

Economic Outlook

Brazil

Fourth Quarter 2013
Economic Analysis

- **The global economy will grow 2.9% in 2013 and 3.6% in 2014**, with some deceleration in emerging economies and recovery in the developed areas.
- **In Brazil, financial tensions receded partially and the depreciation pressures over the currency have eased somewhat** recently. However, the exchange rate is fated to a depreciation.
- **The recent moderation in domestic prices was neither widespread nor sufficient to bring inflation significantly down.** A weaker currency, among other factors, will leave no room for inflation to moderate further.
- **The BCB extends the monetary tightening cycle as the currency weakens and inflation remains resilient.** We expect the SELIC rate to close the year at 10.0% and reach 10.25% at the beginning of 2014.
- **We expect GDP to grow 2.6% in 2013 and 2.8% in 2014**, as investment expansion will not be strong enough to offset the moderation in consumption.
- **Fiscal and external accounts continue to deteriorate.**

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Closing date: November 18, 2013

1. Summary

The economic cycle is improving, above all in advanced economies, although it is still far from a strong recovery. The tension in the financial markets caused by the announcement of the Fed's tapering eased, providing a boost for the global economy. Meanwhile, China continued to stimulate domestic growth, although in a more limited fashion, which helped to dissipate the doubts about its commitment to growth of at least 7.5%. In Europe, more extreme risks are now less relevant and a weak recovery is expected in 2014. We have revised down by 0.2 p.p. the expected growth for the global economy in 2013 and 2014 to 2.9% and 3.6%, respectively.

In Brazil, financial tensions receded partially and the depreciation pressures over the exchange rate eased somewhat as the Fed delayed tapering. The latter was also a consequence of the decision by the central bank to commit to a plan to inject liquidity in dollars on a daily basis. After reaching 2.45 in August, the Brazilian real (BRL) converged to 2.20 in October and then to 2.30 at the beginning of November. The BRL is currently around 13% weaker than it was before Bernanke's tapering speech in May. Moreover, we expect it to continue to depreciate further as the Fed eventually starts its tapering and because the weakening of the currency is the most likely way for the country to recover part of the competitiveness it lost in recent years.

After trending down since June, when it reached 6.70%, inflation stood at 5.84% in October. This decline is fully explained by the moderation in food prices. Service, non-tradable and core measures, among others, show that inflation pressures remain strong. Therefore, the recent moderation in domestic prices was neither widespread nor sufficient to bring inflation down significantly. Looking ahead, a weaker currency and resilient expectations, among other factors, will leave no room for inflation to moderate further. We expect it to close both 2013 and 2014 at 5.8%.

The depreciation of the exchange rate and the resilience of inflation are forcing the Central Bank to adopt a tighter than expected monetary policy. The monetary authority maintained the 50bp adjustment pace in October, bringing the SELIC interest rate to 9.50%. We expect the monetary authority to maintain the 50bp pace at the end of November and then deliver a final 25bp hike in January.

We expect GDP to grow 2.6% in 2013, which represents a recovery compared to 2012, when growth was only 0.9%. However, the expansion will fall short of the average for the last ten years, 3.6%. In 2014, we expect the better performance of the world economy, a somewhat more growth-supportive fiscal policy and a more robust expansion in investment to drive GDP growth slightly up to 2.8%. In both 2013 and 2014, the expansion in investment will not be enough to compensate for the moderation in private consumption.

There are rising concerns regarding the deterioration in fiscal accounts in Brazil. In our view, these concerns are justified as since the end of 2010 the primary surplus has been declining and the gross public debt and the total fiscal deficit have been increasing. Even though the threats of a sovereign downgrade forced the government to recognize the need to introduce changes in the management of fiscal and quasi-fiscal policies, because of the imminence of national and regional elections, it is unlikely that these changes will be implemented in the short-term. At the same time, the rising concerns about the fiscal situation, as well as inflation worries, do not leave much room for fiscal policy to provide extra support to economic activity in 2014. We expect the fiscal results to continue to deteriorate in both 2013 and 2014.

After remaining stable at around 2.0% of GDP for a long period, the current account deficit started to trend upwards at the end of 2012 and reached 3.6% of GDP in September, largely due to a decline in the trade surplus. However, the depreciation of the exchange rate and better oil balance outturns should pave the way for some improvement of the trade balance and, therefore, of the current account deficit. We expect the current account deficit to close this year at 3.6% of GDP and then to recede to around 3.1% next year.

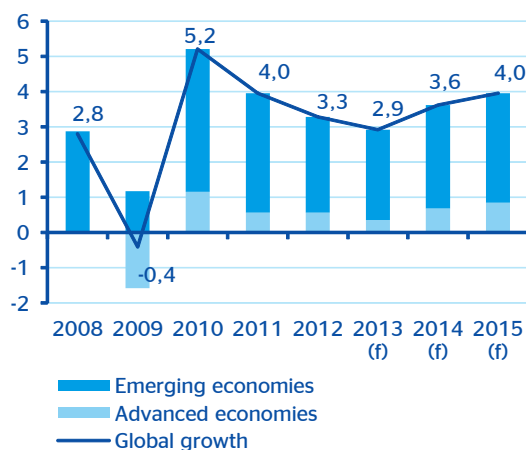
2. A slow global recovery with downward risks

The economic cycle is improving, above all in advanced economies, although it is still far from a strong recovery

Two general features have characterized the global economic scenario in the last quarter. First, the confidence indicators of businesses and the volatility of the financial markets have continued to reflect the low probability of tail risk events, those that could be disruptive for the global situation. Thus, economic recovery is picking up speed and there is less risk of it derailing. However, some events have contributed to a scenario of a feeble global recovery within a one or two-year horizon. They are events with a current impact (the partial closure of the U.S. government) but also a future one (the tightening of financial conditions due to the expected end of the exceptional support of monetary policy).

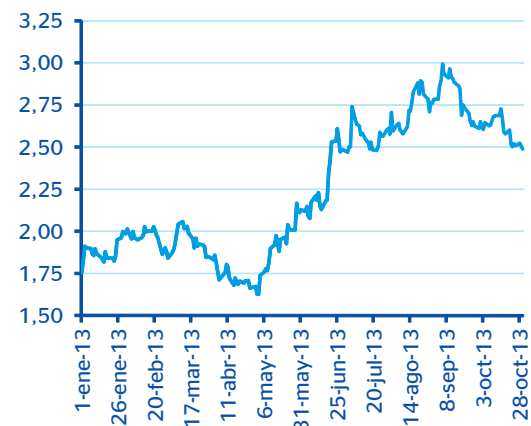
Overall, we have revised down by 0.2 p.p. the expected growth for the global economy in 2013 to 2.9% and in 2014 to 3.6%. The revision of 2013 growth is due to the worse figures recorded in the U.S. and the slowdown in some of the countries in developing Asia, which are also affected by financial turbulence in the wake of the markets' expectation of an imminent tapering of QE following the Fed's announcement last May. Growth in 2014 has also been revised down to 3.6%. The emerging markets are behind this downward revision (except for China, where we stick to our forecasts), although they will continue to be the biggest contributors to global growth (Chart 1). The higher rate of global growth in 2014 is backed by an acceleration of the economy in all geographical areas, except for Asia, where growth is expected to remain at the same levels.

Chart 1
Global growth & contribution by regions



Source: BBVA Research and IMF

Chart 2
U.S.: Yield on 10-year U.S. government debt



Source: BBVA Research and IMF

The tension in the financial markets caused by the announcement of the Fed's tapering eases, providing a boost not only in the U.S.

The Fed surprised the markets when in September it decided not to start the process of tapering its quantitative easing (QE) program. By delaying the start, it underpinned the nature of the program as data-dependent, in addition to the effect from the uncertainty about the fiscal deficit and debt ceiling.

The clarifications on the process of tapering, which the Fed's members are preparing in the light of the unexpected reaction of the market to their first announcement and its delay until (possibly) the start of 2014, have reduced the risks of the recovery derailing.

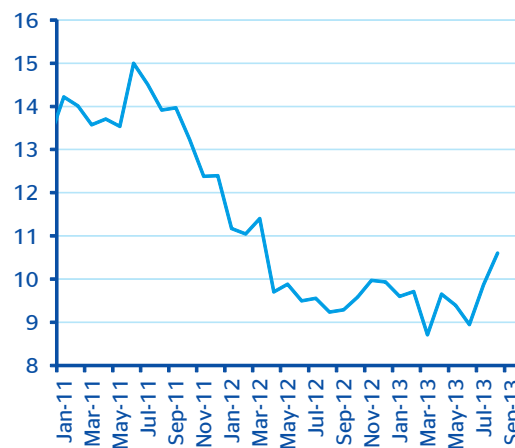
Much of the rise in long-term interest rates recorded since May has been reversed (Chart 2). The markets do not now anticipate rises in Fed Fund rates until 2015. In addition, volatility and financial tensions have eased at a global level, particularly in emerging markets in Asia and Latin America, which are also affected by a reduction in capital inflows, so that fears of a "sudden stop" of funding for emerging markets has gradually been losing intensity. At the same time, emerging markets show indications of a recovery in confidence, after the check in the middle of the year.

In any event, tapering will end up arriving, and change the global scenario of liquidity injections that resulted in indiscriminate flows to emerging markets. The impact of tapering, once it is effectively underway, will be a greater discrimination in flows toward emerging markets according to the fundamentals of each of them.

China once more stimulates its growth, but in a more limited fashion

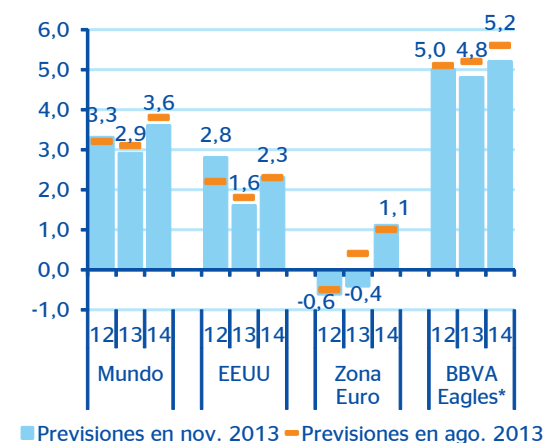
In China, the doubts at the start of the year on the possibility of a sharp adjustment in its economy have also dissipated, at least in the short term. The economy has maintained a high rate of growth, and the most recent data (third quarter) suggest that GDP is picking up (Chart 3). Better than expected figures triggered an upward revision, from 7.6% to 7.7%, in our 2013 GDP growth forecast. Even so, doubts remain on the sustainability of growth in the medium and long term, as the recent upturn in growth has been the result of the improvement in foreign demand, but also of one-off measures of tax policy and public spending with a renewed use of credit.

Chart 3
China: index of industrial output (y/y %)



Source: BBVA Research and Haver

Chart 4
GDP growth in emerging markets (q/q %, seasonally corrected)



EAGLES is the group of emerging economies with the highest contributions to global GDP over the next 10 years. Group consists of China, India, Indonesia, Brazil, Russia, Korea, Turkey, Mexico and Taiwan
Source: BBVA Research and IMF

The perception of Europe improves and the most extreme risks have dissipated

In Europe the forecasts have been confirmed and the economic situation has continued to improve, to the point that the Eurozone emerged from the recession with growth of 0.3% in the second quarter of 2013, after 6 quarters in recession. The reading of the data is positive in two respects: the recent recovery is based on an improvement in domestic demand and also extends to the periphery, contributing to eliminate the systemic risks characterizing previous quarters. The recovery of activity has been helped by a reduction in financial tensions in the area and by a relaxation (de facto) of the more short-term targets of fiscal consolidation, implicitly tolerated by the European authorities.

GDP growth in this part of the year formed part of our scenario, and there has been no additional element to make us change our expectations of a weak recovery. In 2013 Europe's GDP will fall by 0.4% and grow by 1.1% in 2014. The weak recovery is consistent with the deleveraging process underway in the private sector in some economies in the area and the financial fragmentation that is still in place, which affects the capacity of bank credit supply. The next few months will be decisive in making progress toward banking union, with the entry into operation of a single supervisor, the ECB, and the definition of the mechanisms for bank resolution, the model for implementing which is still under discussion.

The fiscal agreement in the U.S. has been another patch that does not address long-term fiscal sustainability and does not prevent a contractive short-term impact

The fiscal agreement reached on October 16 is a simple extension of the current situation, as it only includes that the Government will have finance until January, while the new debt ceiling will be reached in February.

Intense negotiations are drawing near on cuts in discretionary expenditure and increases in taxation. The U.S. thus once more has to address an uncertain process that it has already gone through in these months on previous occasions, and this can only have negative consequences. Most likely, the partial closure of government for 16 days has had a relatively marginal direct effect on GDP for the quarter, perhaps a few tenths of a pp. However, the threat of this process continuing may have an additional impact. In any event, the situation in which economic policies push in opposing directions will continue, with a loose monetary policy that will continue to be so for a long period, and an unnecessarily contractive fiscal policy in the short term. Thus the U.S. public deficit will have fallen without market pressure (unlike in Europe) from 6.8% in 2012 to 4.0% in 2013, which can be considered a drain of 1.3 percentage points of GDP growth in 2013. And the long-term challenges for the fiscal sustainability of the U.S. economy have not been tackled. In our central scenario, a less pronounced fiscal adjustment in 2014 and the contagion of recovery will allow a rise in growth in the U.S., from 1.6% estimated for 2013 to 2.3% in 2014 (Chart 4).

Risks in the forecast: downward bias but a priori with less probability and lower impact

The risks to the moderate recovery scenario detailed above have been reduced. This does not take away the fact that the balance of risks continues to be downward. It is worth pointing out first, due to its nature, the possibility of a "disorderly exit" from the Fed's QE, which could generate an excessive increase in interest rates (in the U.S. and in other countries). Financial conditions that are too tight for the rest of the world could halt a global recovery if it is not especially dynamic, particularly in the Eurozone.

Second, another risk factor is the possible adjustment in growth in China and in other emerging

markets. This could be the result of idiosyncratic factors, but also of dilemmas that domestic policies have to address in a less favorable global financial environment.

Lastly, the resurgence of the euro crisis is a globally relevant risk. The authorities have to support the positive perception of the markets with decisive progress to strengthen monetary union, in particular banking union. In all, there are a number of elements that could lead the better perception to change: from the lack of necessary reforms to unexpected results in the review of the bank balance sheets and the stress tests, which are needed for the implementation of a single banking supervisor, the ECB. Finally, as has been shown by past experience, disagreements on the definition of policies that strengthen the euro area, in this case bank resolution mechanisms, may result in tensions and volatility in the financial markets.

3. Brazil: the economy swings to the rhythm of the exchange rate

Financial tensions receded partially and the pressures over the exchange rate eased somewhat as the Fed delayed tapering

As noted above, the financial stress that followed Ben Bernanke's speech on May 23 eased partially over the last few months, especially from August to the end of October. This had to do with the perception that the withdrawing of the monetary stimuli by the U.S. Federal Reserve would not be as imminent as previously expected.

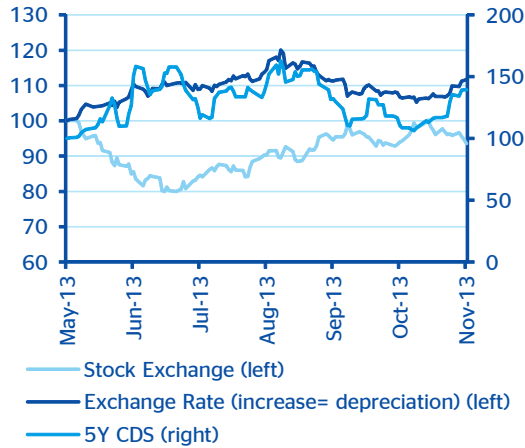
In Brazil, the postponement of the Fed's tapering, as well as more positive news from China, were received with some relief by local financial markets.

From August to the end of October, the Sao Paulo Stock Exchange Index recovered most of the 20% loss it had accumulated from Bernanke's speech to July. Similarly, the 5-year sovereign declined to around 150bp at the end of October after having jumped from 130bp in May to 210bp at the beginning of July. The exchange rate, which depreciated from 2.05 when the tapering talks started at the end of May to 2.45 three months later, converged to around 2.20 at the end of October (see Chart 5).

BBVA's Financial Stress Index depicts very well the degree of tension in domestic financial markets in the last months (see Chart 6). It shows that recent financial tensions peaked in June and receded until October. This index also reveals that although noticeable, recent financial tensions were not as sharp as those seen in the second quarter of 2012, when slow domestic growth, high inflation and increasing uncertainty regarding Brazil's economic policies triggered a deterioration of the prevailing global optimism toward the country (for more details on that period, check our [2Q12 Brazil Economic Outlook](#)). It also makes clear that the recent turbulence caused by the possibility of the Fed withdrawing monetary stimuli was much less marked than the turbulences that followed Lehman Brothers' collapse.

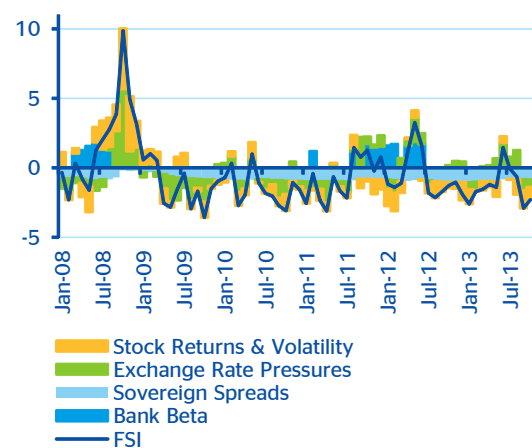
More recently, at the beginning of the November, positive economic outturns in the U.S. led markets to -once again- price in an early tapering. Not surprisingly, this triggered some turbulence in domestic financial markets, which offset part of the improvement observed from July/August until the end of October. More precisely, equity markets lost around 3% in first days of November, the 5-year CDS jumped to more than 180bp and the exchange rate went back to above 2.30 (see Chart 5). Concerns about Brazil's fiscal accounts and the risks of a sovereign rating downgrade also supported this recent worsening of financial markets' mood (see sections below for more details on these issues).

Chart 5
Sao Paulo stock exchange, 5-year sovereign CDS, exchange rate (Index May 23 = 100)



Source: Bloomberg and DataStream

Chart 6
BBVA's Financial Stress Index¹



Source: BBVA Research

The exchange rate is fated to a depreciation

Our Financial Index Stress also indicates that the main driver of the recent bout of tension was the stress in foreign exchange markets. As we discuss below, this stress increased the uncertainty regarding inflation, monetary policy, external and fiscal accounts... and, therefore, the overall performance of the economy.

The fear that a sharp depreciation would drive inflation up and then force the Central Bank of Brazil (BCB) to prolong considerably its ongoing monetary tightening cycle, which would impose another barrier to domestic growth during an election year, compelled the monetary authority to intervene in exchange markets. More precisely, at the end of August, when the Brazilian real (BRL) reached 2.45, almost 20% weaker than the rate prevailing at the end of May, the BCB announced a daily intervention program to offer "hedge to economic agents and liquidity to exchange markets". According to this program, from August 23 to the end of the year, the monetary authority would offer 500 million dollars every day from Monday to Thursday through currency swaps and up to 1.0 billion dollars every Friday through spot buy-back operations. In the announcement, the BCB also communicated that additional intervention could be adopted if deemed necessary. It is worth noting that this announcement followed a series of measures to unwind the capital controls imposed in the last few years (see our [2Q13 Brazil Economic Outlook](#) for more details on these measures).

Following the announcement of the daily intervention program, and signs that the Fed would not start to taper as soon as previously expected, the BRL gradually started to strength, converging to 2.20 in October and then to 2.30 at the beginning of November. In addition, the volatility in exchange markets eased somewhat in October (see Chart 7).

Overall, the BRL is currently around 13% weaker than it was before Bernanke's speech and almost 20% more depreciated than the average in 2012. In addition, exchange rate markets remain relatively turbulent, in spite of the recent reduction in volatility in October.

In our view, the depreciation at the beginning of November, as well as the ongoing tightening of domestic monetary policy and the BCB's dollar intervention program, give some room for the BRL to remain relatively stable or even to appreciate slightly in the short term.

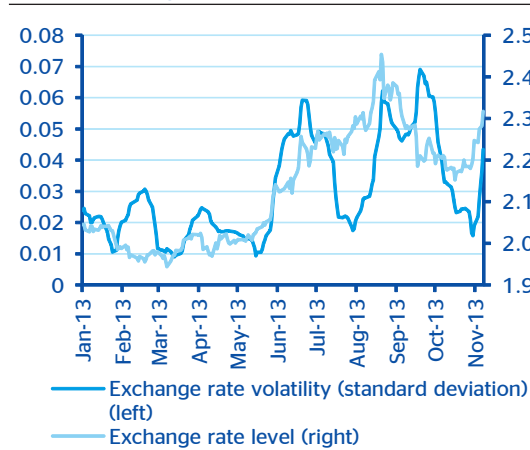
¹: Banking Beta: correlation between banking stocks and overall stock market (only recorded when correlation is bigger than one and during a bear market); Sovereign Spreads: EMBI; Exchange rate pressures: measure FX depreciation and/or drop in foreign reserves; Stock returns: with a minus sign to denote stress; Stock price volatility: from a GARCH model of stock returns. Each component of the index expressed in number of standard deviations around its mean. FSI is the sum of all five components.

Nonetheless, we expect the BRL to continue to depreciate in the medium and long term. In 2014, we expect it to be around 2.35 on average (see Chart 8). This would mean a 8% nominal depreciation compared to 2013.

Two main factors should back this depreciation in 2014 and further ahead: eventual steps towards the tapering in the U.S. and Brazil's need to recover part of the competitiveness lost in recent years. We expect the withdrawing of the monetary stimuli in the U.S. to –sooner or later– be implemented and take some strength off the BRL. In other words, we do not think that the effect of tapering is completely priced in (the exchange rate depreciation at the beginning of November supports this view). Moreover, we see an exchange rate depreciation as the most likely way for the country to get out of the competitiveness problem it faces, given the lack of prospects for the adoption of reforms and a significant increase in productivity.

Chart 7

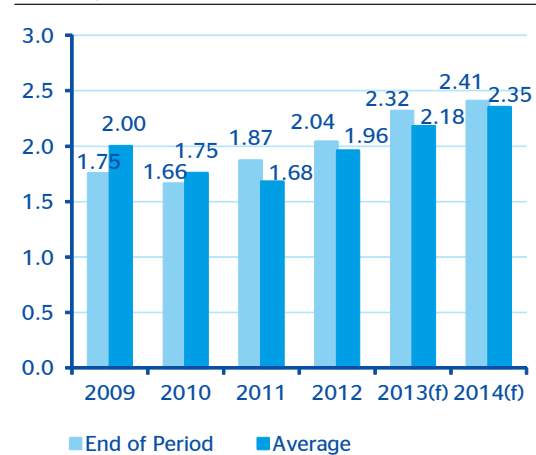
Exchange rate, BRL per USD: level and volatility (30-day moving standard deviation)



Source: Bloomberg and DataStream

Chart 8

Exchange rate, BRL per USD



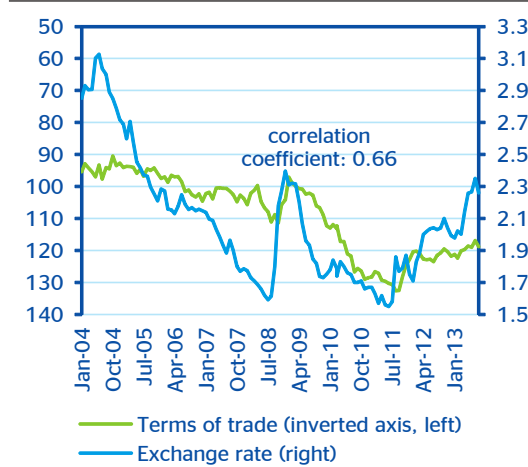
Source: BBVA Research

Taking into account BBVA Research's commodity price forecasts (see our [3Q13 Latin America Economic Outlook](#)), we expect Brazil's terms of trade to continue to deteriorate in 2014. More precisely, we expect it to decline 4% on average compared to 2013 and 8% compared to 2012. As Chart 9 shows, there is a significant correlation between terms of trade and the exchange rate. Therefore, our commodity price forecasts also back the view that the BRL will depreciate further in 2014.

Finally, the expected end of both the dollar purchase program and the monetary tightening cycle should also support a relatively weaker BRL.

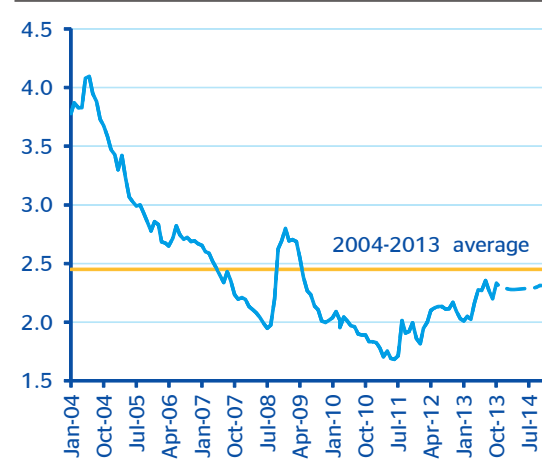
The expected nominal depreciation ahead should be enough to guarantee a depreciation of the currency also in real terms (i.e. to offset the impact of the inflation differential between Brazil and the U.S.). This should help bring the bilateral exchange rate closer to historical averages and equilibrium values. Chart 10 shows that the real exchange rate averaged 2.45 in the last ten years, a value that is not far away from what we estimate as the equilibrium (or long-term) rate. The same chart also shows that the real exchange rate has been getting closer to this average level since mid-2011, when the overvaluation reached its maximum level. We expect this trend to continue in the years ahead.

Chart 9
Terms of trade and exchange rate (BRL per USD)



Source: IPEADATA and BBVA Research

Chart 10
Real exchange rate, BRL per USD (October 2013 prices, deflated using IPCA and US CPI)



Source: IPEADATA and BBVA Research

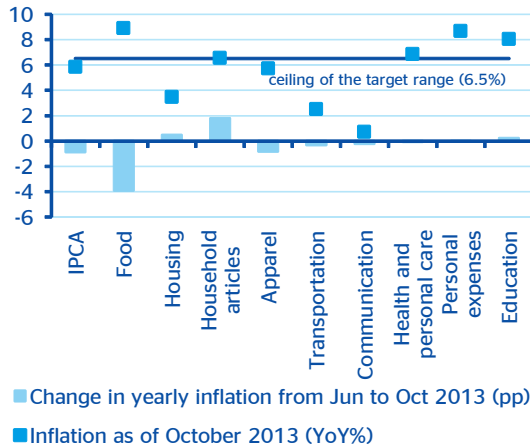
We expect not only the recent depreciation trend to continue ahead but also the volatility in exchange markets to remain in place given the unusual uncertainties hovering around global markets, in particular those related to the U.S. tapering. Local presidential elections, to be held in October 2014, and the risks of a sovereign downgrade should also be a source of uncertainties and therefore of volatility in exchange rate markets. Therefore, our baseline scenario for the BRL faces significant risks. The economy –and therefore our forecasts– are naturally subject to unexpected swings in the exchange rate.

The recent moderation in domestic prices was neither widespread nor sufficient to bring inflation down significantly. Looking ahead, a weaker currency, among other factors, will leave no room for inflation to moderate further

After trending down since June, when it reached 6.70%, yearly inflation stood at 5.84% in October. In the same period, food inflation declined from 12.8% to 8.9%. As the weight of food goods in the IPCA index is around 24%, the 390bp decline in this segment by itself fully explains the 86bp drop in headline inflation. Lower commodity prices in global markets, more positive supply conditions in domestic markets and tax cuts were the main drivers of the moderation in food prices, and therefore of headline inflation.

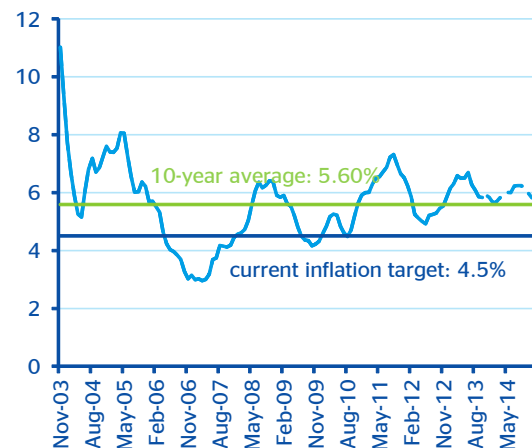
With the clear exception of the food group, and perhaps of apparel goods, inflation increased or remained broadly stable from June to October in the other groups of products (see Chart 11). Therefore, the recent decline in inflation was clearly not widespread.

Chart 11
Yearly inflation: IPCA and main groups of products, variation since June and current levels



Source: BCB and BBVA Research

Chart 12
Yearly inflation, IPCA (%)



Source: BCB and BBVA Research

Another important source of relief for inflation has been administered prices, which have a 23% weight in the IPCA index. The strategic management of prices that the government has under its control drove administered-price inflation down to less than 2.0% since February. In October, inflation in this segment reached 1.0%, the lowest figure in more than twenty years.

Low administered-price inflation contrasts sharply with high figures in services (8.7% as of October), non-tradables (8.2%), and the average of the main core measures (6.3%). Chart 11 also shows that inflation remains above the ceiling of the target range (6.5%) in five out of nine groups of products. Finally, and more importantly, headline inflation remains well above the 4.5% target.

Looking forward, the recent exchange rate depreciation and the expected adjustment in fuel prices will drive inflation up at the end of the year. In our opinion, therefore, inflation's downward trend is over. After declining continuously since June, yearly inflation should increase to 5.9% in November and then close the year at 5.8%.

In spite of the ongoing tightening of monetary conditions, we see no room for inflation to moderate significantly next year. We expect inflation to continue to fluctuate around 6.0% and close 2014 around 5.8% (see Chart 12 and forecast tables at the end of this report).

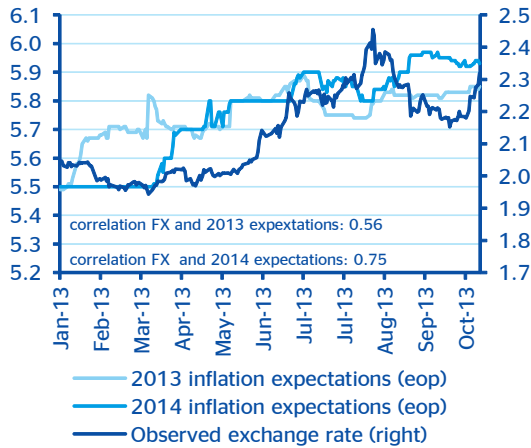
The weakening of the BRL is one of the main factors to understand why inflation will remain under pressure in 2014. The 20% exchange rate depreciation that we expect will accumulate through 2013 and 2014 (see the section above for more details on our BRL forecasts) should drive headline inflation up by at least one percentage point.

The weaker currency is certainly helping to keep inflation expectations at high levels. The significant correlation between recent exchange rate movements and the market's inflation expectations for 2014 support this view (see Chart 13).

Inflation expectations for 2014 are not only being fueled by the depreciation of the BRL. They are also being driven by the perception that the BCB is not fully committed to making inflation converge to 4.5% anytime soon, the view that fiscal policy will not be supportive and the fact that there is practically no room for administered-price inflation to be as low in 2014 as it was in 2013.

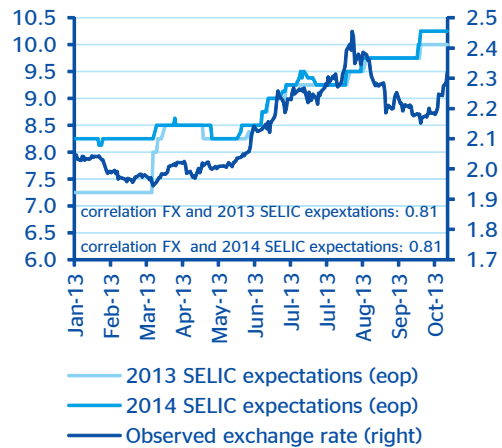
Finally, it is worth noting that high inflation expectations are to some extent partially self-fulfilling, i.e. the mere fact that agents expect inflation to increase or to remain high contributes to the materialization of such scenarios and, therefore, should be a source of concern for the monetary authority.

Chart 13
Observed exchange rate and inflation expectations for the end of 2013 and 2014



Source: BCB and BBVA Research

Chart 14
Observed exchange rate and SELIC expectations for the end of 2013 and 2014

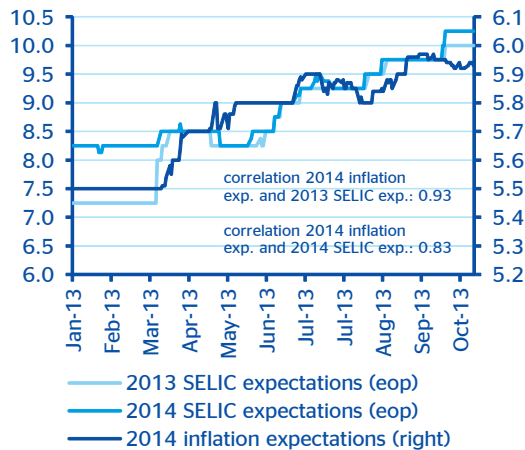


Source: BCB and BBVA Research

The BCB extends the monetary tightening cycle as the currency weakens and inflation remains resilient

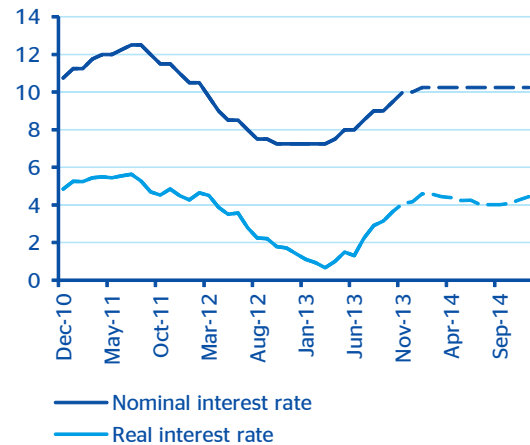
The depreciation of the exchange rate and the resilience of inflation (observed and, especially, expectations) are forcing the BCB to adopt a tighter than expected monetary policy.

Chart 15
Inflation expectations for the end of 2014 and SELIC expectations for the end of 2013 and 2014



Source: BCB and BBVA Research

Chart 16
SELIC interest rate, nominal and real (%)



Source: BCB and BBVA Research

Therefore, the monetary authority maintained the 50bp adjustment pace in October, bringing the SELIC interest rate to 9.50%, 225bp higher than in April, when the adjustment started. In addition, the BCB provided no signs of the end of the ongoing tightening cycle, suggesting that the SELIC will be increased once more by 50bp at the last meeting of the year, at the end of November.

Inflation and exchange rate pressures, as well as the recent BCB signals, led markets to continue to adjust their SELIC forecasts for both 2013 and 2014 up (see Charts 14 and 15). Similarly, we revised our forecasts for the end of this year and the next year to 10.0% and 10.25% from 9.75% and 9.75% three months ago. Therefore, we expect the BCB to deliver a final 25bp hike in January after bringing the SELIC to 10.0% at the end of this year (see Chart 16).

The upward bias we see in our inflation and exchange rate forecasts add an upward bias also in our SELIC expectations.

In any case, it is highly unlikely that the BCB will extend the ongoing tightening cycle much longer because, in our opinion, the monetary authority and especially the government are not willing to end their mandates with an interest rate higher than 10.75%, which was the prevailing rate when both started their terms four years ago.

The relative weakness of domestic activity and the lack of a strong commitment to the goal of bringing inflation down to the 4.5% target (which seems to be replaced by the goal “to set inflation into decline and ensure that this trend persists in the upcoming year” in the BCB’s own words) reinforce the perception that the ongoing tightening cycle is getting close to its end.

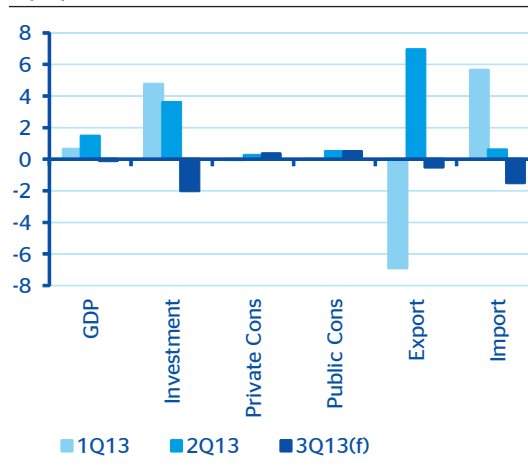
We expect GDP to grow 2.6% in 2013 and 2.8% in 2014, as investment expansion will not be strong enough to offset the moderation in consumption

After surprising sharply to the downside by growing only 0.6% QoQ in 1Q13, GDP came in much higher than forecasted, at 1.5% QoQ in 2Q13. In both periods, the expansion of investment was fundamental to support economic activity growth (see Chart 17).

Investment expanded by 4.7% QoQ and 3.6% QoQ in 1Q13 and 2Q13, respectively. This dynamism contrasted with the poor performance of private consumption (0.0% QoQ and 0.2% QoQ in 1Q13 and 2Q13), which accounts for almost two thirds of total GDP.

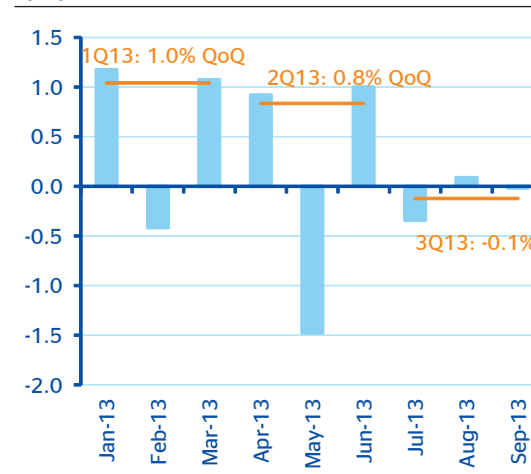
On the one hand, the expansion of investment in the first half of the year followed the series of incentives introduced by the government previously, lower industrial inventories, some improvement in the global environment at the beginning of the year and the fading of some negative shocks that hit the economy over 2012. On the other hand, consumption moderation was driven by some factors that we see as structural, such as the slowdown in credit and labor markets, and also by the particularly high inflation observed in the period.

Chart 17
GDP and demand components, quarterly figures (QoQ %)



Source: BCB and BBVA Research

Chart 18
Economic activity indicator, IBC-Br (MoM % and QoQ %)



Source: BCB and BBVA Research

The financial volatility observed in the months that followed the first talks of tapering at the end of May was partly responsible for driving GDP growth down in 3Q13.

We expect GDP to have declined 0.1% QoQ in the period. The IBC-Br, the BCB's monthly activity indicator that works as a proxy for GDP, supports our view that GDP will contract in the third quarter (see Chart 18). Other high-frequency indicators actually suggest that the contraction can be more significant than we are predicting.

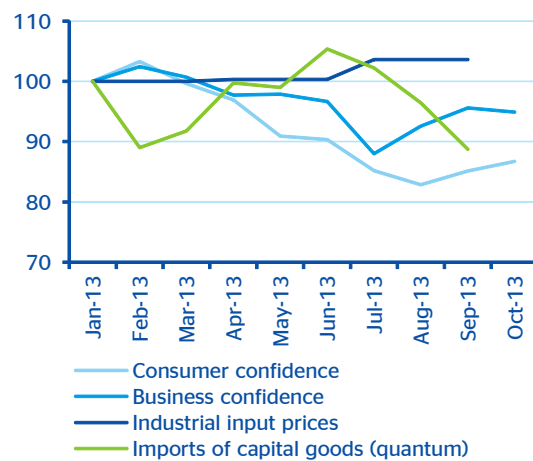
The recent volatility seen in financial markets and the depreciation of the exchange rate hit economic activity in the last months by contributing to drive confidence down, increase interest rates, drive production costs up and put off investment decisions (see Chart 19).

In this environment, we expect investment to have declined by around 2.0% QoQ in 3Q13 (see Chart 17). The contraction in imports of capital goods (see Chart 19) supports this forecast.

In contrast, private consumption should gain some momentum and grow around 0.4% QoQ due to the reduction in inflation and the relative resilience of labor markets. Both the 3.2% QoQ expansion in core retail sales and the 0.2% QoQ increase in broad retail sales (which include auto sales) back our estimate.

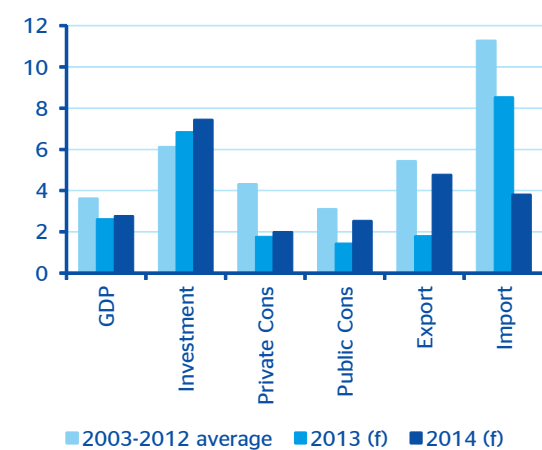
Looking forward, we expect quarterly growth to come back into positive territory again in 4Q13 by growing around 0.4% QoQ. However, the new bout of turbulence at the beginning of November and the preliminary activity indicators suggest that economic activity in 4Q13 did not get off to a good start, which adds a downside bias to this forecast.

Chart 19
Business and consumer confidence, industrial input prices and capital goods imports (Index: Jan/13 = 100)



Source: CNI, IPEADATA and BBVA Research

Chart 20
GDP and demand components, annual figures (%)



Source: BCB and BBVA Research

All things considered, we expect 2013 GDP to grow 2.6%, which represents a recovery compared to 2012, when growth reached only 0.9%, but falls short of the average for the last ten years, which stands at 3.6% (see Chart 20). Our current forecast is somewhat higher than the 2.3% figure we held three months ago. This upward adjustment is mostly due to the upside surprise in 2Q13 GDP (observed: 1.5% QoQ; forecast: 0.6% QoQ).

In 2014, we expect the better performance of the world economy, a somewhat more growth-supportive fiscal policy and a more robust expansion in investment (due to, among other factors, the recent wave of concessions of infrastructure projects to the private sector) to all drive GDP growth slightly up to 2.8%. This estimate is broadly the same one we had three months ago. Nonetheless, risks are to the downside because electoral uncertainties can end up affecting investment decisions more heavily than we are discounting, and a setback in global growth would imply lower than expected exports.

As we have been discussing for some time now (see our previous [Brazil Economic Outlook](#), for example), there is no room for private consumption to maintain the vigor exhibited in the last decade. This is due to a natural moderation in the credit and labor markets. On the one hand, higher indebtedness limits credit expansion and, on the other, less favorable demographics and already very low unemployment constrain the potential of labor markets to support demand.

Therefore, investment or net exports should accelerate strongly ahead to offset the impact of less supportive consumption and maintain growth close to 3.5%. As Chart 20 shows, we do expect net exports and investment to contribute more to growth in the future. However, the expected acceleration will hardly be enough to offset the deceleration in consumption.

The weight of total consumption in GDP, around 83%, is much more significant than the weight of the other demand components (investment 19%, exports 13%, imports (-)15%), making this change of drivers more difficult. Moreover, there are still major barriers that prevent investment and exports from contributing more significantly to growth. Among these barriers, we highlight two: i) the lack of predictability and the interventionist tone of public policies; and ii) the lack of competitiveness of the economy (in particular of the manufacturing sector).

As there are no clear prospects of the barriers that currently constrain the evolution of both investment and exports being withdrawn, the economy continues fated to grow no more than 3.0%.

Rising concerns about fiscal accounts leave little room for fiscal policy to support growth ahead

The decisions by Standard and Poor's and Moody's to downgrade Brazil's rating outlook, announced respectively in June and October, are two symptoms of the increasing worries regarding the evolution of public accounts in Brazil.

In our view, these concerns are justified. They reflect the deterioration in most fiscal indicators (see Chart 21). Since the end of 2010, the gross public debt increased more than 5p.p. and reached 58.8% of GDP, a value that is well above the average for other similar emerging economies.

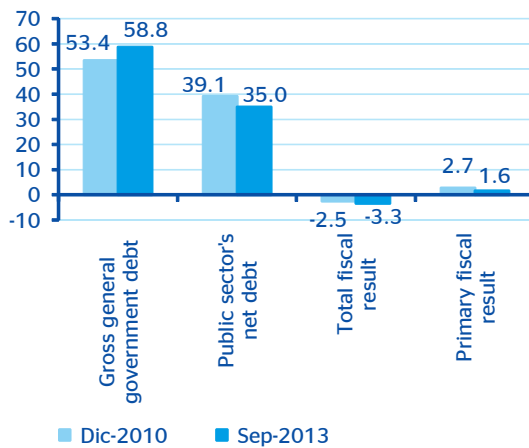
The public sector's net debt, a fiscal indicator widely used in Brazil, declined almost 4p.p. and reached 35% of GDP in September 2013.

These figures contrast with those shown by the general government's gross debt. The differences are due to the fact that the former is net of general government assets and incorporates the BCB and public enterprises². Credits from the government to public banks, such as the BNDES, for example, reduce the net debt and have no direct impact on the gross indicator. An increase in the value of the international reserves due to a depreciation of the BRL, for example, also reduces the net debt without altering the general government's gross debt. In practice, both the loans to the BNDES and higher international reserves have helped to reduce the net debt.

Other fiscal indicators confirm the deterioration suggested by the gross debt indicator, the one we think is more useful for analyzing solvency issues. The primary result has been declining lately and is now around 1.6% of GDP. This figure is well below both the 2.7% level as of December of 2010 and the 3.2% average between 2003 and 2012. Moreover, the total fiscal result, which includes interest payments, is now around -3.3% of GDP, the highest deficit since the Lehman Brothers crisis hit the country in 2009.

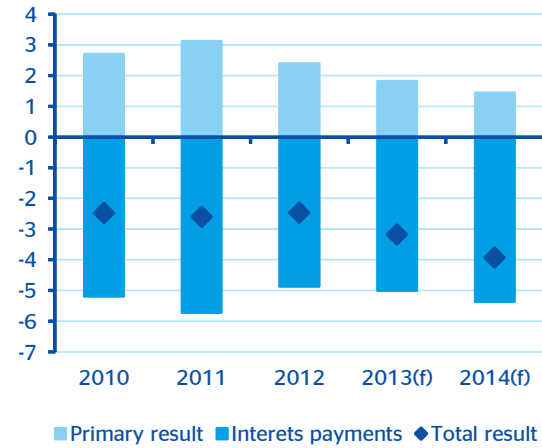
2: By definition, the BCB and the public enterprises are included within the "public sector" but are not considered part of the "general government".

Chart 21
Fiscal indicators (% GDP)



Public sector includes federal and regional governments, the BCB and public enterprises. The general government excludes the BCB and public enterprises. Total and primary results are the values accumulated in the last 12 months
Source: BCB

Chart 22
Fiscal accounts (% GDP)



Source: BCB and BBVA Research

These negative fiscal trends follow the government's decision to use quasi-fiscal and fiscal policies to try to boost growth. Moreover, the recent need to adjust the SELIC rate upwards triggered an increase in the government's borrowing costs, a bill that is particularly significant in Brazil (generally between 5% and 6% of GDP).

Even though the threats of a sovereign downgrade forced some officials, including the President Dilma, to recognize the need to introduce changes in the management of fiscal and quasi-fiscal policies, because of the imminence of national and regional elections (to be held in October 2014) it is unlikely that these changes will be implemented in the short-term.

At the same time, rising concerns about the fiscal situation, as well as inflation worries, leave little room for fiscal policy to provide extra support to economic activity in 2014.

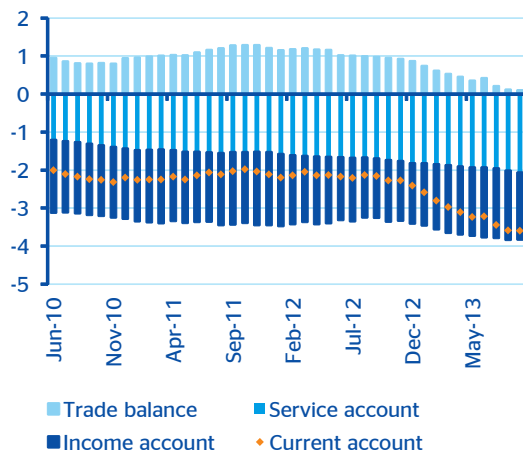
We expect the primary surplus to fall short of official targets and to reach 1.8% and 1.4% of GDP in 2013 and 2014, respectively. This, together with increasing interest payments, should drive the fiscal deficit to 3.2% this year and almost 4.0% in 2014 (see Chart 22).

All in all, we think the government will try to make fiscal policy more growth-supportive in the months ahead and at the same time avoid a credit downgrade, perhaps by committing to a tighter fiscal policy after the elections.

We expect the current account deficit to peak in 2014.

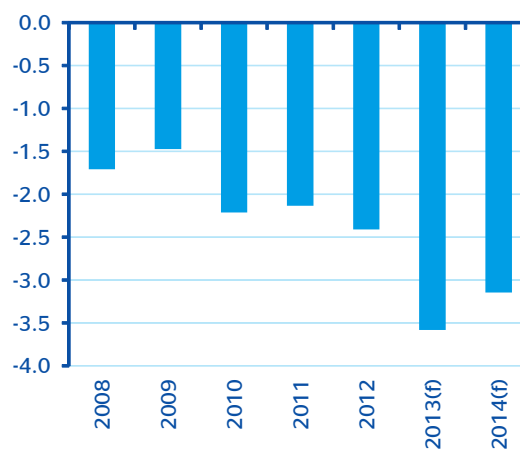
After remaining stable at around 2.0% of GDP for a long period, the current account deficit started to trend upwards at the end of 2012 and reached 3.6% of GDP in September. Nearly two thirds of this deterioration is a consequence of a decline in the trade surplus, while both the income and service accounts are responsible for the remaining one third (see Chart 23).

Chart 23
Current account by components (% GDP)



Source: BCB

Chart 24
Current account (% GDP)



Source: BCB and BBVA Research

The trade balance surplus declined from 0.9% of GDP in December 2012 to 0.1% in September 2013. According to our calculations, 0.5 p.p. of this decline was due to a worsening in the oil balance, which was impacted by the late recording of the oil imports that occurred in the second half of 2012 and by the 3% drop in domestic oil production this year.

Apart from these problems in the oil sector, the trade balance was also impacted by the 2% decline in Brazil's terms of trade and the competitiveness problems faced by the manufacturing sector.

Looking ahead, we expect the depreciation of the exchange rate and better oil balance outturns to pave the way for some improvement of the trade balance and, therefore, of the current account deficit. More precisely, we expect the current account deficit to close this year at close to current levels -3.6% of GDP- and then to recede to around 3.1% next year (see Chart 24).

We think that, given its need for external savings, it is natural for an emerging country such as Brazil to exhibit current account deficits of around 3% or 4% of GDP. Moreover, as we noted above, we expect part of the recent deterioration to be temporary. Finally, Brazil has very significant international reserves that could help the country face adverse scenarios. However, we view with some concern the recent evolution of external accounts in Brazil, especially considering the risks related to the eventual tapering of monetary liquidity by the Fed.

Box. The drivers of Brazil's current account

To understand the performance of Brazil's current account in recent years and to get some insights into its evolution in the future, we use an empirical model that builds on the basic macroeconomic identity between net domestic savings and net external savings. The model breaks down current account movements into series of relevant variables that can potentially explain these movements (demographics, investment, per capita GDP, fiscal balance, private credit, trade-related variables, real exchange rate and net international investment position, or NIIP), and, in parallel, into structural (medium and long-term) and cyclical (short-term) components.

In a first stage, a panel model with 72 countries and for the 1980-2012 period is estimated by using Feasible Generalized Least Squares (FGLS). Long, medium and short-term coefficients for each variable are obtained. Medium and short-term coefficients are then used as a priori information in a Brazilian-specific time series Bayesian model to get Brazilian-specific medium and short-term coefficients. Long-term coefficients generated in the first stage are not re-estimated³.

According to this model, the sharp deterioration of the current account in recent years was almost entirely driven by short-term factors, especially the appreciation of the real exchange rate. The structural current account remained broadly stable, close to -1.0% of GDP, as the pressures coming from the worsening of the oil balance, the higher degree of openness of the country to the global economy and the relative expansion in investment,

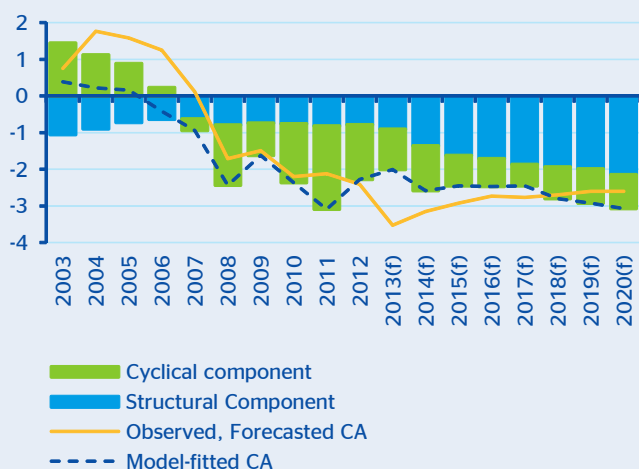
among others, were offset by the structural improvement of public accounts.

Based on our forecasts for the Brazilian economy (i.e. on our assumptions for the independent variables), the model shows that cyclical components should take some pressure off the current account in the future. The depreciation of the real exchange rate will play an important role here. However, as Charts 25 and 26 show, the easing of short-term pressures will be offset by a higher structural deficit, due to a structural deterioration of public accounts, some expansion in investment and slightly less favorable demographics (mostly an aging population), and the current account deficit will reach levels slightly below 3.0% in the future.

Therefore, while in the last decade the current account deteriorated due to short-term factors that reflected the robust growth of the economy, in the coming years the expected slowdown of the economy should prevent the external deficit from increasing further as a response to a higher structural deficit.

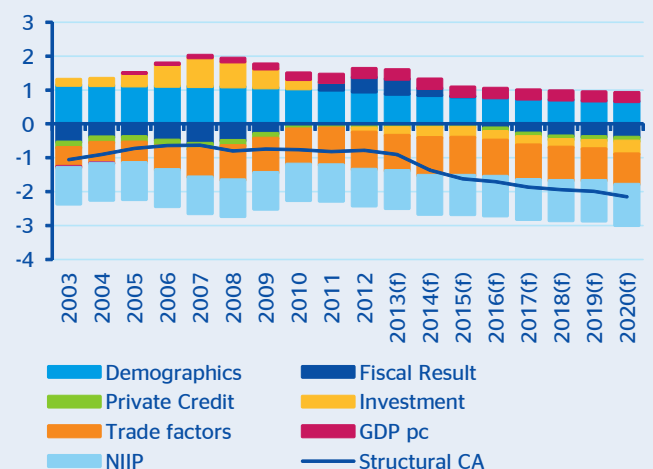
This exercise shows that the current account is particularly reactive to movements in the real exchange rate, the public sector's fiscal balance and the level of investment. Thus, the current account deficit could continue to increase instead of stabilizing around 3.0%, as the model suggests, if the exchange rate stops depreciating, if the fiscal balance worsens significantly in the future or if the investment-to-GDP ratio ends up being much higher than we expect (around 20%).

Chart 25
Current account: structural and cyclical components(% GDP)



Source: BBVA Research

Chart 26
Current account: structural sub-components (% GDP)



Source: BBVA Research

3: More details about this methodology can be obtained, for example, in the BBVA Research Economic Watch "An analysis of the evolution and the determinants of the current account in Spain (in Spanish)" or, alternatively, in "Thousands of models, one story: current account imbalances in the global economy", in the Journal of International Money and Finance, Vol. 31, p. 1319-1338, by Ca' Zorzi, Chidk and Dieppe (2012). The data used in this exercise has been taken from IMF, World Bank, UN, OECD, BBVA Research and "Real effective exchange rates for 178 countries: a new database" by Darvas (2012).

4. Tables

Table 1
Macro Forecasts Yearly

	2011	2012	2013	2014
GDP (% y/y)	2.7	0.9	2.6	2.8
Inflation (% y/y, eop)	6.5	5.8	5.8	5.8
Exchange Rate (vs. USD, eop)	1.87	2.04	2.32	2.41
Interest Rate (% eop)	11.00	7.25	10.00	10.25
Private Consumption (% y/y)	4.1	3.1	1.7	2.0
Government Consumption (% y/y)	1.9	3.2	1.4	2.5
Investment (% y/y)	4.8	-4.0	6.8	7.4
Fiscal Balance (% GDP)	-2.6	-2.5	-3.2	-3.9
Current Account (% GDP)	-2.1	-2.4	-3.6	-3.1

Source: BBVA Research

Table 2
Macro Forecasts Quarterly

	GDP (% y/y)	Inflation (% y/y)	Exchange Rate (vs. USD)	Interest Rate (%)
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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