BBVA Research

Brazil Economic Outlook

2nd QUARTER 2017

Main messages

1. **The recession comes to an end in Brazil.** Activity indicators suggest that the economy grew at a positive rate in 1Q17 following eight consecutive quarters of contraction. Likewise, we keep our 2017 GDP growth forecast at 0.9% and revise upwards, from 1.2% to 1.8%, our GDP forecast for 2018.

2. **Inflation has moderated significantly. It will be close or even below the 4.5% target in 2017-18.** We expect inflation to end this year at 4.3% and 2018 at 4.5%. The stronger-than-expected moderation of inflation leaves more room for cuts in interest rates: the SELIC rate should reach 8.25% at the end of 2017, a historically low level.

3. **The materialization of the fiscal adjustment depends on the approval of the social security reform.** The adoption of a ceiling for public spending is a good news that directly reduces fiscal risk. However, compliance with the new fiscal rule requires a significant spending adjustment, which would be very difficult to implement without a social security reform. Hence, failing to approve such reform would risk the economic recovery.

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GLOBAL

Stronger growth,
but still with significant risks

Positive global momentum

Main trends continue …

- Recovery of industrial production and trade still underway
- Low volatility in financial markets
- Headline inflation continues to rise in advanced economies, but core inflation remains stable

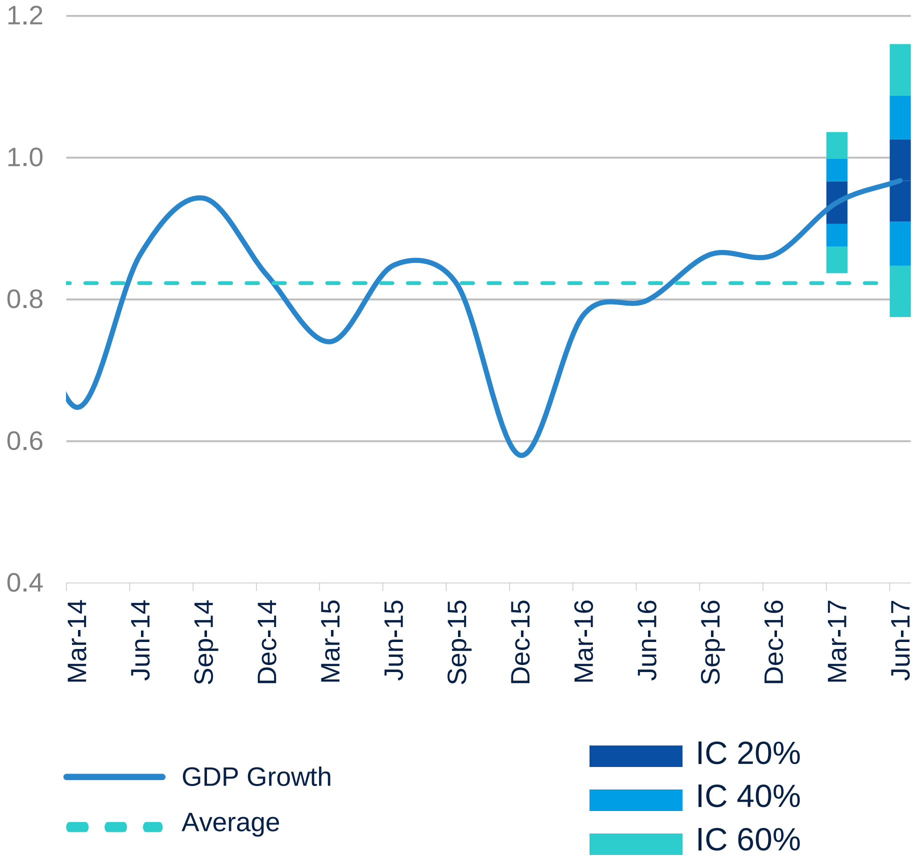
… and central scenarios become more likely

- A strong stimulus to US economy looks less likely…
- …but so does scenarios with strong protectionism
- Central banks in developed countries lean towards policy normalization

Global growth continues to increase at beginning of 2017

Global GDP growth

Forecasts based on BBVA-GAIN model (%, qoq)

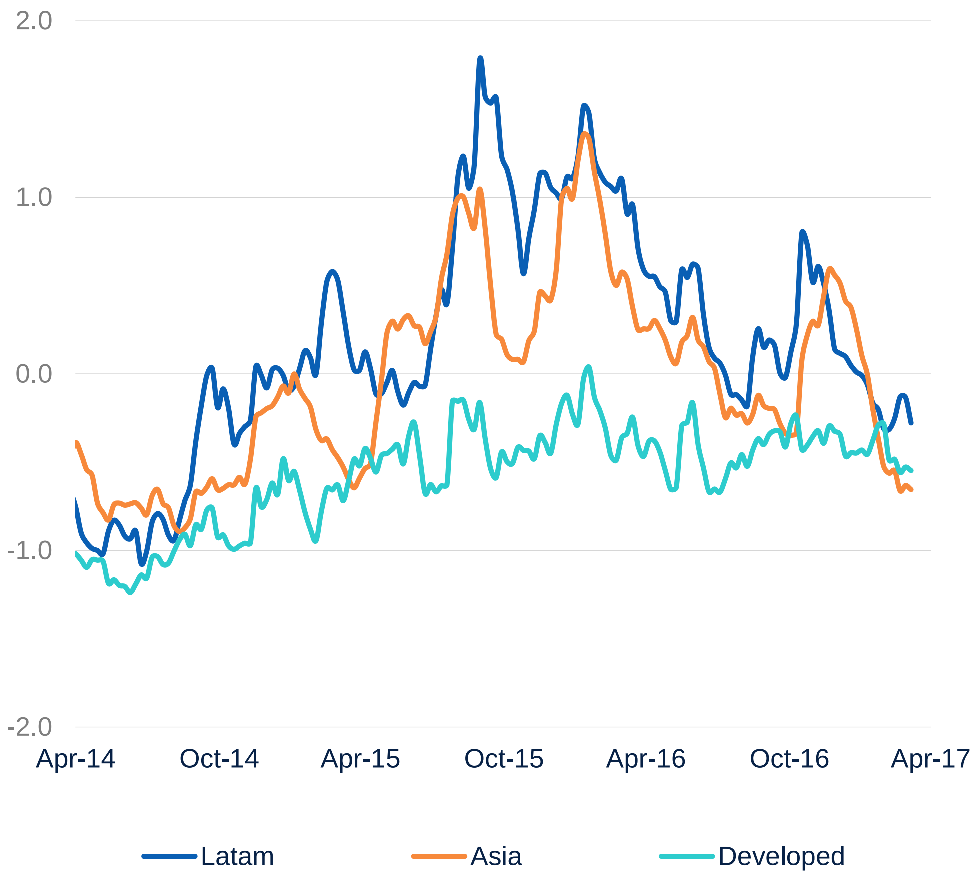


- Confidence indicators remain very high, although hard data still do not capture all the improvement in sentiment.
- China and developed economies show sign of strong growth. However, other emerging economies show mixed signals.

Source: BBVA Research.

Financial stress remains low

BBVA Financial Stress Index
(normalized)



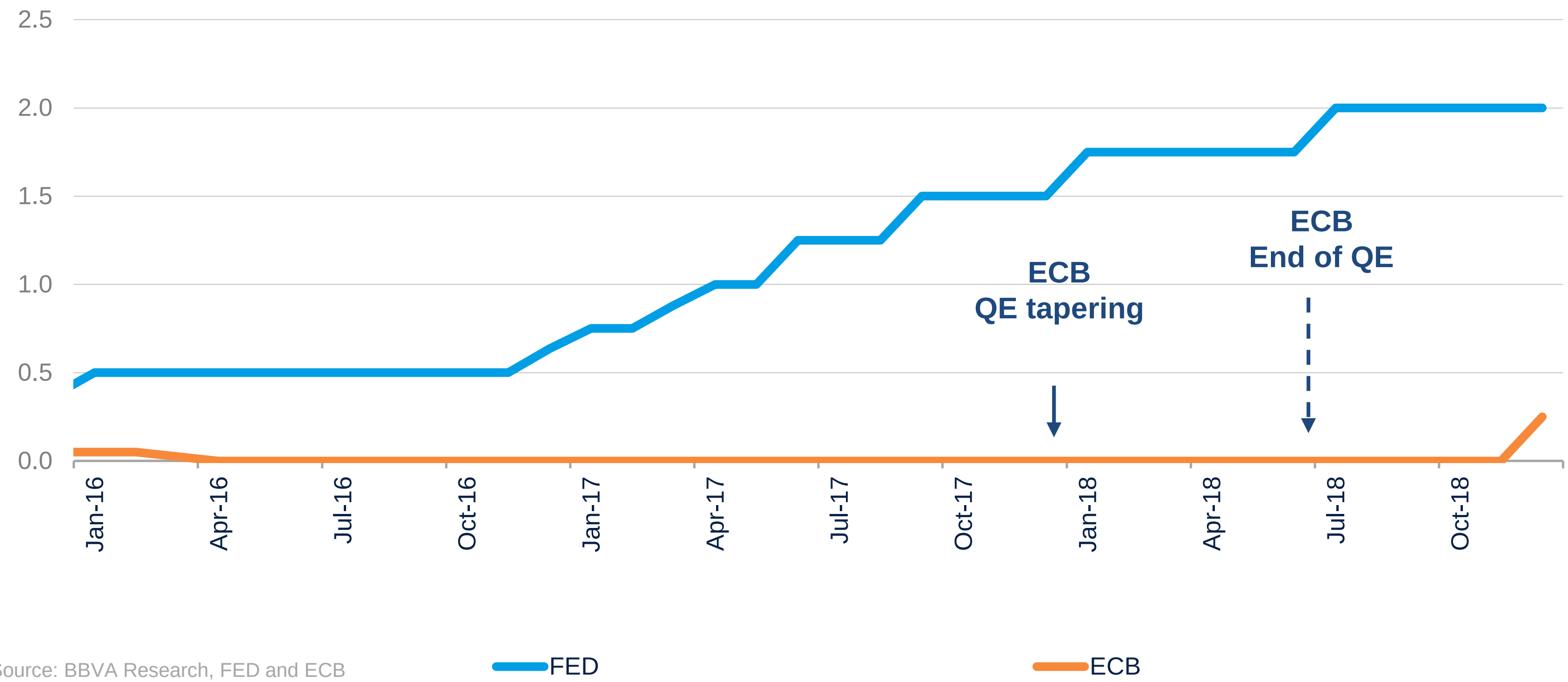
- Volatility has decreased despite uncertainty about economic policies.
- Monetary and fiscal stimulus mask some underlying weakness.
- Europe has been the exception, with some increase in sovereign spreads, linked to elections in France and the political outlook for the region as a whole.

Source: BBVA Research.

Central banks on the way to policy normalization

Official interest rates in the US (Fed) and Eurozone (ECB)

(pp)

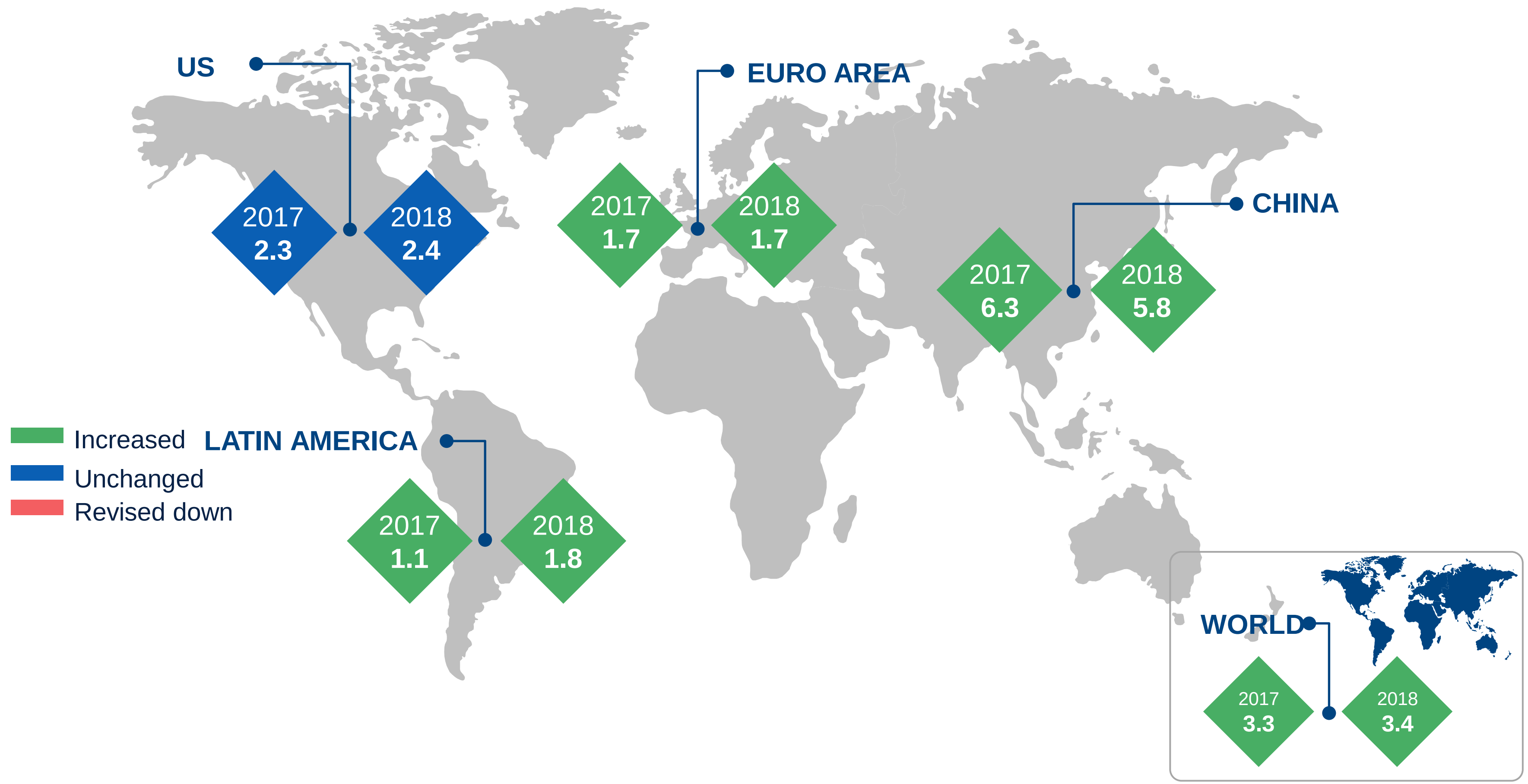


Source: BBVA Research, FED and ECB

Fed continues to increase interest rates, though is still cautious about the economic outlook.

The ECB is to start discussing its exit strategy, but very cautiously.

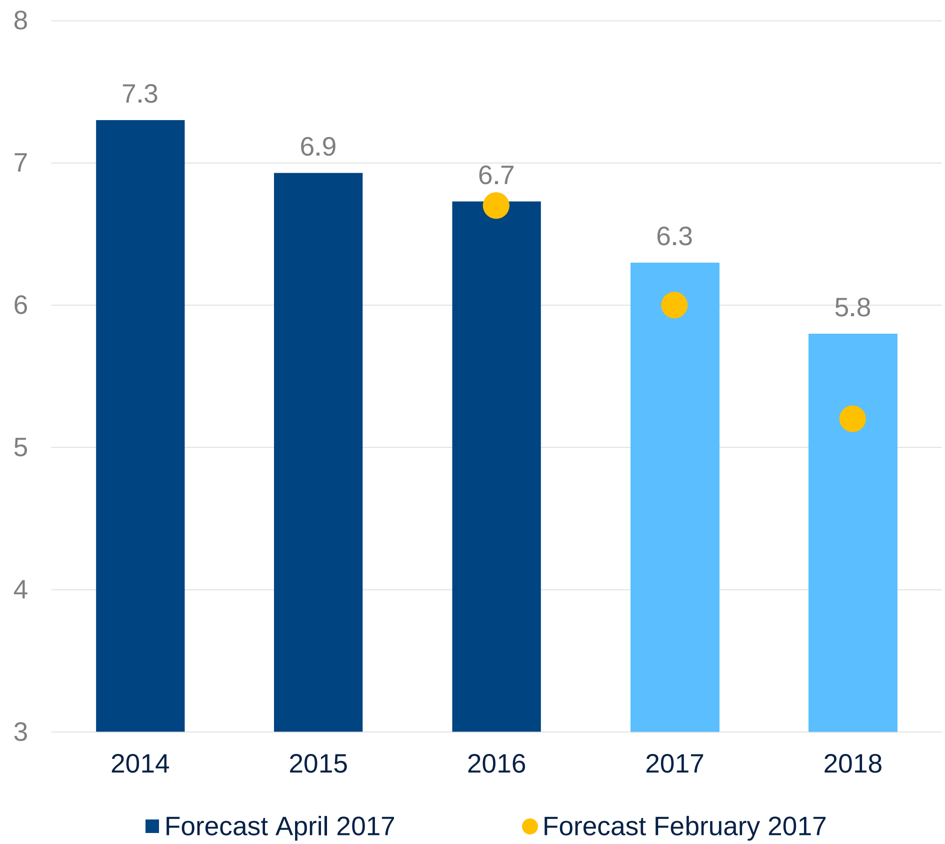
Global growth revised up



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

China: renewed recovery with old engines

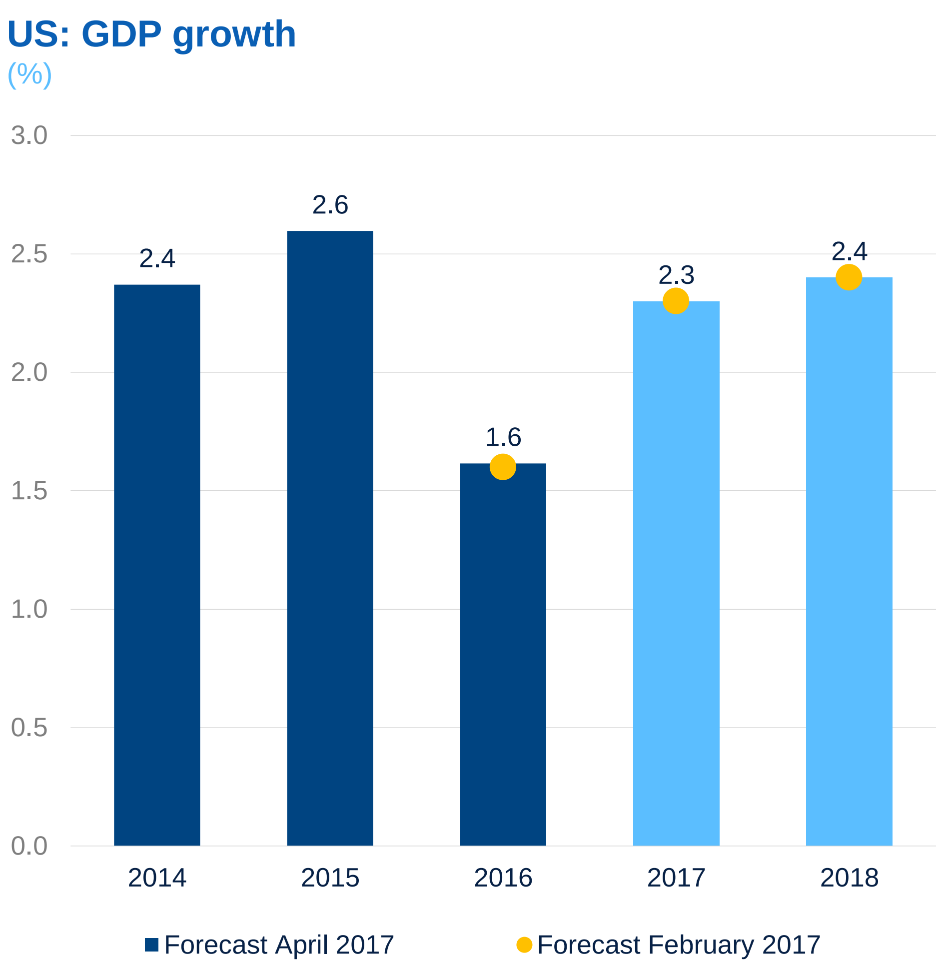
China: GDP growth
(%)



Source: BBVA Research and CEIC.

- We revised up our growth forecasts for 2017-18, due to incoming data and a fiscal impulse. Gradual deceleration underway.
- But medium-term risks are still significant:
  - Rebalancing of growth towards services and consumption has stalled
  - Policy missteps could lead to a disorderly deleveraging

US: diminished prospects of a pro-growth fiscal impulse

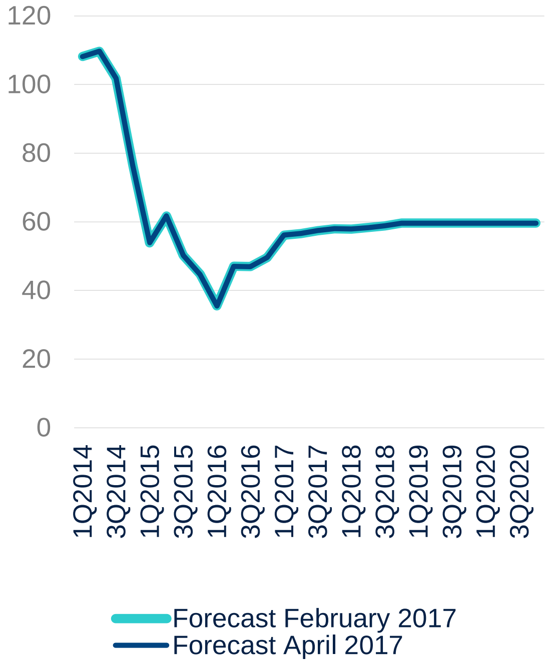


Source: BBVA Research and CEIC.

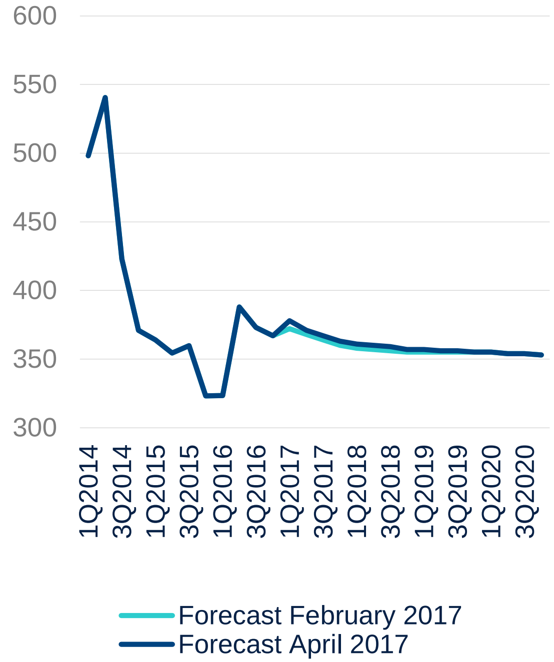
- Growth increases in 2017 given pick up in investment. However, private consumption is expected to slow down.
- Risks stemming from economic policy continue despite a softer tone in the last months.

We maintain our view of gradual convergence of commodity prices to their long-run equilibrium levels

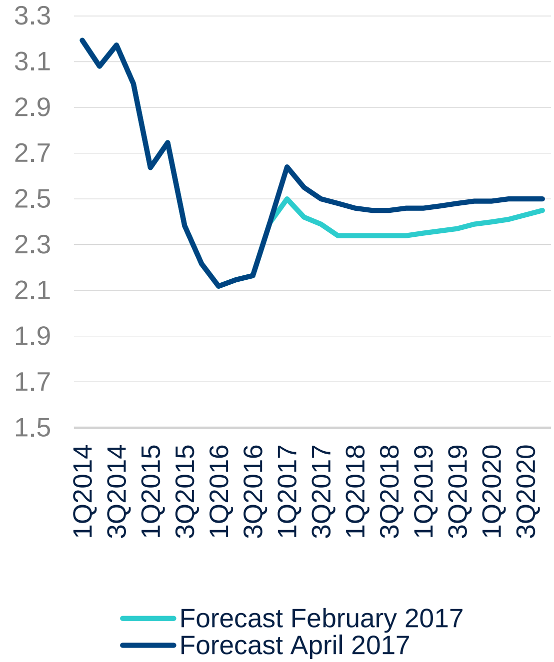
BRENT OIL
(USD/B)



SOYBEANS
(USD/mT)



COPPER
(USD/lb)



Source: BBVA Research and Bloomberg.

Oil prices will continue to get support from OPEC production agreement, as well as increase in demand. Copper prices will benefit from stronger demand and also supply disruptions.

No significant changes in our view for long-term commodity prices. Forecasts mostly unchanged for oil and soybeans relative to February.

Global risks most relevant for Brazil are related to US policies and rebalancing in China

1

Lingering **uncertainty about economic policies** to be implemented in US, especially trade policies

2

Policy stimulus in China to support investment could delay and slow down reforms to reduce structural imbalances

3

Elections in Europe, in (the unlikely) case that Eurosceptic platforms prevail

4

Risks stemming from **monetary policy normalization**, especially in the US

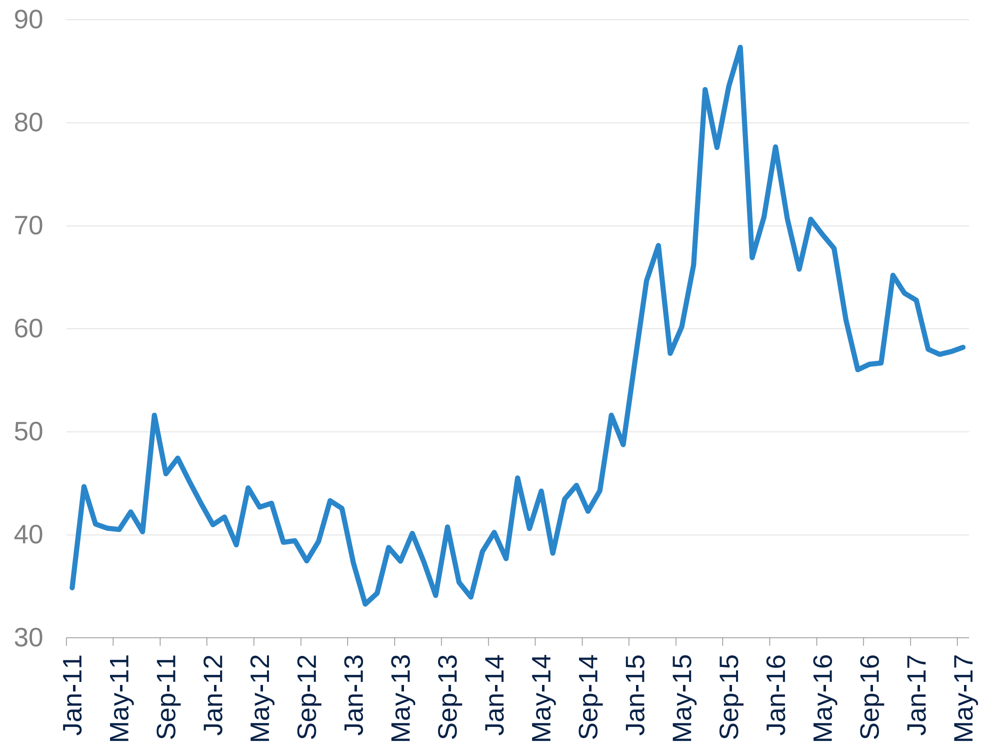
BRAZIL

Economic recovery takes off

Political noise remains at relatively high levels

- Political tensions stopped trending down in the last few months, in part due to the new revelations of ongoing corruption investigations.
- Temer and Rousseff's trial, related to the alleged funding problems during the electoral campaign, has been postponed. Anyway, this issue will continue generating noise.
- In spite of turbulences and low approval ratings (10%), it is still likely that Michel Temer remains in power until next presidential elections, in the end of 2018.

Brazil's Crisis Index*
(based on web searches)

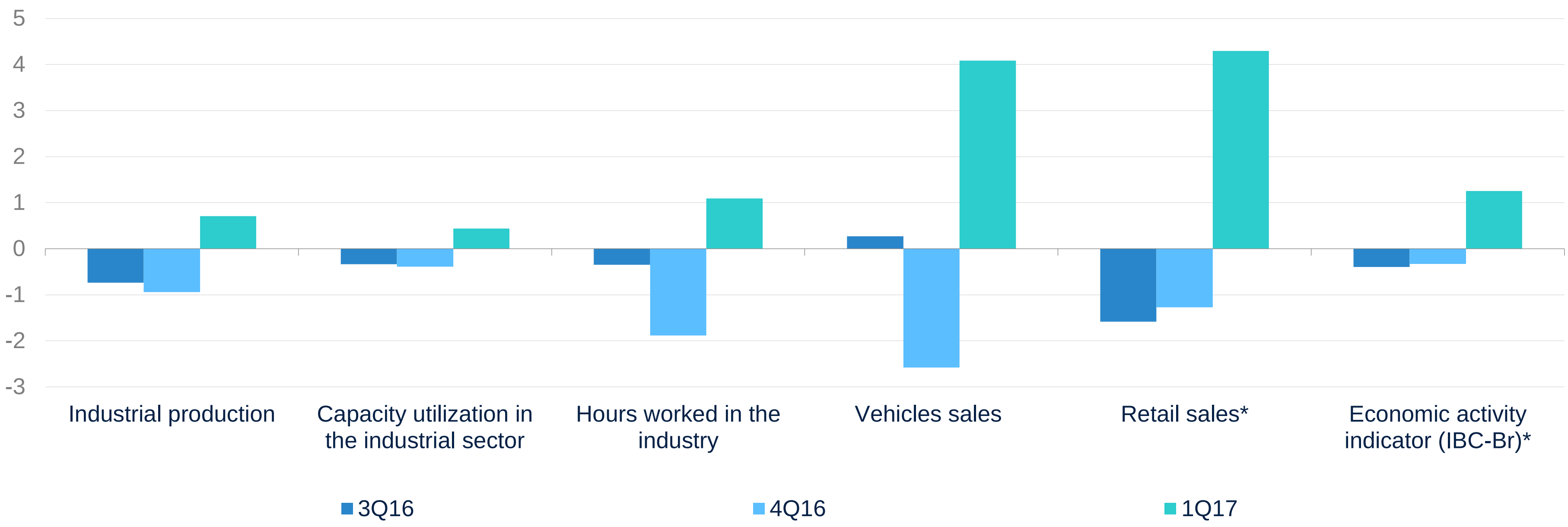


Source: BBVA Research and Google Trends. * Seasonally-adjusted index built on the interest about the term "crise" (crisis in Portuguese).

The green shoots finally appear. GDP to grow positively in 1Q17 following eight quarters of contraction.

Economic activity indicators

(QoQ %)

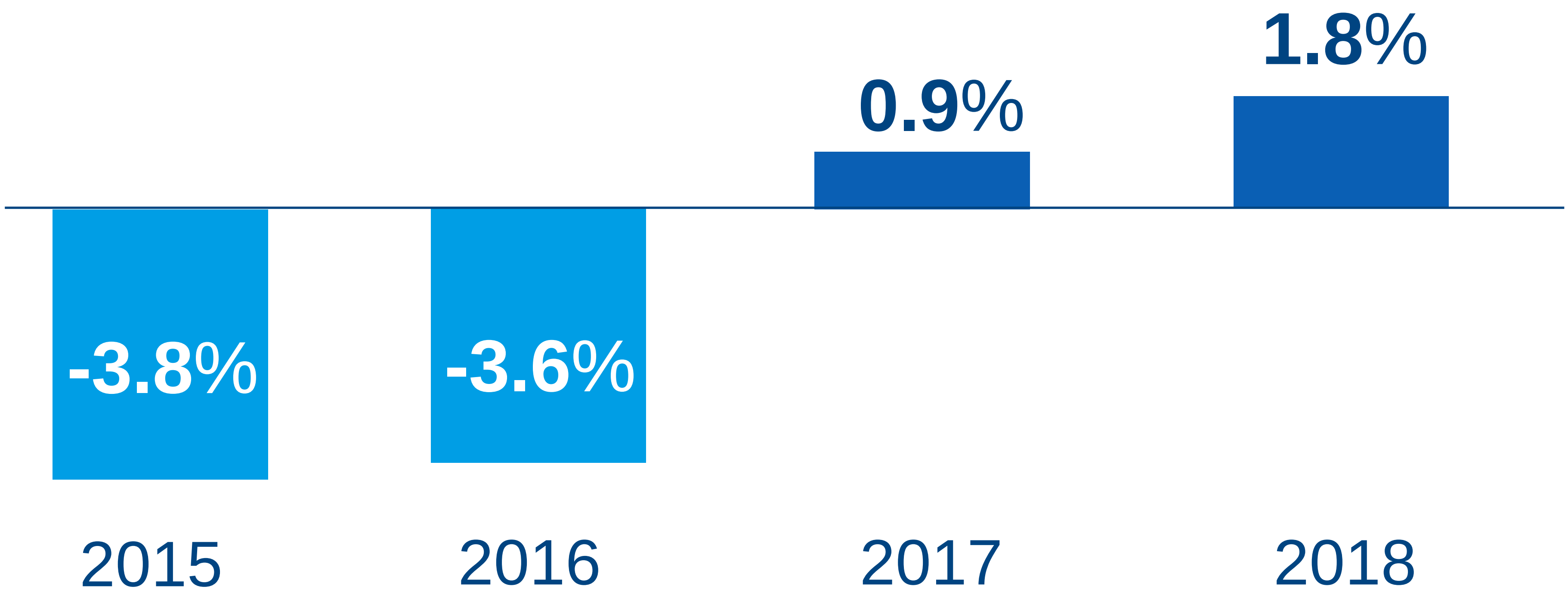


Source: BBVA Research, BCB and IBGE. In the case of 1Q17, the indicators include January and February data. March data was not available at the moment of the elaboration of this report.

Most economic activity indicators suggest positive activity growth in the first quarter of 2017.

Our growth forecast of 0.4 % QoQ for 1Q17 has an upward bias. The primary sector will strongly contribute to positive growth in 1Q17, mostly due to the significate expansion of the agricultural harvest.

The economic environment supports our view that GDP will gradually recover from the deep 2015-16 recession



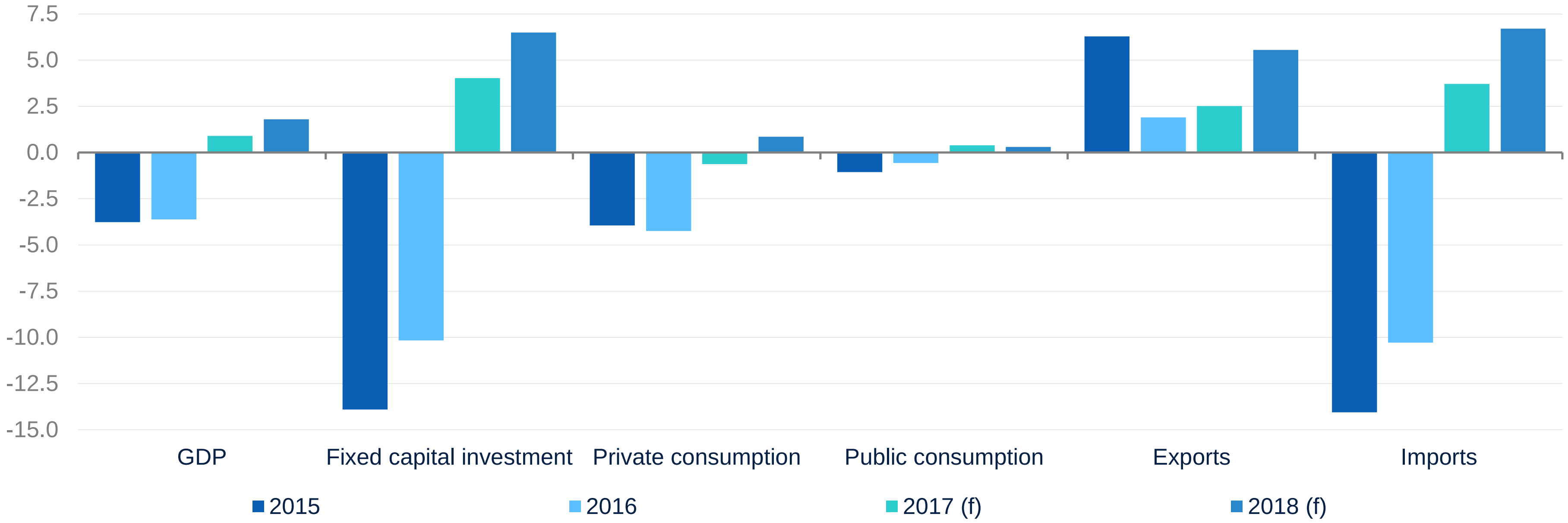
We maintain our 0.95% forecast for 2017 GDP in spite of the signals suggesting stronger-than-expected growth in 1Q17.

We revise upwards our growth forecast for 2018, from 1.2% to 1.8%, due to better prospects for both the global and the local environment.

GDP will be supported by the recovery in investment and the dynamism of exports

GDP growth, by final demand components

(%)



Source: BBVA Research and IBGE. *(f): forecast

Investment should grow at a pace around 5%, after having contracted more than 25% in 2015-16.

Exports will likely continue to contribute positively to growth, thanks to a more robust global growth and a more depreciated exchange rate.

Consumption recovery will be slow as labor markets continue deteriorating. Unemployment reached 13,7% in 1Q17 and is expected to moderate only from the end of this year on.

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A number of factors will support the economic recovery

1. Lower inflation
2. Looser monetary policy
3. Higher confidence in the economy
4. Increased terms of trade
5. Current account adjustment
6. Lower fiscal risk
7. Progress in the reform agenda

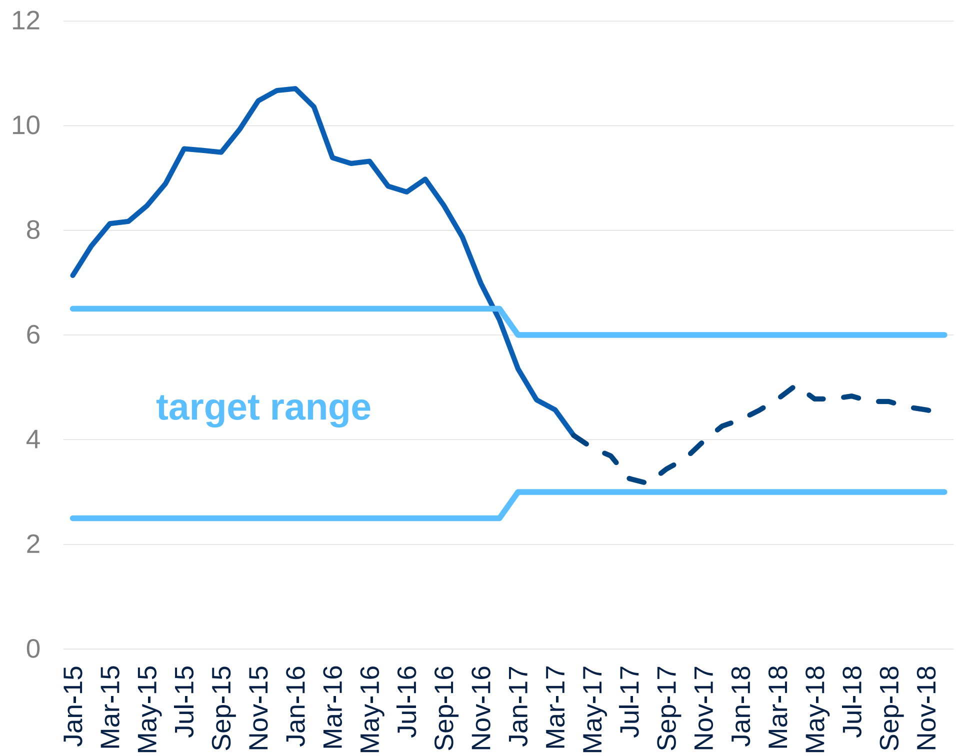
Inflation adjusts quickly downward

- Inflation has moved down from almost 11% at the beginning of 2016 to 4.1% in April, the lowest level in practically ten years.

- The favorable price dynamics is explained by several factors:
  - food prices (favorable supply shock)
  - Smaller adjustments in regulated prices
  - Higher credibility of monetary policy
  - Domestic demand weakness
  - Exchange rate stability

- We forecast inflation to reach 4.3% and 4,5% at the end of 2017 and 2018, respectively. These forecasts are tilted to the downside.

Inflation
(IPCA; % YoY)



Source: BBVA Research and IBGE.

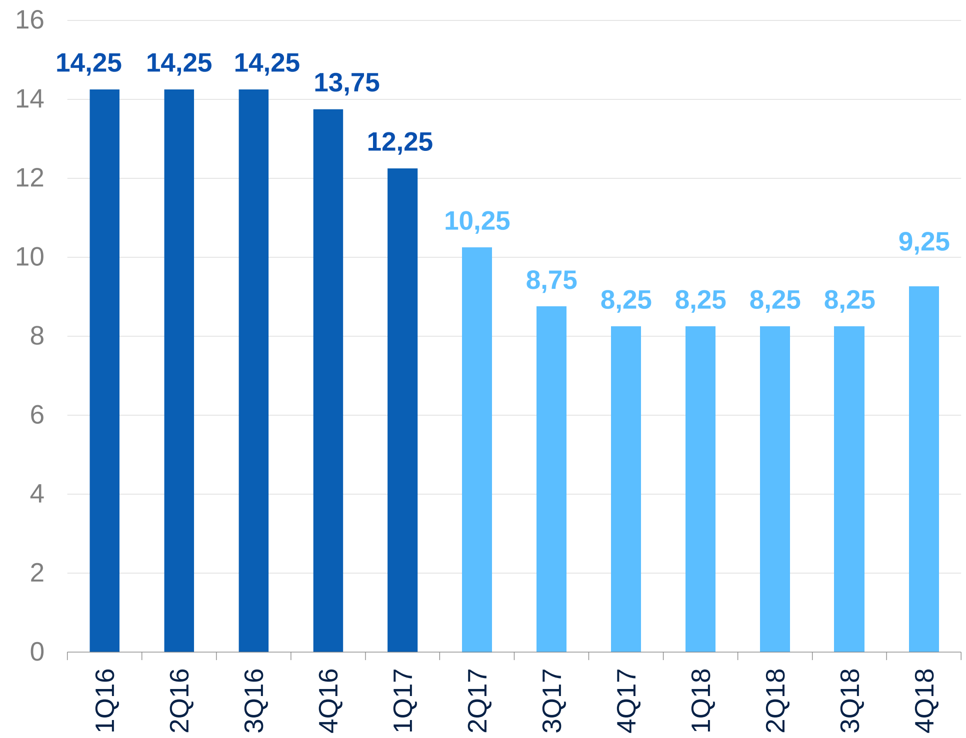
The stronger-than-expected inflation moderation leaves more room for cuts in interest rates

- Following two 25bp cuts at the end of 2016 and two 75bp cuts at the beginning of 2017, the BCB announced a SELIC interest rate cut of 100bp in April.

- The increased BCB aggressiveness in the easing of monetary conditions is in line with the sharp inflation decline and the anchoring of expectations (4.0% in 2017 and 4.4% in 2018).

- We expect the SELIC interest rate to reach 8.25% at year-end after an additional adjustment of 100bp in May, two 75bp cuts in the middle of the year and a final 50bp cut in October.

Policy interest rate: SELIC
(end-of period; forecast from 2Q17 on)



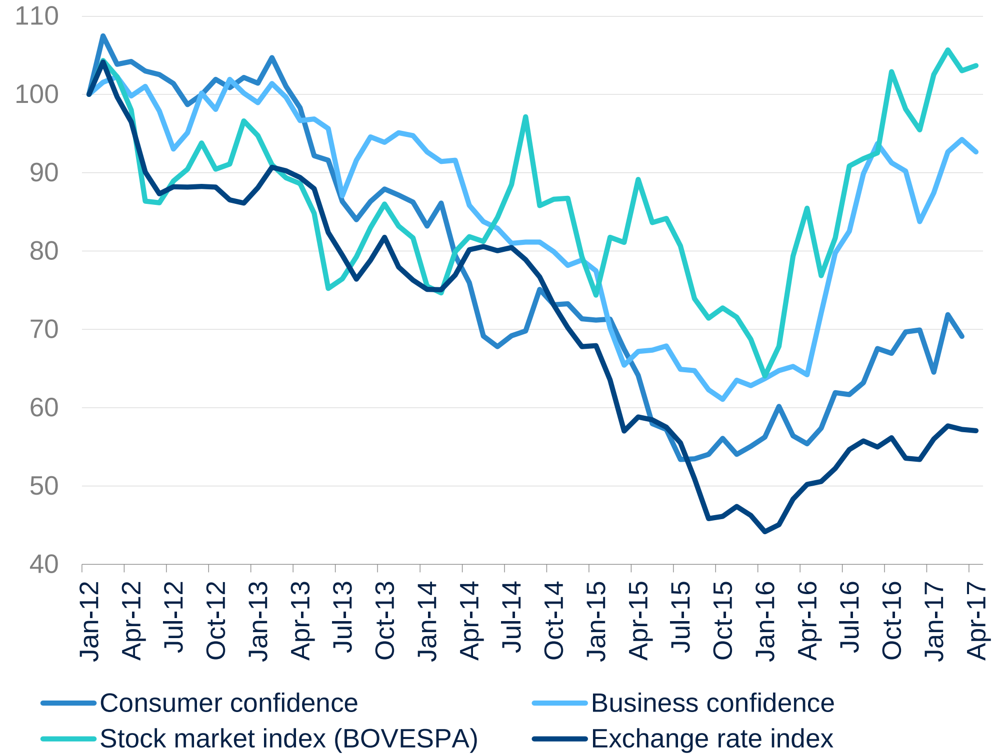
Source: BBVA Research and IBGE.

Higher confidence in the economy.

- Both consumer and business confidence continued to improve in the last months, in line with the lower political uncertainty and the more favorable economic environment.
- Greater confidence in the economy has also been reflected in the price of financial assets.
- The BOVESPA accumulates revenues of 10% on a year-to-date and 30% in 12 months.
- The real has appreciated 2% so far this year and 10% in 12 months.

Confidence, stock market and exchange rate indexes

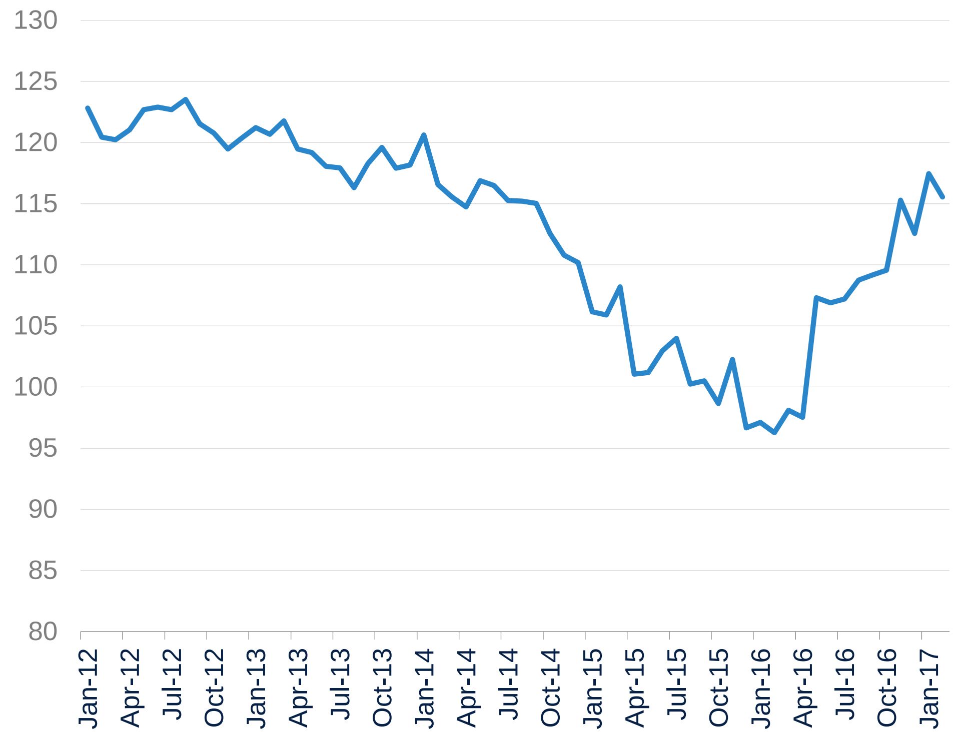
(indexes: Jan-12 = 100; increments in the exchange rate index reflect appreciations)



Recovery in the terms of trade

- The terms of trade –i.e the ratio of the price of exported products to the price of imported products– recovered since the beginning of 2016 an important part of previous losses.
- To a large extent that is the result of the acceleration in global growth and higher commodity prices.
- The recent increase in Brazil's terms of trade supports domestic growth. Moreover, it favors the appreciation of the exchange rate.

Brazil's terms of trade
(index: average of 2006 = 100)

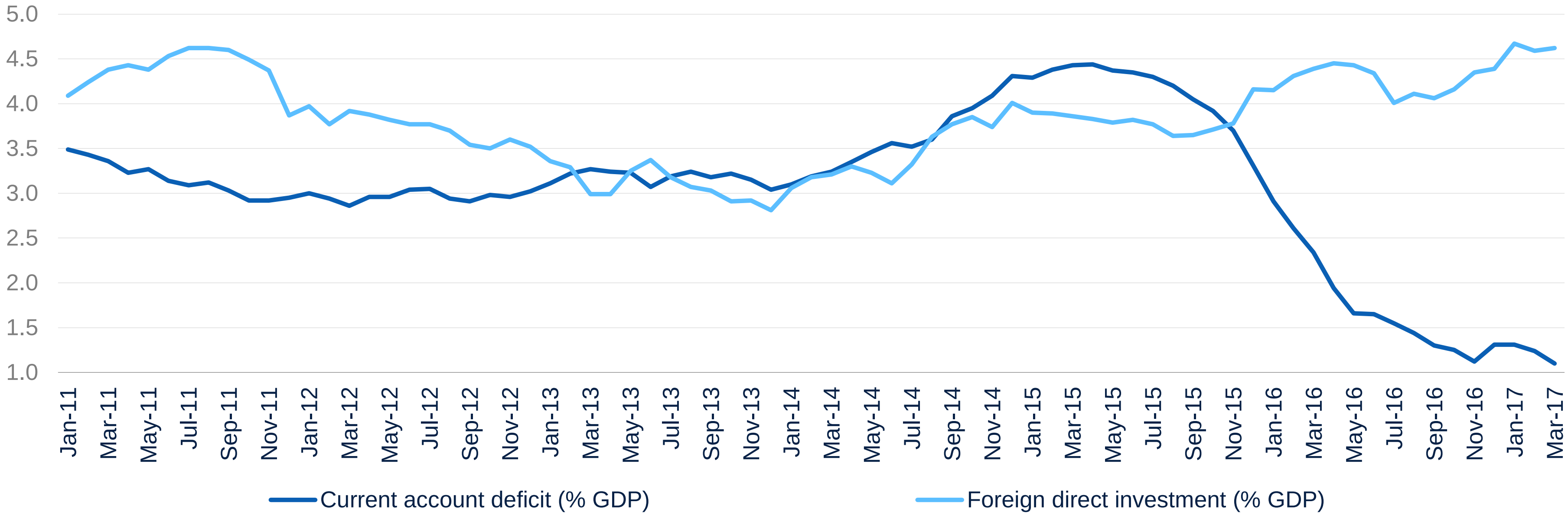


Source: BBVA Research and IPEADATA.

The current account deficit declined sharply while FDI remained robust

Current account deficit and foreign direct investment (FDI) in Brazil

(%, GDP)



Source: BBVA Research and BCB.

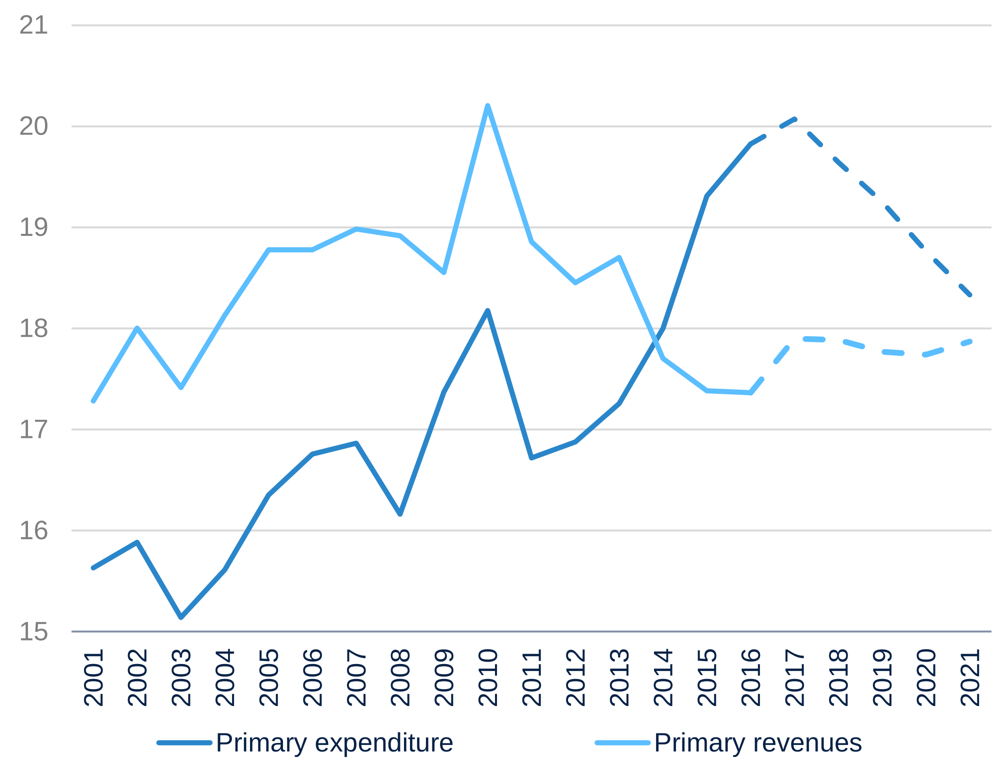
The current account deficit declined to 1.1% of GDP in March. We expect it to remain broadly constant during 2017 and 2018. The greater dynamism of imports will likely be offset by larger exports, mainly of primary products.

The external adjustment takes some pressure off the exchange rate. However, the ongoing reduction of the Selic rate combined with increasing rates in the US will likely drive the Brazilian real down: we expect it to reach 3.3 and 3.5 at end of this and of the next year, respectively.

The adoption of a ceiling for public spending should allow public accounts to improve gradually

- The approval of the law that forces the government to keep primary expenditure constant in real terms improves fiscal prospects.
- The fulfillment of this law and economic recovery will allow the public sector's primary deficit to drop from 2.5% of GDP in 2016 to 1.7% in 2017 and 1.4% in 2018.
- The reduction of the country-risk and a lower SELIC will reduce interest payments, contributing to drive down the nominal deficit from 9.0% of GDP in 2016 to 8.0% in 2017 and 6.8% in 2018.
- Before stabilizing as a consequence of complying with the new fiscal rule, public debt should reach 85% of GDP in 2021.

Federal government's primary accounts
(%, GDP)

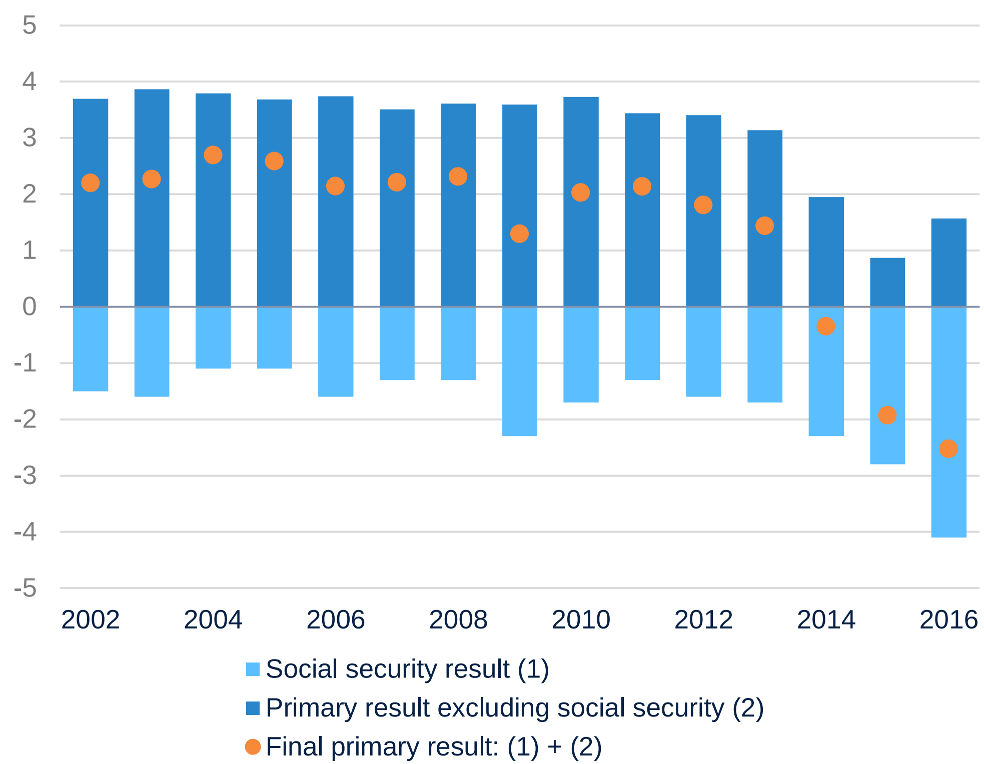


Source: BBVA Research and Ministry of Finance of Brazil.

The compliance with the fiscal law requires a further spending adjustment ,which would be easier with a social security reform

- To avoid having to cut basic services in the future, the government presented a project to reform the social security system and reduce its unsustainable deficit.
- The approval by the Congress of the social security reform is uncertain as it has a high political cost, especially in the current context.
- The non-approval of the reform would risk fiscal improvement, jeopardizing the economic recovery.

Social security and primary results*
(%, GDP)



Source: BBVA Research, BCB and Brazil Minster of Finance. * The social security result refers to federal government. The primary result refers to the consolidated public sector.

The government is working to approve not only a social security reform but also a labor market one

Proposed social security reform

- ✓ Increase retirement age to 62 years for women and 65 years in the case of men
- ✓ Transition rule: retirement age will gradually converge to the proposed ones during the next 20 years.
- ✓ Minimum time of contribution: 25 years
- ✓ Automatic increments of the retirement age as life expectations increases

Main goals

- ✓ Prevent exponential growth of social security spending
- ✓ To pave the way for the government to fulfill the fiscal rule compliance and for a moderation of public debt (from 2020-2022 onwards)
- ✓ To reduce structural interest rates
- ✓ Increase the economically active population and potential GDP

Proposed labor market reform

- ✓ Put an end in worker's compulsory contributions to labor unions
- ✓ Negotiated agreements between employees and employers to prevail over legislation
- ✓ Reduce the room for judicial interpretation of labor market legislation

Main goals

- ✓ Flexibility and modernization of labor market
- ✓ Reducing informality in the labor market
- ✓ Increase employment levels and boost economic growth

Main messages

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3. **The materialization of the fiscal adjustment depends on the approval of the social security reform.** The adoption of a ceiling for public spending is a good news that directly reduces fiscal risk. However, compliance with the new fiscal rule requires a significant spending adjustment, which would be very difficult to implement without a social security reform. Hence, failing to approve such reform would risk the economic recovery.

ANNEX

Brazil forecasts

	2015	2016	2017f	2018f
GDP (%)	-3.8	-3.6	0.9	1.8
Private consumption (%)	-3.9	-4.2	-0.6	0.9
Public consumption (%)	-1.1	-0.6	0.4	0.3
Fixed capital investment (%)	-13.9	-10.2	4.0	6.5
Exports (%)	6.3	1.9	2.5	5.5
Imports (%)	-14.1	-10.3	3.7	6.7
Unemployment rate (average)	8.3	11.3	13.5	12.8
Inflation (end of period, y/y %)	10.7	6.3	4.3	4.5
SELIC interest rate (end of period, y/y %)	14.25	13.75	8.25	9.25
Exchange rate (end of period, BRL/USD)	3.80	3.35	3.30	3.50
Current account (% of GDP)	-3.3	-1.3	-0.7	-1.1
Public sector nominal result (% of GDP)	-10.2	-9.0	-7.9	-6.8
Public sector gross debt (% of GDP)	66.2	69.9	74.6	77.1

f = forecast