BRAZIL UPDATE

A MODEST RECOVERY GAINS TRACTION DESPITE LINGERING POLITICAL RISKS

After 2017’s return to expansion, growth should pick up in 2018

Brazil is recovering from the worst economic downturn in a generation. After contracting a cumulative 9 percent between the first quarter of 2014 and the fourth quarter of 2016, Brazilian real GDP returned to growth in the first quarter of 2017; high-frequency indicators point to this modest expansion continuing in the second quarter. The headwinds that caused Brazil’s recession have dissipated. The country’s terms of trade—the prices of its exports relative to its imports—stabilized in 2017 as the prices of Brazil’s commodity exports stopped falling in US dollar terms. The drought that impaired electricity production between 2014 and 2016 ended as well, allowing the government to cut average retail electricity prices by more than 10 percent between their peak in January 2016 and the second quarter of 2017. Inflation began to slow in 2016, brought down both by lower import prices (a benefit of the stronger currency) and lower charges for household electricity and other utilities. Brazilian real GDP will likely grow about 0.5 percent in 2017 from 2016, before accelerating to 3.0 percent growth in 2018.

Trend inflation is set to slow

The rise in the unemployment rate to its highest since 2004 is slowing the destructive wage-price spiral that has eroded private sector profitability and capital spending since Brazil’s commodity boom ended (Chart 1). In fact, after changes to Brazilian labor law enacted in July, inflation pressures are likely to cool even more. The July labor reforms liberalized employment regulations, permitted employers to negotiate directly with their unions rather than accepting national labor agreements, made union dues voluntary, and legalized part-time and temporary employment contracts. These regulatory changes are likely to slow Brazilian wage growth and reduce the “stickiness” of inflation caused by union contracts that index wage growth to inflation. There is strong cross-country evidence that these types of regulatory changes lower the long-term trend in inflation: Just as falling union membership in the United States has slowed wage growth and inflation since the 1980s, and just as labor market liberalization in the Eurozone has slowed trend inflation there since 2012, changes to labor regulation in Brazil enacted in 2017 will likely cause a reduction in trend inflation there as well.

CHART 1: SLOWER INFLATION ALLOWS THE CENTRAL BANK TO CUT INTEREST RATES AND FOSTER A RECOVERY

Chart sources: Central Bank of Brazil, National Institute of Geography and Statistics, CEIC, The PNC Financial Services Group
The central bank will likely find room to keep cutting interest rates

In addition, Brazilian fiscal policy will become less stimulative in the second half of 2017 and in 2018 as the government reduces its primary balance—the difference between government revenues and government expenditures excluding debt service—by 0.3 to 0.4 percentage points. A smaller public deficit—or framed differently, less stimulative fiscal policy—increases the central bank’s room for more stimulative monetary policy. The Brazilian central bank will likely be able to reduce the Selic rate to 6.5 percent or lower by the end of 2018, setting monetary policy in a modestly accommodative stance, and facilitating a recovery from the 2014 to 2016 downturn.

Political uncertainty is the largest downside risk to Brazil’s outlook and currency. In May, an audio recording seeming to implicate President Michel Temer in the country’s wide-ranging “Car Wash” scandal was released, spurring June’s wave of protests against the government. President Temer has so far outmaneuvered efforts of protesters, prosecutors, judges, and political opponents to unseat him. He still enjoys a degree of support from Brazil’s political establishment despite approval ratings hovering around 5 percent. Even more surprisingly, he has successfully shepherded some economic reforms into law while managing the scandal.

The Brazilian real recovered from more than 4 per US dollar in January 2016 to about 3.25 per dollar in mid-2016, then moved sideways in the subsequent year (Chart 3). Domestic and international factors will likely fuel further appreciation. On the domestic side, the economic recovery and falling inflation support a stronger currency. Internationally, the accommodative monetary policies of most advanced economies, faster and broader-based economic growth, and stable commodity prices support demand for and prices of Brazilian commodity exports. PNC Economics forecasts for the real to appreciate in coming quarters and average around 3.1 per dollar in the second half of 2018 (Chart 3).

**CHARTS 2 & 3: BRAZIL’S CURRENCY IS CHEAPER THAN OTHER EMERGING MARKETS’ AND STILL HAS ROOM TO APPRECIATE**

---

Chart sources: Bank for International Settlements, Central Bank of Brazil, CEIC, The PNC Financial Services
Visit [http://www.pnc.com/economicreports](http://www.pnc.com/economicreports) to view the full listing of economic reports published by PNC’s economists.

Disclaimer: The material presented is of a general nature and does not constitute the provision of investment or economic advice to any person, or a recommendation to buy or sell any security or adopt any investment strategy. Opinions and forecasts expressed herein are subject to change without notice. Relevant information was obtained from sources deemed reliable. Such information is not guaranteed as to its accuracy. You should seek the advice of an investment professional to tailor a financial plan to your particular needs. © 2017 The PNC Financial Services Group, Inc. All rights reserved.