Brazil

Step by step

- **Real GDP contracted by 3.6% on average in 2016. Now, some indicators point to a very gradual upturn in economic activity in the quarters ahead.**
- **The central bank now has free reign to ease monetary conditions (good cop). A stronger real, rapid disinflation and the decline in interest rates are all support factors for an economic recovery.**
- **Meanwhile, fiscal austerity (bad cop) remains essential for the credibility of the policy mix.**

The light at the end of the tunnel

Real GDP contracted for the eighth consecutive quarter in Q4 2016, at a seasonally-adjusted rate of 0.9% q/q. This brings the cumulative decline since year-end 2014 to 8.2%. The recession did not spare any of the components of GDP, neither in terms of supply or demand. With gross fixed capital formation down 1.5% in Q4, investment has declined by 22.8% in two years, to only 16% of GDP in 2016. Household consumption declined 0.6% in Q4, and 9.6% over the past two years, squeezed by a very depressed job market situation. Over the past two years, 3.6 million formal sector jobs were destroyed, bringing the jobless rate to 13% of the active population. Despite ongoing disinflation (see below), real wages continue to decline, and shed another 5.9% year-on-year in February. Given the sluggishness of domestic demand, imports naturally declined 10.4% in volume in 2016. At the same time, exports increased by a feeble 1.6%.

Our forecast of a gradual economic recovery starting in Q4 2016 proved to be too optimistic. Retail sales (bolstered by a recent change in methodology) and household consumption are not expected to swing back into positive territory in Q1 2017. Yet there have been more and more positive signals recently. Business and household confidence indicators continue to pick up. In February, net job destructions in the formal sector came to a halt for the first time since November 2014. Total industrial output, including manufacturing, mining and construction, has picked up (+1.5% y/y, 3-month moving average in February), for the first time since November 2013.

Extraction industries (mining and oil) should continue to benefit from the rebound in commodity prices. At 46.9 in February, the purchasing managers index (PMI) for the manufacturing sector was still lower than 50, the threshold that separates economic expansion from contraction. Yet production capacity utilisation rates in manufacturing increased slightly in January and February, even though they are still 5 points below the long-term average of 81%. The recently observed rebound in domestic automobile sales and especially exports (essentially to Argentina) should stimulate production in the months ahead. The construction sector's recovery is much less certain: the residential market has slumped after the boom years of 2006-2013,

Economic indicators

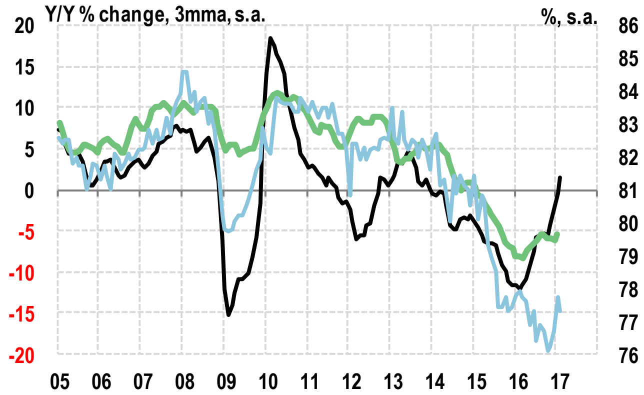

Chart 1 Sources: IBGE, BCB, BNP Paribas

and certain projects and bids to tender have been halted or frozen in connection with the sprawling Petrobras corruption scandal, a legal quagmire that is unlikely to end anytime soon. Lastly, after a tough year for the agricultural sector in 2016, the national statistics institute (IBGE) expects harvests to increase by more than 20% in 2017, notably in the first part of the year. The recent "rotten meat" scandal is unlikely to have more than temporary impact on Brazil's cattle and poultry industries, in which the country is a world leader.

The March consensus of economists calls for average GDP growth of 0.5% in 2017 and 2.4% in 2018, in line with the government's forecast. The IMF is forecasting growth of 0.2% and 1.5%, respectively. In the midst of fiscal austerity, the easing of monetary policy should play a key role in lifting Brazil out of recession.

Monetary policy, the good cop

Even though Brazil is not very open to trade, macroeconomic adjustments have nonetheless helped consolidate the external accounts since 2014. For the past year, the improvement in the terms of trade, thanks to higher commodity prices, notably for metals, has supported this consolidation movement. As a result, Brazil reported a trade surplus of USD 45 bn last year, the highest level since 2006. The current account deficit (USD 23.5 bn) is largely covered by the net inflow of foreign direct investment (USD 71.1 bn), which remains very buoyant despite the economic and political crisis. At the same time, Brazil was hit by a net outflow of portfolio investment (-USD 19.2 bn in 2016), as non-resident investors pulled out of the local bond market (-USD 26.6 bn), but the equity market was still attractive (+USD 6.3 bn). Since late 2015, BRL has regained 24% against the US dollar (after dropping 33% in 2015), and the Sao Paulo stock exchange has gained 47%.

The disinflationary process at work over the past year has continued in this environment. The increase in the IPCA general price index slowed to 4.6% y/y in March 2017, from 10.7% y/y in January 2016. It is now in line with the BCB's target range (4.5%, +/- 2 pp). The BCB no longer considers that disinflation is due solely to the real's appreciation and the slowdown in food prices. It has now spread more broadly to factors and sectors more sensitive to the business cycle and monetary policy, such as the services sector. The Selic rate has been cut four times over the past six months, from 14.25% to 12.25%. It seems highly likely that monetary easing will continue, and could even be amplified, especially since inflation expectations are firmly anchored at 4.15% for year-end 2017, and 4.50% for 2018 and 2019.

In the midst of a deleveraging phase (the bank loan to GDP ratio dropped 4 points to 48.7% in just one year), the slight decline in borrowing rates has not stimulated lending yet, but it has helped ease the financial constraints on rather heavily indebted economic agents. In February, corporate loans outstanding contracted 9.6% y/y with commercial banks and 10.1% y/y with development banks. The non-performing loan ratio for commercial loans 90 days overdue has levelled off in recent months at about 3.5%, which is low considering the severe deterioration in balance sheets since 2011, and major needs for refinancing, notably in foreign currency (more than 50% of corporate debt, including Petrobras, is in foreign currency). As to households, loans outstanding have continued to increase very slightly, and the non-performing loan ratio as dipped in recent months.

All in all, lowering real interest rates is the key to hopes for a gradual but lasting economic recovery, and to the easing of debt servicing charges on public debt.

Fiscal policy, the bad cop

Fiscal austerity is still necessary given the deterioration of public finances and the difficult process of consolidation. The primary and overall deficits have reached 2.3% and 8.5% of GDP, respectively, in the 12 months to February, and the public debt peaked at 70.6% of GDP. After adopting a law last December to freeze public spending in real terms, parliament was recently presented a pension reform project. Amendments will be made and the final text is not expected to be adopted before September.

Local bond yields

Annual %

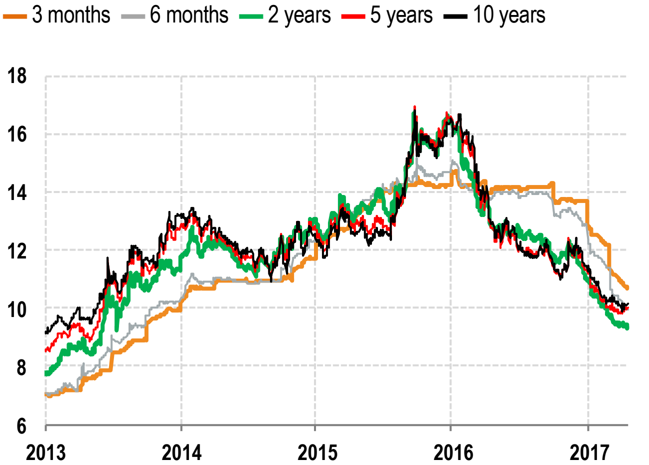

Chart 2 Source: Macrobond

Congress is still divided, and operation Car Wash (Lava Jato) is bound to weaken reform efforts in the run-up to general elections scheduled for October 2018. The corruption investigation hangs like a sword of Damocles over the entire political class. Former president Dilma Rousseff has been brought to trial in the October 2014 presidential campaign finance scandal. The new president, Michel Temer, will not be spared since he was Rousseff's running mate and former vice president, but he nonetheless benefits from immunity.

Justifying its actions based on the downward revision of growth prospects for 2017, the government announced a new series of austerity measures in late March that aims to generate BRL 58.2 bn in additional savings (about 0.9 points of GDP) to comply with its primary deficit target (BRL 139 bn). The programme includes BRL 42 bn in new budget cuts (half from operating expenses and a quarter from the Growth Acceleration Programme), BRL 10 bn in one-off revenues from concessions (notably electrical power), and BRL 6 bn in additional tax revenues (elimination of certain tax loopholes and an adjustment in the financial transactions tax).

All in all, the positive momentum that has been unleashed in recent months remains fragile. An outbreak of social-political risks, the failure of reforms or a real and/or external financial shock could trigger a new bout of weakness in BRL and a reversal in monetary policy, all of which would drive up sovereign risk.