

# Brazil

## A new era

The election of Jair Bolsonaro at the presidency of Brazil has marked a swing to the right, the weakening of traditional political parties and a return of the military to national politics. The new administration faces the challenges of rapidly engaging its fiscal reform, gaining the trust of foreign investors while reconciling ideological differences across its ranks. How society will adjust to a new era of liberal economic policy remains the greatest unknown. Meanwhile, the economy is still recovering at a slow pace. Supply-side indicators continue to show evidence of idle capacity while labour market conditions have yet to markedly improve. Sentiment indicators have shown large upswings in recent months which should help build some momentum in economic activity over Q1 2019.

### ■ Tricephalic leadership?

Since the nomination of Jair Bolsonaro as Brazil's new president, the composition of the cabinet has seen the emergence of three distinctive groups within the administration: the economic technocrats, the military and the anti-globalist nationalists primarily embodied by the minister of Foreign Affairs, Ernesto Araujo, a staunch admirer of President Donald Trump's nationalistic rhetoric.

Leading the economic technocrats' contingent is Paulo Guedes who was confirmed at the head of a "super ministry" made up of the ministry of the Economy, the Ministry of Planning and the Ministry of Industry and Trade. Roberto Campos Neto, a previous executive at Banco Santander will be the next Central Bank governor while Joaquim Levy, another graduate from the University of Chicago – along with Guedes – and former Finance Minister under the 2<sup>nd</sup> Rousseff administration will head the third largest national development bank in the world, BNDES. Roberto Castello Branco, an economist by training and third "Chicago Boy" has been appointed as the new CEO of oil giant Petrobras following previous stints at mining company Vale and at the Central Bank. The leading agro-business lobbyist at the Chamber of Deputies, Tereza Cristina and one of only two women in cabinet will be heading the Minister of Agriculture while Ricardo Salles a lawyer and strong supporter of economic liberalism as well as a fervent critic of Presidents Lula and Rousseff was appointed Minister of the Environment. Moving to deliver on his law and order platform President Bolsonaro appointed former anti-corruption judge Sergio Moro as Minister of Justice and saluted the nomination of Mauricio Valeixo as Brazil's Head of Federal Police. Both men were prominent figures in the "Car Wash" investigation and instigated the police operation that led to the detention of former President Lula in April 2018.

Military figures are also largely represented in the new administration making up more than one third of the new cabinet, a record for Brazil since its transition to a democratic regime<sup>1</sup>. Issues likely to steer up tensions between the three groups include: relations with China, the extent of privatizations and the rules for

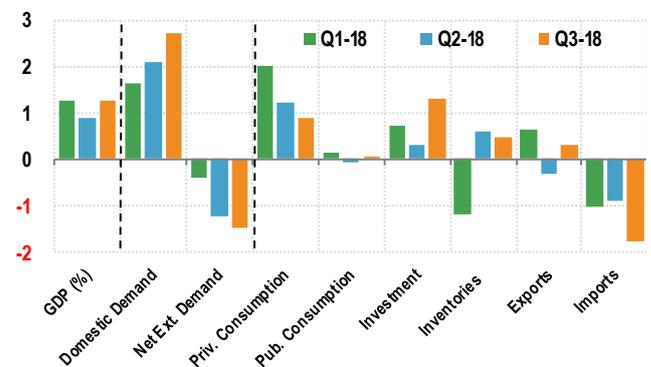
<sup>1</sup> Notable positions occupied by individuals with a military background include the Presidency (Captain), Vice Presidency (General) Ministry of Defense (General), Intelligence Office (General), Ministry in charge of political relations with Congress (General), Ministry of Science and Technology (Air Force senior officer), Ministry of Mining and Energy (Admiral), Ministry of Infrastructure (Military engineer), Ministry of Transparency, Supervision and Control (Captain), Secretary of Communication (General).

### 1- Forecasts

	2017	2018e	2019e	2020e
Real GDP growth (%)	1.1	1.3	3.0	2.5
Inflation (CPI, year average, %)	3.4	3.7	3.8	3.6
Fiscal balance / GDP (%)	-7.8	-7.5	-7.2	-6.6
Gross public debt / GDP (%)	74	77	85	85
Current account balance / GDP (%)	-0.5	-0.9	-1.5	-2.4
External debt / GDP (%)	27	33	35	38
Forex reserves (USD bn)	373	374	375	370
Forex reserves, in months of imports	20.0	18.0	17.0	17.0
Ex change rate USDBRL (year end)	3.3	3.9	3.3	3.2

e: BNP Paribas Group Economic Research estimates and forecasts

### 2- Contribution (p.p.) of components to GDP (y/y)



Source: IBGE, BNP Paribas

foreign investment, pulling out of the Paris climate change accords and its implication for a Mercosur-EU trade deal.<sup>2</sup> Many of these tensions are likely to be further exacerbated when the new Congress reconvenes in February. President Bolsonaro's unwillingness to build a stable coalition in exchange for political appointments may render policy-making more challenging down the line.

<sup>2</sup> Under a new policy, the European Union will refuse to sign trade agreements with countries that do not ratify the Paris climate change agreement.



■ **Rebounding confidence**

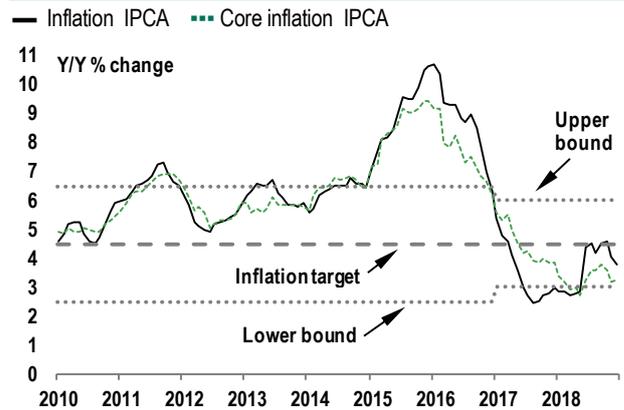
The economy is still recovering at a slow pace. In Q3, the economy expanded by 0.8% q/q and 1.3% y/y in seasonal adjusted terms (s.a). Quarterly data benefitted from a low base effect following a subdued Q2 owing to the truckers' strike. On the demand side, the increase was largely driven by investment and private consumption contributing respectively 1.3 percentage points (pp) and 0.9 pp to the y/y growth rate which was dragged down due to a larger negative contribution of net exports (-1.5 pp) (chart 2). Also as supply continued to outpace demand, the contribution of inventories to y/y GDP variation was again positive (+0.5 pp) for the second consecutive quarter. Revisions to GDP figures were made leading to GDP growing by 1.1% in 2017 vs 1% previously, bringing the statistical carry-over through Q3 2018 to 1.1%.

A number of tailwinds are currently supporting the economy suggesting that a risk of a business cycle reversal is limited. Households are generally better positioned to maintain consumption: real earnings have continuously risen on a y/y basis - albeit at a slow rate - after experiencing negative growth through much of 2016 and household debt relative to disposable income has fallen. Meanwhile, monetary policy is expected to remain accommodative as inflation risk remains subdued (chart 3). Credit to household, which has steadily expanded growing at an average monthly rate of 6.5% y/y through November, will continue to support private consumption while recent regulatory changes in the mortgage market should help boost residential investment.

The post-election phase has also witnessed a bounce back in sentiment indicators. The Consumer Confidence Index (CCI) advanced vigorously through Q4 reaching its highest levels in December since April 2014. Business sentiment also rebounded strongly reflecting the new administration's inclination to implement business friendly policies. The IBRE/FGV Business Confidence Index (BCI) increased by 1 point in December to 95.9 points its strongest rebound since March 2014. The increase was largely driven by optimism in the services, trade and construction sectors as confidence in industry remains subdued for the moment (chart 4). *Markit's* composite PMI was also back in expansion zone in October (50.5) for the first time since May, ultimately reaching 52.4 in December. Bolsonaro's victory has also triggered a series of initial public offerings (IPO) after months of paralysis. The stock market reached historic highs gaining 12% since the second round of the election and is on course to break the 100.000 point mark. Meanwhile the USDBRL has had somewhat of a roller-coaster ride, strengthening ahead and during the elections, to then see much of its gains erased in the last two months of the year. While the currency has recovered somewhat since Bolsonaro's inauguration (+4%), the currency has yet to bounce back from hitting historical lows in 2018 that saw the BRL depreciate by 15% against the USD.

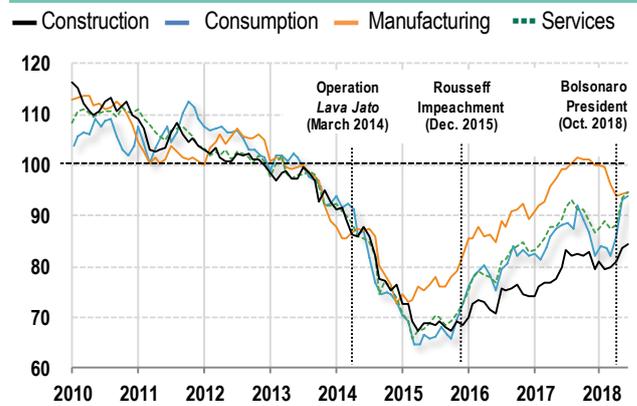
In the shorter term, a new trucker strike represents the greatest downside risk to the growth outlook. Moreover, with capacity utilization in manufacturing remaining far below pre-recession levels, industry still exhibits considerable slack. In line with auto output - which experienced a drop of 14% through H2 2018 - industrial production continues to be weak, essentially stagnating since July.

**3- Inflation remains below target**



Source: IBGE, BNP Paribas

**4- Post-election rebound in confidence indicators**



Source: IBRE/FGV, BNP Paribas

Idle capacity is also evident in the labour market: unemployment remains high at 11.6% decreasing only very slowly while underemployment has increased.

Corporate credit has also yet to recover, exhibiting a negative real growth rate since December 2014.

More fundamentally, reduced scope for fiscal policy flexibility limit the ability of the government to jump start the economy. In the medium term, structural impediments – namely low productivity, trade openness and investment combined with high levels of job informality, inequality and corruption – will continue to weight on the economy's medium term growth prospects.

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