong reasons to think that commodity prices will be significantly more supportive than in the last decade, leaves Brazil with no alternative other than a currency depreciation as a means of restoring the competitiveness of the manufacturing sector and promoting exports.

In addition to this structural issue, there are other domestic factors weighing on the recent BRL performance, such as the increasing distrust of economic policies and the relatively poor macroeconomic results.

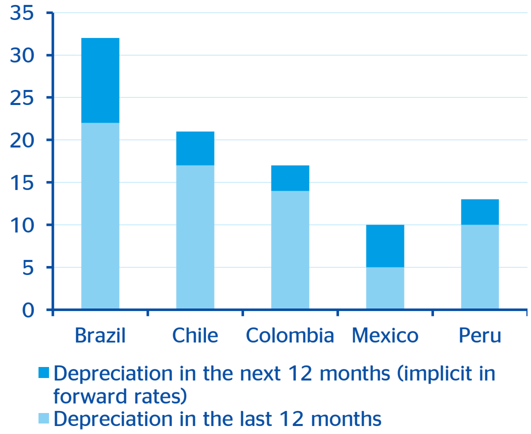
Therefore, there are global and domestic factors behind the recent depreciation of the BRL. Furthermore, we expect those factors to continue and the Brazilian currency to continue weakening over the next two years, at least. During that time spam, general elections will be held (in October 2014) which should help to maintain volatility in domestic financial markets and a weaker currency.

We expect the BRL to average 2.45 to the dollar and close 2014 at 2.51, levels which represent, respectively, a 12% and 6% depreciation from the 2013 figures. In 2015, we expect the rate to average 2.57 and close the year at 2.60. Taking into account our inflation forecasts for both Brazil and the USA, our nominal exchange rate forecasts imply a slight depreciation of the real exchange rate and a gradual convergence to the 2004-2013 average, which is little different from our equilibrium estimates (see Chart 3.4).

Since August 2013, the BCB has been offering currency swaps and dollar repos on a daily basis to provide hedging and liquidity in US dollars, and also to try to reduce exchange rate volatility. In addition, the ongoing monetary tightening cycle helps to prevent a sharper currency depreciation. The US dollar intervention programme is planned to last until the end of June, and we expect the monetary cycle to be over soon (see below for more on this issue). However, we think it likely that the former will be extended and other measures will be announced if the exchange rate volatility continues. Anyway, we expect any forthcoming domestic measure to - at most – only moderate the exchange rate depreciation process, and not to interrupt it.

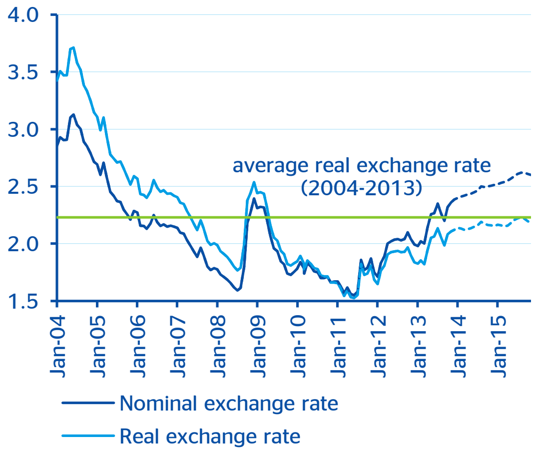
The conjunction of important global and domestic adjustments creates a far from negligible risk that the BRL will weaken more and faster than we are expecting. Additional episodes of external volatility, increased pessimism on Brazil, policy slippage ahead of the presidential elections, a stronger than expected reaction to a (likely) sovereign credit downgrade, popular protests during the Soccer World Cup and/or energy shortage as a consequence of a severe drought. Any of these could trigger a negative-risk scenario, characterised by more significant exchange-rate depreciation, higher inflation, additional monetary tightening and lower growth. Brazil is currently on a razor's edge, and any shock could derail the country's economy.

Chart 3.3
Exchange rates: depreciation in the last 12 months; expected depreciation according to 12 months forward rates (local currency per dollar, %)



Source: Haver Analytics BBVA Research

Chart 3.4
Exchange rate: nominal and real rates* (BRL per USD)



* Real exchange rate at December of 2010 prices. Forecasts from February of 2014 onwards.
Source: BCB and BBVA Research

Box 1. Loss of competitiveness in the Brazilian manufacturing sector over the last few years

Brazilian exports as a proportion of GDP remained virtually unchanged at around 13% of GDP between 2002 and 2012, with an increase in the weighting of primary product exports (from 4% to 6% of GDP) being offset by a reduction in the weighting in GDP of manufactured goods exports, particularly non-basic manufactured products, i.e. those which are less raw material-intensive, in the second half of the period analysed.

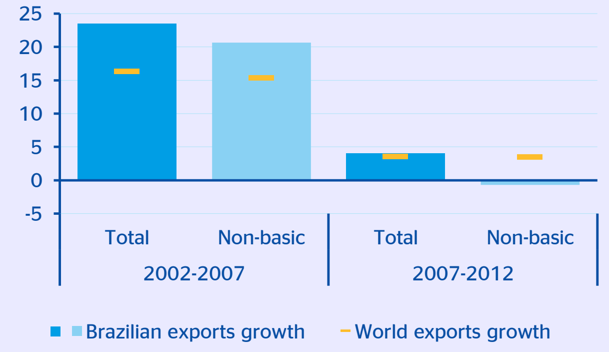
As a proportion of world exports, Brazilian exports did increase from 0.54% in 2002 to 0.68% in 2007 and to 0.74% in 2012. However, increased primary product exports account for a large part of this gain. Basic manufactured goods, i.e. those which are most raw material-intensive, account for 39% of growth in both periods, while non-basic manufactured goods contributed positively (+5%) in the first five-year period, but very negatively in the second (-86%). Taken together, basic and non-basic manufactured goods contributed positively to the expansion in Brazil's exports as a proportion of global exports between 2002 and 2007, and negatively between 2007 and 2012 (for the period as a whole the contribution is small, but positive).

In line with the above, Brazilian exports of manufactured products grew at a noticeably faster rate than global exports of manufactured goods in the first five-year period analysed. However, the situation changed significantly in the second five-year period: Brazilian exports of manufactured goods slackened as did global exports, but the non-basic manufacturing segment showed a slight contraction contrasting with global growth (see Chart B.1.1).

The comparison between the growth in Brazilian exports and global exports by product type (see Chart B.1.2) and RCA (revealed comparative advantage) indicators (see Table B.1.1) in general terms bear out these conclusions.

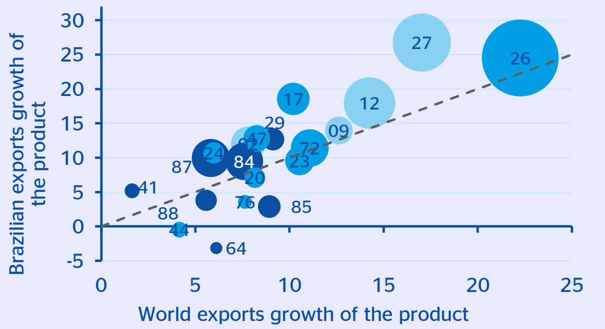
With a few exceptions, the main primary product categories retained and even increased their (already high) level of competitiveness in the last decade, in line with the RCA indicator. Similarly, Brazilian exports of these products almost always grew faster than global exports. Performance in the oil sector was particularly good; here the country appears to be developing a comparative advantage.

Chart B. 1.1
Annual growth in manufacturing exports (total and non-basic) in Brazil (%)



Source: WITS and BBVA Research

Chart B.1.2
Brazil: annual growth in exports in 2002-12 (%)*



The bubble size shows the product's share in the country's exports and colours classify the products by: ● Primary, ● Basic manufactured goods, ● Non-basic manufactured goods. In addition, each product is identified by two HS 2002 classification digits. Above the 45º line, product exports have grown more in the country than in the world, and as such the country has increased its share of world exports.
Source: WITS and BBVA Research

There is a more varied set of results among the main categories of manufactured products. In basic manufacturing, the RCA indicators show relatively stable and relatively high levels of competitiveness in the last decade, with growth in exports equivalent to or higher than global exports, with the main exception in the wood and aluminium sectors. When it comes to non-basic manufacturing, most of the main product categories showed a positive development between 2002 and 2007 and very unfavourable performance between 2007 and 2012. This is the case of the "Machinery and electrical equipment" and "Transport" categories, which have more weight in Brazilian exports. RCA data show that only "Hides and skins" continues to be competitive (RCA>1), although less so than a decade ago. The loss of momentum and competitiveness in the "Footwear" category is very clear.

Tabla B.1.1

Brazil: RCA indicator, weighting in total exports and growth rate by sectors

	RCA			Share of total exports (%)			Annual growth*	
	2002	2007	2012	2002	2007	2012	2002-12	2007-12
Animals and animal products	2.7	3.5	2.7	5.7	5.9	4.3	11.7	-0.4
Vegetable products	4.2	4.2	5.0	10.8	10.6	14.8	18.6	13.6
Food products	4.3	3.9	4.2	12.9	10.2	11.6	13.7	9.2
Mineral products	10.3	9.6	10.5	7.9	13.7	20.0	26.1	14.5
Fuels	0.4	0.5	0.6	3.3	6.5	11.2	29.8	18.4
Chemical products	0.5	0.6	0.6	4.7	4.9	5.2	15.9	7.5
Plastics and rubber	0.6	0.7	0.5	2.5	3.1	2.3	13.6	0.0
Hides and skins	2.1	2.3	1.4	1.8	1.4	0.8	5.7	-5.1
Wood and wood products	2.1	2.1	1.8	7.4	5.8	4.0	8.0	-1.4
Textiles	0.3	0.3	0.4	1.9	1.4	1.5	11.6	7.2
Footwear and headgear	2.8	1.7	0.7	2.8	1.3	0.5	-3.4	-12.0
Stone and glass	0.8	0.6	0.3	2.3	1.8	1.2	8.2	-1.8
Metals	1.6	1.2	1.0	9.7	10.7	6.9	11.1	-2.5
Machinery and electrical equipment	0.4	0.4	0.3	12.0	10.3	6.4	8.0	-3.4
Transport equipment	0.9	1.0	0.8	11.0	9.9	6.4	8.9	-2.6
Miscellaneous	0.3	0.2	0.2	2.0	1.3	0.9	5.7	-1.8
Primary products	1.7	1.7	1.8	0.3	0.3	0.4	21.5	12.8
Basic manufacturing	2.9	2.7	3.2	0.4	0.4	0.4	16.4	7.4
Non-basic manufacturing	0.6	0.6	0.4	0.4	0.3	0.2	9.5	-0.7

* Compound Annual Growth Rate.
Source: WITS and BBVA Research

Performance data for Brazilian exports in the period between 2002 and 2012 leave little room for doubt; in the last few years, between 2007 and 2012 to be precise, there has been a significant loss in competitiveness in the Brazilian manufacturing sector, particularly concentrated in the non-basic manufacturing group. This recent loss of competitiveness wiped out a great deal of the gains from the previous five-year period, between 2002 and 2007.

One of the factors that explains the deterioration in competitiveness levels in the Brazilian manufacturing sector is the 22% increase in the real effective exchange rate between 2002 and 2012, most of it between the end of 2002 and the middle of 2008. The exchange rate was much stronger in the second half of the 2002-12 period, which helps to explain the loss of competitiveness in the manufacturing sector in this period.

Another key factor in understanding the deterioration in the competitiveness in the manufacturing sector in the last few years is the gap between the growth in labour costs and labour productivity.

In the 2002-12 period, unit labour costs in the industrial sector measured in BRL went up by an average of 7.5% a year (growth in USD was 9.0% a year). This growth was particularly high in the last two years of the period analysed, when it grew at a rate of around 14% a year. This growth is much higher than productivity in the Brazilian industrial sector, which at an annual rate of just 2.2% saw particularly low growth, even turning negative in 2011 and 2012.

There are other factors which have the potential to impact the economy's competitiveness and that of the manufacturing sector: the institutional environment, energy costs, tax burdens, capital costs, logistics costs, access to markets, etc. In the case of Brazil, evidence available on these areas for the last decade suggests that there has been little progress – in some cases none at all – in terms of promoting competitiveness. Progress made in some particular cases was not nearly enough to compensate for the general picture of loss of competitiveness in the manufacturing sector. It is illustrative that in 2012 Brazil occupied 27th position out of 188 countries for the cost in dollars of exporting a container and, out of all the countries, registered the second biggest increase in this cost between 2005 and 2012 (+252%).

The lack of a more general and ambitious reform plan reduces the likelihood of there being an improvement in Brazil's competitiveness through productivity gains, which would be the best scenario. So the most likely outcome is that the problem of the lack of competitiveness is resolved (or reduced) by an exchange rate depreciation and an economic activity slowdown.

Inflation will remain around 6.0% in 2014

Inflation surprised to the upside, and closed 2013 at 5.9% YoY. Even though it continued within the broad target range (2.5% - 6.5%), this frustrated the BCB's plans to deliver a lower inflation in 2013 than in 2012, when it reached 5.8% YoY. More recently, in January, inflation eased more than expected to 5.6% YoY (see Chart 3.5).

While the recent exchange rate depreciation prevented inflation from trending downwards at the end of 2013, positive base effects (i.e., high inflation in January of 2013) helped inflation to fall in January.

Looking forward, we expect the pressures related to a weaker exchange rate to continue in place, and positive base effects to wane. In addition, the lack of room to keep administered-price inflation as low as in 2013 will be another factor preventing inflation from falling significantly below 6.0% YoY and converging to the 4.5% YoY target. More precisely, we expect inflation to trend gradually up in the next few months, and to reach 6.0% YoY by June and 6.3% YoY during the third quarter. Some moderation at the end of the year should make inflation close 2014 more or less at the same level as at the end of 2013, i.e. around 5.9% YoY. This expected path implies that inflation will average 6.0% YoY in 2014, slightly less than in the previous year (6.2% YoY).

Regarding the impact of a BRL depreciation on inflation, our estimates and the available evidence for Brazil suggest that the pass-through coefficient is around 5%, i.e. a 10% depreciation implies that inflation will go up around 50bp in 12 months (see Box 2 for a comparative analysis of the impact of a currency depreciation in Brazil). Taking that into account, the exchange rate depreciation should add around 60bp to inflation in 2014.

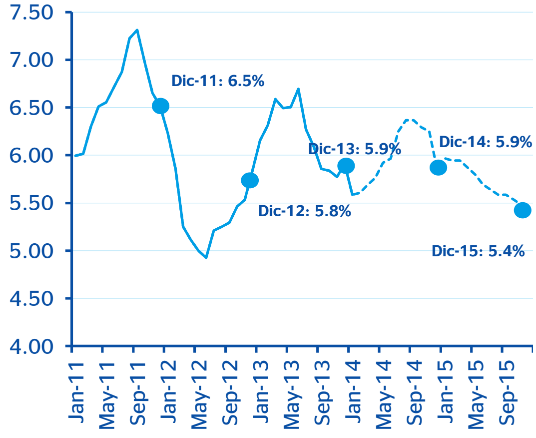
As a consequence of the exchange rate depreciation process, we expect tradable inflation to be under more pressure than in the recent past. On the other hand, non-tradable inflation should be less impacted by the currency depreciation, but should respond more to both the tightening of monetary conditions and the wage deceleration in due course. Therefore, we expect tradable prices, whose weight in the IPCA basket is around 36%, to be under more pressure and non-tradable prices, whose weight on the inflation basket is around 40%, to moderate over the remainder of 2014.

Inflation in administered goods and services, which represent around 24% of the IPCA, should be significantly higher in 2014 than in 2013, when it reached only 1.5% YoY, a record low level. Among other reasons, the government has no fiscal room to subsidise the prices of some goods and services. The case of the energy sector is illustrative. After cutting electricity tariffs by 18%-32% at the beginning of 2013, this year the government will probably be forced to adjust tariffs upwards by more than 10%, given the lack of fiscal resources to subsidise the sector and the negative impact on costs of the severe drought at the beginning of the year.

All in all, we expect inflation to remain close to 6.0% YoY in 2014 as the pressure on tradable and administered-price inflation will offset the impact of tighter monetary conditions and a less robust labour market on non-tradable inflation. Recent inflation readings already support this view (see chart 3.6).

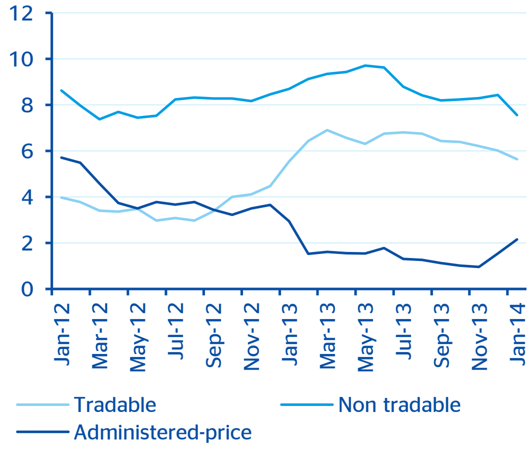
Inflation could diminish somewhat in 2015 (see Chart 3.5), when we expect the exchange rate depreciation process to lose some steam, fiscal and monetary policies to be set tighter and domestic demand to moderate.

Chart 3.5
Inflation (YoY%)



Source: BCB and BBVA Research

Chart 3.6
Inflation by components: tradable, non-tradable and administered-prices (YoY%)



Source: BCB and BBVA Research

Box 2. Exchange rate pass-through in Brazil and Latam

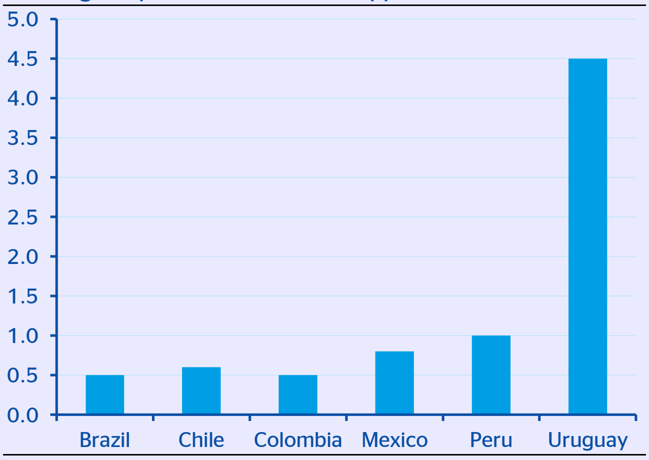
Partly as a result of recent tensions, currencies in Latin American countries have been depreciating continually over the last 12 months. Specifically, the exchange rate has weakened by around 15% in the Andean countries and in Uruguay, somewhat less (around 5%) in Mexico, and significantly more so in Brazil (22%).

Depreciations in those countries, as well as the likelihood of further currency drops may cause some concern about inflationary pressure as 2014 progresses.

In order to evaluate the impact on inflation, the exchange rate pass-through need to be looked at to measure to what extent a specific depreciation of the exchange rate is transferred to domestic prices.

Economic literature suggests that the pass-through of the exchange rate to inflation has been dropping in recent years in Latin America as a result, amongst other reasons, of the effectiveness of monetary policies with inflation targets. Our estimations indicate that the exchange rate pass-through in the region's countries is mainly in the range of 5% to 10%. That is, a depreciation of 10% in the exchange rate has an impact on inflation of between 0.5 and 1.0pp in a 12-month period (see Chart B2.1). The exception is Uruguay, with a pass-through of 4.5pp as a result of a high inflation rate, with inflation expectations that are not anchored within the Central Bank's target range, and heavy dollarization of the economy. So we see that in Peru, where the economy is also relatively dollarized, the pass-through is significantly lower – although higher than in other countries in the region – due to the success of monetary policy in anchoring inflation expectation around an inflation target of 2.0%.

Chart B.2.1
Exchange rate pass-through ratio (impact on inflation of an exchange depreciation of 10%, in pp)

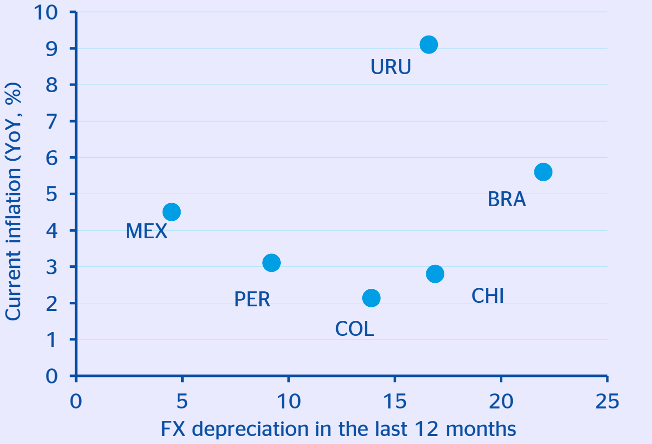


Source: BBVA Research and FMI

Bearing in mind that, with the exception of Uruguay, pass through coefficients are at fairly low levels, the impact of movements in the exchange markets will depend above all on how much each currency depreciates and on current inflation pressures. Chart B2.2 shows that in Mexico, where inflation is slightly over the target range, exchange rate depreciation has been small. In the Andean countries, where depreciation has been rather stronger, inflation is at low levels (both in absolute terms and when compared with the target). The most clearly unfavourable situation is that of Brazil and Uruguay, where inflation is still very high and depreciation has been very strong.

So, the effect on inflation of exchange depreciations should in general be minor and easily absorbable within central banks' target bands. The exceptions are Brazil and Uruguay.

Chart B.2.2
Inflationary risks: real inflation and exchange depreciation over the last 12 months (%)



Source: BBVA Research and Haver Analytics

The current environment requires the BCB to maintain a tighter monetary policy

After taking the Selic rate to 7.25% at the end of 2012, in a bet that interest rates could be maintained at much lower levels than in the recent past without any additional reforms and independently of the fiscal stance, inflation started to trend upwards and breached the ceiling of the target range (6.5% YoY) in March 2013.

The BCB then started to tighten monetary conditions in April 2013, and reinforced the option for a significant adjustment in the Selic rate throughout the year, as inflation expectations failed to recede and as evidence mounted that inflation was hurting both private consumption and the government's approval ratings. In addition, the decision to adjust monetary conditions more aggressively than initially expected (the Selic was increased from 7.25% in April of 2013 to 10.50% in January of 2014) is also a measure intended to recover some of the credibility lost when interest rates were aggressively reduced to 7.25%.

The recent tightening of monetary conditions is a sign that the bet on lower rates did not work out. Even though the ongoing monetary adjustment is already very significant, inflation expectations remain high and there is no prospect of inflation converging to the 4.5% target anytime soon, which is a symptom of damaged credibility.

Anyway, not only domestic factors require that the BCB maintains higher interest rates now, but also the external environment is less conducive for emerging markets keeping low rates.

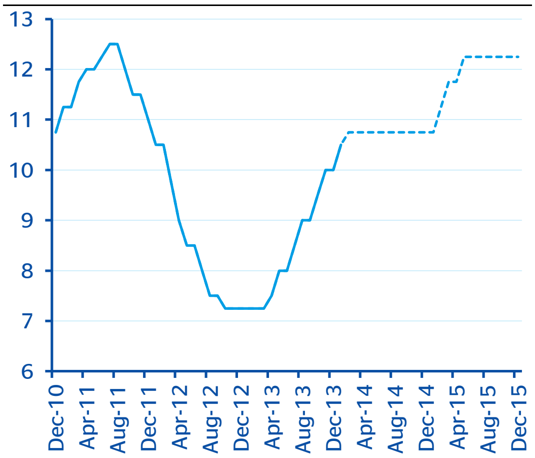
Looking ahead, we expect the monetary authority to hike the Selic rate by 25bp to 10.75% at the end of February. As well as the upward surprise in December forced the BCB to adjust the Selic by 50bp (rather than 25bp) in January, so inflation's surprise fall in January should trigger a 25bp adjustment (rather than 50bp) in February. This smaller adjustment is also in line with the emphasis that the monetary authority has recently been putting on the lagged impact of monetary policy on inflation (suggesting that it considers that most of its job is already done), and with the evidence pointing to the country's still very weak economic activity.

In our view, the February hike will be the final one and the Selic rate will be maintained unchanged at 10.75% - the same interest rate as when both President Dilma Rousseff and the President of the BCB, Alexandre Tombini, were sworn in at the beginning of 2011 – over the remainder of 2014. However, as inflation will remain under pressure, we expect the BCB and the government to try to use other tools (such as macro-prudential or fiscal policies) during the year to prevent inflation from running out of control.

In 2015, we expect a new tightening cycle to be adopted as part of a more general adjustment to tackle inflation, removing part of the distrust of domestic policies and paving the way for growth in subsequent years. The beginning of a monetary tightening cycle by the Fed also supports the view that an adjustment of the Selic will be required in 2015.

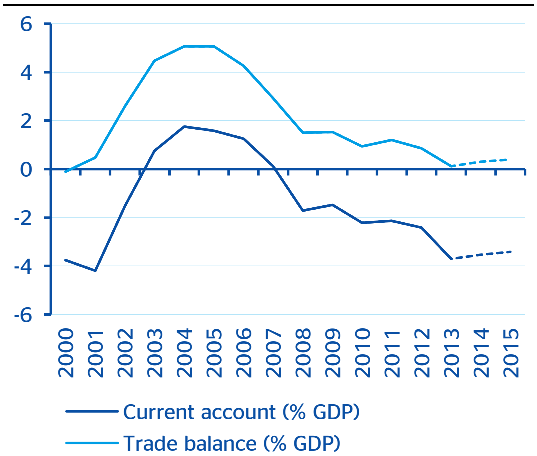
The current risk is that the 2015 adjustment will need to be frontloaded and adopted in 2014. Therefore, we do not rule out a scenario in which the BCB continues to tighten monetary conditions after its monetary policy meeting in February.

Chart 3.7
SELIC (%)



Source: BCB and BBVA Research

Chart 3.8
External accounts: trade balance and current account (% GDP)



Source: BCB and BBVA Research

External and fiscal accounts worsened significantly in 2013. External accounts should improve somewhat, but the fiscal deterioration is likely to continue in 2014

The current account deficit reached 3.7% of GDP in 2013 and the public sector's primary surplus reached 1.9% of GDP, in both cases the worst figure since 2001.

The deterioration of the current account is mostly driven by the reduction in the trade balance. More precisely, the trade surplus declined from 0.9% of GDP in 2012 to 0.1% in 2013 (the lowest figure since 2000), which was due to competitiveness problems in the manufacturing sector (see Box 1). In addition to this, there was a 3% decline in the price of domestic exports and the oil trade balance worsened from 0.1% of GDP in 2012 to -0.5% in 2013 due to supply problems and the late recording of oil imports in the second half of 2012 (the latter was an one-off issue, which therefore should not impact the sector's trade balance from 2014 onwards).

With regard to fiscal accounts, the decline in the public sector's primary surplus follows the government's decision to rely on public expenditure and tax cuts to support economic activity. Both the decline in the primary surplus and higher interest payments drove the total fiscal deficit up to 3.2% of GDP, the worst result since 2009 when the country was hit by the Lehman Brothers crisis.

The deterioration in both external and fiscal accounts has helped to fuel the recent wave of pessimism about the Brazilian economy, with the risks commented on previously. In particular, it has supported the decisions of the main rating agencies to downgrade Brazil's sovereign outlook.

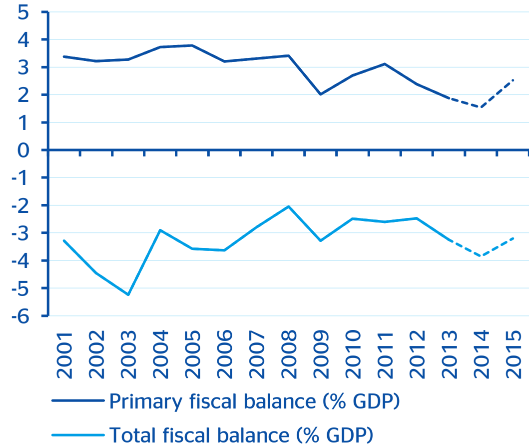
In spite of the undeniable deterioration, we think that the situation in the fiscal and, especially, external areas is not as weak in Brazil as other emerging economies that are currently in the eye of the hurricane. On the one hand, Brazil remains a net external creditor due to its bulky international reserves (17% of GDP), and the short-term external debt is relatively small (11% of the total external debt). On the other hand, the public sector's net debt continues to shrink (although not at the same pace as some years ago), thanks to the generation of a primary surplus, positive GDP growth and the currency depreciation (which increases the value in BRL of international reserves), and the country's gross debt remains practically unchanged (see Chart 3.10). We think that its economic policies, and neither external nor fiscal structural weaknesses, what are making Brazil more vulnerable.

Looking forward, we do not expect any significant change in fiscal or monetary policies in the remainder of 2014. General elections to be held in October make any adjustments potentially more painful (from a political perspective). We do expect more significant adjustments in 2015, not only on the fiscal but also the monetary.

The government has recently announced that it will freeze budgeted spending to pursue a primary surplus of 1.9% of GDP this year. However, we remain sceptical about the achievement of this target, as we see neither significant fiscal room nor particularly high incentives for the government to do so. Therefore, we continue to expect the primary surplus to reach 1.6% in 2014, which will add to higher interest payments and drive the total fiscal deficit to 3.8%, which would be the worst result since 2003 (see Chart 3.9). We expect that a more significant tightening of fiscal policy will be adopted only in 2015, probably too late to avoid a sovereign credit rating downgrade.

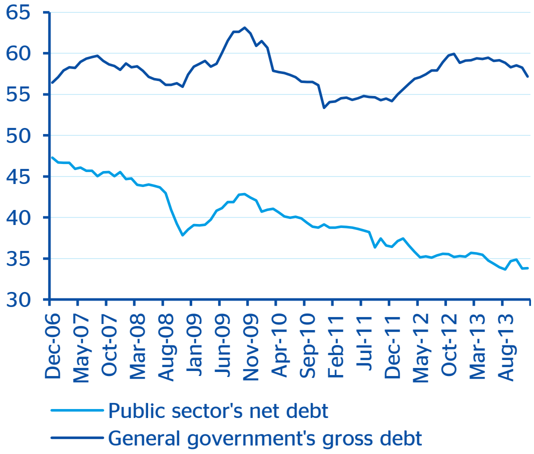
With respect to external accounts, we expect some improvement starting this year, due to the impact of a weaker currency, the acceleration in global growth and a less negative performance of the oil trade balance (as domestic oil production recovers) . In our view, this improvement will occur in spite of another slight downward correction in Brazil's terms of trade and the impact of the depreciation in Argentina (see Box 3). All in all, we expect the current account deficit to decline to 3.5% and 3.4% of GDP in 2014 and 2015 respectively.

Chart 3.9
Public sector's accounts: primary and total balances (% GDP)



Source: BCB and BBVA Research

Chart 3.10
Gross and net public debt (% GDP)



Source: BCB

Growth will remain around 2.0% in 2014 and 2015

Recent indicators suggest that growth could have surprised to the downside, once again, in 4Q13. The IBC-Br, the BCB's economic activity index which works as a monthly proxy for GDP, declined 0.6% MoM and 1.4% MoM in November and December respectively, taking quarterly growth down to 0.2% QoQ (see Chart 3.11). In 3Q13, the IBC-Br also declined 0.2% and GDP contracted 0.5% QoQ. Therefore, activity could have contracted for the second quarter in a row in 4Q13, implying that the economy could have entered a technical recession by the end of 2013.

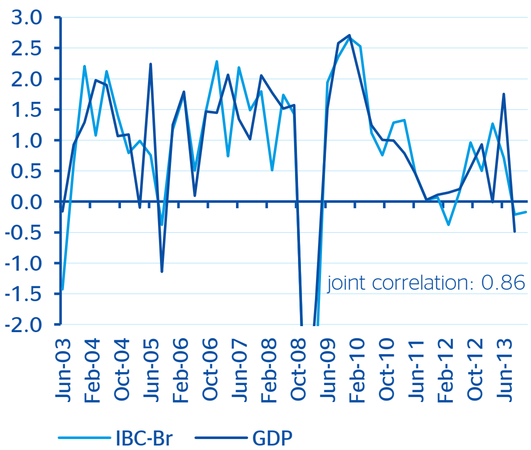
As Chart 3.11 reveals, the correlation between the IBC-Br and GDP is high but not perfect. In some quarters, the difference between the two growth indicators was more than 1.0pp. That is to say that even though the IBC-Br adds a downside bias to our forecasts, we stick to the view that 4Q13 was in positive territory, 0.4% QoQ more precisely.

If our 4Q13 forecast is correct, GDP growth will be around 2.2% in 2013. That is higher than in 2012 (1.0%) but below both growth over the last decade (3.6% on average) and potential growth (see the following section for more on this issue)

Domestic demand probably contributed with 3.5pp to 2013 growth, in comparison to only 1.0pp in 2012 (see Chart 3.12). The moderation in consumption, from 3.3% in 2013 to around 2.1% in 2013, was offset by a rebound in investment, from -4.0% in 2012 to around 6.5% in 2013, thanks to the segment's positive performance in the first half of the year. At the beginning of 2013, investment benefited from expansive fiscal and monetary policies, some specific incentives for the segment (negative real interest rates at the BNDES, the national development bank, for example) and some atypical factors such as the sharp expansion in the number of trucks, following a sharp downward correction in 2012 due to the adoption of new anti-pollution technology.

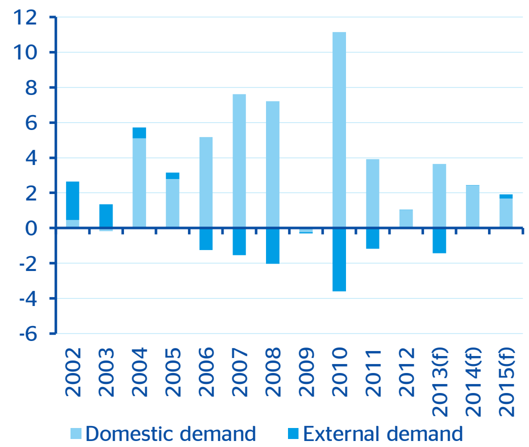
Not surprisingly, the expansion of investment during the first half of the year drove imports significantly higher, driving the contribution of net external demand to GDP down to -1.4pp in the year, in an environment marked by weak export performance, which we forecast to grow only 1.9% in 2013.

Chart 3.11
Growth measures: IBC-Br and GDP (% QoQ)



Source: BCB and BBVA Research

Chart 3.12
GDP growth (% YoY)



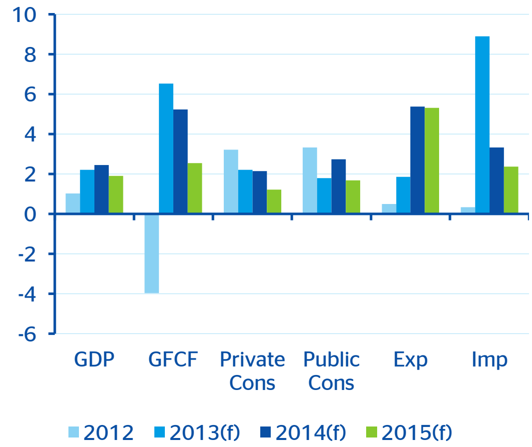
Source: BCB and BBVA Research

We expect GDP growth to reach 2.5% in 2014. A better export performance, supported by a weaker currency and more robust demand in developed countries, coupled with less buoyant imports should make the contribution of next external demand to GDP around zero, a significant improvement compared to 2013, when the contribution was negative (see Chart 3.10). The reduction in imports is related to a moderation of domestic demand, whose contribution to GDP should decline to 2.4pp in 2014. We expect both investment and consumption to lose momentum in 2014, affected by uncertainties regarding the domestic environment, a less-supportive monetary policy and a slowdown in labour markets.

The bias to our 2014 forecast is to the downside, due to the recent turbulence in financial markets, the impact of the depreciation of the Argentinean peso on Brazilian exports (see Box 3) and the risk that growth in 4Q13 was lower than expected, which would reduce the statistical carry-over for growth in 2014.

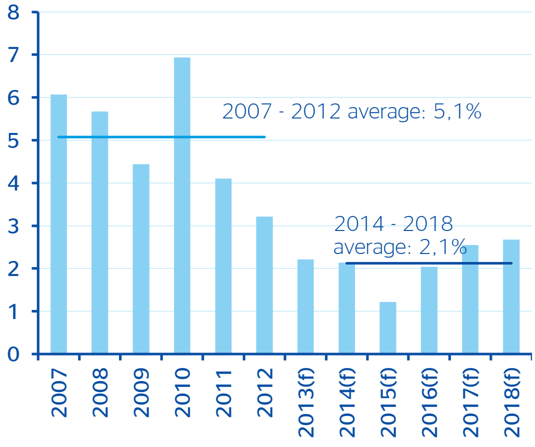
Looking further forward, we expect GDP growth to slow down to around 1.9% in 2015 following the impact of more restrictive fiscal and monetary policies. The change in the tone of economic policies will be required to recover some of the credibility lost in the last few years, and to reduce the vulnerability of the economy in a scenario where the Fed will start to adjust interest rates upwards.

Chart 3.13
GDP growth by demand components (% YoY)



Source: BCB and BBVA Research

Chart 3.14
Private consumption (% YoY)



Source: BCB and BBVA Research

Box 3. The contagion from Argentina to the rest of Latin America will be concentrated on Brazil and Uruguay

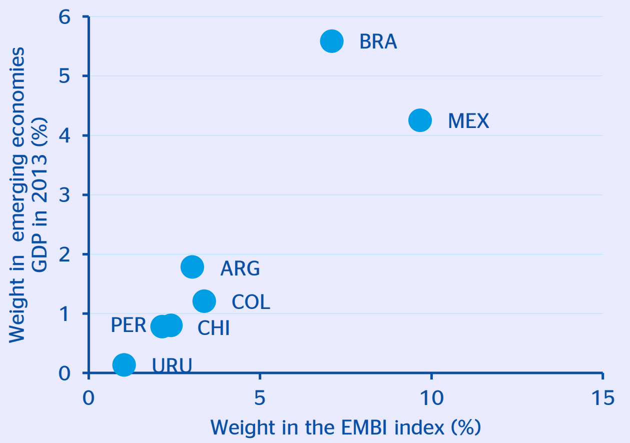
One of the events towards the end of January which contributed to raising doubts about the progress of emerging economies was the increase in the rate at which exchange rates were going down in Argentina. In particular, between 21 and 23 January, the rate of exchange went down by 14% to 6.88 pesos per USD, stabilising a few days later on 23 January at around 8 pesos per USD.

The drop in exchange rates in Argentina coincided with a sharp depreciation of other emerging currencies, such as the Turkish lira and the Russian rouble. Latin America's other currencies all weakened against the dollar from the end of January too. All this has led to certain concerns about the possibility of a widespread crisis in emerging economies. Our view is that the turbulence in financial markets during January and February has had some global components (such as a possible bringing forward of interest rate rises in the US and short-term worries about the Chinese growth rate), but also idiosyncratic factors in the most affected economies (Argentina, Turkey, India, Indonesia and South Africa, among others).

Specifically, there is a series of reasons for which sharp depreciation in the Argentinean exchange rate and a slowdown in its economic activity which might be the consequence of an increase in market interest rates, would have a very limited effect on other countries in the region, apart from Brazil and Uruguay. But even in these two the effect would, in any case, be contained.

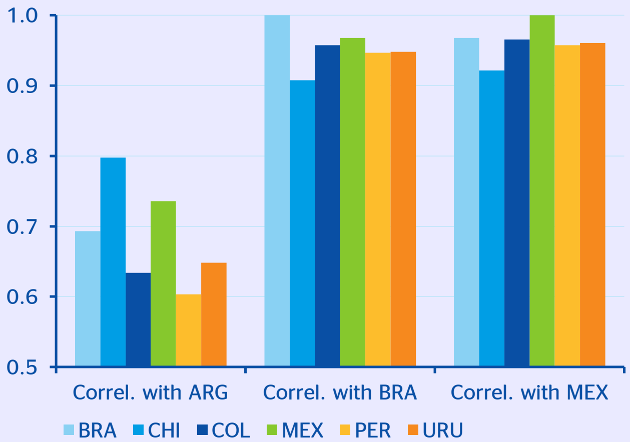
The main channel through which turbulence in Argentina might affect the remaining countries in the region is through its effect on international financial markets and investor mood in the area. However, Argentina's involvement in international financial markets is much less than its economic weighting in the region. Argentina has not returned to international financial markets since it suspended payments in 2001, which has brought its foreign debt level down from 130% of GDP in 2002 to 70% in 2005 and 31% in 2013. Furthermore, capital inflows on the part of non-residents have also been limited in the last few years. All this has meant that Argentina's input in the region's main indexes is very small (see, for example, Chart R.3.1 for the EMBI index). So it is highly unlikely that it can trigger an exit of funds centred on the region. Likewise, the correlation between changes in sovereign spreads in Argentina and the remaining countries in the region is much less than the correlation between Mexico and Brazil, to a large degree because the change in spread in the case of Argentina has been mainly due to idiosyncratic factors.

Chart B.3.1
Latam country weighting in the EMBI index & percentage of emerging economy GDP



Source: BBVA Research and JP Morgan

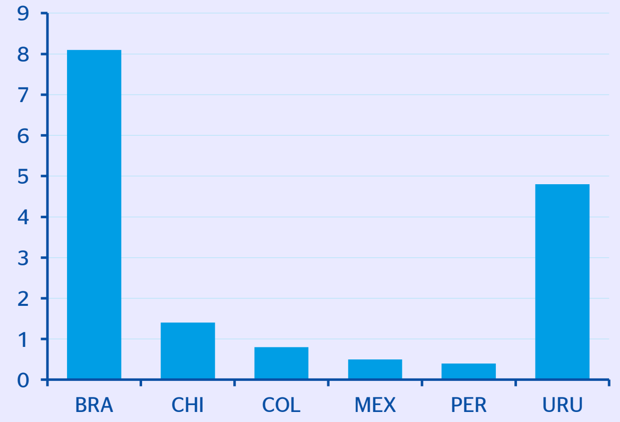
Chart B.3.2
Correlation between each country's sovereign spreads and those of Argentina, Brazil & México (January 2009 - February 2014)



Source: BBVA Research and Haver

The second channel through which contagion might spread from Argentina to the rest of the region is trade and direct investment. However, Argentina's trade links with its neighbours are relatively limited (Chart R.3.3). Exports from the rest of the region to Argentina only make up 2.2% of its total trade, although this percentage is greater in the case of Brazil (8.1% of its exports, particularly in the automotive and chemicals sectors) and Uruguay (4.8% of the total).

Chart B.3.3
Exports to Argentina as a percentage of each country's total



Source: BBVA Research

In the case of Brazil, impact on growth in 2014 is likely to be around -0.2pp, although it could be less if Argentina loosens some of the restrictions it currently applies on imports from Brazil, which is more likely now that the peso is at a more competitive level. This impact would stem particularly from a 10% drop in Brazilian exports to its neighbour (in January 2014 the fall in exports was 14% YoY). In any event, this negative impact on Brazil of the depreciation of the peso and the slackening of activity in Argentina is not entirely incorporated into our growth forecast of 2.5% for Brazil's GDP in 2014, which reinforces the downside risk of this forecast.

In the case of Uruguay the effect on growth would be less than in the case of Brazil, not only because the exposure level is lower, current growth is more robust and economic policy margins are somewhat greater, but also because the relative greater ease of access to foreign currency on the part of individuals as decreed by the Argentinean government could have a positive effect on tourism in Uruguay, which partly compensates the price effect and that of a possible slowdown in economic activity in Argentina.

To sum up, the recent currency depreciation in Argentina and a possible slowdown in its economic activity as a result of the increase in domestic funding costs will have very limited effects on most Latin American countries; even in the case of Brazil and Uruguay, the most exposed to the trade channel, the effect would be very contained. The key risk for the region comes from a possible sharp slowdown in China (with effects on the demand for raw materials and impact on their price) or of a disorderly retreat from monetary stimulus in the US which causes heavy turbulence in international financial markets. Fortunately, the likelihood of either risk event occurring has gone down considerably since the middle of 2013.

Private consumption will contribute less to growth in the longer-term. The performance of exports, and especially investment, will not be good enough to prevent a slowdown in GDP growth.

Private consumption has been slowing down in recent years, and we expect it to continue doing so in the next few years (see Chart 3.14). There are important structural factors behind this moderation.

First, the labour market is already very tight, which reduces the room for expansion in the next few years. The unemployment rate averaged 5.4% in 2013, practically half the 2006 rate and the lowest in more than ten years. In addition, in the last few years wages have been increasing more than productivity. Controlling inflation and addressing competitiveness problems will require moderation of wages in the next few years.

Second, household credit increased from less than 15% in 2006 to 26% of GDP in 2013 and the level of household debt increased from 23% to 46% of annual income in the same period. A similar expansion in forthcoming years is neither expected nor desirable.

Finally, demographics are becoming gradually less favourable. The ageing of the population and lower fertility imply that the labour force will not grow as rapidly as in the past. In addition to that, the reduction in the participation rate (a common feature in countries transitioning towards development) also limits the room for future expansion of private consumption.

A sharper expansion of labour productivity, a significant reduction in still-high lending rates, a reduction in labour informality and changes to Brazil's pension system, among other things, could potentially ease some of these constraints. However, we regard each of these changes as unlikely, given the (current and expected) paralysis in the agenda of economic reforms.

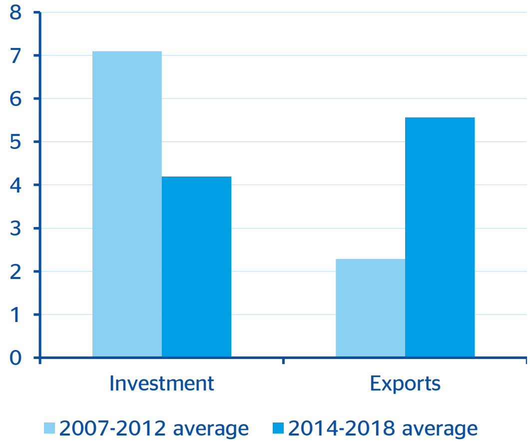
The main problem related to the moderation in private consumption is that this component represents more than 60% of GDP. In order to compensate for this slowdown, other demand components, such as exports and investment which currently represent around 11% and 20% of GDP respectively, would need to grow at an unusual rapid pace in the next few years to maintain economic expansion around 3.5%-4.0%.

We do expect exports to react to the depreciation of the exchange rate and to more robust demand from developed countries in the next few years, and to make a greater contribution to GDP growth than in the recent past. However, the expected expansion is far from being exceptional. In addition, we are less optimistic about the evolution of investment. A sharper expansion in this segment would require reforms and changes in policies that we also see as unlikely. Taking this into account, we expect investment to actually lose steam in the years ahead in spite of the hosting of two of the world's top sporting events[2] (see Chart 3.14).

A transition from a growth model centred on private consumption to one more dependent on exports is likely to occur gradually in the next few years. In fact, this rebalancing has already begun, and is in line with the ongoing change in relative prices. However, as the prospects for investment are not particularly bright, this transition is likely to be flawed. We see no strong reasons to expect economic activity to grow sustainably around 3.5% - 4.0% in the next few years, and our forecast is that potential growth will more likely to be around 2.5% - 3.0%.

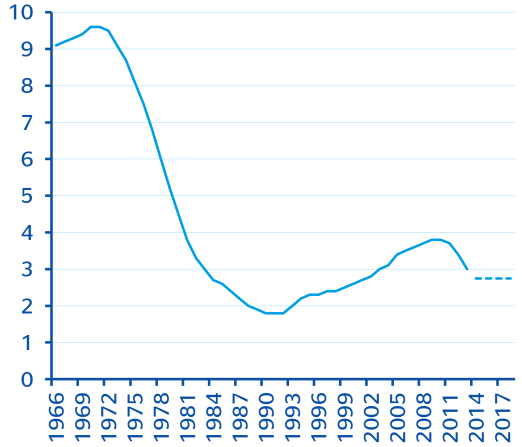
2: We expect them to have a marginal impact on economic activity, in particular on investment.

Chart 3.15
Exports and investment growth (% YoY)



Source: BCB and BBVA Research

Chart 3.16
Potential GDP (% YoY)



Source: BCB and BBVA Research

4. Tables

Table 4.1
Macro Forecasts Yearly

	2012	2013	2014	2015
GDP (% y/y)	1.0	2.2	2.5	1.9
Inflation (% y/y, eop)	5.8	5.9	5.9	5.4
Exchange Rate (vs. USD, eop)	2.04	2.36	2.51	2.60
Interest Rate (%, eop)	7.25	10.00	10.75	12.25
Private Consumption (% y/y)	3.2	2.2	2.1	1.2
Government Consumption (% y/y)	3.3	1.8	2.7	1.7
Fixed Investment (% y/y)	-4.0	6.5	5.2	2.5
Fiscal Balance (% GDP)	-2.5	-3.2	-3.8	-3.2
Current Account (% GDP)	-2.4	-3.7	-3.5	-3.4

Source: BBVA Research

Table 4.2
Macro Forecasts Quarterly

	GDP (% y/y)	Inflation (% y/y; eop)	Exchange Rate (vs. USD; eop)	Interest Rate (%; eop)
Q1 12	0.8	5.3	1.83	9.75
Q2 12	0.5	4.9	2.02	8.50
Q3 12	0.9	5.3	2.03	7.25
Q4 12	1.4	5.8	2.04	7.25
Q1 13	1.9	6.6	2.02	7.25
Q2 13	3.3	6.7	2.26	8.00
Q3 13	2.8	5.9	2.26	9.00
Q4 13	2.4	5.8	2.32	10.00
Q1 14	2.7	5.8	2.32	10.25
Q2 14	2.1	6.0	2.35	10.25
Q3 14	3.0	6.2	2.36	10.25
Q4 14	3.2	5.8	2.41	10.25

Source: BBVA Research

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This report has been produced by the Emerging Economies Unit:

Enestor Dos Santos
enestor.dossantos@bbva.com

BBVA Research

Contact details

BBVA Research
Paseo Castellana, 81 - 7th floor
28046 Madrid (Spain)
Tel.: +34 91 374 60 00 and +34 91 537 70 00
Fax: +34 91 374 30 25
bbvaresearch@bbva.com
www.bbvaresearch.com