Brazil

A crucial turning point ahead

Despite uncertainty over the new government's reform programme, the markets and investors reacted positively to the political changes of the past few months. The same cannot be said for the local population, who fears a shift towards liberalism and the hardships of reforms, after weathering the turmoil of the political and economic crisis over the past two years. Squeezed by a sluggish labour market, a decline in purchasing power eroded by inflation and a heavy debt burden, household consumption is unlikely to make a positive contribution to the economic recovery for several more months. Even so, the economy could benefit from a gradual rebound in private investment.

Eyes on reforms

After president Dilma Rousseff (PT) was officially ousted on 31 August, vice-president Michel Temer (PMDB), the interim president since 12 May, was sworn in with full powers as Brazil's new president. The collapse of the Workers' Party (PT), discredited by the Petrobras corruption scandal, was confirmed following the municipal elections of 2 October (runoffs will be held in certain cities on 30 October). The PT was relegated to 10th place among the political parties after losing 59% of the municipalities it has held since 2012. Although the people rejected the political class as a whole, the Brazilian Democratic Movement (PMDB) and Brazilian Social Democracy Party (PSDB) were the big winners of these local elections, which have taken on a national character in the current environment. Allies within the new government, the two parties seem to be heading for a confrontation in the 2018 general election.

With its legitimacy bolstered by the municipal elections, the Temer government now seems to be in a good position to launch its full reform programme – which is highly unpopular with the local population – at a time when public finances remain under pressure. The primary deficit continued to widen, to 2.8% of GDP in the 12 months to August, while the overall deficit has levelled off at 9.6% of GDP, thanks to profits generated by the central bank's currency swap operations against a backdrop of the real's appreciation. Gross public debt rose above 70% of GDP in August.

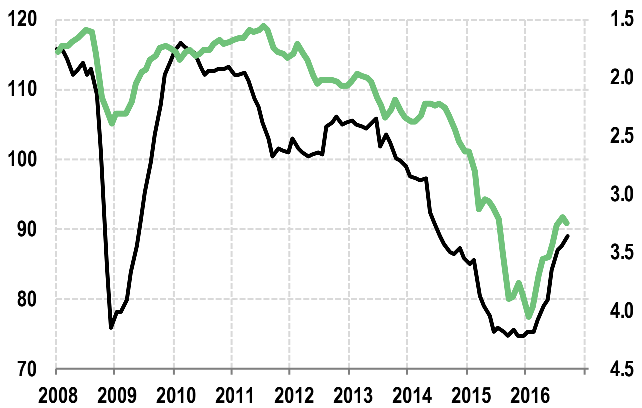
No major tax reform has been announced. The parliament is debating a proposal to place a ceiling on public spending increases (+6% a year in real terms since 2009) indexed to the previous year's inflation rate. The pension system, which has run up a deficit of 2% of GDP, has been weakened by an aging population (the over-60 age group is growing 4% a year), the low retirement age (less than 55 on average) and pension indexation. Pension reform could be adopted by mid-2017. A concession and privatisation programme has also been launched in the energy sector (hydrocarbons, electrical power) and in infrastructure (transport, water). The restructuring of Petrobras has been launched around four key points: major asset disposals (USD 14.4 bn in 2016, a very ambitious target), vital debt reduction (gross debt of USD 124 bn and a net debt/EBITDA ratio of 4.5 at mid-2016), a 50% decline in investment spending over 5 years to USD 100 bn, and regulatory changes in the hydrocarbon market (broader opening to private investors, elimination of the requirement for Petrobras to hold a 30% stake in joint ventures, end of its natural gas transport monopoly, etc.).

1- Forecasts

	2014	2015	2016f	2017f
Real GDP growth (%)	0.1	-3.8	-3.0	2.0
Inflation (CPI, year average, %)	6.3	9.0	8.8	5.0
Fiscal balance / GDP (%)	-6.2	-10.3	-10.1	-9.4
Gross public debt / GDP (%)	58.9	66.2	73.3	78.3
Current account balance / GDP (%)	-4.4	-3.3	-1.0	-1.5
External debt / GDP (%)	23.2	30.4	34.7	34.2
Forex reserves (USD bn)	355	349	350	355
Forex reserves, in months of imports	15.6	15.2	14.8	14.6
Exchange rate USD/BRL (year end)	2.5	3.9	3.2	3.0

f: BNP Paribas Group Economic Research estimates and forecasts

2- Business confidence and the exchange rate



Sources: Central bank, Fundação Getulio Vargas

A few positive economic and financial signals

Mired in a recessionary spiral for the past two years, the Brazilian economy reported its sixth consecutive quarterly decline, with Q2 2016 GDP down a seasonally-adjusted 0.6% q/q. Despite the upturn in household confidence since May, private consumption contracted again in Q2 (-0.7% q/q) and retail sales remained sluggish in July. Several factors are to blame: 1) a depressed labour market (see below), 2) a decline in purchasing power (squeezed by real wages eroded by high inflation – 8.6% in September) and 3) sluggish credit growth, undermined by high interest rates (Selic at 14.25%, and astronomical bank intermediation margins) and deleveraging by households, strapped with high debt servicing (21% of GDP).

Foreign trade made a negative contribution to Q2 GDP growth due to a big increase in imports of intermediate and capital goods.

Import growth reflects the uptick in investment (+0.4% q/q in Q2, ending a 10-quarter decline) and the rebound in monthly industrial output since March. Although these positive economic signals are still fragile (industrial output contracted in August), they nonetheless reflect the upturn in business confidence since March. The markets are clearly giving the green light again, bolstered by the very accommodating monetary policies maintained in the advanced economies. Since early 2016, the Brazilian real has appreciated 22% against the dollar and the IBOVESPA stock market index has gained 37%. The yield on 4-year Treasury notes (10.5%) and the premium on 5-year sovereign CDS (270 bp) contracted by 520 bp and 220bp, respectively. Brazil continued to attract foreign direct investment (USD 41 bn in the first 8 months of 2016), notably in a few key sectors, including light and heavy vehicles, hydrocarbon extraction, real estate and retailing. Net equity portfolio investment flows have amounted to USD 4.2 bn since the beginning of the year. The government easily refinanced its MLT global bonds (260% refinancing ratio), unlike the private sector (36% of refinancing), which increased its external debt in the short term. There is nothing really alarming about Brazil's external position considering that the current account deficit has still narrowed in recent months and the country still boasts very substantial foreign reserves.

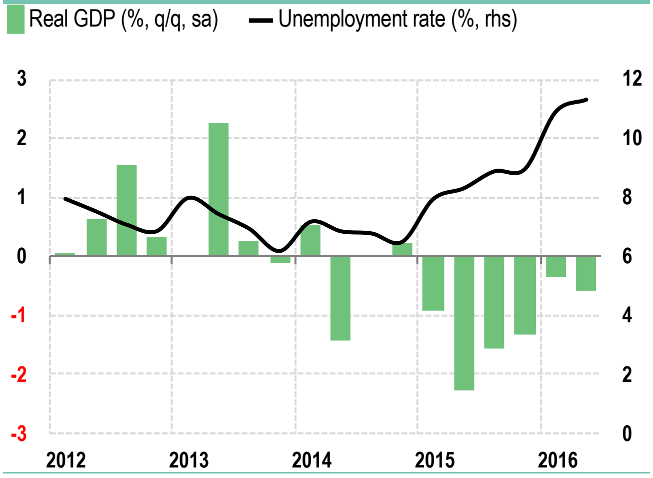
With the announcement of fiscal reforms, financial stabilisation, the dissipation of food price shocks and better anchorage of inflation expectations, the central bank could decide to launch a round of monetary easing in the very near future. Its (partial) transmission via the traditional bank lending channel would help loosen the stranglehold on companies and households and stimulate domestic demand.

A sluggish labour market hampers the recovery

Household consumption accounts for 66% of real GDP and contributed 60% of real GDP growth between 2004 and 2014. This growth engine has stalled over the past six quarters (-9% since year-end 2014), notably due to the sharp deterioration in labour market conditions.

With GDP growth averaging 3.7% a year between 2004 and 2014, the Brazilian economy managed to create 14.1 million net formal jobs (1.3 million a year), of which 70% were in retailing and services and only 16% in the manufacturing sector. The participation rate did not increase significantly over the period (61% at year-end 2014 according to the new IBGE methodology introduced in March 2016), and new entrants were easily absorbed in the labour market. The official unemployment rate declined by nearly seven points to 4.3% (6.5% according to the new methodology). The 2008-09 global crisis had only a mild impact on the Brazilian labour market in terms of its duration and intensity, with a slowdown in job creations and a short-lived rise in the unemployment rate. The external shock created by the global crisis did not halt the improvement in labour productivity observed since 2004, although it coincided with the moment working hours began trending downwards (-5% since 2008).

3- Economic growth and unemployment rate



Source: IBGE

The severe recession over the past two years ended up destroying 2.8 million net formal jobs (7% of total employment), including nearly 1 million jobs in the manufacturing sector (11% of sector employment), 800,000 construction jobs (-25%) and 600,000 service sector jobs (-4%). Although the general downturn in the labour market can be traced back to Q4 2014, the manufacturing sector began destroying jobs as early as mid-2013, while the services sector was more resilient until the end of Q1 2015. Initially, the very rapid upturn in the unemployment rate (to 11.8% non-adjusted for seasonal variations in August 2016) reflected the slowdown in gross hiring, which bottomed out in Q2 and Q3 2015. By H2 2015, this trend was overtaken by the acceleration in layoffs, while gross hiring began picking up again. Another negative impact of the crisis was that it halted the downward trend in the informal sector (to 38% in mid-2016): the switch from the formal to informal sector can serve as a potential transitory stage before workers left the labour market, and labour productivity declined 5% between 2013 and 2015.

According to the latest figures, the labour market continues to deteriorate. For the thirteenth consecutive month, formal employment declined by another 0.3% between July and August, bringing the annual contraction to 2.2%. Given the usual lag between an economic recovery and its repercussions on employment, the labour market is unlikely to show tangible signs of improvement before mid-2017. We are maintaining our scenario of a gradual rebound in private investment in the quarters ahead, while household consumption will remain in a slump for a few more quarters. We expect real GDP to level off in Q3 2016 before picking up very gradually as of Q4.

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