We now expect a Selic rate of 8.25% in 2017

- Economic activity has been showing signs of a gradual recovery, likely having started in 1Q17. We forecast 1.0% GDP growth in 2017 and 4.0% growth in 2018.
- Congress will continue debating Social Security reform this month. We expect approval for the reforms in 2Q17.
- We have left unchanged our exchange rate forecasts of BRL 3.35 per dollar for YE17 and BRL 3.45 per dollar for YE18.
- Inflation and inflation expectations continue to fall. We have reduced our 2017 forecast for the extended national consumer price index (IPCA) to 4.1% (from 4.4%). We maintain our 3.8% inflation forecast for 2018.
- The Central Bank of Brazil (BCB) has signaled the possibility of further interest rate cuts and frontloading the easing cycle. We now expect a year-end Selic rate of 8.25% for both 2017 and 2018.

Indicators suggest a gradual recovery starting in 1Q17

Brazil’s GDP shrank by 0.9% in the fourth quarter of 2016. This was the eighth consecutive quarterly decline in economic activity. On the supply side, services activity shrank for the eighth consecutive quarter, falling by 0.8%, the longest downward trend since the beginning of the historical series. On the demand side, the biggest news was a drop in household spending (-0.6%), also down for the eighth consecutive quarter. Inventory variation contributed around 0.5 percentage points (pp), according to our calculations. Therefore, GDP shrank by 3.6% in 2016, compared with 2015. The carry over for 2017 was -1.1%, slightly worse than expected (-0.9%).

Industrial output remained broadly stable. Industrial output generally matched expectations in January, falling slightly (-0.1%) after rising by 2.4% the preceding month. In the annual comparison, output rose by 1.4%, moving into positive territory for the first time since December 2014. Looking ahead, we expect activity to improve at the margin, in line with our diffusion index (which tracks the number of rising indicators based on a wide dataset that includes business and consumer confidence, retail sales and credit demand). Increasing diffusion usually precedes economic activity. We expect the index to end January at around 55% (three-month moving average), having shown a recovery at the margin in recent months.

Industrial output was broadly stable in January

[Graph showing Industrial output index]

Source: IBGE, Itaú

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Business and consumer confidence continues to rise. In February, business and consumer confidence remained above the 2H16 average. Although industrial confidence has weakened, inventories shrank again. We expect the cyclical inventory adjustment to continue as we move ahead, which will support the economic recovery.

Our GDP forecasts remain unchanged. We are forecasting that first-quarter 2017 GDP will rise by 0.5% compared with the previous quarter, after seasonal adjustments. Short-term indicators show rising industrial output and stable retail sales. As leading indicators have improved at the margin and fundamentals continue to perform within expected parameters, we are maintaining our forecast of 1.0% GDP growth in 2017 and 4.0% growth in 2018.

Formal employment losses continue to slow. January saw a net destruction of 40,000 formal jobs in Brazil (according to figures from CAGED, the government’s employment registry). Stripping out seasonal effects, we estimate that there has been an improvement in the three-month moving average, to -57,000 from -81,000. We expect job destruction to continue through the second half of this year. However, hiring – which usually reacts before net job creation – showed the fourth consecutive monthly increase at the margin in January, indicating that the rate of job destruction will likely continue to slow over the coming months.

The unemployment rate rose again. The national unemployment rate rose to 12.6% in January. The seasonally adjusted unemployment rate, meanwhile, registered its 26th consecutive monthly increase, rising to 13.0% from 12.7%, exceeding our estimate of 12.8%. The unemployment rate has increased at a fairly constant rate in recent months. We are therefore now forecasting that unemployment will reach 13.4% by the end of 2017 (compared with our previous estimate of 13.2%) and 12.9% in the fourth quarter of 2018.
Unemployment rate increases further in January

[Graph showing a rising trend in unemployment rate from January 2013 to January 2017]

Source: IBGE, Itaú

Fiscal update: A focus on Social Security reform

In March, a Lower House Special Committee will continue debating the Social Security reform bill (PEC 287). The bill would set a minimum retirement age of 65 and standardize the rules on access to Social Security benefits for men and women, public sector workers and private sector workers, and urban and rural residents.

Changes to Social Security are essential if the government is to comply with the spending cap over the next few years. Social Security expenditure represented 40% of the federal government’s total primary expenditure (8.0% of GDP) in 2016 and will increase in real terms in future years as the population ages. The proposed reforms would bring the federal budget into line with Brazil’s current demographic scenario. It would also reduce the need for significant cuts to the rest of the budget and support ongoing structural adjustments to Brazil’s public expenditure.

We believe that Social Security reforms are likely to be approved (albeit with some amendments) by Congress in the second quarter of 2017.

If approved, these measures will play a critical role in stabilizing medium-term public debt. We are forecasting a return to primary surpluses only in 2020, but we believe that the renewed growth and structural decline in interest rates that would likely follow the adoption of the reforms could, if they persist, significantly slow the pace of public debt growth. We expect public debt to remain stable at around 80% of GDP from 2018 on.

Without reforms, Social Security would make the spending cap unsustainable

[Graph showing Social Security expenditure as a percentage of central government primary expenditure over time]

Source: National Treasury, Itaú

We expect to see a primary deficit amounting to 2.2% of GDP in 2017 (BRL 142 billion), in line with the government target. However, this target is ambitious; to meet it the government would have to receive BRL 60 billion in extraordinary revenues (BRL 50 billion included in the budget and BRL 10 billion from the tax regularization program, still not included in the budget). In order to address doubts about its ability to obtain significant extraordinary revenues, the government is likely to announce BRL 40 billion in funding contingencies at the end of March. These contingencies are likely to be gradually reversed throughout the year as extraordinary revenues are confirmed and the economy begins to grow again.

For 2018, we expect a primary deficit amounting to 1.6% of GDP (BRL 116 billion). This forecast takes into account the spending cap (approved in 2016) and extraordinary revenues totaling BRL 35 billion (0.5% of GDP), assumptions which are compatible with a gradual reversal of Brazil’s fiscal imbalance.

The external scenario justifies further BRL depreciation ahead

The exchange rate fluctuated around BRL 3.10 per dollar throughout February. The external environment remained favorable for emerging markets, with higher commodity prices, on average, and less risk aversion.
We continue to forecast an exchange rate of BRL 3.35 to the dollar at end 2017 and BRL 3.45 to the dollar at end 2018. Even though the improving outlook of approval for fiscal reforms has reduced country risk and increased foreign investors’ appetite for Brazilian assets, the international scenario is likely to become more challenging ahead. We are forecasting US interest rates increases and commodity prices drop from their current levels throughout the year, which justifies a currency depreciation from current levels.

Current account deficit being comfortably financed. The seasonally adjusted, annualized three-month moving average current account deficit has been hovering in the range of USD 20-30 billion since the second half of last year. The main positive contribution comes from the trade balance. On the financing side, direct investment in Brazil has been resilient (4.7% of GDP), easily covering the current account deficit. With less dependence on volatile capital, the financing risk for the balance of payments is reduced.

We have lowered this year’s inflation forecast

Our IPCA inflation forecast for 2017 has been revised downward from 4.4% to 4.1%. Lower-than-expected inflation at the start of the year, particularly in food and service prices, has justified a lower IPCA forecast for 2017. On a 12-month trailing basis, we expect the inflation rate to fall back to 4.6% in March, 4.0% in June and 3.9% in September. We note that disinflation tends to trigger a welcome debate about possible reductions in the inflation target. The National Monetary Committee (CMN) will meet in June to reassess 2018’s 4.5% inflation target and to set the target for the following year.

On a disaggregated basis, we are now forecasting a 3.7% rise in market prices (down from our previous forecast of 4.1%) and a 5.5% increase in regulated prices (previously 5.4%) for 2017. Looking at market prices, we have reduced our inflation forecast for food consumed at home from 3.0% to 2.3% based on positive results from the beginning of the year in both the wholesale and retail markets. After ending the year up 9.4%, the 12-month variation for food at home subgroup is likely to fall back to around 3% in the first quarter. The likelihood of bumper crops in Brazil and the world’s other main food-producing nations as weather conditions improve is likely to ensure that food prices behave well throughout the year. Strong food price disinflation this year, a result of the positive supply shock, is likely to reduce the IPCA by 1.1 pp, equivalent to half the forecasted drop in inflation in 2017. In the other segments, we are forecasting a 4.9% increase in service prices (compared with 6.5% in 2016) and 2.8% increase in industrial prices (compared with 4.8% in 2016). The labor market and real estate sector continue to face adverse conditions, which – along with a reduced inertial effect from past inflation and a smaller increase in the minimum salary – are likely to have a moderating effect on salary and rent costs, thereby contributing to a further fall in services inflation this year. Looking at the main components of regulated prices, we are forecasting no price variation for gasoline and fixed-line telephony; a 4% price increase for medicinal drugs; a 7% increase in urban bus fares;

In the years ahead, we expect the combination of a more appreciated Brazilian real, a recovery in domestic demand and commodity prices below current levels to result in slightly wider current account deficits. We now forecast trade surpluses of USD 49 billion for 2017 (up from our previous forecast of USD 46 billion) and USD 35 billion for 2018 (previously USD 34 billion). These revisions reflect rising export volumes of oil and fuels since the beginning of the year. We forecast a USD 32 billion current account deficit in 2017 (previously USD 33 billion) and a USD 50 billion deficit in 2018.

Direct investment is enough to fully cover the current account deficit

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an 8% rise in electricity prices and an 11% price bump for health plans. 

**Our inflation forecast for 2018 remains at 3.8%**. On a disaggregated basis, we are forecasting a 3.5% rise in market prices and a 4.7% increase in regulated prices. The output gap (which is still in negative territory), lower inertia from this year’s inflation and stable inflation forecasts are the main drivers of forecasts that next year’s inflation will drop below target. As noted above, any occasions when inflation comes in below the center of the target range in the middle of this year will likely be opportunities to discuss reducing the inflation target for the years ahead. We believe that a lower target will be credible and will help reinforce the goal of reducing inflation to levels close to those of peer countries. On the other hand, retaining the 4.5% target could have an impact on expectations and, consequently, on inflation itself.

**The main inflation-scenario risk factors stem from external uncertainties and, more particularly, domestic political issues.** Greater external uncertainty, despite the apparent tranquility shown by markets at the beginning of this year, could trigger an increase in risk premiums, which could in turn result in further depreciation of the Brazilian real. Special attention should be paid to the possibility of a faster rise in U.S. interest rates than initially considered. In fiscal terms, any new difficulties that hamper progress on the necessary reforms and adjustments could also create apprehension in the markets and have an additional impact on risk premiums and exchange rates. However, the amount of progress to date and the prospects for the approval of the fiscal reforms – particularly Social Security reforms – have both been positive.

**The high level of idle capacity in the economy may also help to push down inflation further.** The negative output gap (the difference between potential GDP and actual GDP) could lead to faster market price disinflation over the next few months, particularly in areas that are more sensitive to the economic cycle, like industrial goods and services. The inflation surprises in recent months already constitute evidence that there is a more widespread disinflation process ongoing in exactly these segments. This means that progress on fiscal reforms could improve the outlook for inflation, either by shifting exchange-rate and inflation expectations or through a gradual switch from expansionary to neutral or even contractionary fiscal policies.

**More solidly grounded expectations reinforce the scenario of falling inflation.** According to the central bank’s focus survey, median inflation expectations for 2016 retreated again last month, from 4.64% to 4.36%, which is below the target. In turn, median expectations for 2018 and onward remain stable at 4.5%, reflecting economic agents’ increasing conviction that the BCB will take steps to ensure that the IPCA will indeed converge with the target. Finally, we should note that average inflation forecasts for 2018 to 2020 already indicate inflation falling below 4.5%, a clear indication that median forecast figures could be lowered over the coming weeks.
We now expect a Selic rate of 8.25% in 2017

At its February monetary policy meeting, the central bank cut interest rates again, this time by 75 bps, bringing the Selic rate to 12.25%. In the meeting minutes, the BCB signaled that the length of the cycle will depend on its estimates of the Brazilian economy’s “structural interest rate”, which the committee will reassess over time. Furthermore, the BCB highlighted that the possible acceleration in the pace of easing will depend on the length of the cycle, as well as on the behavior of economic activity, risk factors (the external environment, food price shocks and the prolonged recession) and inflation forecasts and expectations, in that order.

We now expect a Selic rate of 8.25% at the end of both 2017 and 2018. Based on BCB signals that further interest rate cuts are possible and that it may frontload the easing cycle, we now expect the Selic rate to reach 8.25% by the end of this year (down from 9.25% in our previous scenario). For the time being, we are forecasting four 75-bp rate cuts and a further two cuts of 50 bps each for 2017. We understand that there is a chance the BCB may decide to accelerate the easing cycle at its April meeting, in particular, if the external scenario remains benign and domestic data point to a more rapid and intense disinflationary process. Our 2018 Selic rate forecast remains unchanged at 8.25%.

Forecast: Brazil

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<tbody>
<tr>
<td>Real GDP growth - %</td>
<td>4.0</td>
<td>1.9</td>
<td>3.0</td>
<td>0.5</td>
<td>-3.8</td>
<td>-3.6</td>
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<td>Nominal GDP - BRL bn</td>
<td>4,376</td>
<td>4,815</td>
<td>5,332</td>
<td>5,779</td>
<td>6,001</td>
<td>6,267</td>
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<tr>
<td>Nominal GDP - USD bn</td>
<td>2,612</td>
<td>2,463</td>
<td>2,468</td>
<td>2,455</td>
<td>1,802</td>
<td>1,797</td>
<td>2,041</td>
<td>2,081</td>
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<tr>
<td>Population (millions)</td>
<td>197.4</td>
<td>199.2</td>
<td>201.0</td>
<td>202.8</td>
<td>204.5</td>
<td>206.1</td>
<td>207.7</td>
<td>209.2</td>
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<td>Per Capita GDP - USD</td>
<td>13,234</td>
<td>12,362</td>
<td>12,278</td>
<td>12,106</td>
<td>8,611</td>
<td>8,722</td>
<td>9,828</td>
<td>9,947</td>
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<td>Nation-wide Unemployment Rate - year avg (*)</td>
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<td>7.2</td>
<td>6.8</td>
<td>8.3</td>
<td>11.3</td>
<td>13.1</td>
<td>13.2</td>
<td></td>
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<tr>
<td>Nation-wide Unemployment Rate - year end (*)</td>
<td>-</td>
<td>7.4</td>
<td>6.8</td>
<td>7.1</td>
<td>9.7</td>
<td>12.7</td>
<td>13.4</td>
<td>12.9</td>
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Inflation

| IPCA - %                              | 6.5  | 5.8  | 5.9  | 6.4  | 10.7 | 6.3  | 4.1   | 3.8   |
| IGP–M - %                             | 5.1  | 7.8  | 5.5  | 3.7  | 10.5 | 7.2  | 3.5   | 3.8   |

Interest Rate

| Selic - eop - %                       | 11.00| 7.25 | 10.00| 11.75| 14.25| 13.75| 8.25  | 8.25  |

Balance of Payments

| BRL / USD - eop | 1.87 | 2.05 | 2.36 | 2.66 | 3.96 | 3.26 | 3.35  | 3.45  |
| Trade Balance - USD bn                  | 30   | 19   | 2    | -4   | 20   | 48   | 49    | 35    |
| Current Account - % GDP                 | -2.9 | -3.0 | -3.0 | -4.2 | -3.3 | -1.3 | -1.6  | -2.4  |
| Direct Investment (liabilities) - % GDP | 3.9  | 3.5  | 2.8  | 3.9  | 4.2  | 4.4  | 3.8   | 3.9   |
| International Reserves - USD bn         | 352  | 379  | 376  | 374  | 369  | 372  | 372   | 372   |

Public Finances

| Primary Balance - % GDP                | 2.9  | 2.2  | 1.7  | -0.6 | -1.9 | -2.5 | -2.2  | -1.6  |
| Nominal Balance - % GDP                | -2.5 | -2.3 | -3.0 | -6.0 | -10.2| -9.0 | -7.9  | -6.7  |
| Gross Public Debt - % GDP              | 51.3 | 53.7 | 51.5 | 56.3 | 65.5 | 69.9 | 74.6  | 76.0  |
| Net Public Debt - % GDP                | 34.5 | 32.3 | 30.6 | 33.1 | 36.0 | 46.2 | 51.5  | 54.0  |

Source: IBGE, FGV, BCB and Itaú

(*) Nation-wide Unemployment Rate measured by PNADC

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