

Brazil Business Forecast Report Q3 2014

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Abstracts

Core Views

With persistent currency weakness and rising interest rates set to temper private consumption growth, and fixed investment to receive only a moderate boost from the June 2014 FIFA World Cup and final year of the PAC II growth acceleration programme, we expect Brazil's economic recovery to falter this year. Indeed, we forecast real GDP growth of 2.0% in 2014, down from 2.3% in 2013.

Elevated inflation will keep interest rates high in the coming months, and we forecast one more rate hike to 11.25% before the central bank pauses. However, we maintain our view that the bank will switch focus from reining in inflation to stimulating growth by year-end, in line with our end-2014 Selic rate forecast of 10.75%.

While the widespread public protests begun in June have largely subsided, we believe that this marked a turning point for the Brazilian electorate. As such, we anticipate that public unrest could flare up again should political progress on reforms stall.

With President Dilma Rousseff the candidate best positioned to win the October 2014 presidential election, we anticipate that major reforms are likely to be limited in the coming years, implying a modest reining in of expansionary fiscal policy and a continued piecemeal approach to improving the outlook for state-owned oil company Petrobras.

Major Forecast Changes

We have downgraded our 2014 real GDP growth forecast from 2.4% to 2.0%, as the potential for a more significant increase in interest rates than we initially anticipated, as well as persistent currency weakness will temper real private consumption growth this

year. A continuation of the Banco Central do Brasil's aggressive monetary tightening cycle saw us upgrade our short-term Selic rate target to 11.25%, implying 25 basis points of hikes from the current level. In light of more significant rate hikes in the short term, we increased our end-2014 interest rate forecast to 10.75%, from 10.50% previously.

Given a very weak start to 2014, and our view that downside pressures on the Brazilian real will persist in the coming months, we have revised our average and end-year exchange rate forecasts to BRL2.400/USD and BRL2.450/USD respectively, from BRL2.350/ USD and BRL2.400/USD previously.

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With Brazilian real GDP set for a period of more moderate growth over the medium term, significant business environment challenges and growing competition for investment from Mexico, we believe that the economy will figure prominently on the country's policy agenda over the medium term. In addition, with the PAC growth acceleration programme scheduled to end in 2014, the government will be challenged to continue improving Brazil's social development metrics in order to provide the foundations for robust long-term growth.

CHAPTER 2: ECONOMIC OUTLOOK

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We believe that Brazil's economic recovery will falter this year, and are revising down our 2014 real GDP growth forecast from 2.4% to 2.0%, below our 2013 estimate of 2.3% growth. Indeed, further monetary tightening, significant exchange rate weakness and ongoing project delays in the infrastructure sector will negatively impact both the private consumption and fixed investment components, weighing on headline growth.

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We expect that a continued pick-up in revenue growth will prevent further deterioration in Brazil's fiscal accounts this year, even as spending picks up moderately. As such, we forecast Brazil's nominal fiscal shortfall to come in at 3.3% of GDP this year, in line with the 2013 print. Moreover, with the government likely to rein in spending in following the October 2014 general election, we forecast modest fiscal consolidation beginning in 2015.

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With the benchmark Selic target rate standing at 11.00%, we believe that the Banco Central do Brasil will enact one more 25 basis points rate hike to 11.25% before ending the monetary tightening cycle, which began in April 2013. Indeed, we expect that the bank will increasingly shift its focus from tempering inflation to stimulating growth in the coming months, in line with our end-2014 interest rate forecast of 10.75%. However, we note upside risks to this view should supply-side price pressures send headline inflation significantly higher in the coming months.

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With import growth set to continue outpacing export growth, we anticipate a further widening of Brazil's current account shortfall this year to 4.2% of GDP, from 3.6% in 2013. While the current account deficit will remain relatively well covered by the financial account surplus, we expect that the financial account will remain off its recent highs, as portfolio inflows moderate on the back of rising yields in developed markets, and foreign direct investment is negatively impacted by a slower medium-term growth story in Brazil.

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