BTMU Focus Latin America

Brazil: Macroeconomic Performance

(3Q GDP and Current Monthly Indicators)

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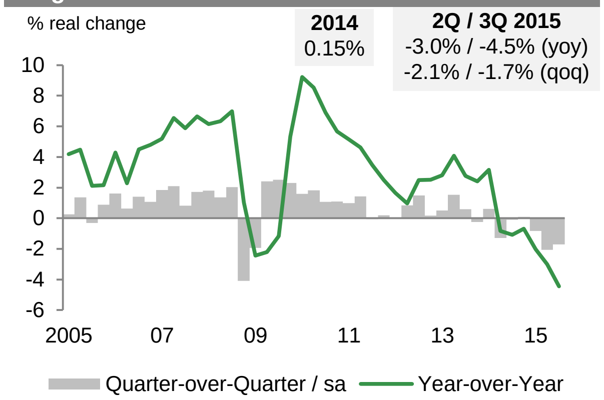
Contents

I) Brazil: Growth Momentum (1)

▪ The Brazilian economy is still in free fall.

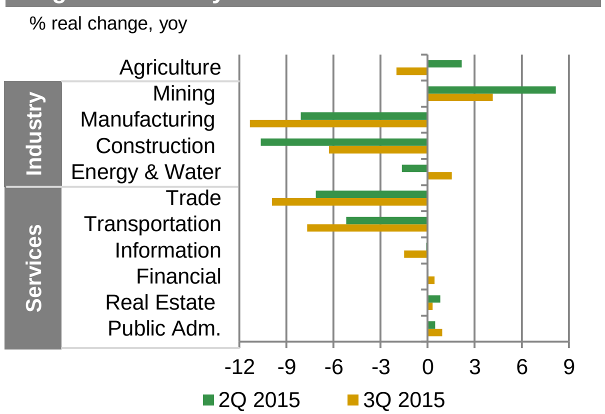
- More than a year has gone by since Brazil slipped into an economic recession, and the perception is that the largest economy of Latin America is still in free fall, exacerbated by the government's fruitless and paltry efforts to fill an ever-deeper fiscal hole, amid an ongoing political crisis that has sapped President Rousseff's capacity to steer the country out of recession. As the third-quarter data revealed, the Brazilian economy shrank further in 3Q 2015 as sectors that are relatively more reactive to changes in domestic demand, such as manufacturing, trade and transportation, contracted at a faster pace in response to sharp cutbacks in spending by firms and households, rather than by the government. In fact, public spending hardly declined in 3Q; while household consumption and gross fixed capital formation (GFCF), two engines of growth during the commodity-price boom period, posted their largest yoy drop on record. Equally troubling is the fact that export volume fell in 3Q on a qoq basis despite the dramatic depreciation of the real. All this suggests the end of the recession is still nowhere in sight.

Figure 1: GDP



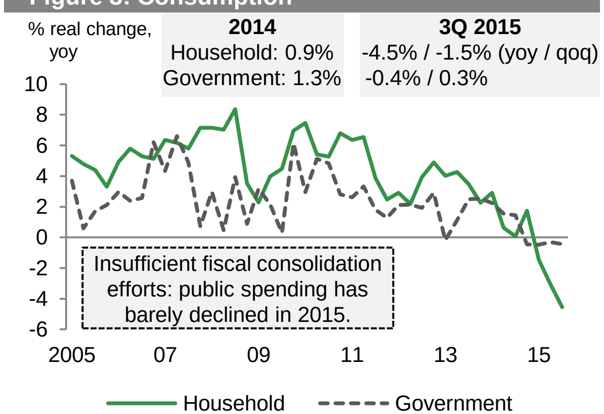
Source: Instituto Brasileiro de Geografia e Estatistica (IBGE); BTMU

Figure 2: GDP by Sector



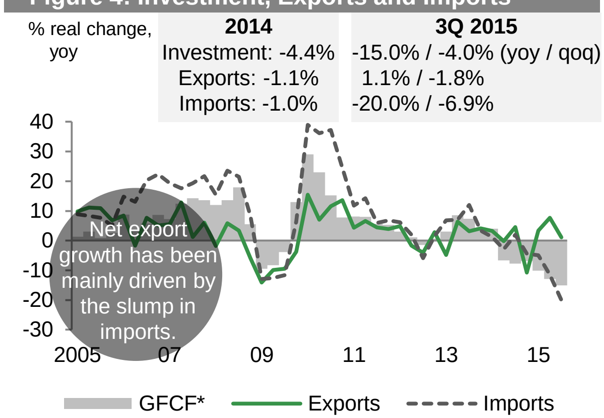
Source: IBGE; BTMU

Figure 3: Consumption



Source: IBGE; BTMU

Figure 4: Investment, Exports and Imports



*Gross fixed capital formation
Source: IBGE; BTMU

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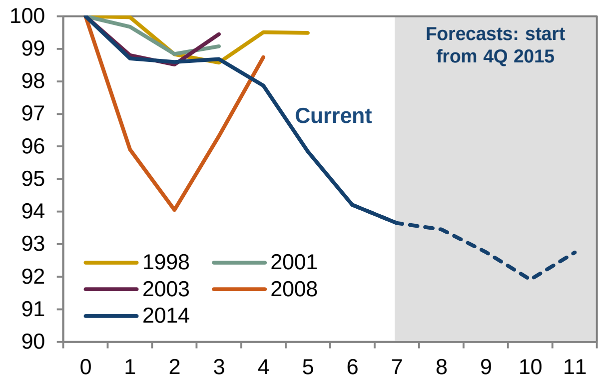
I) Brazil: Growth Momentum (2)

▪ The current severe recession is probably of Brazil's own making.

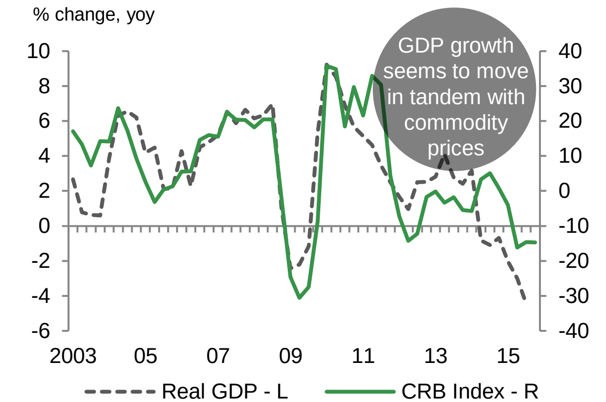
- The Brazilian economy, once a beacon of progress for other Latin American economies, is heading for one of its steepest and longest recessions in decades. There is no doubt the largest economy of the region, whose exports are heavily concentrated in raw materials, has been buffeted by the dry-up of windfalls from the recent commodity-price boom. Intriguingly, though, countries that display a higher degree of commodity dependence, such as Chile, Colombia and Peru, are faring much better that Brazil, which hints that there must be other factors to blame. The truth is many of the country's urgent economic problems are of its own making. After the 2008 global financial crisis, Brazil greatly benefited from the strong rebound in commodity prices and capital inflows, which along with undue fiscal and monetary stimulus, arguably fueled GDP growth in 2010 and 2011. The problem is that those policies also fostered imbalances, fueled inflation, and placed public finances on an unsustainable path, leaving the economy fragile and vulnerable to external shocks (continued on next slide).

Figure 5: Episodes of Recession (GDP)*



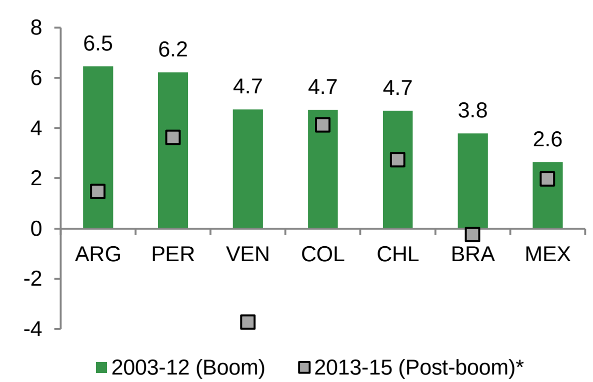
*Start: 2 consec. quarters of neg. growth, End: returning to initial point
Source: IBGE; Consensus Economics; BTMU

Figure 6: Real GDP and CRB Index*



*Commodity Research Bureau Index
Source: IBGE; Commodity Research Bureau (CRB); BTMU

Figure 7: GDP Growth of Major LatAm Economies



* 2015 growth rates are forecasted
Source: IMF, WEO October 15; Consensus Economics; BTMU

Figure 8: Degree of Commodity Dependence*

Country	Trade		Public Finance	Investment
	Gross Exports	Net Exports	Fiscal Revenues	FDI
Argentina	High	Moderate	Low	Low
Brazil	High	Low	Low	Moderate
Chile	Very High	High	Moderate	High
Colombia	Very High	Moderate	Moderate	High
Mexico	Very Low	Very Low	High	Very Low
Peru	Very High	Moderate	Moderate	High

*Own Classification, see our latest Special Report (January 2016)
Source: BTMU

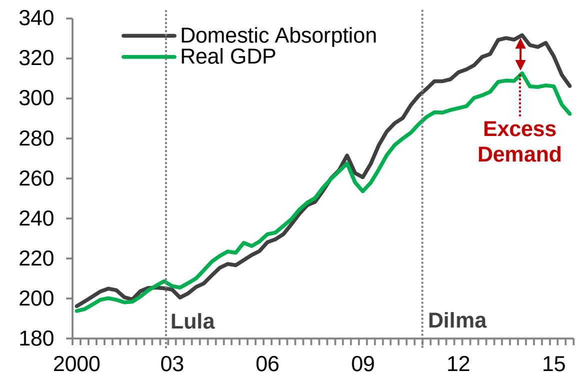
I) Brazil: Growth Momentum (3)

- **Still no end in sight for Brazil's protracted recession: the economy will contract further in 2016.**

- At the end of 2014, the situation had become unsustainable and urgent corrections were needed. Indeed, some adjustments were made in 2015: the central bank raised interest rates to tame inflation; the real depreciated greatly, helping narrow the current-account deficit; and both households and firms naturally cut back spending. Although those adjustments were welcome, one major issue stays unsolved: the government's unsustainable debt path. Now Brazil is caught in a self-constructed fiscal trap: the government signals its willingness to rein in spending, but its failures are constantly feeding back into the real economy through expectations and pressures on the currency and inflation, which makes it harder for the economy to stabilize and resume growth. Against this gloomy backdrop, the economy is expected to have shrunk by more than 3.5% in 2015. And given the absent of foreseeable growth drivers coming from the external front, and the continued weakening of several domestic drivers, it is probable GDP will contract further in 2016.

Figure 9: GDP and Domestic Absorption*

Billion BRL, constant prices, seasonally adjusted using Census X-13

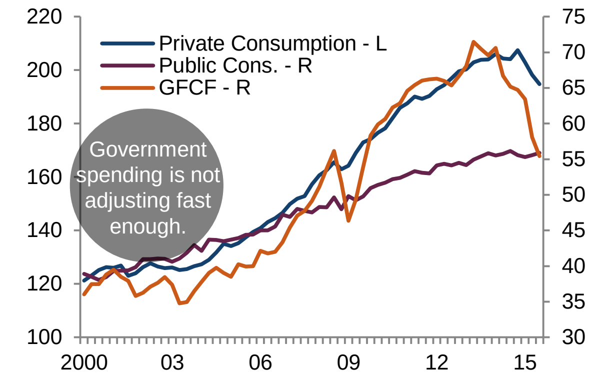


*Domestic Absorption = Private and Public Consumption + GFCF

Source: IBGE; BTMU

Figure 10: Domestic Absorption Components

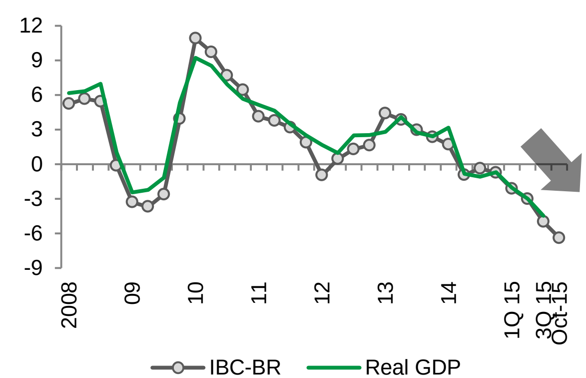
Billion BRL, constant prices, seasonally adjusted using Census X-13



Source: IBGE; BTMU

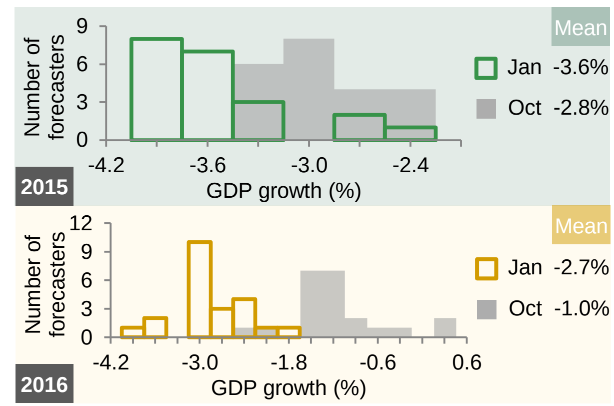
Figure 11: Index of Economic Activity and GDP

% real change, yoy



Source: IBGE; Banco Central do Brasil; BTMU

Figure 12: GDP Growth (private forecasts)



Source: Consensus Economics; BTMU

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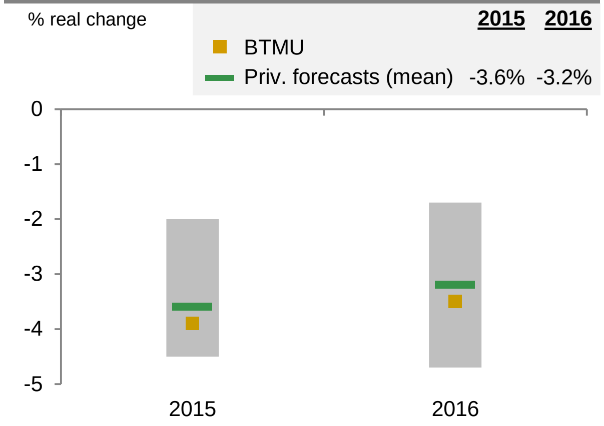
I) Brazil: Growth Momentum (4)

▪ A recovery in household consumption in 2017 is becoming more uncertain.

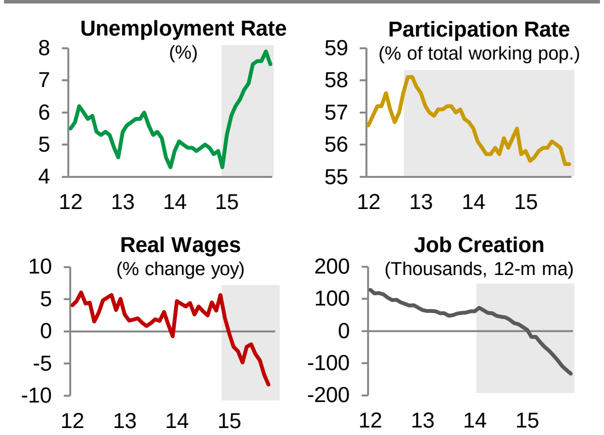
- Household consumption is set to post its steepest contraction on record in 2015. It is also becoming evident that consumer spending will sink further in 2016, as the prime drivers of consumption strongly hint. First, labor market conditions continue to weaken in response to the sharp contraction in real output. Net formal job losses, for instance, hit more than one million last year, which exceeded the jobs created in the prior two years combined. True, Brazil's jobless rate, at 7.5%, is still below the financial-crisis levels, though it may not describe the situation accurately: the portion of the working-age population who are actively seeking job (the participation rate) has been falling since late 2012. In fact, if that rate is held constant, the jobless rate would be 11.8%. Second, lending conditions are too getting tighter by the day, as both consumers and banks take a more cautious stance. To make things more complicated, inflation and interest rates are expected to remain high throughout 2016, while depreciation pressures on the real will likely persist. At this point, even a recovery in 2017 is uncertain.

Figure 13: Private Consumption (Forecasts)



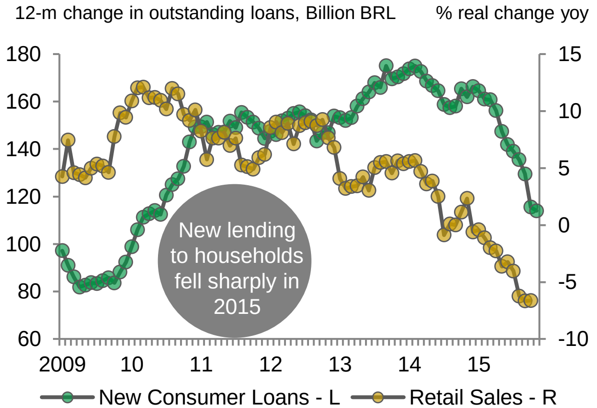
Source: Consensus Economics; BTMU

Figure 14: Labor Market



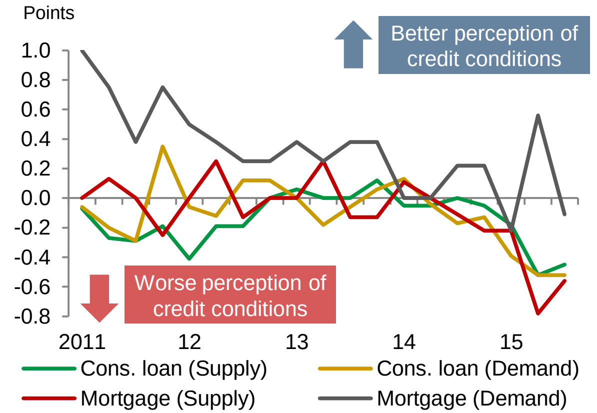
Source: IBGE ; Ministerio do Trabalho e Emprego; BTMU

Figure 15: Net New Cons. Loans* & Retail Sales



*Excludes operations carried out with rural and housing sectors
Source: IBGE; Banco Central do Brasil; BTMU

Figure 16: Credit Conditions for Households



*Point scale ranges from -2(worse) to 2 (better) points.
Source: Quarterly Survey held by Banco Central do Brasil; BTMU

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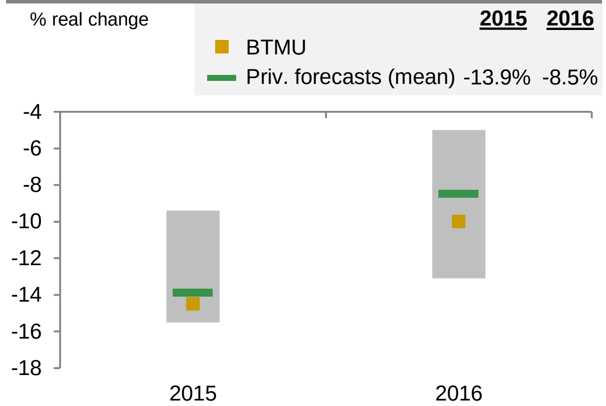
I) Brazil: Growth Momentum (5)

▪ Another disastrous year ahead for investments.

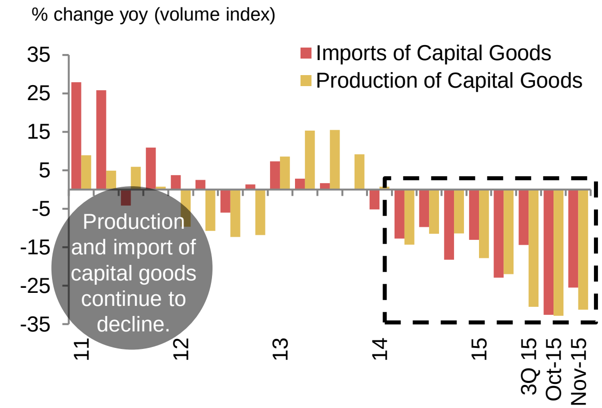
- The fact that GFCF, a measure of investment in property and equipment, contracted qoq for a ninth consecutive quarter in 3Q 2015 says much about the profound distrust of the business community in the government's ability to deliver on its professed fiscal target amid a fragmented political landscape. More importantly still, it says much about the adverse economic conditions in which firms have been operating. The weakening real, for example, has raised the prices of imported capital goods; while the slump in domestic demand has puffed up the decline in production of capital goods. High interest rates and the downgrade of Brazil's credit rating to junk status have also contributed to the collapse of GFCF by raising borrowing costs. So not surprisingly, firms and banks have started to take a more cautious stance, which is reflected in the tightening lending conditions. Now, chances are that most of those adverse conditions will persist or even intensify in 2016, suggesting another gloomy year ahead. If so, it would not be shocking to see GFCF sagging by double-digit percentages again.

Figure 17: Gross Fixed Investment (Forecasts)



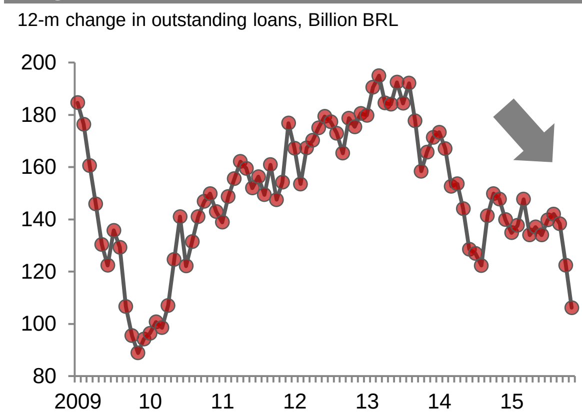
Source: Consensus Economics; BTMU

Figure 18: Production & Import of Capital Goods



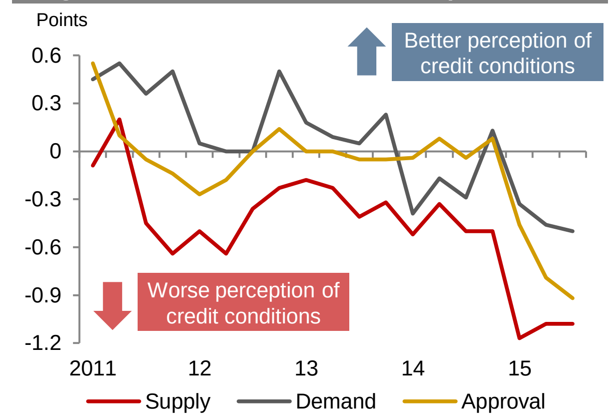
Source: IBGE; FUNCEX; BTMU

Figure 19: Net New Loans to Businesses



Source: Banco Central do Brasil; BTMU

Figure 20: Credit Conditions for Corporates



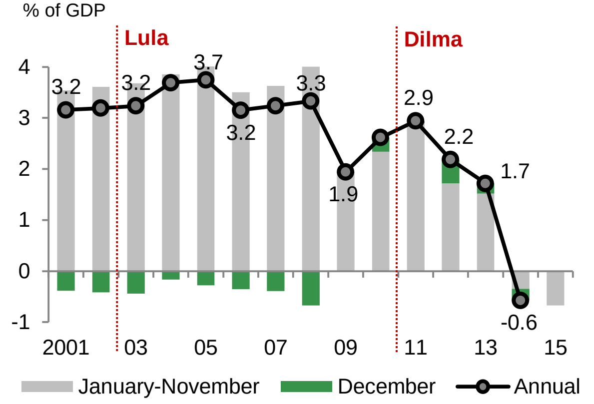
*Point scale ranges from -2(worse) to 2 (better) points.
Source: Quarterly Survey held by Banco Central do Brasil; BTMU

II) Brazil: Public Finance

▪ The fiscal crisis will linger throughout 2016 and continue to hinder economic recovery.

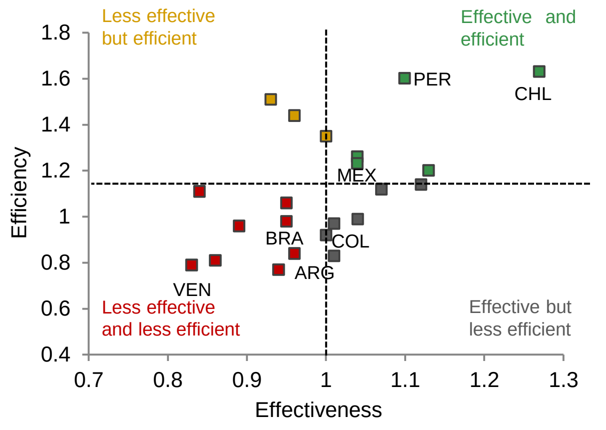
- The resignation of Mr. Levy, Brazil's former finance minister, in December 2015 and his replacement by Nelson Barbosa set a new chapter in the country's escalating fiscal crisis. Mr. Barbosa, a left-leaning economist who reportedly favored fiscal-stimulus measures and interventionist policies when he was the deputy finance minister during Ms. Rousseff's first term, assured investors that the government will take the needed measures to achieve a primary surplus of 0.5% in 2016. Still, analysts aired their skepticism and feared the President will try to bring back the old policy playbook in a calculated move to build political support ahead of the impeachment process against her. Regardless of Ms. Rousseff's aims, the country's fiscal plight will linger this year and possibly beyond. First, because Brazil's rigidity in public spending is a structural issue that cannot be fixed without a strong political consensus. Second, even a surplus of 0.5% is a herculean task given the sheer scale of the cuts (+1.5% of GDP). Third, even if the target is met, additional efforts will be needed in order to stabilize the debt.

Figure 21: Government Primary Balance*



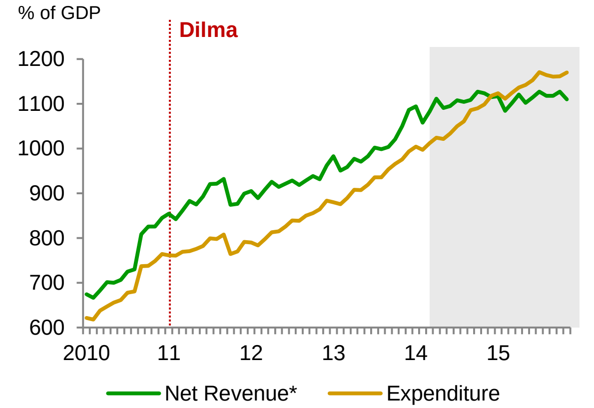
*Consolidated Public Sector
Source: Banco Central do Brasil; CRB; BTMU

Figure 22: Pub. Sector Efficiency in Latin America



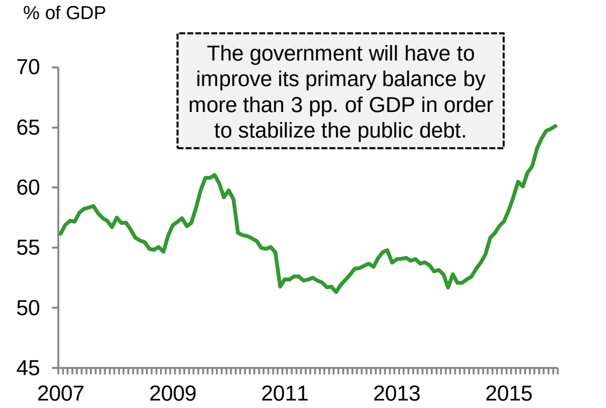
Source: Alfonso, Romero and Monsalve (2013), IDB; BTMU

Figure 23: Government's Revenue & Expenditure



Source: Ministerio da Fazenda; BTMU

Figure 24: Gross General Government Debt



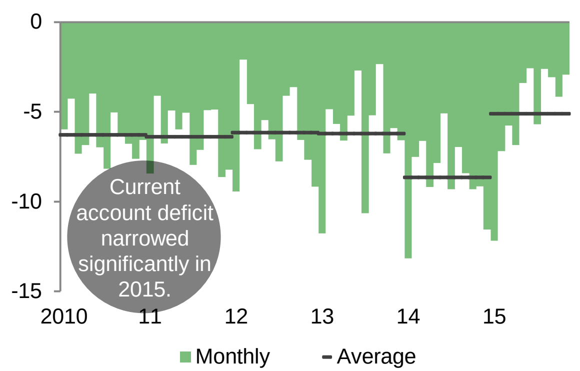
Source: Banco Central do Brasil; BTMU

III) Brazil: External Sector (1)

▪ Current account deficit is narrowing, but on the back of lower imports rather than stronger exports.

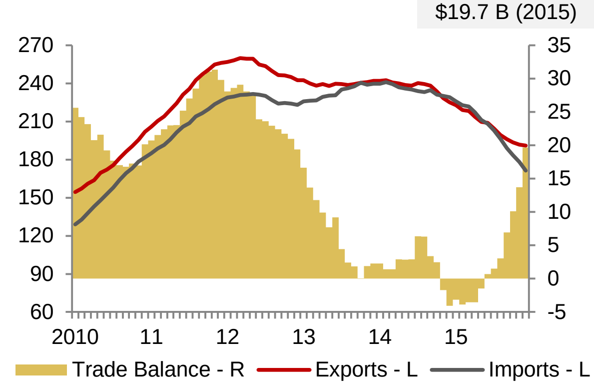
- When an economy is stuck in an acute recession with no end in sight or easy way out, it can sometimes be tricky to find something positive to say. In the case of Brazil, that faint glimmer of hope is the country's enhanced external position, which has improved much faster than anticipated. In fact, current account deficit in 2015 is set to be around 40% smaller than a year earlier, underpinned by an improving trade balance that swung from a deficit of $4 billion in 2014 to a surplus of $19.7 billion in 2015. That could be a pivotal upturn for Brazil as it may signal that the weaker currency is finally giving exporters a boost, and helping to pave the way for economic recovery. But the reality is dimmer: the large trade surplus recorded last year was essentially driven by imports instead of exports. As a matter of fact, imports collapsed by double-digit rate in both value and volume. True, low oil prices explain a part of the plummet, especially in value, but most of the blame can be pinned on the tumbling currency and domestic demand (continued on next slide).

Figure 25: Current Account Balance



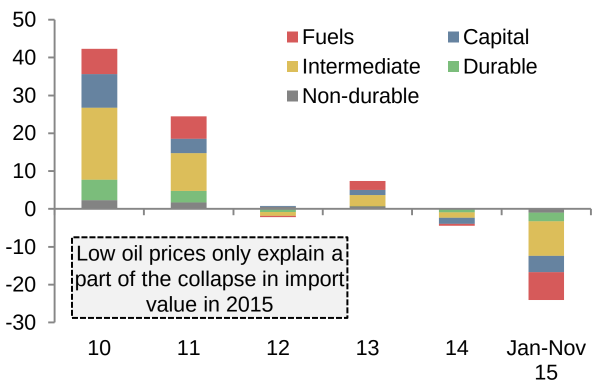
Source: Banco Central do Brasil; BTMU

Figure 26: Trade Balance, Exports and Imports



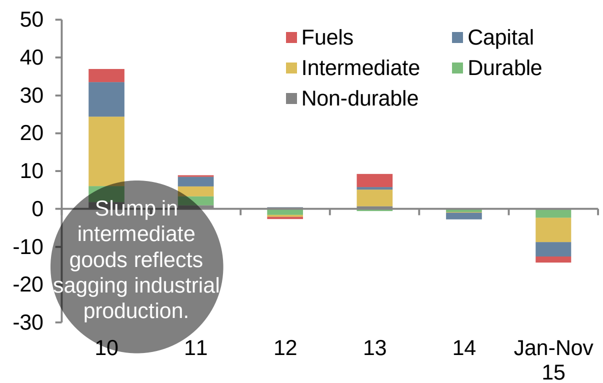
Source: Ministry of Development, Industry and Foreign Trade; BTMU

Figure 27: Nominal Imports



Source: FUNCEX; BTMU

Figure 28: Real Imports



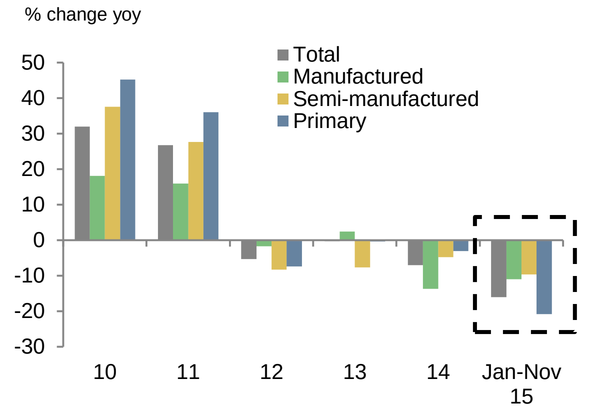
Source: FUNCEX; BTMU

III) Brazil: External Sector (2)

▪ The prevalence of wage indexation is probably impairing the effects of a weaker real on exports.

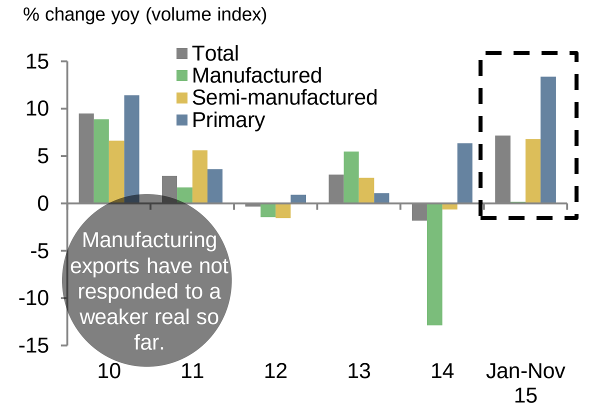
- Brazil's exports retracted for a 4th consecutive year in 2015 in nominal terms, as they were hit hard by the steady decline in overall export prices (mainly explained by low commodity prices and their direct effects on manufacturing costs). But intriguingly, export volume grew at an average pace of around 7% from January to November 2015, which is the fastest rate in five years. That is of course good news, though not without one important caveat: the sturdy recovery stemmed from higher production of primary goods (~commodities) rather than from a weaker real. In fact, manufacturing exports barely grew despite a nearly 50% depreciation in the real in 2015. That naturally raises the question of why a weaker real has so far failed to spur exports. Surely external factors such as the global trade slowdown are part of the reason. But it is also possible the issue is internal: high incidence of wage indexation has put intense upward pressures on non-tradable prices (~services), averting the price ratio between tradables and non-tradables, a different measure for real exchange rate, from depreciating.

Figure 29: Nominal Exports



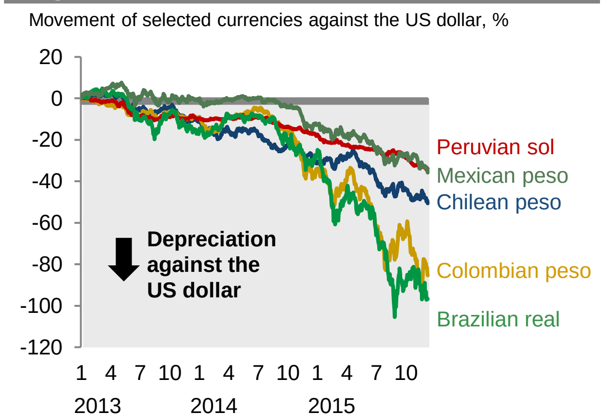
Source: FUNCEX; BTMU

Figure 30: Real Exports



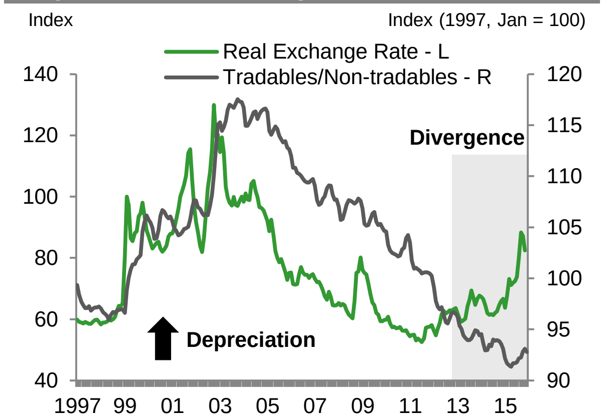
Source: FUNCEX; BTMU

Figure 31: Latin American Currencies



Source: Thomson Reuters Datastream; BTMU

Figure 32: Real Exchange Rates



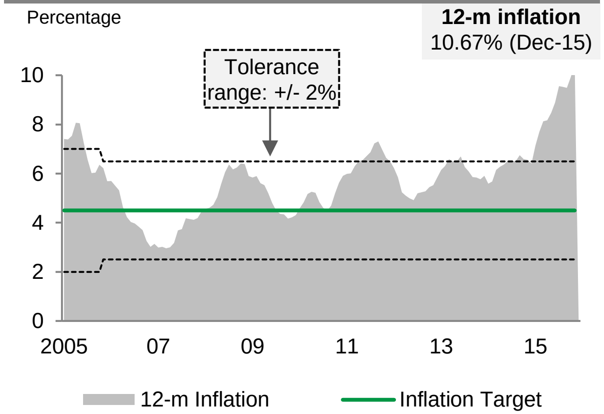
Source: FUNCEX; Banco Central do Brasil; BTMU

IV) Brazil: Prices and Monetary Policy (1)

▪ Inflation continues to ramp up despite severe downturn in domestic demand.

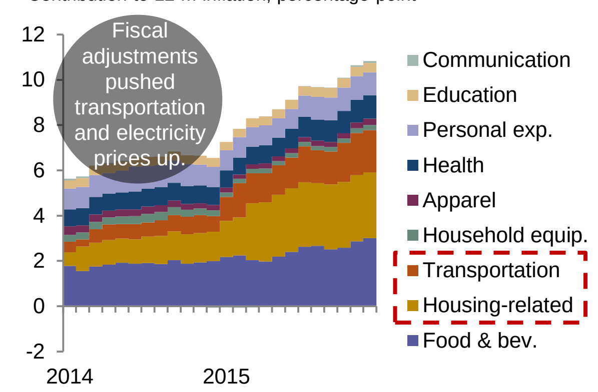
- Brazil's 12-month IPCA inflation soared sharply in 2015, reaching to double-digit levels in the final two months. As we stressed in our last report, a large part of the blame rests with the fiscal consolidation measures (e.g., rolling back energy subsidy and tax breaks to industry) that led government-regulated prices to skyrocket. In fact, the spike in regulated prices alone, a category that has a weight of about 23% of a consumer's basket, added an extra 2.9 pp. to the overall inflation rate in 2015. Ironically, that is probably a comforting fact for the central bank, as upward pressures on those prices should gradually ease this year. Much more disturbing is, perhaps, the fact that market prices ramped up by 8.5% in 2015 in spite of the severe downturn in economic activity. Why? First, because the surge was partially driven by currency depreciation (echoed in prices of tradable goods), a force that is unlikely to reverse or wear off entirely in the short term amid an external backdrop that is becoming increasingly clouded, and a fiscal crisis that will possibly linger for a while (continued on next slide).

Figure 33: IPCA* Inflation and Inflation Target



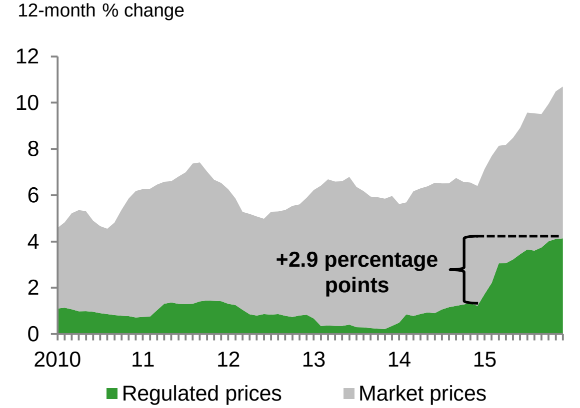
*Extended National Consumer Price Index
Source: IBGE; BTMU

Figure 34: IPAC Inflation by Components



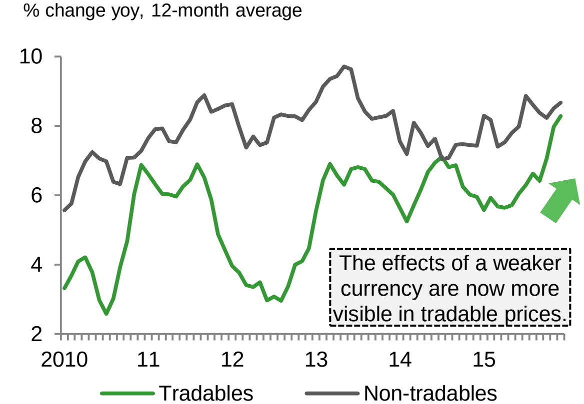
Source: IBGE; BTMU

Figure 35: Regulated and Market Prices*



*Overall prices = market prices + regulated prices
Source: IBGE; BTMU

Figure 36: Tradable and Non-tradable Prices*



*Market prices = tradable (~goods) + non-tradable (~service) prices
Source: IBGE; BTMU

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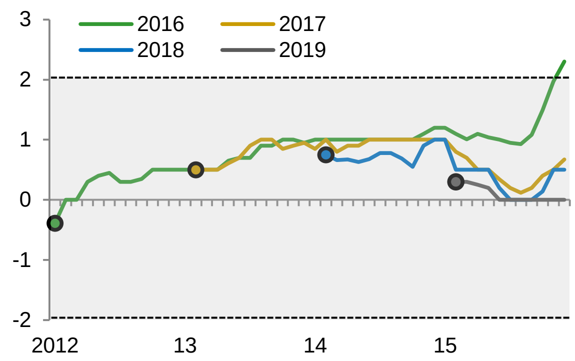
IV) Brazil: Prices and Monetary Policy (2)

▪ The central bank opens up the possibility of another tightening cycle to tame rising inflation.

- Second, because service inflation (~non-tradables) remained stubbornly high at above 8% throughout 2015 even in the face of a steep contraction in domestic demand. One major force keeping it so high and persistent is the behavior of nominal wage growth, which has been largely influenced by the use of wage indexation (to past inflation rather than future inflation). No wonder nominal wages grew at an average pace of 6% in the first half of 2015; and the central bank is still concern about the possibility of wage increases this year that are not compatible with productivity growth. Worse yet, short-term and medium-term inflation expectations have begun to climb during 4Q 2015, forcing policymakers to open up the possibility of a new tightening cycle. That might help tame rising inflation and expectations, but it could also throw the fragile economy into an even deeper recession. Evidently, the central bank is facing a policy conundrum, but if its objective is to see inflation returning to the target of 4.5% at the end of 2017, there may be no other effective option but to raise interest rates.

Figure 37: Inflation Expectations

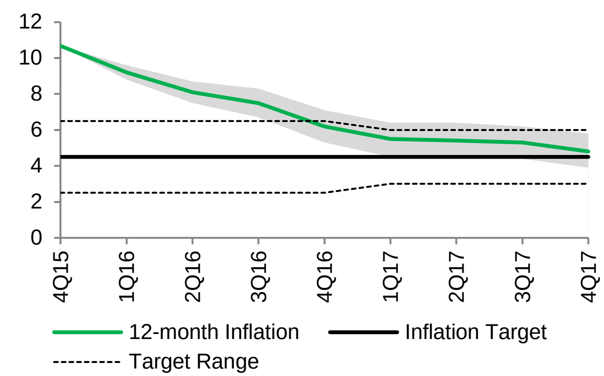
Difference between inflation expectations and target inflation, %



Note: target inflation is 4.5%, and tolerance range is +/- 2%
Source: Banco Central do Brasil; BTMU

Figure 38: Inflation (Central Bank's Forecast)

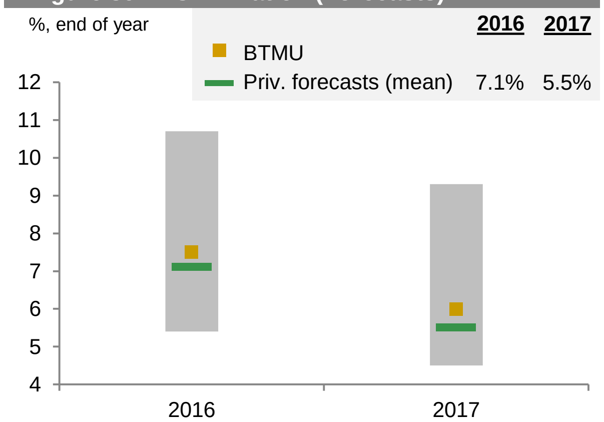
12-month IPCA inflation, %



Source: Banco Central do Brasil, Inflation Report, Dec 15; BTMU

Figure 39: IPCA Inflation (Forecasts)

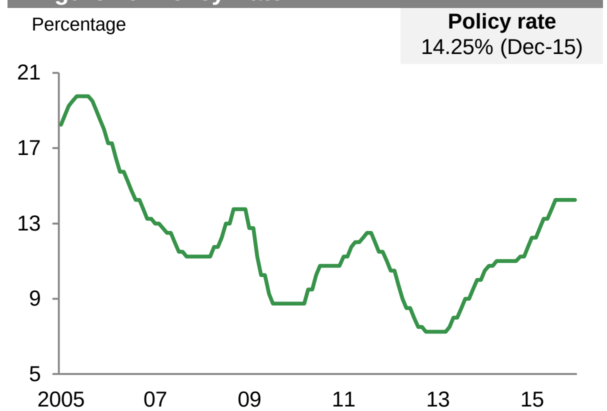
%, end of year



Source: Bloomberg; BTMU

Figure 40: Policy Rate

Percentage



Source: Banco Central do Brasil; BTMU