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Perspectives for the Brazilian Economy

November 2016

Brazilian Economy - Main Themes

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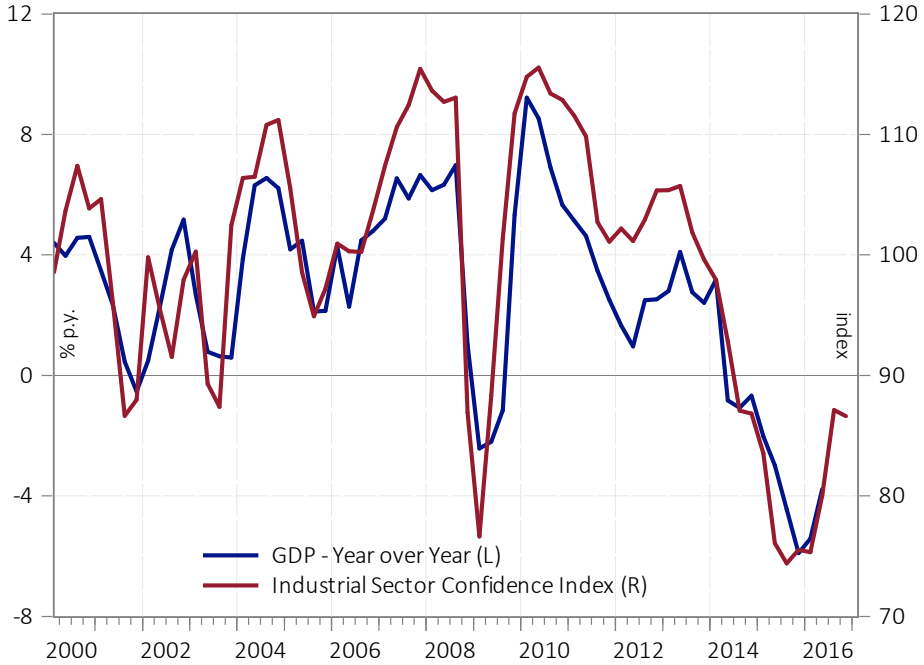
- The current crisis is the worst at least since the 1980´s, but it is also a big opportunity for change.
- GDP is stabilizing but growth will take time to firm. 2017 will still be a slow year. Maybe respectable growth comes in 2018.
- It is critical to understand that Brazil´s economic problems are domestic. Contrary to the 1980s and 1990s, the external position of the economy is solid and external debt is pretty low. Insolvency in hard currency is very unlikely.
- Fiscal adjustment and supply side reforms are the key elements to watch.
- Political uncertainty still high due to Brazilian “mani pulite” investigations
- Current administration is firm in the pursuit of reforms, but the long term outlook depends crucially on which political forces win 2018 elections

Economic growth coming, but will take time

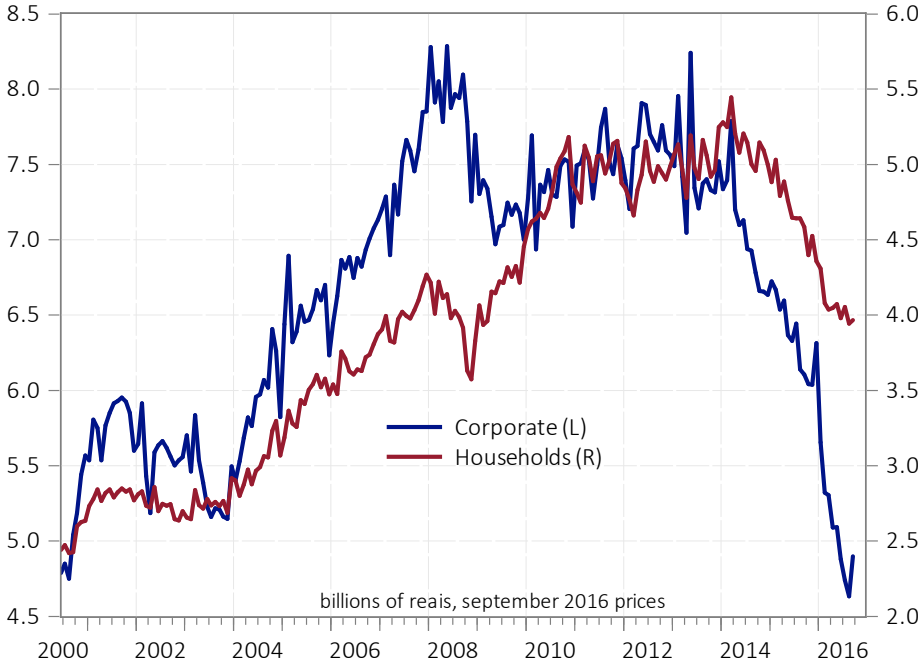
Confidence indexes are recovering, but credit overhang and other obstacles still present

Industrial confidence Index and GDP



Source: IBGE, FGV

Domestic Credit Origination

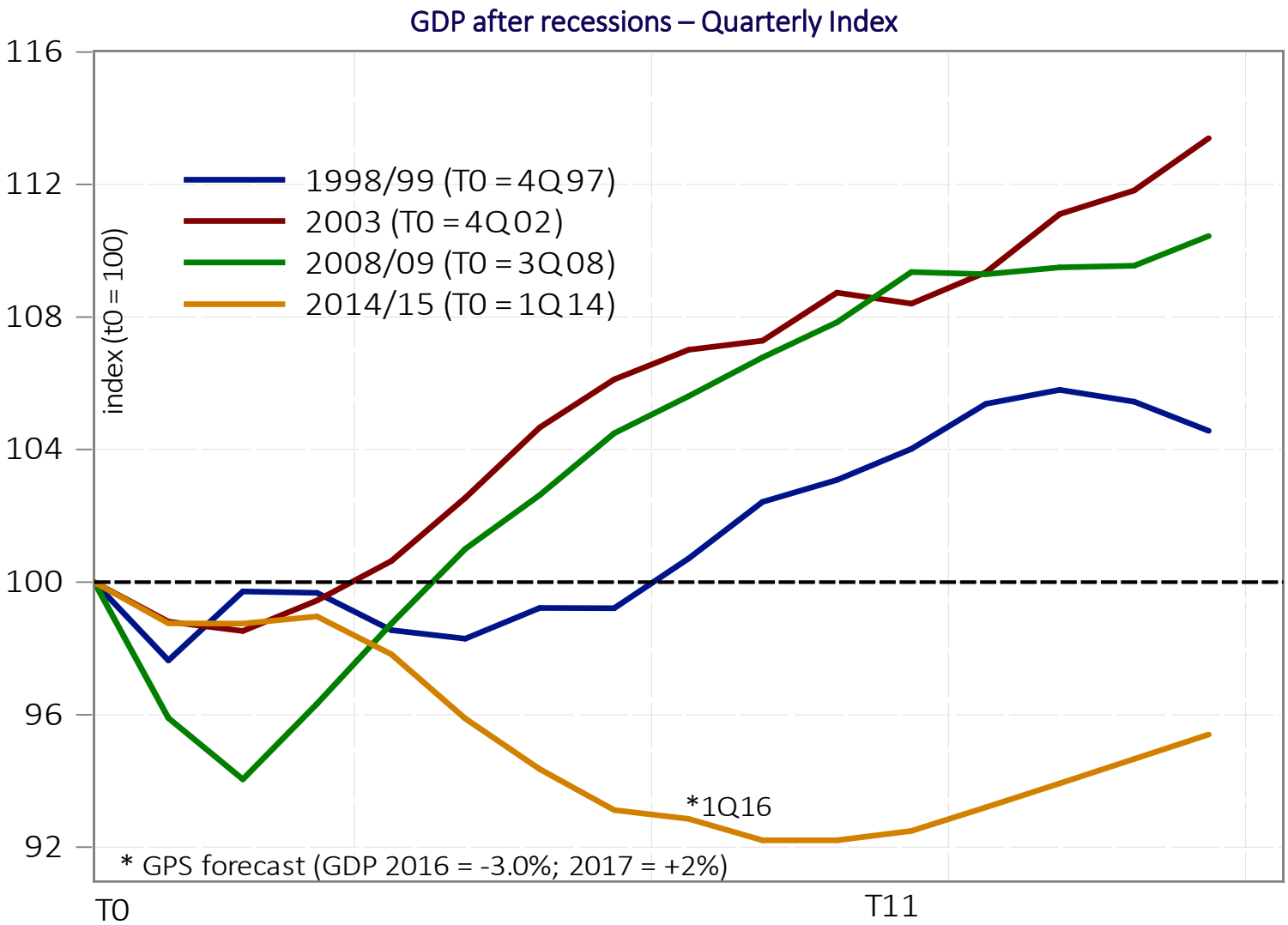


Source: Brazilian Central Bank

- The worst is past, but intensity of recovery still uncertain.
- Short term inventory cycle may boost growth beyond expectations in 2017. But credit overhang is an impediment.
- GDP growth range forecast currently at 0.5%-1.0%.

Recovery is likely to remain fragile in 2017

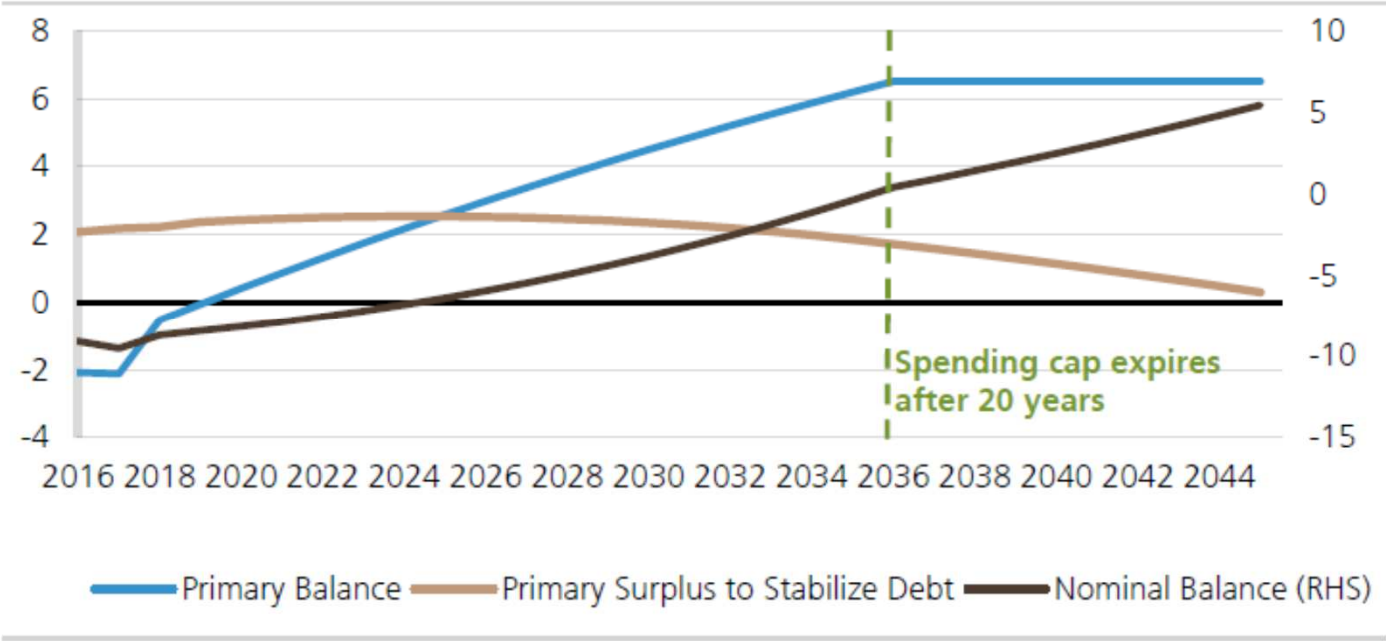
Slow growth raises the risk of a double dip



Source: IBGE. GPS forecasts

Fiscal adjustment is the key to recovery

Reforms to stabilize debt/GDP: expenditure ceiling is a long term story



Source: BCB, National Treasury, UBS

- Constitutional ceiling to expenditures was the first crucial test.
- Next comes Social Security, much more difficult, in 1S2017.
- States and municipalities adjustment still in early stages, but it is also inevitable

Fiscal adjustment is the key to recovery

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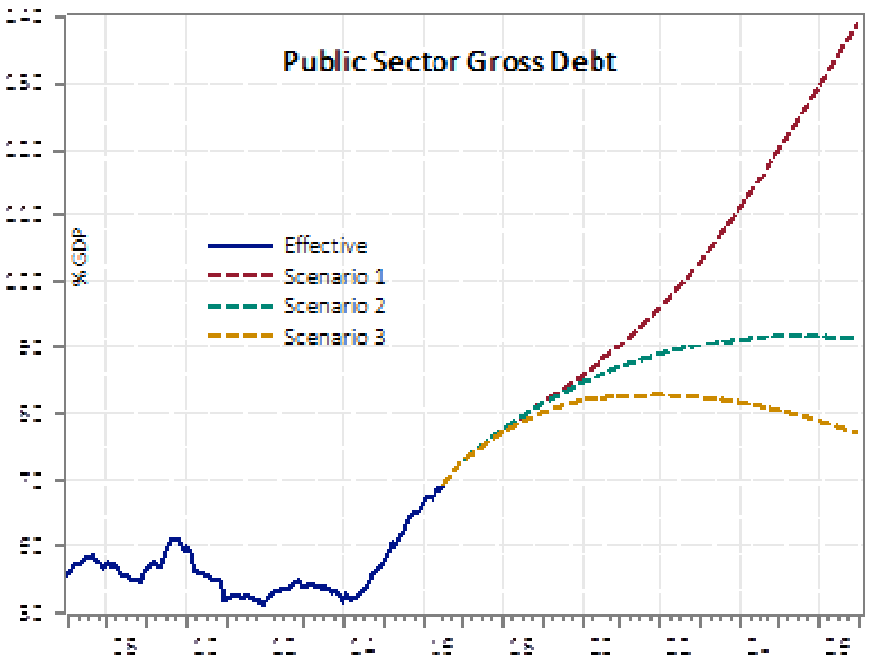
With the ceiling and social security reform debt/GDP is likely to stabilize in a few years



	Scenario 1	Scenario 2	Scenario 3
R$ 100 bi from BNDES	x	x	x
Expenditures Cap (except Social Security)	x	x	x
Expenditures Cap (including Social Security reform)		x	x
Extraordinary Receipts (2% GDP in 4 years)			x
First year of Primary Surplus	--	2020	2019
First year of decline in Gross Debt	--	2026	2022

Source: BCB, National Treasury, GPS

- No reform path leads to bankruptcy
- Political establishment already concluded it needs to act
- Long process, though, as fiscal adjustment involves reducing rent seeking and constraining special interest groups´ access to public funds

Markets for now seem to believe in the adjustment

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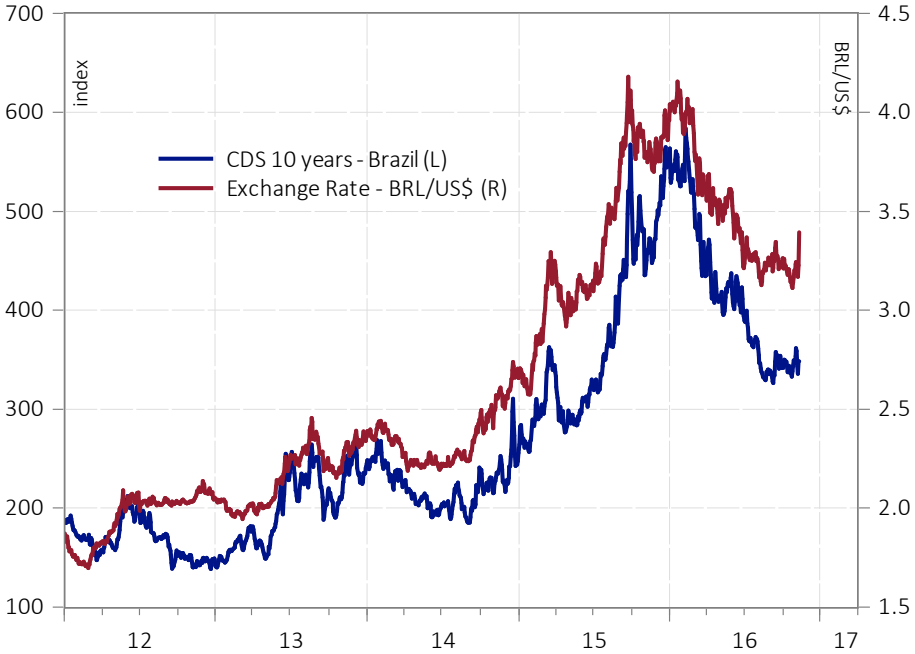
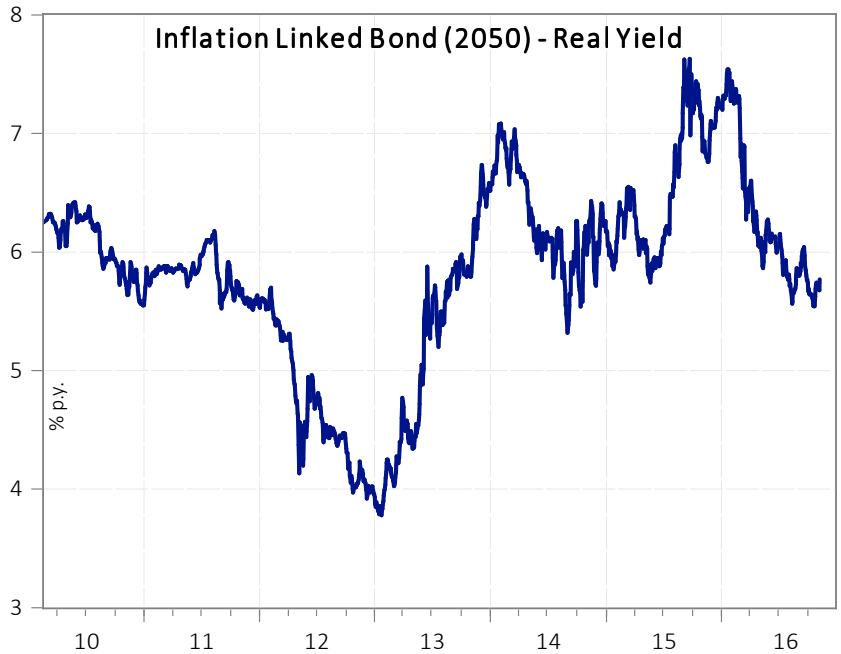
Domestic risks still declining, but global factors may shorten the horizon for adjustment



Source: Bloomberg



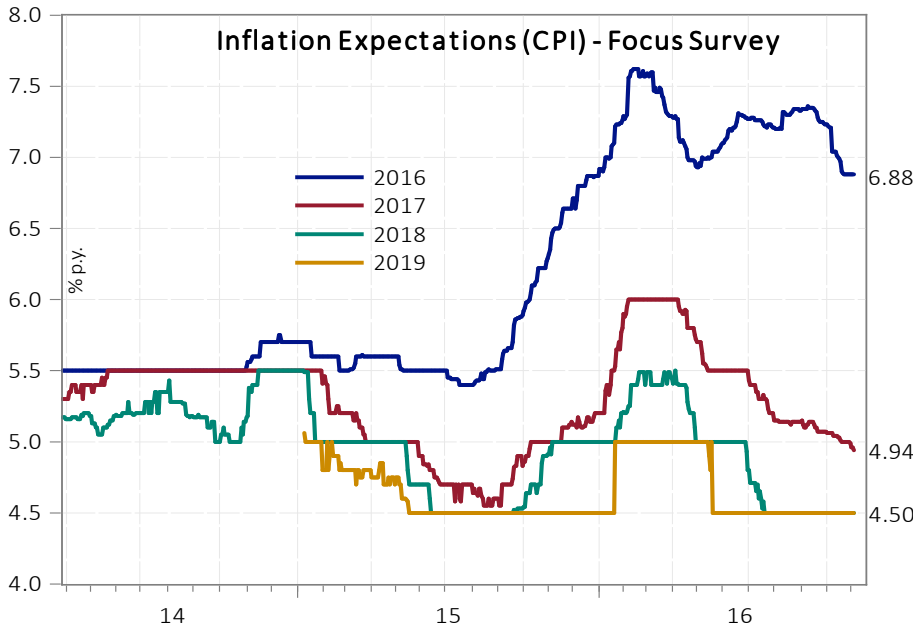
Source: Bloomberg, Anbima

- Constitutional Ceiling to expenditures was the first crucial test. Next comes Social Security, much more difficult, in 1S2017.
- For now, markets believe there will be in sufficient progress. Political upheaval still possible coming from “car wash” investigations.

Inflation is declining and lower rates will follow

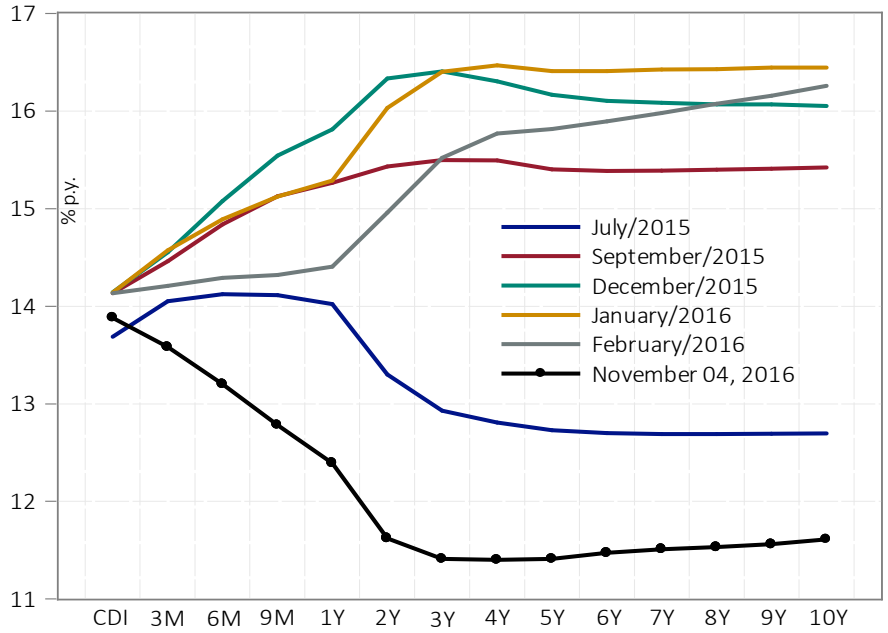
Inflation expectations started to come down, due to lower FX pressures and the recession

Inflation Expectations (IPCA) – Focus (% p.y.)



Source: Central Bank

Domestic Nominal Yield Curve (% p.y.)



Source: Bloomberg

- The consolidation of a reform agenda might allow a ~400bps easing cycle to start in 2H2016, bringing the SELIC rate to 10%. Higher global rates may limit/delay the space for monetary easing, though.

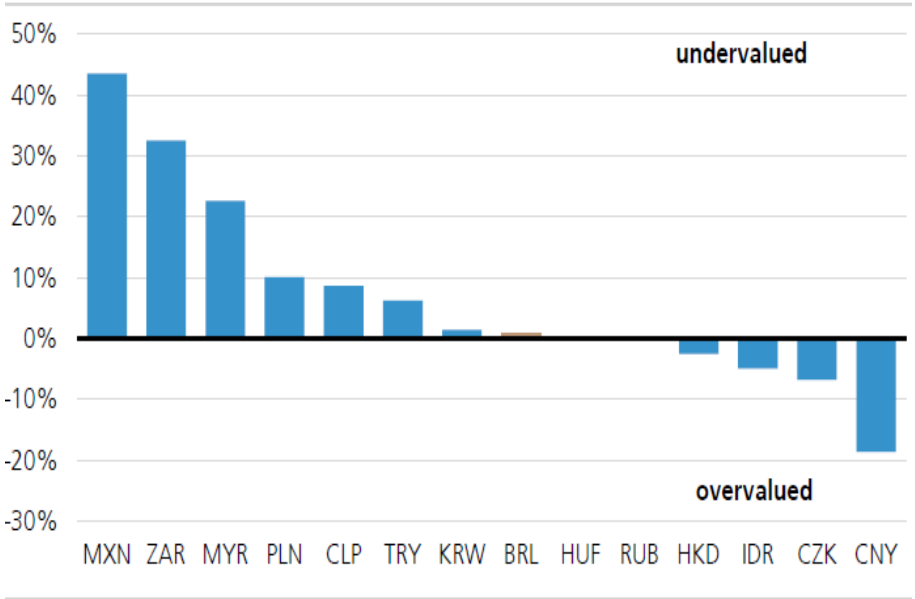
- Structurally, conditions are favorable to much lower rates. Single digit nominal benchmark rate is likely at the end of the cycle.

BRL trading at reasonable levels currently

The currency trades close to fair value and external adjustment is well advanced

BRL – Real Effective Exchange Rate close to fair value

Source: Brazilian Central Bank, GPS



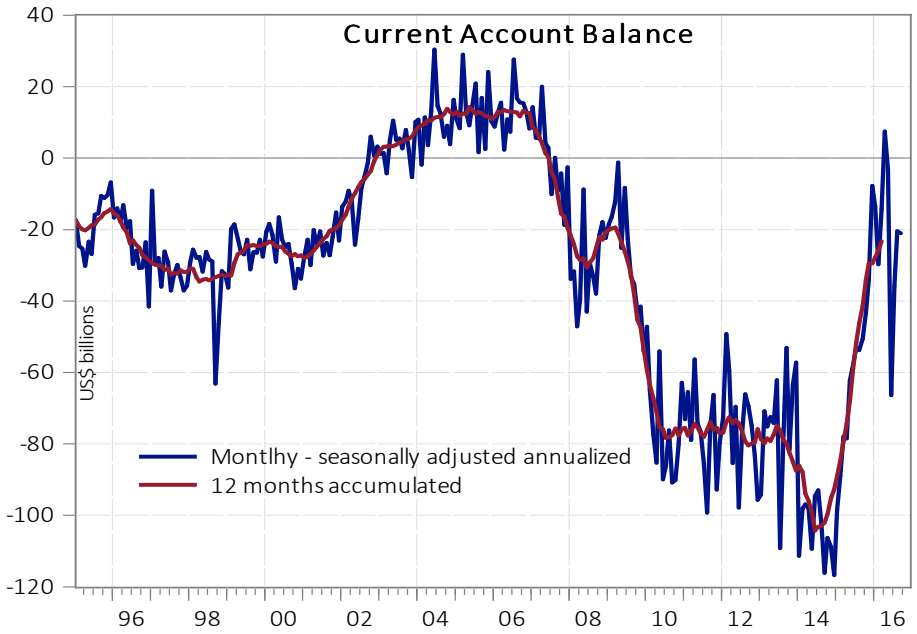
Source: Brazilian Central Bank, BIS, UBS

- Fair value of the BRL at ~ 3.5/USD.
- At ~R$ 4.2/USD the BRL would be 1SD cheap.
- At ~R$ 3.0 the BRL would be 1 SD expensive.

Solid external position and a rapid adjustment

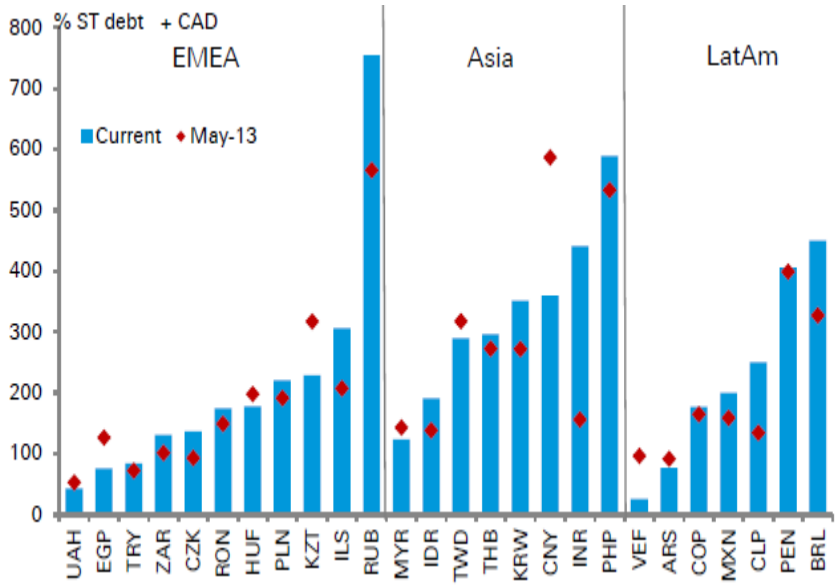
External adjustment is well advanced and FX reserves position is solid in the EM space

Current Account Deficit close to equilibrium



Source: Central Bank

FX reserves as a % of gross external financing requirements (ST debt + CA deficit)



Source: Deutsche Bank

- The current account deficit has declined considerably. Capital flows may resume in more intensity in 2017, if fiscal adjustment and economic recovery are confirmed.
- International direct investment still solid (US$ 75 billion over the last 12 months, much above the CA deficit)

Competitiveness improving, but reforms needed

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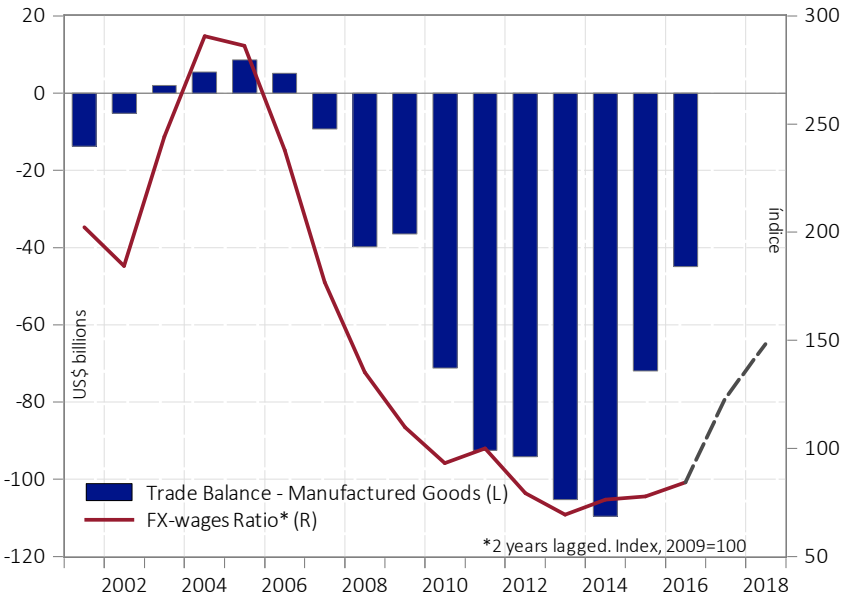
Industry Costs are declining in USD terms, but tax reform is required

Wages X manufacturing external trade



Source: Central Bank, IBGE

Taxation profiles - 2013

	LAC	OECD	Brasil
Taxes in income and profits	27.4	33.0	20.8
Social security contributions	16.6	26.0	25.6
Payroll taxes	0.6	1.0	2.5
Property taxes	3.4	6.0	5.6
General Consumption Taxes	31.2	20.0	39.3
Specific Consumption Taxes	18.3	10.0	3.2
Other Taxes	2.6	3.0	3.0
Total	100	99	100

Source: OECD, Brazilian Treasury

- ULC is closely related to the external deficit in manufacturing over the last few years. Structural improvements depend on more openness to trade and internal reforms
- Tax reform is key to integration into global production chains