Reforms start to take shape, but uncertainties remain

- The government has proposed a ceiling for public spending growth and has started discussions on social security reform. However, it is still unclear whether the new government can reach the political consensus needed to approve the fiscal measures.

- The 2016 target for the consolidated primary result has been revised downward, to -2.6% from -1.5% of GDP. We have reduced our primary result forecast to -2.4% from -1.7% of GDP in 2016 and to -1.5% from -1.0% of GDP in 2017.

- The most recent data on economic activity was surprisingly positive. We have revised our 2016 GDP forecast to -3.5% (previously -4.0%). For 2017, we have maintained expectations for moderate growth, at 1.0%. Industry may recover in the second half of the year, but the labor market is likely to remain weak given its lagged reaction to economic activity. We expect unemployment to end the year at 12.5% and to end 2017 at 13.0%.

- We have revised our exchange-rate forecast to 3.65 reais per dollar for the end of 2016 (from 3.75) and to 3.85 reais per dollar for the end of 2017 (from 3.95). This level reflects the more benign external scenario driven by the likely delay in interest rate hike by the Federal Reserve.

- We have increased our forecast for consumer inflation, measured by the IPCA, this year to 7.2% from 6.9%, in light of greater pressure from food prices. The projected increase for market prices has risen to 7.5% from 7.1%, while we maintained the forecast for regulated price inflation at 6.5%. Our inflation forecast for 2017 remains at 5.0%.

- The recession makes room for interest rate cuts ahead. Higher current inflation and fiscal uncertainties, however, suggest caution. We deferred our expected timing for the first rate cut to August. We now forecast the Selic rate at 12.75% by the end of 2016 (12.25% previously).

Government proposes spending ceiling and begins discussions on social security reform

In May, the government announced its plans to reverse the rising trend in public spending, which has already lasted at least two decades. The first measure was a rule (the details of which are still to be seen) setting a ceiling for government spending growth. The idea is to prevent spending from rising above the previous year’s inflation, so that spending as a proportion of GDP falls as the economy grows.

Additionally, discussions focusing on social security reform are under way. The number of beneficiaries has been growing faster than the economy. Additionally, many social security payments are indexed to the minimum wage, which usually rises faster than inflation. This means that changes in the way benefits are granted and changes to benefit indexation rules are needed to prevent expenditures from rising much faster than nominal GDP.

However, it is still unclear whether a political consensus can be reached to approve the fiscal measures, at least in their original version.

Meanwhile, the data on economic activity was a positive surprise. The 2016 recession is likely to be less harsh than expected. Additionally, there are signs that the industrial sector may start to recover: inventories continue to fall, opening room for production to resume growth from the second half of the year onward. However, unemployment, which has a lagged reaction to economic activity, is likely to keep rising for some time.

The exchange rate appreciated on a more benign external scenario. The possibility of the Fed delaying interest rate hike boosted the BRL and other currencies. Domestically, however, uncertainties about the public accounts dynamic and the still-elevated country risk tend to prevent a further appreciation of the currency.

We have increased our inflation forecast for 2016 as a result of the food-price shock. However, this does not mean a trend change: the economic
recession, the relative exchange-rate stability and the expectation of a better fiscal outlook are consistent with falling inflation. We have therefore maintained our IPCA forecast for 2017 unchanged.

We believe that economic outlook (weak activity, particularly in the labor market, and falling inflation) are consistent with an easing cycle beginning in the second half of the year. The speed and intensity of interest-rate cuts will depend on several factors, particularly the approval and implementation of the proposed fiscal adjustments.

**Fiscal reform efforts begin, but from a worse initial condition**

**Fiscal results continue to deteriorate.** In April, the 12-month cumulative primary deficit reached BRL 139 billion (2.3% of GDP). Over the same period, the nominal deficit was BRL 603 billion (10.1% of GDP), under pressure from interest expenses of BRL 464 billion (7.8% of GDP). As a result, gross debt continues to increase and reached 67.5% of GDP in April, reinforcing the need for structural reforms to change this negative dynamic.

Trend in fiscal accounts show the need of reforms

![Trend in fiscal accounts showing the need of reforms](source)

The government reduced the target for the consolidated primary result in 2016 to -2.6% from -1.5% of GDP. The new target forecasts a central government deficit of BRL 170 billion (-2.7% of GDP) and a surplus of BRL 6 billion (0.1% of GDP) for the regional governments. The 1.1% drop in GDP compared with the previous target takes into account disappointing revenues, mandatory expenditures above the original budget figures and a buffer to aid regional governments and pay other expenses.

To reverse this larger fiscal imbalance, the government announced a proposal to constitutionally limit public spending growth. If approved by Congress, the spending ceiling will prevent federal expenditures from growing above previous year’s inflation, which would help to reverse the growth trend in public expenditures (see graph).

In additional to limiting spending growth, the government announced that it intends to implement social security reforms. The most likely changes include setting a minimum retirement age of 65 for men and women and decoupling benefit indexation from the minimum wage.

We believe that, if approved, these measures will be an important step toward stabilizing public debt in the medium term.

![Spending ceiling could reverse the rising trend in public spending](source)

We have reduced our forecast for the primary result to -2.4% from -1.7% of GDP in 2016 and to -1.5% from -1.0% in 2017. We assumed that fiscal measures will be approved, but with adjustments that will reduce some of their fiscal impact. For 2016, we have incorporated a BRL 30 million (0.5% of GDP) increase in mandatory spending, included in the new fiscal target, and removed BRL 10 billion in tax increases that we were still expecting to see (0.2% of...
GDP). The difference between our estimate and the government’s target reflects a better scenario for economic activity than the target forecast (-3.5% vs. 3.8% estimated by the government, based on the Focus bulletin) and extraordinary revenues, such as the payroll auction and the Caixa Seguridade IPO. The projection for 2017 has been reduced, reflecting the lower number for 2016 and taking into account efforts to reduce spending by 0.2% of GDP and to increase revenues by 0.8% of GDP.

We expect gross debt to reach 72% of GDP in 2016 and 76% in 2017. Our estimate takes into account payment of the BNDES debt to the National Treasury: BRL 40 billion (0.6% of GDP) this year and BRL 30 billion (0.5% of GDP) in 2017. This measure, announced last month by the economic team, does not require congressional approval and will mitigate the impact of primary deficits on public debt.

**Economic activity better than expected, but labor market likely to remain weak**

**Economic activity was better than expected during the first quarter.** GDP shrank 0.3% in 1Q16 compared with the previous quarter, after seasonal adjustment. The result beat our forecasts and market expectations (both -0.8%). On the demand side, we saw the fifth consecutive drop in household consumption (-1.7%). On the supply side, the Service sector shrunk less than we expected. The highlight was activity in “other services” (including lodging away from home, food and other services), which remained practically stable during the first quarter, well ahead of our expectations (-1.1%). We project a reversal in the next quarter, however, as the shrinking wage bill is not compatible with increases in this activity.

**Leading indicators are stabilizing.** Our diffusion index – which shows the number of rising indicators, based on a wide dataset, including business and consumer confidence, retail sales and credit demand – ended March at around 43% (3-month moving average), close to the neutral level (44%). Preliminary figures for April and May indicate some improvement. These indicators are consistent with relative stability in economic activity during the second half of this year.

**Diffusion suggests relative stability during the second half**

Source: IBGE, Itaú
Industry is also showing signs of improvement and is likely to resume growth in the second half of the year. Industrial production outpaced our April forecasts. The number of industrial sectors that are presenting positive growth, which is good leading indicator for industrial production growth, is also on the rise. We believe that output is currently weaker than demand, which will lead to a cyclical recovery in output when the inventory adjustment has been completed.

To achieve sustainable growth in industrial output, fiscal reforms and adjustments need to be implemented, which will provide greater economic predictability. These reforms will reduce uncertainty and provide favorable conditions for interest-rate cuts from the second half of the year onward.

We have revised our 2016 growth projection up to -3.5% from -4.0%. We still expect a contraction in the second quarter of 2016, particularly in activities that depend on the labor market. Furthermore, we expect a payback for some of the positive surprises from 1Q16. However, the better-than-expected results in recent data and the outlook for an industrial recovery have improved our GDP forecast for this year, which now stands at -3.5% (previously -4.0%). In 2017, the ongoing inventory adjustment, deleveraging in the economy and the expected reforms should allow for a moderate recovery. We are therefore maintaining our forecast for a 1.0% GDP increase in 2017.

Despite signs of improvement in the economy, the labor market will likely continue to deteriorate for some time.

Job creation remains negative. In April, a net 62 thousand formal jobs were lost (CAGED). The three-month moving average shows that 172,000 jobs were destroyed (stripping out seasonal effects). As a result, the job market continues to shrink quickly. The effects remain widespread, affecting seven out of eight sectors of economic activity.
Unemployment rising. In April, the national unemployment rate rose to 11.2%. At the margin, it increased from 10.2% to 10.6% (our seasonal adjustment) and continues to rise, having increased almost 4 pp since its lowest level in mid-2014. Because any reaction from the job market lags behind economic activity, we expect the situation to continue as we move ahead. We have maintained our unemployment forecast for end of the year at 12.5%, and at 13.0% in 2017.

Increase in unemployment is likely to continue

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<td>7.5</td>
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<tr>
<td>Apr-16</td>
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Source: IBGE, Itaú

Stronger BRL amid a more benign external scenario

The BRL reached its strongest level in 2016, below 3.40 reais per dollar. U.S. labor market data disappointed in May, damping expectations of an earlier rate hike by the Federal Reserve. Thus, the BRL appreciated along with other emerging market currencies.

We have revised our exchange-rate forecast to 3.65 reais per dollar for the end of 2016 (from 3.75) and to 3.85 for the end of 2017 (from 3.95). In the international scenario, the likely change in the Fed’s plan, which should result in interest rate hike only in the second half of the year, strengthened the BRL. In Brazil, the possibility of domestic adjustments should afford the BRL some support, but the government may face hurdles getting these measures approved.

April revealed a USD 412 million current-account surplus, the first positive monthly result since 2009. The data confirm the ongoing current-account adjustment, which began last year with the exchange-rate depreciation and the slowdown in economic activity. However, this does not change our forecast for a small deficit in 2016. In recent months, the external adjustment pace has been slower than in 2015. On the financing side, direct investment in Brazil has been resilient, but portfolio flows, which are typically more volatile, continue to retreat.

Current account deficit keeps receding, but at a slower pace than in 2015

We have maintained our external-account estimates for the next two years. We are forecasting a USD 52 billion trade surplus for 2016 and USD 55 billion for 2017. For the current account, we expect a USD 15 billion deficit in 2016 and USD 7 billion deficit in 2017.

We have raised our inflation forecast for this year while maintaining our forecast for 2017

We have increased our forecast for inflation (as measured by the IPCA) this year to 7.2% from 6.9%, based on expectations for a sharper rise in food prices. The significant increase in grain prices seen recently, and the outlook for further increases, should put additional pressure on the prices of certain foods, particularly meats, vegetable oils and wheat.
derivatives. We have therefore revised upward our forecast for a food at home price increase, to 10.0% from 8.8%. We have also made a upward adjustment in our forecast for industrial prices to 6.0 from 5.6% (compared with 6.2% in 2015). We have maintained our estimate for private services increase at 7.3% (vs. 8.1% in 2015). As a result, the inflation forecast for market prices has risen to 7.5% from 7.1% (compared with 8.5% in 2015), while our inflation forecast for managed prices remains stable, at 6.5% (compared with 18.1% in 2015).

We are forecasting a 1.7% second-quarter increase for the IPCA (compared with 2.3% over the same period in 2015), with the 12-month rate dropping to 8.8%. In the first quarter, the IPCA rose 2.6%, with a 12-month rate of 9.4%. For the remaining periods, we are forecasting a 1.0% variation in the third quarter (1.4% in 2015) and 1.6% in the fourth quarter (2.8% in 2015).

Inflation is likely to drop to 7.2% this year

Despite the improving outlook for public accounts, with signs of reform and adjustments ahead, we believe that the fiscal issue remains a significant risk factor for inflation. If reforms are not approved, the risk premium would rise and the currency would depreciate, generating fresh inflationary pressures. Higher inflation could also come from tax hikes and/or increases in regulated prices, or also from worsening inflation expectations. On the other hand, favorable fiscal developments could result in an improved outlook for inflation in the longer term, either through exchange rates and inflation expectations, or as a result of its effects on the aggregate demand.

Weaker economic activity should help to reduce inflation. The significant economic slowdown could lead to faster market-price disinflation in the second half of the year, particularly for industrial products and services.

We are holding our IPCA inflation projection stable for 2017, at 5%. Among the factors that will bring inflation down are: i) the end of relative price adjustments (regulated prices and exchange rates); ii) less inflationary inertia; iii) more-favorable weather conditions; and iv) the impact of continued weakness in economic activity.

Almost three quarters of the 2016 inflation slowdown will come from regulated prices

Monetary Policy: we now expect the first interest-rate cut to take place in August

The economic scenario suggests room for interest-rate cuts ahead. The economy is still in recession despite initial signs of stability. The unemployment rate is likely to continue to rise, limiting room to pass prices on to the consumer. The exchange rate stabilized recently, although volatility remains elevated. Under these conditions, we expect inflation to recede, which would be consistent to a loosening of monetary policy in the second half.
Higher current inflation, however, suggests caution. The latest IPCA inflation results have shown a reversal in the recent downward trend. We believe that this pressure is temporary (see the inflation section above). However, this could lead the central bank to wait longer before initiating an easing cycle.

Furthermore, the domestic outlook remains uncertain. The new economic team has been signaling a wide-ranging fiscal adjustment, which is important for medium-term economic stability. However, there is still uncertainty about whether there is a political consensus to approve it.

In this environment, we have postponed our expectations for a start of the easing cycle from July to August.

We now expect the Selic benchmark rate at 12.75% by the end of the year (compared with 12.25% previously), with three 0.50 pp cuts starting in August. We believe that the easing cycle will extend into 2017 until the Selic reaches 10.00%.

### Forecast: Brazil

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<td>Selic - eop - %</td>
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<td>BRL / USD - eop</td>
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<td>Primary Balance - % GDP</td>
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<td>33.1</td>
<td>36.0</td>
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Source: IBGE, FGV, BCB and Itaú

(*) Nation-wide Unemployment Rate measured by PNADC

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