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Brazil Update

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All eyes on the spending cap

Jose Carlos Faria
Chief Economist
+55-11-2113-5185

Spending cap bill is modified

The rapporteur of the Special Committee in charge of the spending cap bill has presented his report, suggesting some modifications to the constitutional amendment. The committee could vote on the report on Thursday. According to the local press, the government has agreed to some important changes in the spending cap bill. First, the government has agreed to raise the minimum budget earmarked for healthcare and education, which will no longer be frozen at 2016 levels. The bill could determine that at least 15% of current net revenues will have to be spent on healthcare – a requirement that was previously scheduled to kick in only in 2020. This would increase spending on healthcare by approximately BRL8bn in 2017. Second, the inflation index that will adjust the spending ceiling every hear would no longer be the previous calendar year's inflation rate, but the 12-month inflation registered in July of the previous year. This makes sense, because Congress has to approve the budget before the end of the year. Third, the ceiling would continue to exist for 20 years, and the government would still be able to revise the rules after the initial 10 years, as in the original proposal. However, it would also be possible to revise the indexation mechanisms every four years, coinciding with the presidential mandate. This would be a better option than allowing a revision of the whole ceiling every 4 years, as the rapporteur had intended to do. As we mentioned before, we believe it would be very difficult to pass the spending cap amendment without modifications. The most important change here is the one increasing healthcare spending, but we always thought that this was inevitable. It is important to mention that these changes will likely be approved by the Special Committee, but the Lower House floor will ultimately decide on the final structure of the bill. All in all, if the government manages to pass the amendment with these three modifications only, it will be a positive outcome, in our opinion. Even so, given the rigidity of the spending structure and the fact that social security benefits amount to roughly 40% of federal spending, the fiscal adjustment will only succeed if the government passes a social security reform after the ceiling our opinion.

Goldfajn sounds slightly more hawkish

Speaking at the Senate Economic Committee on Tuesday, BCB President Ilan Goldfajn. Goldfajn repeated several statements that had already been published in the central bank's Inflation Report last week, reaffirming the intention of making inflation converge to the 4.5% target in 2017. Goldfajn also repeated the remarks published in the Inflation Report about the three conditions for the authorities to initiate an easing cycle (namely limited persistence of food price shock, disinflation of IPCA components, and lower uncertainty about the fiscal adjustment implementation). The Goldfajn, however, added that the BCB "does not have a pre-established timetable for monetary easing," as the COPOM decision will depend on several factors, including inflation expectations and forecasts. This comment suggests that the BCB has not yet made a final decision to cut rates, perhaps because market inflation expectations for 2017 have not converged to the 4.1% target yet. Despite Goldfajn's cautious remarks, we still expect the COPOM to cut the SELIC rate by 25bps at the next meeting later this month.

Industrial production fell 3.8% MoM in August

The decline was much worse than our forecast of -2.5% MoM, and interrupted a sequence of five consecutive increases. Mining production fell 1.8% MoM (led by iron ore) and manufacturing declined 3.6% MoM. Durable goods plunged -9.3% MoM, led by a sharp decline in vehicle production that resulted from the suspension of production in some factories due to supply chain issues. Intermediate goods fell 4.3% MoM, non-durables were down 0.9% MoM, and capital goods rose 0.4% MoM. On a year-on-year basis, industrial production declined 5.2%, led by a 12.5% YoY plunge in durable consumer goods (the silver lining is that capital goods rose 5.0% YoY). We believe the larger-than-expected fall in August was caused mainly by temporary factors and does not alter the trend of a gradual recovery of the industrial sector, in line with other indicators, including business confidence and capacity utilization. As we stressed before, we do expect a slow recovery, as inventory levels remain relatively high, and household consumption remains subdued amid intense credit rationing and rising unemployment, whereas a recovery in investment depends on the mitigation of political uncertainty and fiscal policy risk.

Temer approval ratings remain low

According to the latest CNI/Ibope poll conducted, 39% of the interviewees said they consider acting president Michel Temer's government bad or very bad, unchanged from June. The share of those who consider the government regular fell slightly to 34% from 36%, and those who consider it good or very good rose slightly to 14% from 13%. Temer's "personal" approval rating fell to 28% from 31%. For 38% (vs. 44%) of the interviewees, the Temer government is similar to President Dilma Rousseff's government, while 31% (vs. 25%) believe it is worse and 24% (vs. 23%) said it is better. In our opinion, the negative ratings reflect mainly the economic situation (as unemployment is still rising despite the stabilization of some economic indicators), and the intense controversy surrounding Rousseff's impeachment. While we expect Temer's popularity to eventually improve as the economy recovers, the current low approval ratings do not bode well for the president to pass unpopular reforms in Congress.

Figure 1: Macroeconomic forecasts

	2009	2010	2011	2012	2013	2014	2015	2016F	2017F
Economic Activity									
Real GDP (%YoY)	-0.1	7.5	3.9	1.9	3.0	0.1	-3.8	-3.1	1.2
Nominal GDP (R$bn)	3,333.0	3,885.8	4,373.7	4,805.9	5,316.5	5,687.3	5,904.3	6,147.7	6,541.6
Nominal GDP (US$bn)	1,672.6	2,209.8	2,612.9	2,459.0	2,461.4	2,415.9	1,772.3	1,767.2	1,943.1
GDP per capita (US$)	8,642.1	11,303.2	13,236.5	12,341.9	12,244.0	11,914.7	8,667.5	8,578.7	9,364.7
Household consumption (%YoY)	4.2	6.4	4.8	3.9	3.5	1.3	-4.0	-4.2	1.2
Investment (%YoY)	-1.9	17.8	6.6	-0.6	5.8	-4.5	-14.1	-9.0	4.5
Industrial production (%YoY)	-7.1	10.2	0.4	-2.3	2.1	-3.2	-8.3	-6.0	3.0
Unemployment Rate (%)	8.6	8.5	7.6	7.4	7.1	6.8	8.5	11.4	12.1
Prices									
IPCA (%)	4.3	5.9	6.5	5.8	5.9	6.4	10.7	7.3	5.1
IGP-M (%)	-1.7	11.3	5.1	7.8	5.5	3.7	10.5	8.0	5.3
Fiscal Accounts									
Primary balance (% of GDP)	1.9	2.6	2.9	2.2	1.7	-0.6	-1.9	-2.7	-2.2
Nominal balance (% of GDP)	-3.2	-2.4	-2.5	-2.3	-3.0	-6.0	-10.4	-8.8	-9.3
Gross public debt (% of GDP) year end	60.9	51.7	51.3	53.8	51.7	57.2	66.5	73.2	78.0
External Accounts									
Trade balance (US$bn)	25.0	18.5	27.6	17.4	0.4	-6.6	17.7	50.0	45.0
Current account balance (US$bn)	-26.3	-75.8	-77.0	-74.2	-74.8	-104.2	-58.9	-16.5	-28.0
Current account balance (% of GDP)	-1.6	-3.4	-2.9	-3.0	-3.0	-4.3	-3.3	-0.9	-1.4
Foreign direct investment (US$bn)	25.9	48.5	66.7	65.3	64.0	62.5	57.2	45.0	50.0
Foreign exchange reserves (US$bn)	239.1	288.6	352.0	378.6	375.8	374.1	368.7	368.7	368.7
Debt Indicators									
Gross external debt (US$bn)	277.6	351.9	404.1	455.3	486.7	560.4	545.4	535.4	538.4
Gross external debt (% of GDP)	16.6	15.9	15.5	18.5	19.8	23.2	30.8	30.3	27.7
Interest and exchange rates									
Overnight interest rate (%, eop)	8.8	10.8	11.0	7.3	10.0	11.8	14.3	13.5	10.8
Exchange rate (BRL/US$, eop)	1.74	1.67	1.88	2.04	2.34	2.66	3.90	3.25	3.45
Exchange rate (BRL/US$, average)	2.00	1.76	1.67	1.95	2.16	2.35	3.33	3.48	3.37

Source: DB Global Markets Research

	GDP %	IPCA %	BRL/USD	Avg SELIC
2010	7.5	5.9	1.7	10.0
2011	3.9	6.5	1.9	11.7
2012	1.9	5.8	2.0	8.5
2013	3.0	5.9	2.3	8.4
2014	0.1	6.4	2.7	11.0
2015	-3.8	10.7	3.9	13.6
2016F	-3.1	7.3	3.3	14.1
2017F	1.2	5.1	3.5	11.5
2018F	2.2	4.7	3.5	10.8
2019F	1.7	4.8	3.6	12.9
2020F	1.6	4.5	3.7	11.0
2021F	2.0	4.5	3.8	10.5

	IPCA MoM%	IPCA YoY%	SELIC %
Sep-16	0.18	8.58	14.25
Oct-16	0.40	8.13	14.00
Nov-16	0.45	7.53	13.50
Dec-16	0.70	7.26	13.50
Jan-17	0.80	6.76	13.00
Feb-17	0.70	6.55	12.50
Mar-17	0.40	6.51	12.50
Apr-17	0.40	6.29	12.00
May-17	0.40	5.89	11.50
Jun-17	0.20	5.73	11.50
Jul-17	0.10	5.29	11.00
Aug-17	0.20	5.04	11.00

Source: National statistics, Deutsche Bank forecasts

Appendix 1

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International locations

Deutsche Bank AG
Deutsche Bank Place
Level 16
Corner of Hunter & Phillip Streets
Sydney, NSW 2000
Australia
Tel: (61) 2 8258 1234

Deutsche Bank AG
Große Gallusstraße 10-14
60272 Frankfurt am Main
Germany
Tel: (49) 69 910 00

Deutsche Bank AG
Filiale Hongkong
International Commerce Centre,
1 Austin Road West,Kowloon,
Hong Kong
Tel: (852) 2203 8888

Deutsche Securities Inc.
2-11-1 Nagatacho
Sanno Park Tower
Chiyoda-ku, Tokyo 100-6171
Japan
Tel: (81) 3 5156 6770

Deutsche Bank AG London
1 Great Winchester Street
London EC2N 2EQ
United Kingdom
Tel: (44) 20 7545 8000

Deutsche Bank Securities Inc.
60 Wall Street
New York, NY 10005
United States of America
Tel: (1) 212 250 2500