BTMU Focus Latin America

Brazil: Macroeconomic Performance

(2015 GDP and Current Monthly Indicators)

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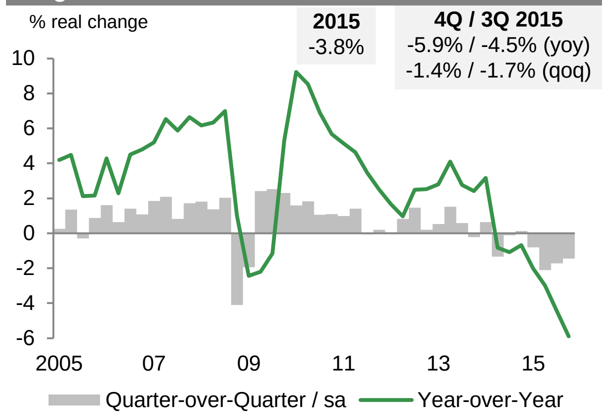
▪ The Brazilian economy in 2015 posted its biggest contraction in 25 years.

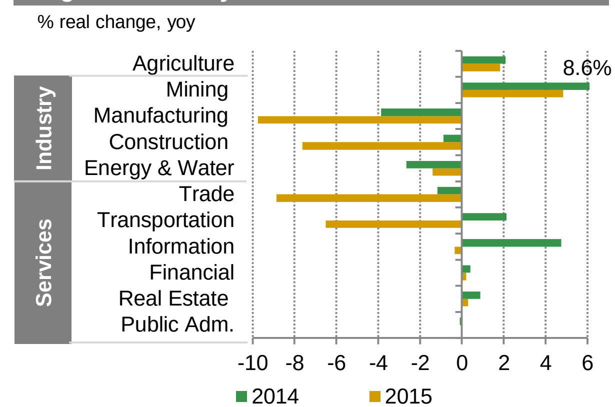
- The Brazilian economy, once a bright spot in Latin America, a region that has been especially battered by the end of the commodity-price boom, shrank by 3.8% in 2015, its steepest contraction in 25 years. Not only was the downturn severe, it was across all components of domestic demand too. For starters, household consumption contracted by a sharp 4%, the largest on record, amid falling real wages, job cuts, rising debt burden, and other factors that have depressed consumer confidence. Perhaps more nerve-wracking is the fact that gross fixed capital formation (GFCF), a proxy for investment, plunged by 14.1% as firms limited its production capacity and cut capital expenditures in response to weaker domestic demand. Those gloomy results, however, came as no surprise as the country is mired in an ever-escalating political crisis (sparked and fueled by a massive corruption scandal at Petobras) that has undermined the government's timid efforts to tackle its ballooning debt, and opened up the possibility of impeaching President Dilma Rousseff. A possibility that is no longer far-fetched.

Figure 1: GDP



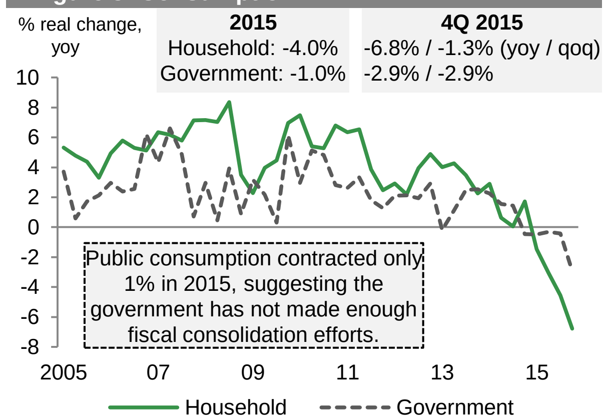
Source: Instituto Brasileiro de Geografia e Estatistica (IBGE); BTMU

Figure 2: GDP by Sector



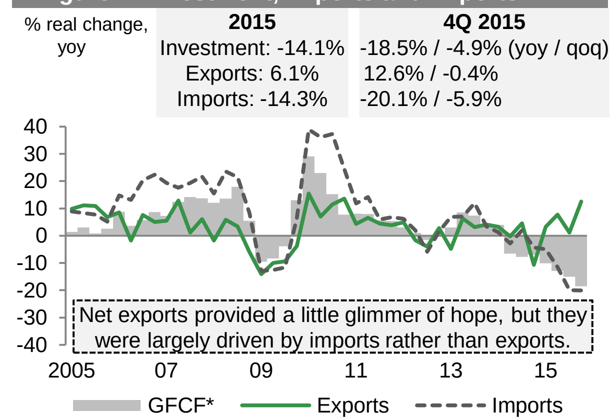
Source: IBGE; BTMU

Figure 3: Consumption



Source: IBGE; BTMU

Figure 4: Investment, Exports and Imports



*Gross fixed capital formation
Source: IBGE; BTMU

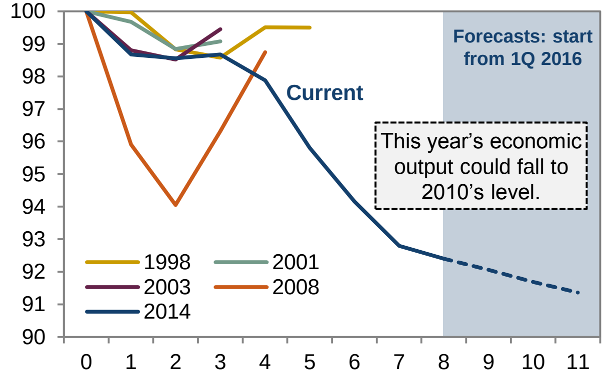
I) Brazil: Growth Momentum (2)

▪ There is still a long way to go: Brazil's economy will probably sink again by more than 3% this year.

- The already tumultuous political situation in Brazil has become increasingly unpredictable, particularly in the wake of recent events in the ever-widening Car Wash investigation that centers on Petrobras. Luiz Inácio Lula da Silva, Brazil's popular ex-president and the political mentor of Ms. Rousseff, was briefly detained for questioning by police on March 4th about favors he and his family allegedly received. He has denied any wrongdoing, and accepted to join the cabinet as chief of staff, a move aimed at giving him some legal protection as well as helping derail the ongoing impeachment process against President Rousseff. All this does not bode well for the economy as it will probably extend the country's political paralysis and divert the executive from balancing public finances, which would put extra pressures on the currency and hurt consumer and business confidence. The economy will likely contract again by more than 3% in 2016 given this gloomy environment. Even a recovery in 2017 is uncertain at this point. And if it does occur, it will probably be slow and fragile.

Figure 5: Episodes of Recession (GDP)*

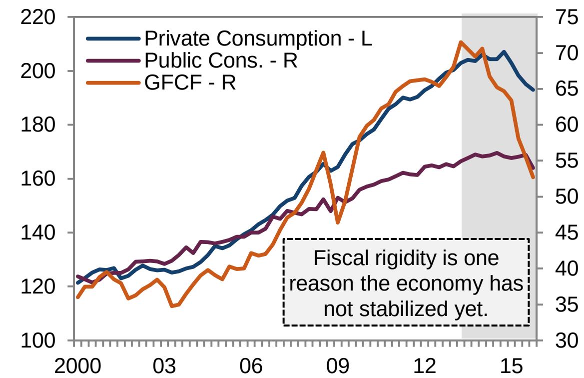
Economic activity index, quarter before the recession (0) = 100



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

Figure 6: Domestic Absorption Components

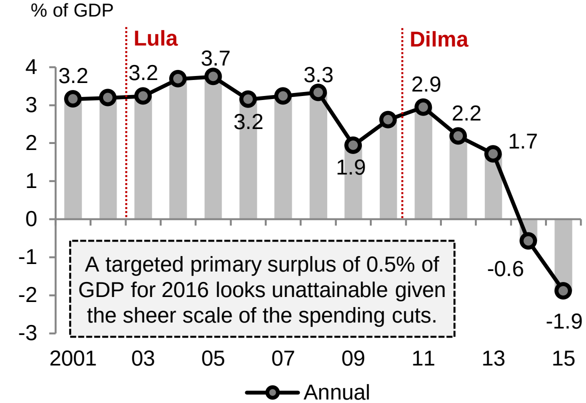
Billion BRL, constant prices, seasonally adjusted using Census X-13



Source: IBGE; BTMU

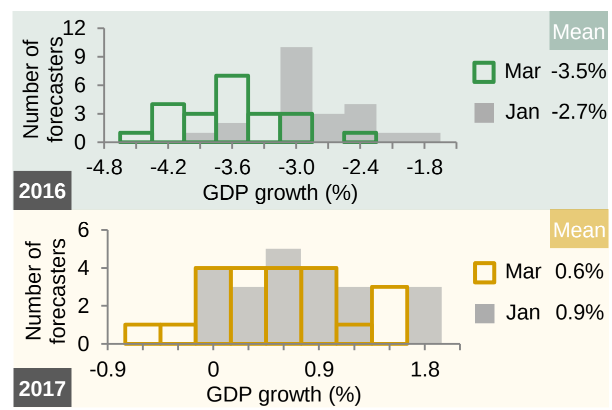
Figure 7: Government Primary Balance*

% of GDP



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

Figure 8: GDP Growth (private forecasts)



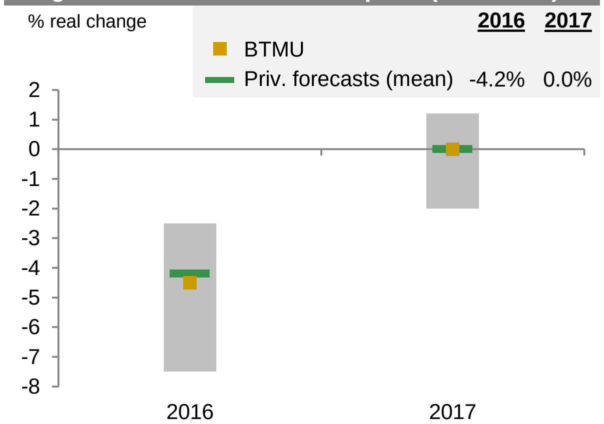
Source: Consensus Economics; BTMU

I) Brazil: Growth Momentum (3)

▪ Domestic demand will contract further this year.

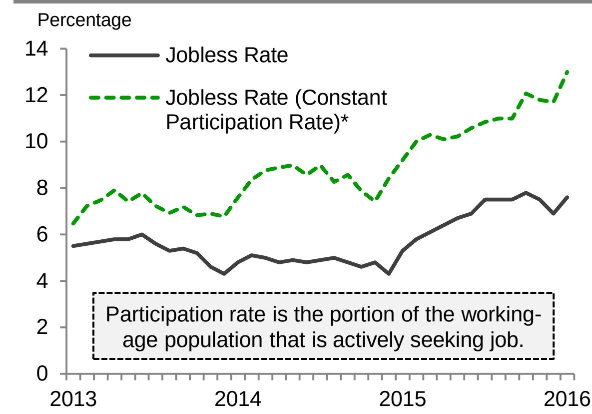
- Gone are the years when domestic demand was the primary engine of economic growth for Brazil, a country that has not made enough effort to open up its economy over the last decade. In fact, consumer spending and investment, two main components of Brazil's domestic demand, posted massive annual drops in 2015 as households and firms adjusted to the dim economic conditions. This year's outcomes are unlikely to be much better than last year's, as underlying drivers of both components will probably stay weak throughout most of 2016. Labor market conditions for workers, for instance, will probably get worse in the coming months as unemployment continues to rise, and wages keep failing to keep up with inflation. Also, business conditions will likely remain challenging and unfavorable this year given the clouds surrounding Brazil's politics and policies. The worry is that, with the country's investment rate at this low level (~17% of GDP), another sharp fall in investment this year will impact not only on short-term growth, but also on the potential growth rate of the economy and its recovery path.

Figure 9: Household Consumption (Forecasts)



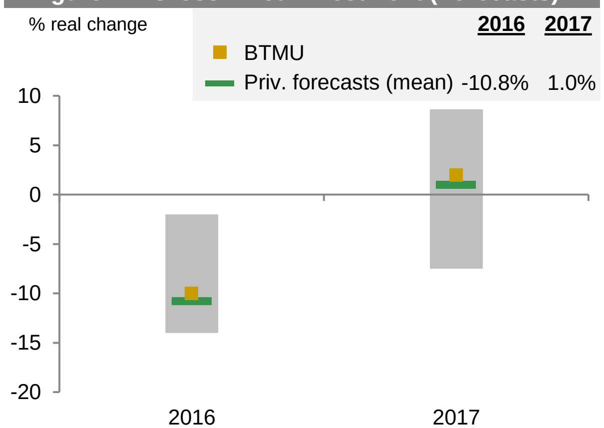
Source: Consensus Economics; BTMU

Figure 10: Unemployment Rate



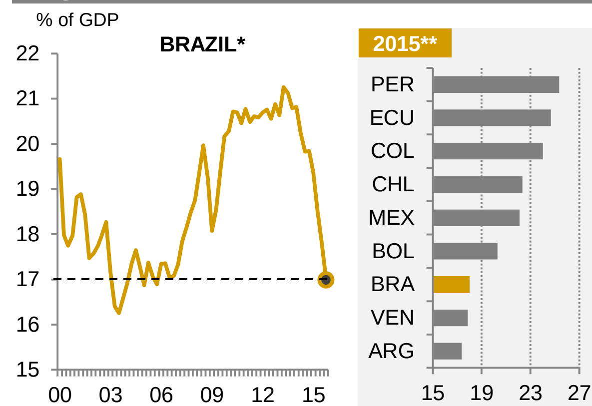
*Own estimate, setting participation rate constant at 58.2% (Nov-12)
Source: IBGE; BTMU

Figure 11: Gross Fixed Investment (Forecasts)



Source: Consensus Economics; BTMU

Figure 12: Investment Rates



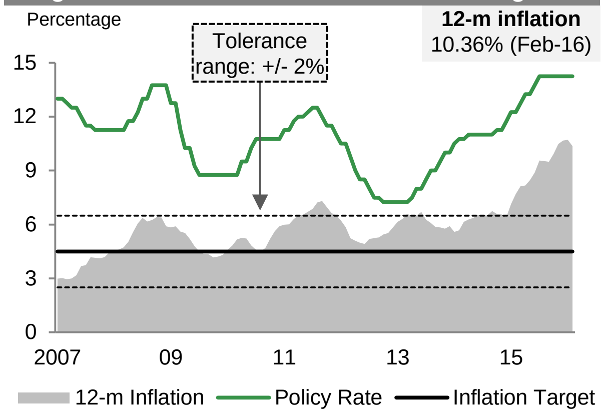
*seasonally adjusted using Census X-13; **Forecasted by IMF
Source: IBGE; IMF, WEO October 2015; BTMU

II) Brazil: Prices and Monetary Policy

▪ The central bank might cut interest rates to support the economy despite high inflation.

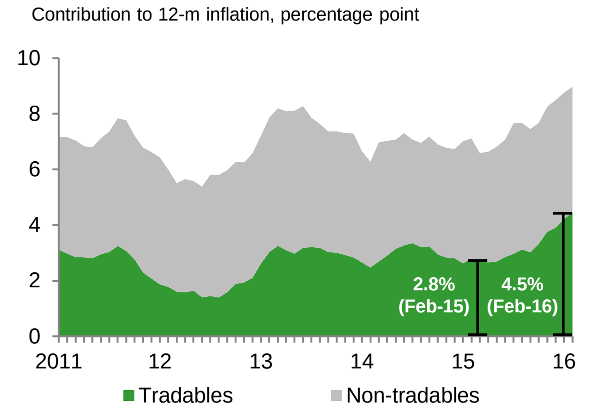
- Brazil's 12-month CPI inflation eased a bit to 10.4% in February from its peak of 10.7% in January, as upward pressures on government-regulated prices began to ebb. In fact, regulated prices, which have a weight of about 23% of the consumer's basket, increased by 14.9% yoy in February, down from 18.1% in December. It is likely this downward trend will continue throughout 2016, although inflation will probably end the year well above the central bank's target of 4.5%. One reason is the sharp rise in non-regulated prices (i.e., market prices) over the past few months, which clearly points to a visible impact of the depreciation of the real on domestic prices. Another worry is the recent climb in both short-term and medium-term inflation expectations, which will make it harder for inflation to return to 4.5% at the end of 2017. In this context of high inflation, the recent decisions by the central bank to keep the Selic rate unchanged at 14.25%, after signaling its intention to hike, not only caught markets and analysts by surprise, but also suggest a possible U-turn in its tight monetary-policy stance.

Figure 13: IPCA* Inflation and Inflation Target



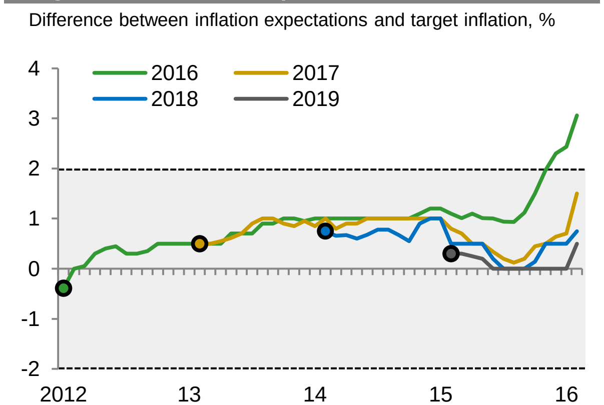
*Extended National Consumer Price Index
Source: IBGE; BTMU

Figure 14: Market Prices*



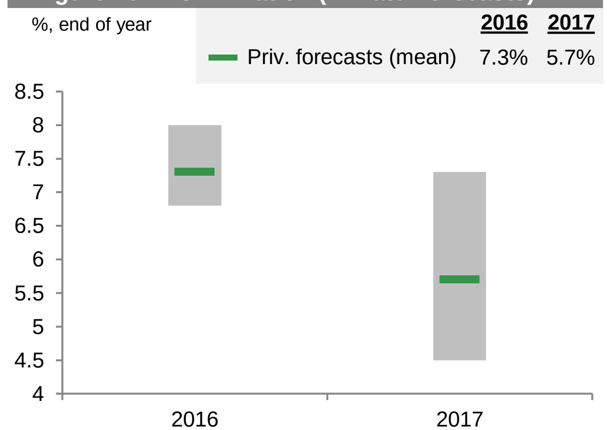
*Market prices = tradable (~goods) + non-tradable (~service)
Source: IBGE; BTMU

Figure 15: Inflation Expectations



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

Figure 16: IPCA Inflation (Private Forecasts)



Source: Consensus Economics; BTMU

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