

Wash" investigation). Under these circumstances, it is hard to believe that the economy will recover if the government returns to the same populist policies that were mainly responsible for the crisis in the first place. In the absence of a comprehensive fiscal adjustment and without a significant economic recovery, the risk is that Brazil might have to generate increasing inflation rates to cope with its ballooning public debt, a perverse process that we all remember very well from the 1980s.

In light of the latest developments, we are updating our macroeconomic forecasts to take into consideration the higher risks. While our scenario is not one of uncontrolled inflation, it envisages a much slower economic recovery, weaker exchange rate, and higher inflation. We are optimistically assuming that, despite the latest setbacks, the government will manage to obtain a minimum support from Congress to at least avoid another consolidated primary fiscal deficit in 2016 (most likely through higher taxes), gaining time to slowly work on structural measures that could produce better fiscal results in the coming years. In our scenario, we assume that President Dilma Rousseff will complete her second mandate, but we expect Brazil to lose its investment grade status in 1Q16. That said, the scenario remains quite volatile due to high political uncertainty reflecting Rousseff's lack of support in Congress, the "Car Wash" investigation and the economic crisis. Therefore, the risk remains on the downside, as the government could fail to obtain political support to minimally shore up the fiscal accounts, leading to greater financial and economic instability.

We cut our 2015 GDP forecast to -2.8% from -2.3%, and our 2016 GDP forecast to -0.5% from -0.2%. We expect fixed-asset investment to plunge roughly 11% this year, and the external sector's positive contribution will prevent a larger economic contraction. We raised our 2015 IPCA consumer price index forecast slightly to 9.4% from 9.3%, and our 2016 IPCA projection to 5.9% from 5.4% (mainly due to the weaker FX). We now expect the BRL to finish 2015 at BRL3.70/USD, and 2016 at BRL3.90/USD (instead of BRL3.40/USD and BRL3.65/USD, respectively). Despite the higher inflation, we continue to expect the BCB to cut the SELIC rate to 11.50% in 2016 (with the easing cycle still beginning in April), as we expect the authorities to throw in the towel and postpone convergence of inflation to the 4.5% target again (although we still do not see inflation at 4.5% in 2017). The silver lining is that the deeper recession and weaker FX will produce a larger adjustment in the external accounts: we cut our current account deficit forecast to USD70.0bn from USD76bn for 2015, and to USD63bn from USD76bn for 2016.

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