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Uncertainty is here to stay

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- **Economic upturn hindered by political issues and structural weaknesses**
- **Inflation falls below lower bound of target**
- **Current account continues to improve**
- **More rate cuts expected, but fiscal deficits limits room for strong easing**
- **Higher USD/BRL in second half of this year**

One year after impeachment of president Dilma, political uncertainty continues

One year after the formal impeachment of president Dilma Rousseff and slightly more than one year before general elections in October 2018, the political and economic situation remains highly unstable. The economy is moving out of recession at a snail's pace. In the first quarter of 2017, GDP grew by 1% qoq while continuing to contract in annual terms (-0.4% yoy). The second quarter figures will be published on 1 September. Monthly economic activity data remain highly erratic and do not yet point to an imminent recovery. We maintain our growth forecast of 0.5% for 2017 and 2.5% for 2018, but risks remain tilted to the downside. On a positive note, inflation and the current account have improved. This leaves room for a less restrictive monetary policy, without endangering the hitherto sound external position.

Economic activity index remains erratic



Source: Bloomberg

Reform process is running out of steam

One year ago the government of president Temer vigorously initiated a real-term spending freeze, and in July 2017 a labour market reform package was approved. However, pension reform measures, which are so important for fiscal consolidation, were significantly watered down and the chances of approval during the last year of this

government seem small given the increasingly troublesome political situation. The reform process has hence lost a lot of steam after a vibrant start one year ago. This is a pity, as Brazil not only needs to deal with a precarious fiscal situation but must also cope with many long-lasting structural weakness, such as low savings and investments.

Indictment of president Temer further complicates the situation

In June, President Temer was formerly accused of corruption in the ongoing investigation around the state-owned oil company Petrobras. Although he survived a vote in the lower house to lift his immunity and start an investigation by the Supreme court, his position has weakened and his approval rating has fallen to a dramatic 5%. Still, markets reacted positively to the outcome of the vote to lift his immunity, which was won with a bigger margin than anticipated. This provides no guarantee that future votes will have a similar outcome. With elections nearing, MPs might want to further distance themselves from the unpopular president. We continue to assume that with or without Mr Temer, the current coalition will remain in place until the elections. However, the political situation will make it increasingly difficult to lower the fiscal deficit to more viable levels and to turn the current vicious circle into a virtuous one, in which Brazil is able to profit from more favourable commodity prices, robust global demand and continuing ample global liquidity.

Nominal Fiscal deficit remains high ...



Source: EIU

... and government debt levels keep rising



Source: EIU

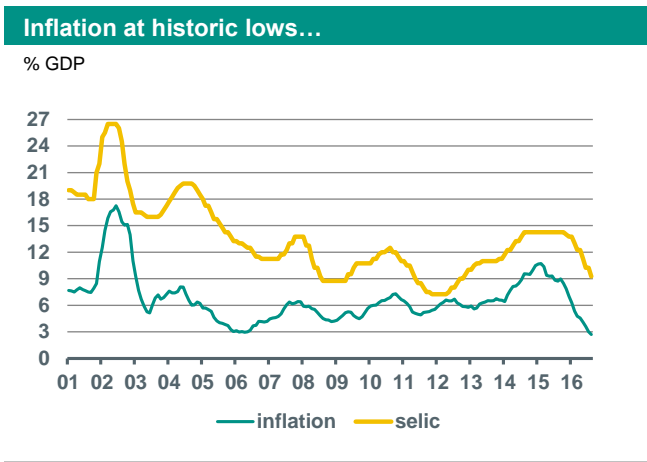
Fiscal targets changed again

For the second time this year the government has substantially changed its primary fiscal targets for the years until 2020. The proposed targets for the primary deficit of the central government in 2017 have moved from BRL 139 bn to 159 bn, or 2.4% of GDP. The primary deficit for 2018 was raised by BRL 30 bn to -2.4% of GDP. Measures that were already approved, such as the spending cap, will help limit the budget deficit, but are not sufficient to compensate for the impact of slow growth on fiscal revenues. Moreover, even these targets appear difficult to achieve given this and the fact that there is little hope for approval of further structural reforms by Congress in the current presidential term. A recently announced new privatisation initiative might bring some relief. Privatisation efforts are focused on transport and utilities. The government also plans to sell the operating rights for airports and ports, and to sell the energy firm Eletrobras, but this may face stiff opposition.

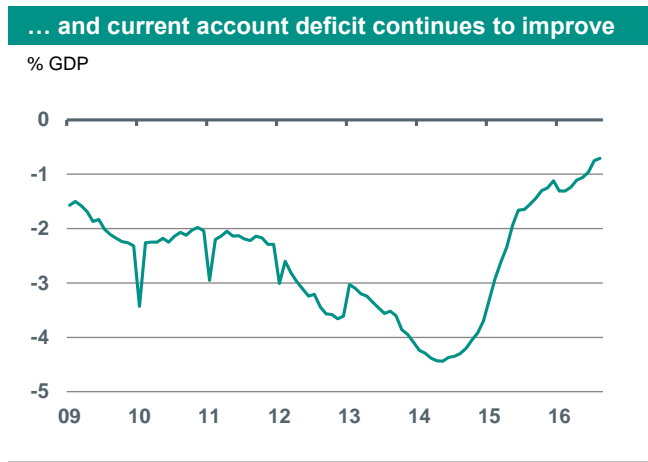
Fiscal austerity remains essential in light of the nominal fiscal deficit, which was close around 9% of GDP last year, and a rapidly rising government debt will be expected to reach around 80% of GDP next year. A positive aspect in this respect is that S&P removed its negative watch, which considerably diminishes the risks of an imminent downgrade of the speculative grade BB rating. However, S&P maintained its negative outlook, as have Moody's (Ba2) and Fitch (BB) .

Inflation falls through lower bound of inflation target range

While the fiscal target has changed for the worse, the inflation target has changed for the better. The central target for 2018 was lowered from a current 4.5% for 2017/18 to 4.25% in 2019 and 4% in 2020. The upper and lower margins have already been reduced from +/- 2% to +/- 1.5% and remained unchanged. The lower inflation target shows the central bank's strong commitment to anchor inflation expectations. In April, inflation fell below the central target for the first time since the end of 2009. Since then, inflation dropped further, reaching 2.7% yoy in July, and is even below the lower bound of the inflation range. Favourable food prices, subdued demand and a stronger currency explain most of the slowdown. While inflation may bounce back a little towards the end of the year to an estimated 3.5%, that would still be well within the lower range of the inflation target. This leaves room for further monetary easing. We expect the Selic rate to be cut from its current level of 9.25% to 7.5% at end-2017. For Brazil, this means a low real interest rate of 4%. A further reduction in rates is not likely given the ongoing dire fiscal situation and political uncertainty.



Source: Bloomberg



Source: Bloomberg

Current account continues to improve

Another positive feature of the current economic malaise is the rising surplus of the trade balance and a quickly falling current account deficit. Export earnings rose by almost 19% yoy in the first seven months of this year. It is especially auspicious that exports of manufacturers (mainly in the automotive and aviation industry) rose by almost 11%. This partly reflects the recovery in Argentina, which is an important destination for manufactured products. But overall, China remains the most important export destination, with a share of over 20% of total exports. Import earnings rose as well, but by only 7.2%. These factors resulted in a new record trade surplus of USD43 bn, which is almost equal to the entire surplus of 2016 (USD 48 bn). In July, the current account registered a deficit

after four consecutive months of surplus, but the 12-month moving average continued to fall to a mere 0.7% of GDP in July.

FDI remains strong

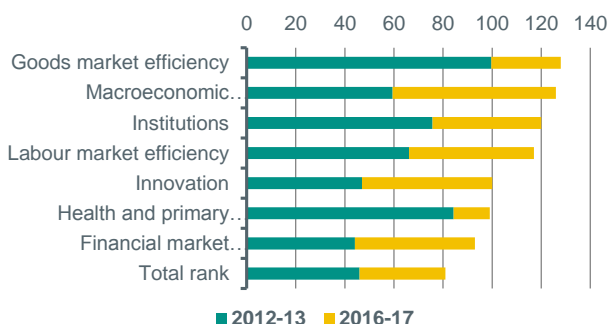
Another positive development is that despite all the political turbulence, foreign direct investments continue to pour into the country. In the first seven months of 2017, FDI amounted to USD 40 bn compared to an already strong 34 bn in the same period last year. Looking at the 12-month moving average, FDI flows now cover over six times the current account deficit. An auction in October of off-shore pre-salt oil and gas blocks could give a further boost to FDI flows and the privatisation plans - if successful. Still, even though Brazil remains an important recipient of FDI flows, they are not high enough to raise the investment rate to levels compatible with stronger structural growth. Both the saving and the investment ratio have fallen in recent years to the very low levels seen during other crisis episodes in the 1980s and 1990s, and are now only slowly stabilising.

Structural weaknesses getting worse

Other protracted weaknesses have resulted in poor scores in various rankings concerning Brazil's competitive position. Brazil scores 122 out of 190 in the 2017 World Bank Ease of doing Business index (EDB). While Brazil has scored poorly on EDB for a long time, until 2012 it did relatively well in the Global Competitiveness Index (GCI) of the World Economic Forum. However, since that time this ranking has also deteriorated significantly. In 2012-2013 it ranked 48 out of 144 countries, but the ranking for 2016-17 fell to 81 out of 138. The most problematic factors are related to tax regulation and tax rates, bureaucracy, labour regulations and the macro-economic environment. Infrastructure remains an issue, but has been overshadowed by other concerns that are now more urgent.

Strong deterioration in Ease of Doing Business

Index, 2012-13 figures rebased to 138



Source: World Economic Forum, Global Competitiveness Index

But both savings and investment ratio remains low

% GDP



Source: EIU

Eleven out of the twelve pillars of the GCI deteriorated in the period between 2012-13 and 2016-17. The worst performing pillar remains that of 'good markets efficiency', placing 128 out of 138. This was also the worst performing pillar in 2012-13, but at that time it stood at 104 out of 144. The sub-score for competition now stands at 132, with a score of 3.6 (scale from 1-7). This is equal to Zimbabwe, Algeria and Mauretania. In Latin America, only Argentina and Venezuela are performing worse. Brazil also scores very poorly for institutions (score of 3.2 and place 120). Its score for the sub-factor 'public trust in

politicians' is a low 1.3, lower than any of the other 138 countries. On a positive note, Brazil still scores relatively well on market size (rank: 8), technological readiness (rank: 59) and business sophistication (rank: 63). A new GCI score will be published end-September and there will most likely not yet be many signs of improvement.

Tax reforms could help

In the GCI, Brazil scores 1.8 for 'effect of taxation on incentives to invest' and 2.2 for 'effect of taxation on incentives to work'. The difficult tax environment has long been an issue, which has only gotten worse with the deterioration of the fiscal situation. Brazil's total corporate tax rate (as % of profits) is now 68% according to the World Bank, against 46% in Latin America in general and 41% in the OECD. Not only is the level of taxation high, but the process is also complex. And according to the World Bank, the average company in Brazil spends over 2000 hours per year on preparing, filing and paying taxes. This compares to an average of 343 hours in Latin America and 163 hours in the OECD. A tax reform measure aimed at simplifying this system is currently under discussion in congress. If approved, it could give overall competitiveness a boost.

Higher USD/BRL in second half of this year

On 22 June we released our latest FX Watch on the Brazilian real (BRL). We expected that political uncertainty in Brazil would result in waves of weakness in the Brazilian real. This has not materialised so far for several reasons. First, currency markets have focussed more on the political situation in the US and Trump's controversial actions and tweets than the political limbo in Brazil. This has weighed on the US dollar across the board including on the bilateral USD/BRL rate. Second, US Treasury yields have declined as financial markets have reduced their expectations about a possible Fed rate hike this year. Financial markets are currently pricing in a probability of 35% for a December rate hike. There is only one Fed rate hike (25bp) priced in for the next 18 months. This is very low. Lower US Treasury yields and Fed rate hike expectations have weighed on the US dollar, but supported sentiment towards emerging markets such as Brazil as yields in Brazil are more attractive.

What do we expect going forward? We think that US dollar weakness has gone a bit too far at the moment. As a result, better-than-expected US data will probably result in some US dollar recovery also reflected in a higher USD/BRL. Moreover, if investor sentiment were to deteriorate, it is likely that investors will refocus on the political situation in Brazil as well and this is generally not positive. So we expect USD/BRL to move higher in the second half of this year, mainly because of a US dollar recovery. Therefore, we keep our year-end 2017 forecast for USD/BRL at 3.30. However, we expect US dollar weakness to return next year and hence we will keep our USD/BRL forecast for year-end 2018 unchanged at 3.00. The upside in the Brazilian real will likely be limited because of the general elections in Brazil scheduled for October 2018.

Key forecasts for the economy of Brazil

	2014	2015	2016	2017e	2018e
GDP (% yoy)	0.5	-3.8	-3.6	0.5	2.5
CPI inflation (% yoy)	6.3	9.0	8.7	3.9	4.2
CPI Inflation (% eoy)	6.4	10.7	6.3	3.5	4.3
Budget balance (% GDP)	-6.0	-10.0	-9.0	-8.0	-6.5
Government debt (% GDP)	56	65	70	77	82
Current account (% GDP)	-4.2	-3.3	-1.3	-0.5	-2.0
Gross fixed investment (% GDP)	20	18	16	17	17
Gross national savings (% GDP)	16	14	14	16	15
USD/BRL (eop)	2.66	3.90	3.26	3.3	3.0
EUR/BRL (eop)	3.21	4.24	3.44	3.8	3.6

Economic growth, budget balance, current account balance for 2017 and 2018 are rounded figures

Source: EIU, ABN AMRO Group Economics

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