# Brazil

## A slow recovery in the making

- **Despite persistent economic recession in Q3 2016, the financial markets are still "bullish" on the new president's reform programme.**
- **A stronger real (BRL), disinflation and monetary policy easing should underpin a slow recovery in real GDP throughout 2017.**
- **Nonetheless, budget austerity, unpopular reforms and a deteriorated job market will continue to weigh down consumption.**

### Bullish markets on the one hand…

After the great sell-off of 2015, Brazil's financial market rebounded strongly in 2016. The launch of impeachment procedures against President Dilma Rousseff in late 2015 helped restore investor confidence, which was further bolstered by the fiscal austerity and structural reforms presented by Michel Temer, interim president since May 2016, and officially inaugurated as president in August. Until Donald Trump's election, external factors were also playing favourably in all of the emerging markets: China was causing fewer concerns, commodity prices rebounded and the normalisation of US monetary policy was postponed.

Despite a few year-end tensions following Donald Trump's election and a new outbreak of domestic political turmoil (corruption scandals), the real (BRL) ended up gaining 22% against the USD in 2016 compared to the previous year. The Ibovespa stock index rose 39% in the local currency, while yields on Treasury bonds and CDS premiums on sovereign bonds denominated in foreign currency shrank by 550 basis points (bp) and 140 bp, respectively.

### … a sluggish real economy on the other

The financial markets are often considered to be the harbingers of cyclical turning points. Yet Brazil's economic recovery is playing hard to get, despite a few encouraging economic signals in Q2 2016 (rebound in investment and industrial output). Economic growth was disappointing in Q3. Seasonally-adjusted (sa) GDP continued to contract by 0.8% q/q, after -0.5% in Q1 and -0.4% in Q2, extending the current recession to seven quarters. Investment contracted again, with GFCF down 3.1% q/q, underscoring the fragility of business confidence and the operational disruptions plaguing sectors like construction, at the heart of Operation "Car Wash" (Lava Jato), and manufacturing, hard hit by sluggish domestic and foreign demand. Since 2013, the investment rate has contracted by nearly 5 points of GDP at constant prices, to barely 18% in 2016. Exports were buoyant earlier in the year, but declined 2.8% q/q in Q3. At the same time, household consumption contracted for the seventh consecutive quarter (-0.6% q/q), which surprised on the upside given the ongoing downturn in the job market (on a seasonally-adjusted basis, the unemployment rate was above 12% in November, with 127,000 net job destructions), the decline in household purchasing power (real wages fell 6.1% year-on-year in October) and sluggish lending (with the exception of credit cards).

**Real GDP growth (%)**

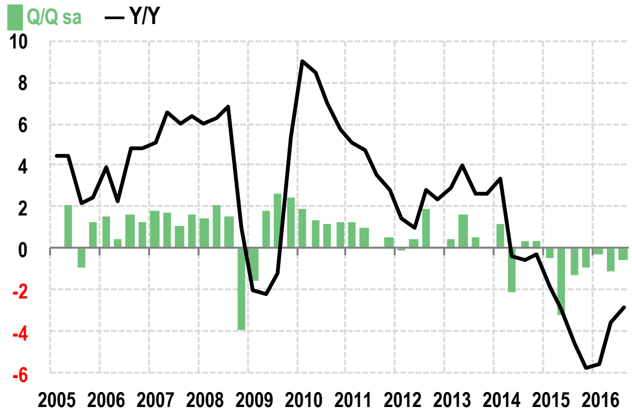


**Chart 1** Source: IBGE

### Fiscal austerity and popular mistrust of reforms…

Welcomed by the markets but much less so by Brazilians, the government's law freezing current public spending in real terms was passed in December before the end of the parliamentary session. The government also presented the first part of its proposed labour law reform package, based on an agreement between employers and unions. It introduces greater job market flexibility (facilitating part-time job contracts and telecommuting, while respecting the legal 44-hour workweek, etc.).

The 2017 legislative agenda is relatively dense and potentially strewn with obstacles. The biggest pitfall could be pension reform. The second pillar of fiscal reform, it will probably need several amendments before winning congressional approval, given the popular backlash, notably over the proposal to raise the legal retirement age to 65 (from the current average of 54). Plans for concessions and privatisations in the hydrocarbon, mining, water/sanitation and transport sectors should give rise to two bidding cycles this year. As to business sentiment, the World Bank's latest "Doing business" index ranked Brazil 123rd out of 190 countries. This poor showing has led to the elaboration of a series of measures to improve tax efficiency and slash red tape.

A priori, the formalisation of these measures should provide a sufficiently firm base for the consolidation of public finances in the medium term. In the meantime, the most recent figures for November do not reveal any fiscal improvements. The consolidated public sector primary deficit rose to nearly BRL 157 bn over 12 months, i.e. 2.5% of GDP, compared to 1.9% at end-2015. The overall deficit is still higher than 9% of GDP, and public debt has crossed the threshold of 70% of GDP.

### … make a substantial easing of monetary policy the main game changer

Disinflation has accelerated in recent months due to the persistently sluggish economic environment, strong appreciation of BRL and the recent decline in food prices. The IPCA general price index was up 6.3% year-on-year in December 2016, compared to 10.7% in the year-earlier period, which is within the fluctuation band of 4.5% +/-2 percentage points tolerated by Brazil's central bank (BCB). Until recently, the BCB was constrained to maintain high interest rates (the Selic was held at 14.25% between July 2015 and September 2016), but initiated a monetary easing cycle in October. After two 25 bp key rate cuts, it surprised market expectations by reducing rates by 75 bp in January. The monetary authorities also announced a series of measures to foster bank lending (simplification of mandatory reserve requirements, improvements in the credit office, stimulation of real-estate loans, and a better framework for using credit cards).

Inflation expectations are now firmly anchored around the 4.5% target in 2017 and 2018. Central bank communications suggest that the reduction in interest rates is far from over, and it could maintain the rapid pace of rates cuts in the months ahead. Indeed, the advancement of fiscal and structural reforms reduces the risk of fiscal dominance. Just a year ago, it was feared that the central bank may have to forego its inflation target to avoid an overly abrupt fiscal adjustment. Since the 11 January monetary policy meeting, the yield on Treasury bonds has fallen again (-30 bp to 10.9% on 5-year instruments), as have risk premiums on sovereign bonds in hard currency.

The upturn in US interest rates and the USD are unlikely to derail the nominal appreciation of BRL. Despite lower domestic interest rates, the good standing of the current account deficit and dynamic capital flows should help maintain the BRL's positive momentum.

### … and support factor for a gradual recovery in 2017

In 2016, the carry-over effect from GDP growth was a negative 3.5% in the first three quarters of the year. Based on monthly and leading indicators (industrial output, retail sales, PMI surveys, corporate and household confidence indicators, the job market and lending), we do not foresee a rebound in activity in Q4 2016, nor in the very first months of 2017. Consequently, we have lowered our 2016 and 2017 growth forecasts to -3.7% and 1%, respectively, compared with -3% and 2% previously.

### Inflation, policy rate and foreign exchange rate

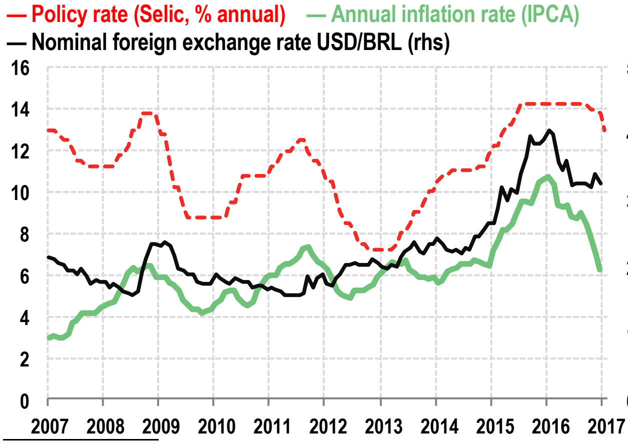


Chart 2 Sources: BCB, IBGE

Ongoing monetary easing and a gradual increase in corporate investment spending should buoy the economic recovery, even though confidence indicators are still fragile. Although disinflation and interest rate cuts are expected to boost household purchasing power, poor job market prospects, at least through mid-2017, and households deleveraging could hamper the recovery of private consumption. Consequently, it is only expected to rise moderately this year. Assuming that investment picks up, the acceleration in imports is likely to prevent net exports from making a positive contribution to GDP growth, despite what is expected to be a bumper harvest. The secondary and services sectors are expected to continue struggling this year.