

Brazil Economic Outlook

Second Quarter 2014
Economic Analysis

- **Brazil will grow by no more than 2.0% in both 2014 and 2015**, marking five years of subdued expansion. This feeble half-decade will contrast with the robust dynamism of the economy in the previous years.
- **Inflation is high and trending up.** It will close 2014 higher than 6.0% and will not decelerate significantly in 2015, even with economic policies moving into a less expansive stance.
- **The exchange rate appreciation is likely to be short-lived.** The deceleration of the Chinese economy, less supportive commodity prices, the US tapering, as well as some domestic factors, will favour a forthcoming depreciation of the Brazilian real.

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1. Summary

Average GDP growth between 2011 and 2015 will be of 1.9%, well-below the 3.6% pace of the previous decade. GDP growth reached 2.3% in 2013, somewhat higher than in 2012. Private consumption continued to lose steam last year in line with the structural exhaustion of credit and labour markets. In an environment marked by less support from economic policies, we expect the gradual deceleration of private consumption to continue weighing on domestic growth in 2014 and 2015. Moreover, neither exports nor investment is expected to exhibit a growth strong enough to offset the consumption deceleration. We expect GDP to grow by 2.0% in 2014 and 1.6% in 2015. These figures are lower than we expected three months ago, at 2.5% and 2.0% respectively, due to i) the deceleration of the Chinese economy; ii) activity moderation and exchange rate depreciation in Argentina; and iii) the uncertainty brought on by the risk of domestic energy rationing. Our annual GDP forecasts are in line with the view that the economy will go through some adjustment after the presidential elections that will be held later this year, in October.

Inflation: high and trending up. After closing 2013 at 5.9% YoY, inflation reached 6.3% YoY in April, which was mostly due to the upward trend in administered-price inflation. The pressure from higher market-set inflation is less significant, and highly concentrated on the tradable segment due to the exchange rate depreciation accumulated in the last twelve months. We expect administered-price inflation to continue accelerating over the remainder of the year and the exchange rate depreciation to continue fueling tradable inflation. Annual inflation should trend up furthermore over the second and third quarters, before easing to 6.2% at the end of 2014. In 2015, we expect inflation to average 5.8% YoY and to close the year at 5.6%. Our inflation forecasts are higher than three months ago, mainly because of the impact of the drought that hit the country at the beginning of 2014 on food and energy prices.

The end of the monetary tightening cycle will be confirmed soon, but a further adjustment of monetary conditions will be required no later than at the beginning of 2015. High and increasing inflation, together with resilient expectations, have forced the Central Bank of Brazil (BCB) to extend the tightening cycle until April and take the Selic to 11.0%. The recent signs suggest that the current tightening cycle is already over, and that from now on the monetary authority will assess the impact on inflation of the recent adjustment. To rein in inflation and to try to restore credibility in its economic policies, we expect the BCB to tighten monetary conditions further after the October elections, probably during the first year of the new government in 2015. The normalisation of the monetary conditions in the US should help to determine a new round of Selic adjustments.

We expect fiscal policy to become gradually less expansive. Following the change in the tone of monetary policy, from expansive in 2012 to contractionary at the beginning of 2014, we expect fiscal policy to go through a similar adjustment from now onwards, but especially after the elections, in order to fight inflation and other domestic imbalances. The public sector's primary surplus is expected to reach 1.5% in 2014, below the 1.9% target announced in February, and then to increase to 1.9% in 2015.

Exchange rate: short-term appreciation; long-term depreciation. The price of Brazilian assets increased sharply in the last three months, erasing the losses observed since the beginning of the tapering but not those accumulated over the past year. In particular, the Brazilian real gained 8.0% in the period. We regard this appreciation as short-lived, and expect it to depreciate and reach 2.5% and 2.6% at the end of 2014 and 2015 respectively, due to lower terms of trade, current account deficit/competitiveness problems and the normalisation of monetary conditions in the US.

Current account: expectations of improvement delayed to 2015. In line with recent data pointing to lower-than-expected exports due to the deceleration in China, the moderation in commodity prices and the lower demand for manufacturing products by Argentina, we now expect the current account deficit to remain practically stable and to close 2014 at 3.7%. A gradual improvement should start in 2015.

2. Global scenario marked by deceleration in China and Fed tapering

The global recovery continues, but the improvement is being hampered by the slowdown in the emerging markets

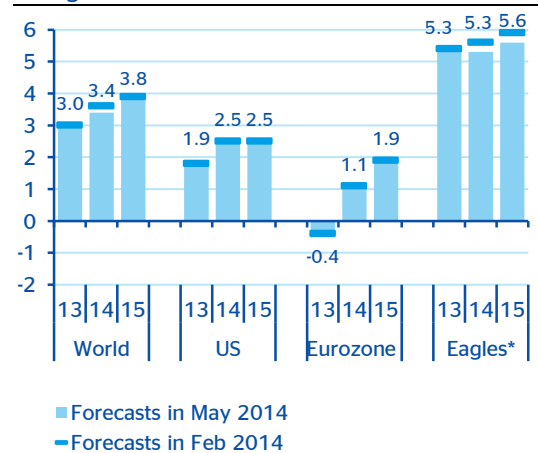
The global economic cycle remains robust at the start of 2014. According to our estimates, in the first quarter of 2014 global GDP has accelerated very slightly to around 0.8% QoQ, and we expect this pace to be maintained for the first part of the year. The driver of this sustained global recovery is the cyclical improvement in the developed markets (DMs), which has offset the deceleration in some emerging markets (Ems) in Asia and Latin America. Meanwhile, in the last few months the financial markets have performed very differently in the two regions and, within them, with more differentiation between the EMs. Capital flows, asset prices, interest rates and financial tension indicators have fundamentally performed in line with the outlook for rate hikes in the US, and, in the case of emerging economies, in line with expectations as to the intensity of China's deceleration and with idiosyncratic factors. So, in the last few months, and particularly in March and April, there has been a recovery in asset prices in emerging economies and a reduction in financial tensions, increased slightly at the beginning of 2014 (Figure 2.1).

Figure 2.1
BBVA Research Financial Tensions index in DMs and EMs



Source: BBVA Research

Figure 2.2
GDP growth forecasts (%)



EAGLEs is the group of emerging economies which will contribute most to world GDP in the next 10 years. It is formed by China, India, Indonesia, Brazil, Russia, Turkey and Mexico.
Source: IMF and BBVA Research

To sum up, our assessment of the global scenario has a downward bias compared with our valuation three months ago, which is reflected in the adjustments to our forecasts. After growing at 3.0% in 2013, global GDP will start to accelerate again in 2014 and 2015 at around 3.4% and 3.8% respectively (Figure 2.2), figures that demonstrate both the variations in growth expectations in diverse regions and the increased, although slight, contribution to global growth by the developed economies. Although there have been no significant changes in either the US or the eurozone, the downward pressures on our forecasts are above all visible in the EMs in 2014 and 2015, in both Asia and Latin America, in line with concerns over the slowing of the Chinese economy. In this context, there are still short- and medium-term downside risks to our forecast. Some factors with a global impact could make themselves felt more intensely than expected in the base scenario on a short-term time horizon, such as a tighter monetary policy on the part of the Fed, reduced global demand

stemming from economic slowdown in China or, with an (even) lower macroeconomic impact, geopolitical risks derived from Eastern Europe.

In the developed economies, the US overcomes the impact of an unusually cold winter and the perspectives for an improvement in the eurozone have strengthened

US GDP has maintained steady growth at the beginning of 2014 in spite of the impact of unusually adverse weather conditions, and the labour market has improved. As a result, the Fed has pressed ahead with the announced moderation in its balance-sheet expansion. In this context, we are expecting the Fed to complete its exit from the asset-purchase programme towards the end of the year, and the market to focus on a possible change in inflation trends as it anticipates the start of interest-rate hikes in a scenario of a gradual acceleration in GDP growth. The leading indicators point to a more robust start to the second quarter than to the first and support our arguments for maintaining our forecast for US growth at 2.5% in 2014, and the same in 2015 (Figure 2.2). The forecast has upside risks if the improvement in confidence provides additional incentives to corporate investment and job-creation.

On the European side, our short-term models point to an acceleration of around 0.5% QoQ in 1Q14. However, the boost from the external sector could moderate in the coming months due to: i) euro appreciation; ii) the reduced demand from China; and iii) geopolitical risks in the East if the crisis in Ukraine continues. In the light of all these factors, we maintain our forecasts for the eurozone in 2014 at 1.1%, and 1.9% in 2015, (Figure 2.2) in a scenario of contained financial tensions and fiscal and monetary policies that do not put a brake on growth.

Finally, among developed economies, there is slightly more uncertainty about the growth outlook for Japan, which has a QE programme underway since January 2013, together with fiscal stimuli to return to having inflation and favouring consumption and investment. Thus, we have revised downwards our outlook for growth in 2014 by four basis points to 1.1%, and we are maintaining our estimate for 2015 at 1.3%.

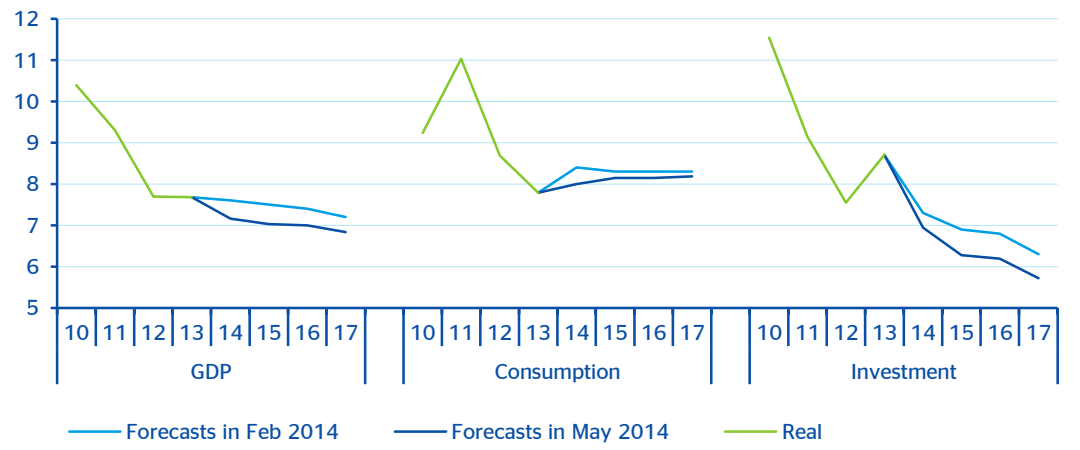
In China, the deceleration at the start of 2014 is here to stay, in an environment of lower-than-expected inflation

In line with our outlook in our last quarterly report, uncertainties about the cyclical strength of the Chinese economy have materialised, with a deceleration in activity during the first quarter of 2014, although lower than anticipated by the analyst consensus. The latest data from indicators on both domestic and foreign demand show the loss of momentum in the cycle, more so in investment than in consumption (Figure 2.3), in an environment of lower-than-expected inflation. At the same time, the authorities are starting to introduce measures to deal with the vulnerabilities arising from economic policy decisions taken in the last few years to support growth in the short term. Those decisions involved postponing the deleveraging of local governments and companies, and continuing to approve infrastructure projects and excess installed capacity which are unlikely to be profitable, while households, who are financing the process, are receiving negative real interest rates on their savings. This is an inefficient allocation of resources, which has also encouraged the development of financial systems in parallel with the more regulated one and which may be a source of problems in the future. To this end, regulations on the non-banking financial sector, shadow banking and environmental protection are all being made more robust.

In view of this, we have revised Chinese growth downwards to 7.2% and 7.0% in 2014 and 2015 respectively, nearly half a point less than expected three months ago (Figure 2.3). The increasing importance of China as a source of world demand in the last few years is undeniable. But the differentiation between areas is unchanged, with higher exposures in Southeast Asia, some South American and African countries and, among developed economies, Germany. According to our estimates, the impact on world growth of each point of Chinese growth lost is around 4pp, principally as a result of lower demand from China itself.

Note also that the expected adjustment in the Chinese scenario is limited, and clearly not enough to unleash episodes of global financial uncertainty.

Figure 2.3
China: Growth forecasts (%)



Source: BBVA Research

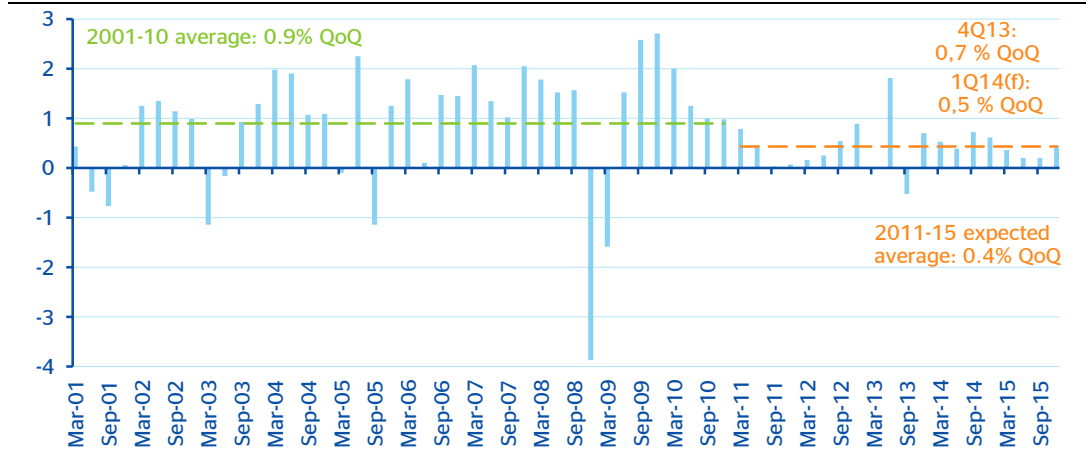
In summary, there are two factors with a global impact on the forecast horizon: possible surprises in the Fed's tapering process and lower growth of Chinese demand, with macro-economic repercussions that are clearly differentiated between economies. As happened in May 2013, the sudden perception by the market that the tightening by the Federal Reserve of the monetary cycle was imminent, with a withdrawal of quantitative easing, increased financial volatility in emerging economies. There was a clear differentiation between different countries, however, with greater FX volatility in those economies with more exposure to foreign short-term funding. Within the EMs, it is the Asian economies which are most exposed to a drop in Chinese demand, as well as a handful of raw materials exporters in South America. The result of all these factors is a map of vulnerabilities where differentiation is a vital factor.

3. Brazil will grow by no more than 2.0% in both 2014 and 2015

Average GDP growth between 2011 and 2015 will be of 1.9%; well below the 3.6% pace of the previous decade

Economic activity surprised to the upside in the fourth quarter of 2013. GDP expanded by 0.7% QoQ in the period, topping both BBVA Research and market consensus forecasts of 0.4% QoQ and 0.3% QoQ respectively, as consumption and exports were more supportive than anticipated. The rebound in the last quarter of the year, which followed a 0.5% QoQ contraction of the economy in the third quarter, dispelled the worries about the country entering into a recession. However, that was not the beginning of a new upward trend. Data available for the first quarter of 2014 suggest that the economy lost momentum at the beginning of the year. This was due, among other reasons, to the less expansive tone of economic policies and the impact of the deceleration of both China and Argentina (see below for more on these issues). Accordingly, we expect 1Q14 GDP to have grown 0.5% QoQ (Figure 3.1), although slower growth should not be taken as a surprise.

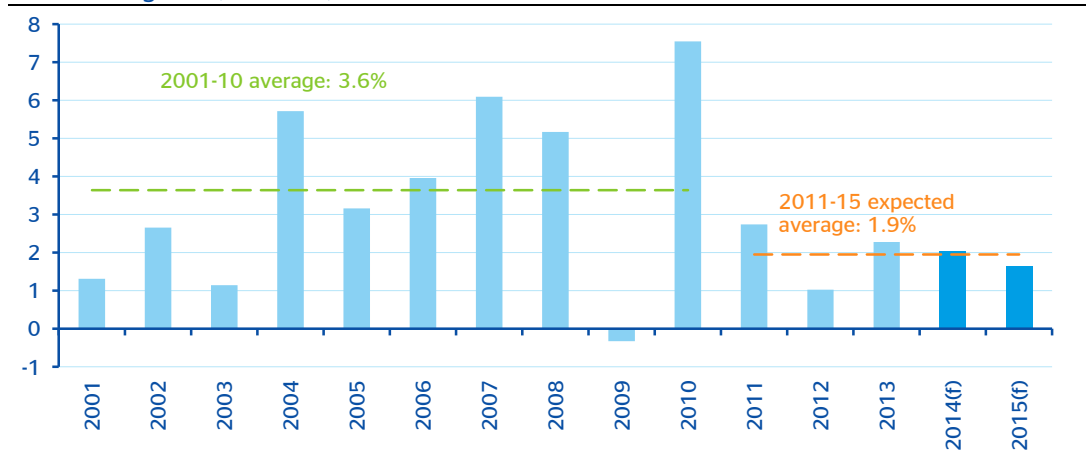
Figure 3.1
Quarterly GDP growth, 2001-15, observed and forecast (QoQ %)



Source: IBGE and BBVA Research

Taking into account the data for the fourth quarter of the year, GDP growth reached 2.3% in 2013, somewhat higher than in 2012 when it reached only 1.0% (Figure 3.2). Nonetheless, private consumption continued to lose steam last year. It grew by 2.3% in comparison with 3.2% in 2012, 4.1% in 2011 and 6.9% in 2010 (Figure 3.3). Public consumption also slowed down in 2013, to 1.9% from 3.3% in 2012.

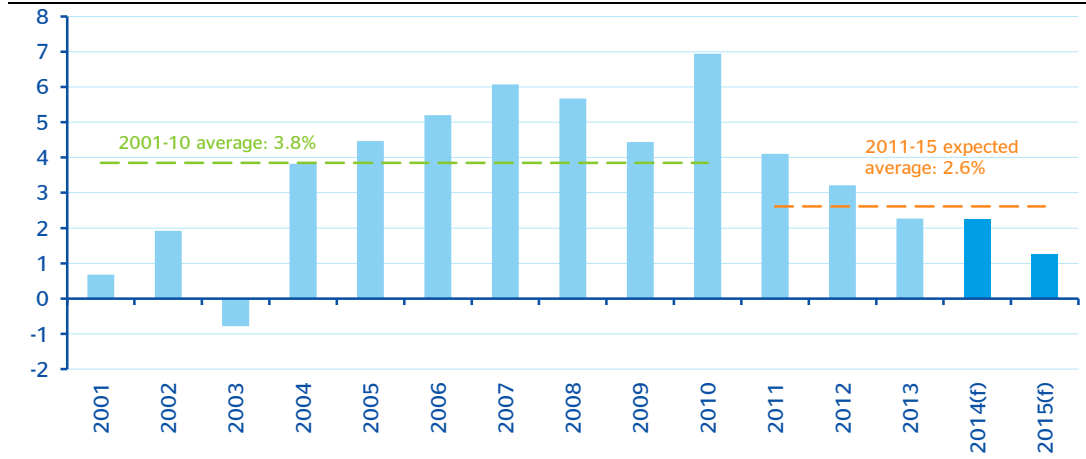
Figure 3.2
Annual GDP growth, 2001-15, observed and forecast (%)



Source: IBGE and BBVA Research

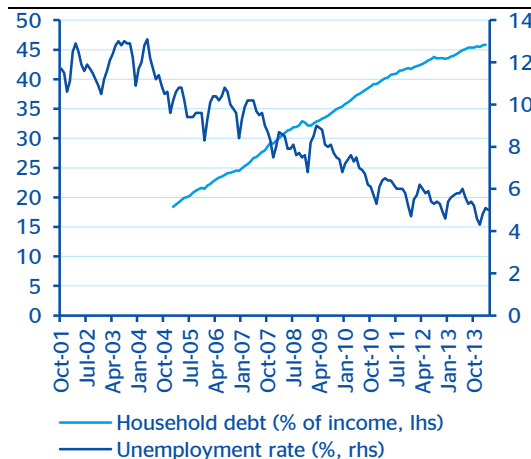
As we have been highlighting in our reports (see our previous [Brazil Economic Outlook](#), for example), there are some structural factors behind the moderation in private consumption. In particular, we emphasise the exhaustion of credit and labour markets after years of robust expansion. The former is mostly due to the increasing household debt and the latter is related to the fact that the room to continue incorporating people into the labour market is much smaller than before (the unemployment rate is already below the equilibrium level). In addition to these structural factors, declining confidence, high inflation and rising interest rates contributed to bring consumption down last year (Figures 3.4 and 3.5).

Figure 3.3
Private consumption growth, 2001-15, observed and forecast (%)



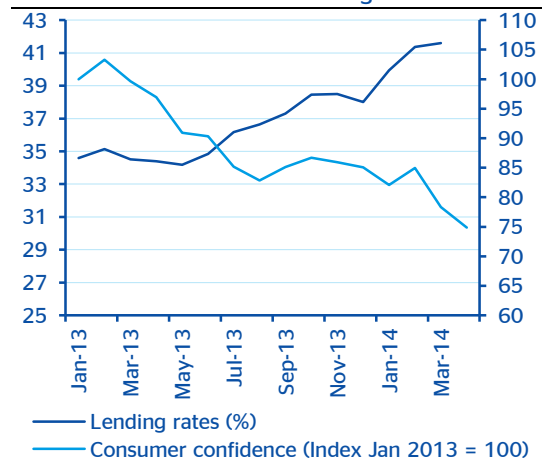
Source: IBGE and BBVA Research

Figure 3.4
Structural drivers of private consumption: labour and credit markets



Source: IBGE and BBVA Research

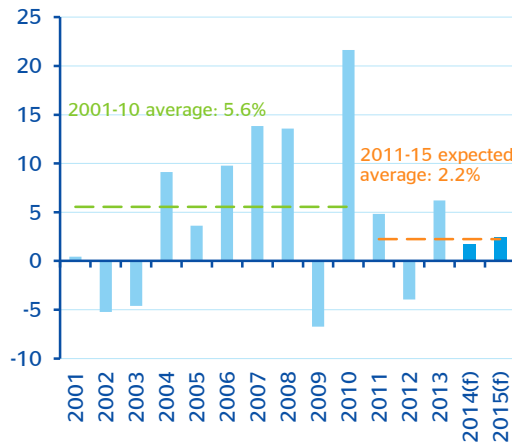
Figure 3.5
Short-term drivers of private consumption: consumer confidence and lending interest rates*



* See figures below for data on other short-term drivers of private consumption such as inflation.
Source: Central Bank of Brazil and BBVA Research

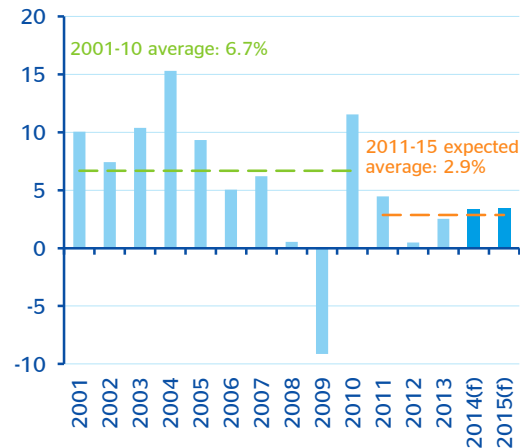
Low growth in 2013 - and also in 2011 and 2012 - was not only due to the slowdown in private consumption. Weak investment and exports also played a role. The former grew by 6.2% in 2013, favoured by the 4.0% drop in 2012. Moreover, growth in investment was mostly concentrated in the first half of 2013, when fiscal and quasi-fiscal policies were particularly supportive. With respect to exports, they expanded by only 2.5% in 2013 after having stayed practically stable in 2012. The growth of exports in 2013 was significantly below the 8.3% growth recorded by imports in the same period. In our view, uncertainty regarding domestic economic policies and the competitiveness problems faced by the manufacturing sector, among other reasons, helped to hold investment and exports down not only in 2013, but also in the previous two years (Figures 3.6 and 3.7).

Figure 3.6
Investment growth, 2001-15, observed and forecast (%)



Source: IBGE and BBVA Research

Figure 3.7
Exports growth, 2001-15, observed and forecast (%)



Source: IBGE and BBVA Research

Looking ahead, we expect the gradual deceleration of private consumption to continue to weigh on domestic growth, as structural problems will remain mostly unaddressed. Moreover, neither exports nor investment are expected to exhibit growth strong enough to offset the deceleration in consumption, as uncertainty and competitiveness problems will probably remain in place as significant barriers. Moreover, the tone of economic policies, especially monetary policy, will gradually become less supportive.

We expect GDP to grow by 2.0% in 2014 and 1.6% in 2015. These figures are lower than we expected three months ago, at 2.5% and 2.0% respectively. This downward revision is mostly driven by new doses of pessimism regarding the upcoming performance of investment and exports. This is fundamentally due to three factors. First is the deceleration of the Chinese economy. Second, activity moderation and exchange rate depreciation in Argentina, which should affect especially the Brazilian manufacturing sector (Brazilian exports to Argentina, declined by 17% in the first four months of 2014, in comparison with the same period last year). Third, the uncertainty brought about by the risk of domestic energy rationing, which is a consequence of i) insufficient rainfall at the beginning of the year, ii) limited investment in the past, and iii) mismanagement of the policies for the sector, such as the 15-20% cut in electricity tariffs announced at the beginning of 2013 that stimulated demand in a context of relatively weak supply¹.

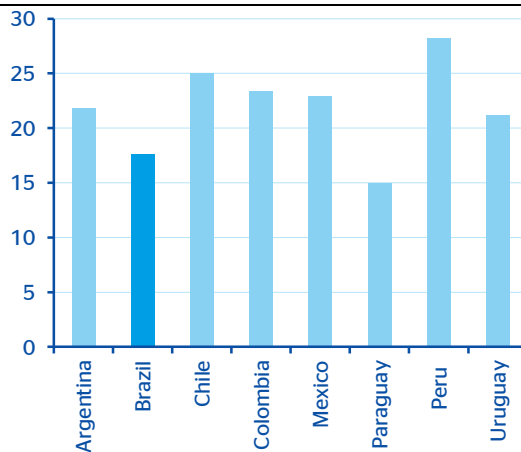
By demand components, private consumption should hold up relatively well and grow by 2.5% this year, roughly the same as in 2013. However, in 2015 it should lose some ground, following the gradual tightening of economic policies (Figure 3.3). Public consumption is expected to grow by around 2.5% in the next two years (accordingly, average public consumption growth in the 2011-15 would be 2.4%, less than the 3.3% average pace between 2001 and 2010). Moreover, we expect investment to decelerate further ahead and to grow by around 2.0% in both 2014 and in 2015 (Figure 3.6). Finally, net exports are likely to contribute gradually more to growth over the next two years. The recovery of the world economy and the weakening of the exchange rate, in spite of the recent appreciation, which we regard as limited and temporary, should bring some support to exports (Figure 3.7). In addition, a moderation in imports driven by the deceleration of domestic demand will benefit GDP growth ahead. We forecast imports to grow around 2.0% in both 2014 and 2015, taking the 2011-15 growth average to 5.2%, compared to 9.2% in the 2001-10 decade.

1: Together, these factors helped to drive business confidence significantly down at the beginning of the year (from 54.3 in December to 49.2 in April, for example, below the confidence mark of 50, according to the CNI indicator).

Our annual GDP forecasts are in line with the view that the economy will go through some adjustment after the presidential elections that will be held later this year, in October. We think that if President Dilma Rousseff is reelected or, especially, if one of the two main opposition candidates (Aecio Neves and Eduardo Campos) should win, economic policies will be adjusted to correct some distortions, to try to recover some of the credibility lost in the last years and pave the way for growth from 2016 onwards. Even though President Rousseff continues to be the favourite to win the October elections, recent polls show that her candidacy has been losing momentum.

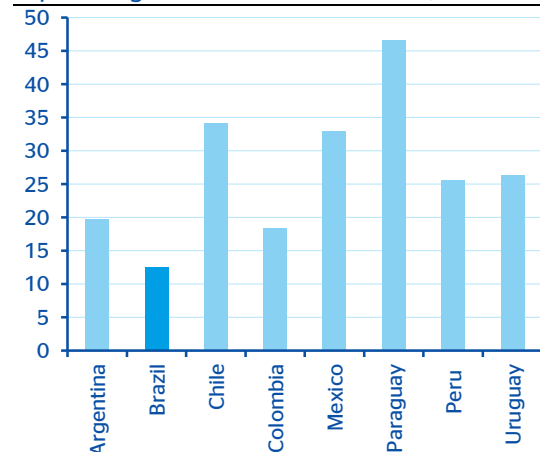
In our view, the adjustment of some economic policies, including the adoption of a tighter fiscal policy and the upward correction of (currently subsidised) supervised prices, is a necessary condition for the country once again to display growth rates higher than 3.0% from 2016 on. That adjustment should be focused on driving up both investment and exports, as the dependence on consumption is already excessive, and the reliance on exports and investment is minimal (Figures 3.8 and 3.9). Failing to implement these adjustments will leave Brazil in an uncomfortable situation to face the normalisation of monetary policy in the US and the economic moderation in China.

Figure 3.8
Investment (gross capital formation) 2012 (% GDP)



Source: World Bank

Figure 3.9
Exports of goods and services (% GDP), 2012



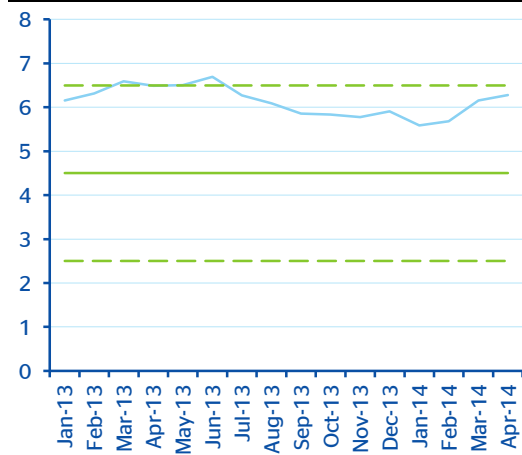
Source: World Bank

In spite of the downward revision, we still see a downward bias to our GDP forecasts for the country, especially in 2014. The balance of risks for growth is unfavourable. External factors, in particular a sharper slowdown in China, and domestic issues, such as an energy shortage that could occur either in 2014 as in 2015, could pave the way for lower-than-expected growth ahead. Although less likely than negative risks, there are some factors that could support higher growth in the future. Among others, we highlight the risk that a turnaround in economic policies reduces uncertainty and increases confidence in the domestic economy. Along the same lines, a more positive evolution of the plan to cede infrastructure projects to the private sector would favour investment and drive growth upwards.

Inflation: high and trending up

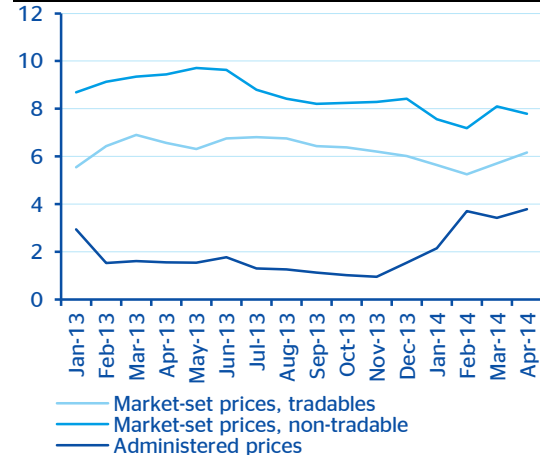
Even though economic activity has been growing at a low, sub-optimal pace for some years, inflation has remained under pressure. Recently, after closing 2013 at 5.9% YoY, inflation eased somewhat at the very beginning of the year and then it started to grow again and reached 6.3% YoY in April (Figure 3.10).

Figure 3.10
Inflation: observed and target range (YoY %)



Source: IBGE

Figure 3.11
Inflation, by segments (YoY %)



Source: Central Bank of Brazil

The persistence of inflation at high levels in spite of feeble activity growth is, in our view, mainly a symptom of a significant supply problem faced by the Brazilian economy. Insufficient investment, low productivity, high production costs and labour shortages, among other things, are behind this problem. Moreover, in addition to the supply constraint, indexation continues to be a feature of the price adjustment system in Brazil, and therefore another reason behind high inflation figures. Finally, the expansive tone of fiscal and quasi-fiscal policies in the last years also contributed to keep inflation at high levels.

The beginning of a new upward trend in inflation at the beginning of this year is mainly due to the upward trend in administered-price inflation. After reaching historically low levels at the end of 2013, there is no more room for the government to continue subsidising prices that it has under supervision (such as gasoline and energy tariffs). The pressure from higher market-set inflation is less significant, and highly concentrated on the tradable segment due to the exchange rate depreciation accumulated in the last twelve months (11%). Inflation in the non-tradable sector remains very high, in line with the structural problems highlighted above. However, its recent dynamics are less negative, due to moderation in domestic demand and the impact of the tightening of monetary conditions (Figure 3.11).

We expect administered-price inflation to continue to accelerate over the remainder of the year, and the exchange rate depreciation to continue to fuel tradable inflation. Consequently, annual inflation should trend up furthermore over the second and third quarters, before easing somewhat at the end of the year. More precisely, inflation is likely to reach 6.5% YoY in June, to peak at 6.8% YoY during the third quarter and close the year at 6.2% YoY. Inflation will be above the 6.5% target ceiling during most of the second half of 2014.

In 2015, we expect inflation to moderate somewhat, following the tighter tone of monetary and fiscal policies (see below for more details) and the additional moderation of domestic demand. We forecast it to average 5.8% YoY and close the year at 5.6%. The exchange rate depreciation and administered-price inflation will continue weighing negatively on domestic prices. With respect to the latter, we expect a gradual normalisation of supervised prices over the next few years, especially from 2015 onwards. In other words, we do not expect these prices to converge abruptly to market, unsubsidised, levels in 2015. Anyway, this calls attention to the fact that inflation dynamics will be shaped by the magnitude and the pace at which the government unwinds the implicit subsidies on some of the prices it has under control. The lack of formal rules governing the adjustment in these prices makes them more subject to political - rather than technical - decisions. This is particularly important at this moment, given the uncertainties on the political front (typical of an electoral year) and the important role played by managed prices on overall inflation dynamics.

Our inflation forecasts are higher than three months ago, when we expected it to reach 5.9% in 2014 and 5.4% in 2015. The main reason for this upward revision is the impact of the drought that hit the country at the beginning of 2014 on food and energy prices. The impact on food prices, the main driver of inflation upward revision in 2014, will likely be short-lived: food inflation peaked in March and is expected to ease gradually in the next few months. The impact on energy prices will be felt not only in 2014 but also in 2015, in line with the scheme that the government adopted to respond to the recent shock.

4. Economic policies: moving into a less expansive stance

The end of the monetary tightening cycle will be confirmed soon, but a further adjustment of monetary conditions will be required no later than at the beginning of 2015

High and increasing inflation, together with resilient expectations for inflation ahead, have forced the Central Bank of Brazil (BCB) to extend the tightening cycle until April and take the Selic to 11.0%, 375bp higher than at the beginning of the cycle in April of 2013. In our view, both the upward surprise in inflation at the end of 2013, which frustrated the BCB's intention to deliver lower inflation in 2013 than in 2012, and the impact of the weather-related supply-shock on food prices were particularly important factors in BCB's recent decisions.

The recent signs released by the monetary authority, especially the emphasis on the fact that monetary policy affects inflation with lags, suggest that the current tightening cycle is already over, even though annual inflation continues to deteriorate. The monetary authority should confirm this in its next meeting at the end of May, by leaving the Selic rate unchanged at 11.0%. If the BCB surprises and decides to extend the tightening cycle further, we would expect this additional adjustment to be marginal.

With nominal interest rates at 11.0% and real rates close to - or slightly higher than - neutral, even with GDP running below its potential, the monetary authority will assess the impact on inflation of the adjustment that it implemented in the last few months (Figure 4.1).

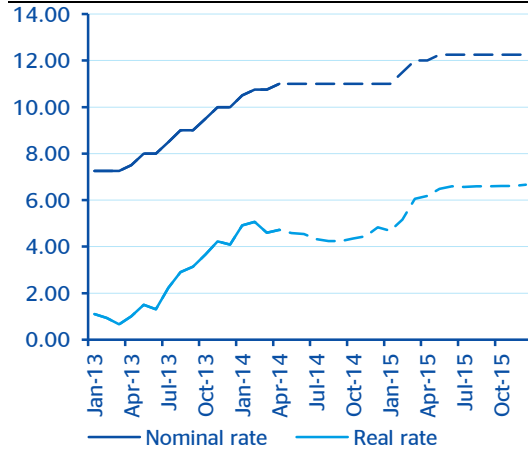
Accordingly, the debate is moving away from the magnitude of the cycle, and is increasingly focusing on the impact of the tightening on domestic prices.

We share the concerns that the increasing participation of private consumption in GDP and of earmarked credit on total credit, as well as the relevance of administered-price inflation (the gap between supervised and free prices is increasing) represents a problem for monetary policy. However, we think that the main factor constraining monetary policy at this moment is credibility. In our view, the recent tightening of monetary conditions was not enough to restore the credibility lost during the easing cycle that took the Selic to only 7.25% in 2012, and to prove that the monetary authority is free from political interference.

Figure 4.2 shows that inflation dynamics were not very different during this tightening cycle than in the previous ones, suggesting that the efficiency of monetary policy is not very different from the past². In fact, it reveals that the dynamics of observed and expected inflation are more positive than in the previous cycles, due to the performance of market-set prices. However, this is mainly explained by food inflation, which lost 6.6pp since April of 2013 and took 1.6pp off overall inflation, mostly due to issues unrelated to monetary policy (during previous cycles the food group's contribution to inflation was between +0.1pp and +0.6pp). Anyway, even after stripping out food inflation, inflation dynamics during different periods are relatively similar, supporting the claim that monetary policy is affecting inflation as in the past.

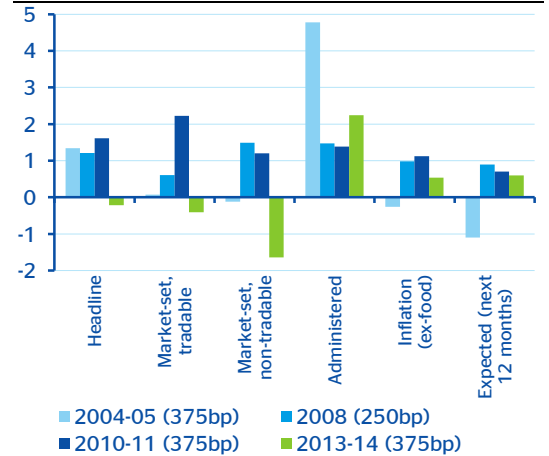
2: Figure 3.13 builds on a table and on an original idea included in the BCB document "Discurso do Diretor de Política Econômica do Banco Central, Carlos Hamilton Araújo, na Macro Vision International Conference 2014".

Figure 4.1
Selic: nominal and real rates (%)



Source: Central Bank of Brazil and BBVA Research

Figure 4.2
Change in different inflation measures during the last monetary tightening cycles (pp)*

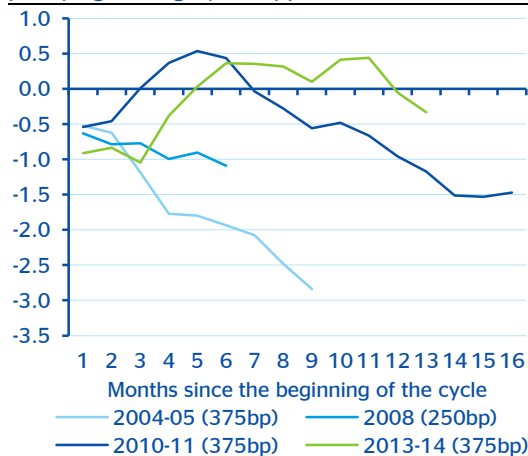


* Tightening cycles: 1) From Sep/04 to May/05 (Selic hiked by 375bp); 2) Apr/08 to Sep/08 (250 bps); 3) Apr/10 to Jul/11 (375bp); 4) Apr/13-Apr/14 (375bp to date).
Source: Central Bank of Brazil and BBVA Research

Even though the performance of inflation measures was broadly similar during the past tightening cycles, Figure 4.3 shows that the difference between observed inflation and expected inflation is very small currently (and much smaller than at the end of previous cycles). In other words, at variance with other periods in the recent past, analysts are not expecting inflation to slow down at the end of this tightening cycle. We take this as a sign of distrust in the BCB, as a measure of the credibility problem we referred to before.

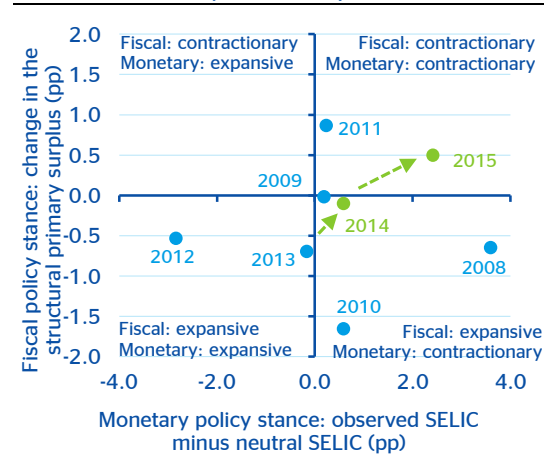
To rein in inflation and to restore credibility in its economic policies, we expect the BCB to tighten monetary conditions further after the October elections, probably during the first year of the new government in 2015. The normalisation of the monetary conditions in the US should help to determine a new round of Selic adjustments in 2015. Considering all this, we expect the Selic rate to reach 12.25% in 2015.

Figure 4.3
Difference between observed and expected inflation in 12-months during the last monetary policy tightening cycles (pp)*



* Tightening cycles: 1) From Sep/04 to May/05 (Selic hiked by 375bp); 2) Apr/08 to Sep/08 (250 bps); 3) Apr/10 to Jul/11 (375bp); 4) Apr/13-Apr/14 (375bp to date).
Source: Central Bank of Brazil and BBVA Research

Figure 4.4
Stance of monetary and fiscal policies, 2008-15*



* Monetary stance: observed Selic minus neutral Selic; fiscal stance: change in the structural primary surplus.
Source: Itaú (observed structural primary surplus), Central Bank of Brazil and BBVA Research

Fiscal policy: low primary surpluses, but a less expansive stance

Following the change in the tone of monetary policy, from expansive in 2012 to contractionary in the beginning of 2014, we expect fiscal policy to go through a similar adjustment from now onwards. More precisely, after remaining in expansive terrain for two years, fiscal policy should be close to the neutrality in 2014 and move into contractionary terrain in 2015 (Figure 4.4).

To some extent, this “two-step” expected adjustment of fiscal policy in 2014 and 2015 is comparable with the “one-step” adjustment that followed the 2010 elections. As in 2011, the first year of the government of the President Dilma, we expect to see both monetary and fiscal policies playing in the same direction in 2015 to fight inflation and other domestic imbalances, either if President Dilma is re-elected or if an opposition candidate wins.

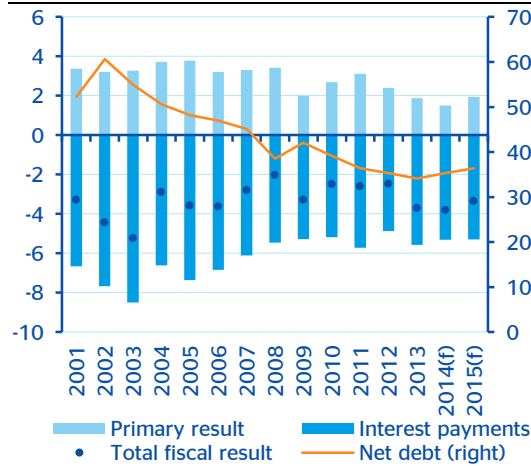
Our expectations regarding the tone of fiscal policy build on our view that primary surplus will not worsen significantly this year, after the sharp deterioration in the last years, when the observed primary surplus declined from 3.1% of GDP in 2011 to 1.9% in 2013. We expect the public sector's primary surplus to reach 1.5% in 2014, below the 1.9% target announced in February. Weak domestic demand and tax incentives granted in the recent past will prevent tax revenues from contributing significantly more than in the previous years. In addition, it will not be easy for the government to keep non-recurrent revenues as high as in the recent past. Finally, the room of manoeuvre to cut expenditures is not significant, among other reasons, due to the need to inject resources -around 0.3% of GDP- to support energy companies that are facing much higher than expected costs due to the problems that are hitting the sector.

After this year's elections, in 2015, we expect the government to cut expenditure, withdraw previously conceded incentives and even rise taxes to deliver a higher primary surplus and ease the concerns about the deterioration of public accounts and the impact of an expansive fiscal policy on inflation. Comments from opposition candidates and also from the current government support the view that a fiscal adjustment will be adopted in 2015 independently of who wins the elections. Accordingly, we forecast the 2015 primary surplus to increase to around 1.9% of GDP.

High interest payments, to some extent related to the tightening of monetary policy, will weigh on public accounts in both 2014 and 2015. More precisely, we forecast the tax burden to be around 5.3% of GDP in both years, which coupled with our primary surplus forecasts imply an overall fiscal deficit of 3.8% in 2014 and 3.4% in 2015 (Figure 4.5).

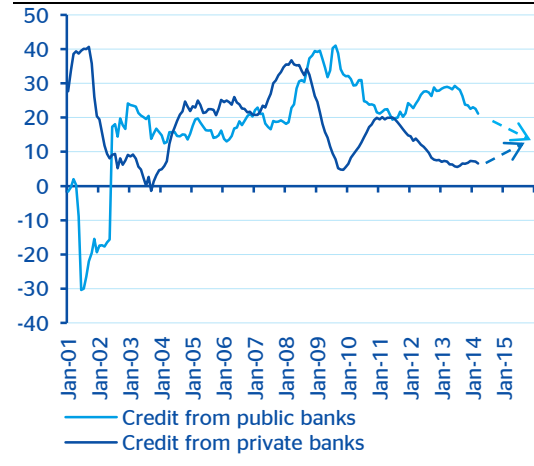
Finally, we also expect quasi-fiscal policy to become less expansive in the next few years. Credit from public banks has been growing at an excessive pace since the end of 2008. From then to the end of 2013, public credit grew 28% on average, in comparison to a 11% growth in private credit, and the share of public banks on the total credit stock increased from 34% to 52%. In this period, credit from public banks has been one of the main tools used by the government to support growth. However, concerns about the fiscal impact of this expansion, rising inflation and financial stability forced the government to commit to a slowdown. Accordingly, public credit growth started to moderate starting at the middle of 2013, while private credit exhibits a still very timid recovery. In our view, credit from public banks will decelerate further over 2014 and 2015 and converge to growth rates of around 15%, similar to the pace we expect credit from private banks to expand in the period (Figure 4.6).

Figure 4.5
Fiscal results and public net debt (% GDP)



Source: Central Bank of Brazil and BBVA Research

Figure 4.6
Credit from public banks (YoY, %)



Source: Central Bank of Brazil and BBVA Research

5. Exchange rate: short-term appreciation; long-term depreciation

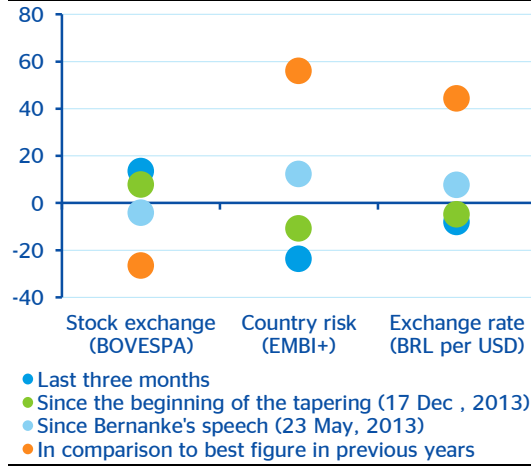
The price of domestic assets recovered sharply in the last three-months, erasing the losses accumulated since the beginning of the tapering

The price of Brazilian assets increased sharply in the last three months: the BOVESPA stock exchange index increased 13%, the country-risk declined 66 bps (or 24%) and the Brazilian real (BRL) appreciated 8% with respect to the US dollar (Figure 5.1), even though Brazil's sovereign credit rating was cut from BBB to BBB- by S&P in the period.

This upward correction in the price of domestic assets erases the losses accumulated since the beginning of the tapering by the Fed at the end of 2013. However, it does not erase the losses that followed the famous Ben Bernanke's speech in May of 2013, when the Fed first suggested that the withdrawing of the monetary stimulus was not far away. Not to say that prices are still significantly below the record-high levels observed in the last years (May 2008 in the case of the BOVESPA, January of 2013 in the case of the country-risk and July of 2011 in the case of the BRL).

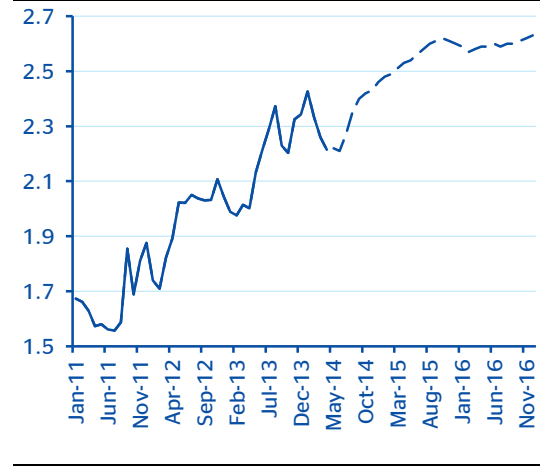
The movements in Brazilian financial markets are broadly in line with those in global financial markets, or at least with those observed in other emerging markets (see our [2Q14 Latin America Economic Outlook](#) for comparable data between Brazil and other countries in the region). However, some idiosyncrasies have also been playing an important role. The recent rebound in Brazilian markets is also related to the adoption of a tighter monetary policy, which among other things is already working as an important attractor of capital flows into domestic fixed income, and the perspectives of correction in fiscal policy after the elections. Similarly, the losses observed in the last years are also explained by local domestic factors, such as growth deceleration, inflation, weaker fiscal and external accounts, excessive intervention of the government in the economy, in particular in some estate-owned companies with a very important weight on the IBOVESPA index, etc. These factors are also behind the recent moderation in house prices after some years of excessive growth (see Box 1).

Figure 5.1
Stock exchange (BOVESPA), country-risk (EMBI+) and exchange rate (BRL per USD), (% change)*



* A value higher than zero means an increase in the BOVESPA index, an increase in the country-risk and a depreciation of the Brazilian real (BRL).
Source: Haver Analytics and BBVA Research

Figure 5.2
Exchange rate (BRL per USD)



Source: Central Bank of Brazil and BBVA Research

It is worth noting that the recent rebound in the price of domestic assets occurred in spite of both the deceleration of economic activity during the year up to date and the lack of support of terms of trade, which declined 1.0% QoQ and 3.0% YoY in 1Q14.

In our view, the recent recovery in domestic financial markets, in special of the Brazilian real, is more a temporary correction following the excessive losses observed since the implementation of the tapering than the beginning of a sustainable, long-lasting upward trend.

The exchange rate could stay at current levels –around 2.2– in the short-term, which will be good news for inflation. However, the end of the monetary tightening cycle and the gradual reduction of the BCB intervention in exchange rate markets should favour a depreciation of the currency ahead. More importantly, we expect China and commodity prices to be slightly less supportive in the future, driving down Brazil's terms of trade by 3% in 2014 and by an additional 3% in 2015. That coupled with current account deficit / competitiveness problems and with the normalisation of monetary conditions in the US support our view that the exchange rate is destined for a depreciation (see Figure 5.2 and table in Section 6).

Current account: expectations of improvement delayed to 2015

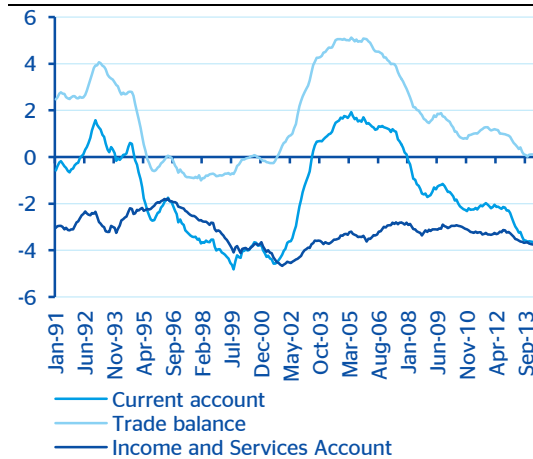
Most of the changes in the Brazilian current account are historically explained by variations in the trade balance rather than by changes in either the service or the income accounts (Figure 5.3). The deterioration of the trade balance is certainly the driver of the worsening in the current balance accumulated since 2005. From then to the end of 2013, the current balance declined from +1.8% of GDP to -3.6%, while the trade surplus shrank from 5.1% to 0.1% and the other components of the current account barely changed at all (they represented -3.3% of GDP at the beginning of 2005 and -3.7% of GDP in December of 2013).

Some months ago, we expected the trade balance to show some signs of recovery starting at the beginning of the year. That has not happened. Exports dropped by 3.0% in the first four months of the year, broadly the same as imports (-3.5%). The main drivers of the poor performance of exports at the beginning of the year are the deceleration in China, with the consequent moderation in both commodity prices and terms of trade, and the lower demand for manufacturing products from Argentina (exports to the country, which represent almost 10% of total exports, declined 17% YoY)³. Taking these factors into account, as well as the impact of an exchange rate that has appreciated more than expected in the short-term, we

3: For more about our view on commodity prices, see our 2Q14 Latin America Economic Outlook.

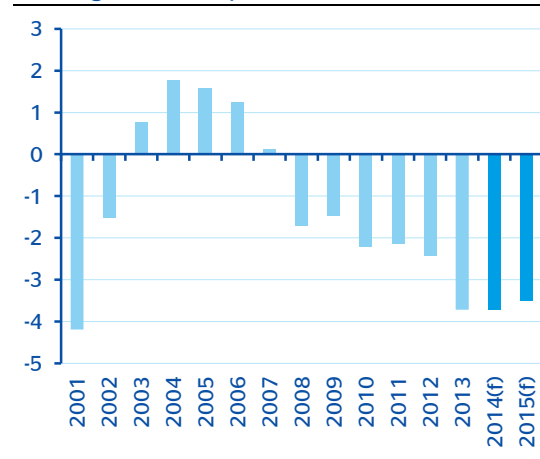
now expect the trade surplus to close 2014 at only 0.1% of GDP. In 2015, we expect the impact of the currency depreciation and additional moderation in domestic demand, as well as some improvement in global demand, to drive the trade surplus up slightly to 0.3%.

Figure 5.3
Current account, income and services account, trade balance (% GDP)*



* Income and services account includes international transfers. Therefore, in this figure, current account = trade balance + income and services account.
Source: Central Bank of Brazil and BBVA Research

Figure 5.4
Exchange rate (BRL per USD)



Source: Central Bank of Brazil and BBVA Research

Due to the downward revision in our trade surplus forecasts, we now expect the current account deficit to remain practically stable and to close 2014 at 3.7%, rather than declining to 3.5% as we expected three months ago. The gradual improvement of the current account should start in 2015, with a slight reduction of the deficit to 3.5%. In our baseline scenario, the exchange rate depreciation and the relative improvement of the global economy should pave the way for further reductions of the current account deficit after 2015.

Box 1. House prices in Latin America: very dynamic, but no significant risks

As the IMF warned in 2011, house prices in real terms in Latin America have been growing at an average annual rate of 10% since 2005⁴, significantly above previous decades⁵. The increase in an asset price may represent a problem when the increase is not justified by the supply and demand fundamentals and is sustained simply by the expectation of higher prices in the future. We should remember that sharp falls in house prices are usually associated with production and lifestyle losses that are twice as intense and long-lasting as those associated with stock market corrections, for example⁶.

It is very difficult to discern whether there is a bubble in an asset price, and the property market is no exception. Nevertheless, indicators do exist which can flag up possible overvaluations in house prices over and above supply and demand fundamentals. One of these is to make comparisons with previous price cycles to detect “excessive” rises.⁷ In the case of Latin America, house price series are not long enough to cover several cycles. In any event, strong house price rises such as those mentioned above for Latin America are a necessary but not sufficient condition for the existence of a bubble, since they may be justified by a change in the supply and demand fundamentals. Additional indicators are needed, relating the house price with its fundamentals, to support any claim about the existence of a bubble.

Of these additional indicators, two stand out: the first measures the accessibility of housing; the second compares the price of buying with the price of renting. Among accessibility indicators, the most widely used measure is the ratio of house prices to household income, since a higher ratio implies a greater effort on the part of households to pay for housing, which will reduce demand and eventually lead to downward pressure on prices.

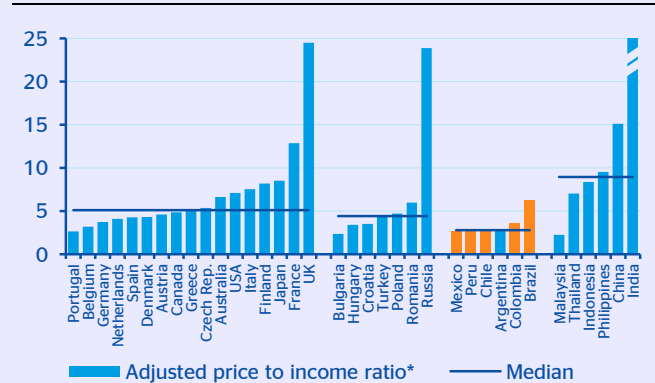
On the other hand, if we use as an additional indicator, the relationship between sale and rental prices, we start from the basis that renting represents the implicit benefit of possessing a property, in the same way as the dividend is the benefit of possessing a stock. Rentals tend to be more connected to market factors, so that an excessive hike in the ratio of the sale price to the rental (taking into account taxes, maintenance costs and other outgoings), indicates that the benefit of a property asset for its owners is low when compared with other assets and, as such, it is difficult to sustain it in the future. For the benefit of owning a property asset to increase to a level commensurate with that of other assets, its price will tend to adjust downwards.

In the case of Latin America, the metrics available from those mentioned above point to relatively low ratios

compared with other country blocks, with the exception of Brazil. Of particular interest, among the accessibility indicators, is that the median price to income ratio in Latin America is below developed countries in Europe, other emerging countries and the Asian countries (see Figure B.1.1)⁸. Looking only at Pacific Alliance countries, the time it takes an average household to finish paying for their home is slightly higher in Colombia and very similar in Chile, Peru and Mexico.

Of course, comparing international measures of accessibility to housing omits idiosyncratic factors which might account for the differences mentioned above, such as, for example, the differing degrees of access to mortgage lending (greater in developed countries and in emerging Europe), or the rate of demographic growth. So another important dimension is to detect upward trends in the accessibility indicators or substantial deviations from historical averages which may give rise to concerns about overvaluation in property markets. Within the limitations imposed by the flimsy historical data in Latin America, the ratio of accessibility in Brazil in 2013 was particularly high vs. its historical average and, to a lesser degree, also in Colombia and Peru, while in Chile and Mexico the ratios are actually below their historical averages (Figure B.1.2). However, bear in mind that the trend towards lower long-term interest rates in the region will favour an increase in the price to income ratio, since it will make higher-value housing financially more accessible, even though the size of the mortgage market is relatively small in the region (see below).

Figure B.1.1
Price to income ratio

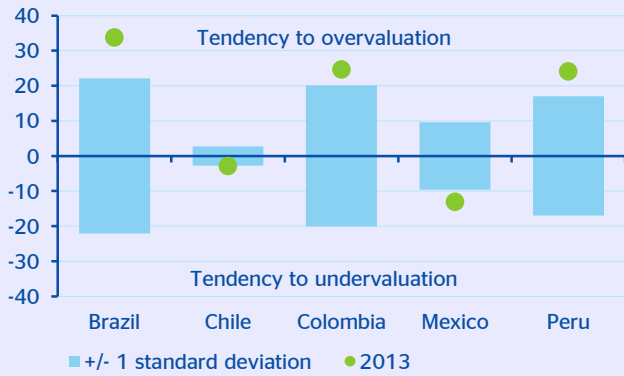


* Adjusted for PPP and average size of households in each country.
Source: Global Property Guide and BBVA Research

13: Average growth in house prices in the Pacific Alliance countries between 2011 and 2013 is exactly 10%.
14: IMF, Regional Economic Outlook. Western Hemisphere: Watching Out for Overheating. April 2011 pg. 39-44.
15: IMF, World Economic Outlook 2003, chapter 2: When Bubbles Burst.
16: IMF, WEO (2013).

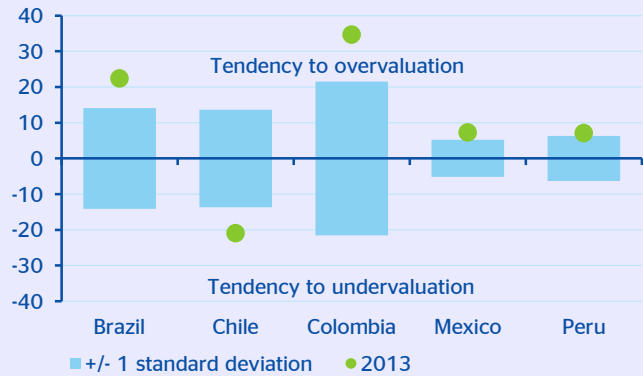
17: Data based on the Global Property Guide and the United Nations statistical division, prices adjusted for PPP and average size of household. The median is taken rather than the mean in order to avoid extreme values, particularly important in Europe, the emerging European markets and Asia. In the case of Asian countries this is particularly relevant, since the median is 9 years and the mean is 14, influenced by India. In Latin America, the mean and median are 2.8 and 3.5 years, respectively.

Figure B.1.2
Price to income ratio as % of the historical average*



* The periods with available data are, in the case of Brazil, from 2008 to 2013; 2001-2013 for Chile; 1998-2013 for Colombia; 2000-2013 for Mexico and 2007-2013 for Peru.
Source: Global Property Guide and BBVA Research

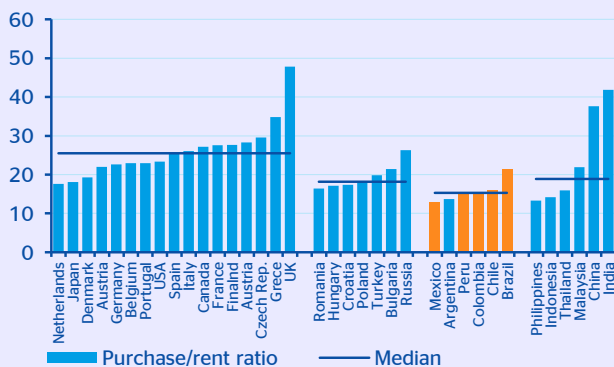
Figure B.1.4
Purchase to rental ratio as % of the historical average*



* The periods with available data are, in the case of Brazil, from 2008 to 2013; 2001-2013 for Chile; 1998-2013 for Colombia; 2000-2013 for Mexico and 2007-2013 for Peru.
Source: Global Property Guide and BBVA Research

As with the accessibility indicator, the purchase to rental price ratio (Figure B.1.3) is lower in Pacific Alliance countries than in Brazil and than the median in the remaining economies. As in the case of the accessibility index, it is important to back up the transversal analysis with a look at recent trends in the purchase/rental price ratio, compared to each country's track record, in order to eliminate idiosyncratic factors. The results are similar to the accessibility ratio, with the same data limitation of a relatively short time series. The changes and current situation of the purchase to rental ratio point to a major misalignment in Brazil and a smaller one in Colombia, while both Peru and Mexico are more aligned with their historical averages and Chile⁹ is significantly below.

Figure B.1.3
Purchase to rental ratio



Source: Global Property Guide and BBVA Research

The measures described above indicate that, in general, there are no signs of an increase in house prices that go beyond that dictated by the fundamentals, except in Brazil and, to a much lesser degree, in Colombia and Peru. Even so, it is advisable to analyse the momentum of these prices over the last few years. In general, we can say that although there has been a sustained and robust climb in house prices, this increase has gone hand in hand with growth in disposable income in these countries, so there are no significant signs of misalignment with the fundamentals.

In Brazil, the gap between the recent growth in house prices and income suggests the existence of a not inconsiderable misalignment in pricing. Despite signs of overvaluation, the evidence available indicates that the problem is concentrated in particular regions, such as Rio de Janeiro and Sao Paulo. Furthermore, we should also bear in mind that in the case of Brazil, the sharp increase in house prices is partly due to the very low base due to the virtual stagnation of the housing market in that country. Finally, there are recent signs of moderation in prices: after growing at rates of over 20% in real terms a few years ago, in 2013 growth was below 10% even in the most dynamic markets. It is to be hoped that this moderation will continue in the coming years in order to avoid an even greater misalignment of prices.

18: The purchase to rental price ratio ought to be adjusted to take into account the effect of changes on interest rates and taxes. Higher income taxes (from which interest payments on mortgages are deducted) would encourage a higher purchase to rental price ratio. Meanwhile, higher taxes on property transactions (or on owning property), or higher interest rates would favour a lower ratio by penalising property ownership. In the case of Peru, the only country for which indicators for rentals and prices in monetary terms exist, and where the ratio can be calculated adjusted for taxes and interest rates, the indicator corroborates the trends found in the case of the non-adjusted indicator.

When it comes to Colombia, house prices went up in the order of 10% in real terms in 2013, although there were major differences between cities. The purchase to rental ratio indicator has remained stable since 2011 although above the levels of the previous decade, related to the population's greater purchasing power, better transport systems and low interest rates. The mortgage market, which is increasingly leaning towards higher value housing, reflects the booming middle classes. For the future we estimate a moderation in prices, a result of lower public incentives for middle-income housing. We calculate that prices will have to grow below a real rate of 6% in the next few years to offset the moderate overvaluation centred on some of the country's cities.

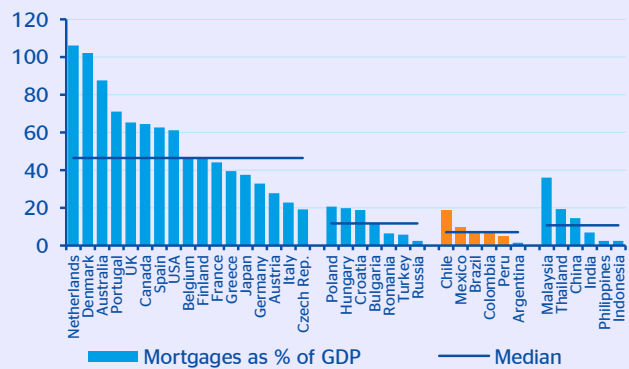
In Chile and Peru the market has been characterised by dynamism in sales and sustained rises in price in real terms, which in the last quarter of 2013 reached 5.5% YoY in Chile and 12.2% in Peru, although in the latter country very influenced by the significant depreciation in the exchange rate in a highly dollarised property market¹⁰. In Chile the rise in sales has reduced the existing stock, which has contributed to maintaining prices high but with lower growth than in the past. In both cases, the areas with the biggest increases have been those targeted at middle-incomes, which is consistent with the growth in the population of the middle- and upper-middle income segments. In the future we estimate that growth will continue in price but at a slower rate than between 2008 and 2012.

Finally, in Mexico the situation is somewhat different, since house prices have risen by around 4% YoY in real terms in the last few years, a rate similar to that of the national consumer price index. There has been no increase in momentum on the demand side, although borrowing conditions are historically the best they have ever been. The price to income ratio is at its lowest ever recorded level, helped by widespread competition between banks and low interest rates. The effects of the phenomenon of excess housing supply continue, particularly for new units in the social housing category. Thus, prices in middle-income and residential segments have risen faster than in the social housing segment, reflecting greater preference for existing housing stock¹¹.

In terms of macroeconomic risks arising from a possible property market adjustment, the main channel for contagion to other sectors tends to be through the negative impact on the quality of mortgage lending, which in turn affects the health of the financial system. In the case of Latin America in

general, and the Pacific Alliance in particular, mortgage lending still represents a relatively small proportion of total credit (Figure B.1.3). Except in the case of Chile (18.7% of GDP), in the other PA economies, mortgage lending accounts for a very small proportion: in the order of 9.1% in Mexico, 7.7% in Brazil, 5.3% in Colombia and 4.9% in Peru¹². For this reason, in our view a possible overvaluation scenario in the sector, followed by a price correction, would have a very contained impact on the financial sector in the region.

Figure B.1.5
Mortgage lending as % of GDP



Data from 2013 for Mexico, Brazil and Colombia; 2012 for Chile, Peru and Argentina. Source: Housing Finance Network (HOFINET) and BBVA Research

In view of the accessibility and profitability indicators for property ownership, the rapid rise in house prices in Latin America does not appear to be linked to the emergence of a price bubble, but rather to be supported to a large degree by the growing demand for housing, driven particularly by the improved financial situation of the middle classes in these countries, combined with a relatively inelastic supply in the short term, especially in some cities which have experienced the biggest price hikes in the last few years. However, it could be said that there will be a not inconsiderable overvaluation in house prices in the case of Brazil and to a lesser extent in Colombia and Peru, but it will not be enough to usher in a brusque price correction. In any event, even in the case of a substantial adjustment in house prices, the macroeconomic impact of this adjustment would be limited, unlike the situation six years ago in the US and in Spain, since mortgage lending represents a small fraction of total credit. In the context of greater stability and strong fundamentals, there is a lot of room for developing the mortgage sector in the region under appropriate financing conditions.

19: The increase in prices in Peru was 7.2% in dollars, less than in previous years.
 20: Colombia Real Estate Outlook 2013, Chile Real Estate Outlook 2013, Peru Real Estate Outlook 2013, Mexico Real Estate Outlook 1H14.
 21: In the case of Mexico this percentage only includes bank credit. If public housing institutions are included (Infonavit and Fovissste) the proportion represents 9.4% of GDP.

6. Forecasts table

Table 4.1
Macro Forecasts

	2012	2013	2014	2015
GDP (% y/y)	1.0	2.3	2.0	1.6
Inflation (% y/y, eop)	5.8	5.9	6.2	5.6
Exchange Rate (vs. USD, eop)	2.04	2.34	2.46	2.60
Interest Rate (% eop)	7.25	10.00	11.00	12.25
Private Consumption (% y/y)	3.2	2.3	2.3	1.3
Government Consumption (% y/y)	3.3	1.9	3.1	1.5
Fixed Investment (% y/y)	-4.0	6.2	1.7	2.4
Exports (% y/y)	0.5	2.5	3.3	3.5
Imports (% y/y)	0.3	8.3	2.0	2.2
Fiscal Balance (% GDP)	-2.5	-3.3	-3.8	-3.4
Current Account (% GDP)	-2.4	-3.6	-3.7	-3.5

Source: BBVA Research

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