



Brazil

Slow deterioration

In a less favourable macroeconomic and macro-financial backdrop for emerging countries, the weaknesses of the Brazilian economy are becoming increasingly apparent. Inflationary pressures and the deterioration of public finances reflect the limits of Brazil's growth model and increasingly highlight the need for vital reforms that the electoral calendar keeps pushing back, at least until next year. In the meantime, the lack of visibility could strain investor confidence and undermine the country's external resilience.

■ Clouds are accumulating

In a less favourable macroeconomic and macro-financial environment for emerging countries, Brazil is seen as one of the most vulnerable economies. Sovereign risk premiums have widened since May 2013 (see chart 1), following the announcement of the imminent tapering of the QE3 in the United States. Since early 2014, bad news have been accumulating for the Brazilian economy: fears of slowdown in China, Argentina's forced devaluation, the contraction in industrial output, sluggish confidence indicators, record trade deficits, stubbornly high inflation despite the ongoing monetary tightening, the downgrade of its sovereign rating to one notch above the speculative grade category (BBB- with a stable outlook) by Standard & Poor's, as well as the drought that has swept several of the country's agricultural regions. Looking beyond cyclical factors, Brazil's economic fundamentals show several structural weaknesses at the domestic level that could end up affecting the country's external resilience and dampen investor confidence.

■ Internal imbalances are confirmed

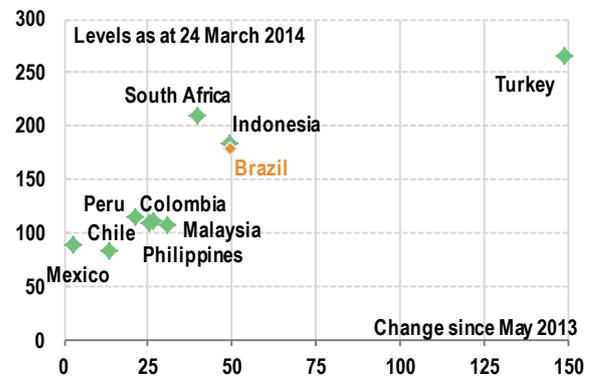
The Q4 2013 GDP growth figure was higher than expected at 0.7% q/q and related to the exceptional increase in exports pertaining to Libra's pre-salt oilfield concessions (+4.1% q/q). Full-year GDP growth reached 2.3% in 2013 thanks to the strong performance of the agriculture (up 6.5%), buoyed by a bumper soybean harvest. Growth in the industrial sector was limited to 1.2%. On the expenditures side, higher interest rates and the sharp slowdown in real wages (from an average increase of 4.8% in 2012 to less than 2% respectively in 2013) ended up eroding household consumption, which rose only by 2.3%. Investment slowed sharply in H2, but the full-year performance was good at 6.3% albeit driven by increasing lending to the agricultural sector at preferential rates. This upturn is likely to be short lived, however, given the slowdown in subsidised loans from public banks.

Going forward, the short-term outlook is not very encouraging. Industrial output is contracting (down 2.5% y/y and 2.4% y/y, respectively in December and January) and the PMI index has not picked up (at around 50 for virtually the past year).

1- Increasing risk premiums in the emerging countries

5-year CDS since May 2013, basis points (bp)

Change/Levels CDS Emerging countries | Change/Levels CDS Brazil



Source: Bloomberg

Retail sales remained buoyant in the beginning of the year (+6.2% y/y in January vs. a Q4 2013 average of +5.5%), but consumer confidence indicators have been steadily declining since early 2013.

Most importantly, inflationary pressures are still strong (5.7% y/y in February, compared to the central bank's target at 4.5%), despite a series of interest rate hikes (from 7.25% in April 2013 to 10.75% at the time of writing). Regulated prices rose 3.7% (vs. an average of 1.5% over 2013). However, the authorities have decided not to carry over the impact of higher electricity wholesale prices to end consumers until 2015. Core inflation has also accelerated to more than 6%, and the diffusion index is touching historical highs¹.

Although moderate, the public deficit continues to widen. It reached 3.6% of GDP in January, up from 2.5% in 2012 and 3.3% in 2013. The primary surplus is not high enough to offset the increase in interest charges. Beyond the public deficit, the Treasury's loans to public banks for on-lending increase the public debt. Thanks to repo operations used for sterilisation purposes, the consolidated gross public debt ratio declined at the end of the year (to 57.2% of GDP at year-end 2013, vs. a full-year average at 58.8%). At these levels, the public debt is still sustainable, the majority of public securities are issued at

¹ 69.3% of the prices making up the index are rising.



fixed rates, the share of foreign-currency denominated debt is low and debt instruments are very largely held by residents.

The government maintains a primary surplus target of 1.9% of GDP in 2014, which seems very optimistic because it assumes GDP growth at 2.5%. Meanwhile, the budget calls for cuts of up to BRL 44 bn (0.9% of GDP), including BRL 13.5 bn in reductions of mandatory expenditures and a BRL 30.5 bn decrease in discretionary expenditures. However, the government has already announced an additional BRL 4 bn in fiscal transfers from the Treasury that were not included in the budget in order to compensate energy suppliers for the increase in energy prices that were not passed on to consumers.

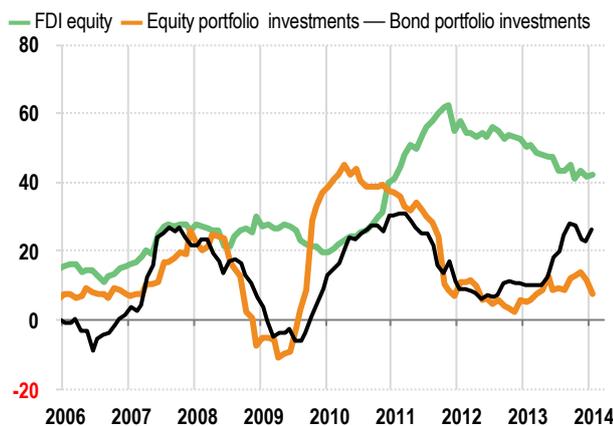
■ External resilience is being put to the test

Even though the basic balance² was positive until 2013, thanks to foreign direct investment inflows, the widening of the current account deficit has accelerated since 2011 (from 2.1% of GDP to 3.7% in 2013). In the first two months of the year, the trade balance even reached record-high deficits of USD 4.1 bn and USD 2.1 bn, respectively, due to the decline in iron ore prices and the sharp drop-off in exports to Argentina. As a result, the current account deficit continued to widen to 6.6% of GDP in January.

Portfolio investments (notably bonds) which have been attracted by the *carry trade* as well as the fiscal incentives, have helped to cover the country's external financing requirements. Yet, even a very gradual normalisation of the US monetary policy could reverse the situation. Indeed, the value of the stock of portfolio investments accounted for 25% of GDP at year-end 2013.

2- No recurrent capital flight since 2013

12-month rolling flows (USD bn)



Source: BCB

However, with foreign reserves of USD 356 bn (16% of GDP) and an external debt of only USD 309 bn (13.7% of GDP) at year-end 2013, Brazil has a solid external position. Moreover, short-term liabilities account for only 10% of its total external debt.

On the exchange rate side, the central bank continues the daily interventions (amounting to USD 200 mn) in the currency swap market to contain the real's depreciating trend. To date, the central bank's position amounts to USD 82 bn (for an estimated cost of about USD 3.5 bn). Yet, despite these support measures, the real continues to be vulnerable to both internal and external financial shocks.

■ No improvements expected in the short term

After the prosperous times, Brazil is struggling. Given the ongoing monetary tightening, we expect real GDP growth at 1.7% in 2014. The low investment rates, inflationary pressures and the deterioration of public finances are increasing concerns. In a rather lacklustre international environment, the lack of confidence in domestic policies could kindle real fears among investors and undermine the country's external resilience.

Alexandra Wentzinger

alexandra.wentzinger@bnpparibas.com

Economic forecasts

	2012	2013	2014f	2015f
Real GDP growth (%)	1.0	2.3	1.7	1.8
Inflation (CPI, year average, %)	5.4	6.2	6.3	6.1
Fiscal balance* / GDP (%)	-2.5	-3.3	-3.8	-3.5
Gross public debt** / GDP (%)	58.7	57.2	60.0	60.5
Current account balance / GDP (%)	-2.4	-3.7	-3.7	-3.4
External debt / GDP (%)	13.9	14.1	14.3	13.9
Forex reserves (USD bn)	369	356	350	345
Forex reserves, in months of imports	14.6	12.3	12.1	11.7
Ex change rate /USD (year end)	2.0	2.4	2.4	2.5

* Consolidated public sector ** Excluding public companies

f: BNP Paribas forecasts

² Current account balance + net direct investment