BRAZIL

DEFYING EXPECTATIONS

Brazil's cyclical performance continues to boast positive surprises. Growth and employment have held up well, core inflation is retreating, trade surpluses are beating all-time records and the real is holding its ground despite a rising dollar. Against this backdrop, the Central Bank eased its monetary policy in August for the first time in a year. These developments coupled with the revival of social policies, have helped spur a rise in Lula's approval ratings. In search of new growth drivers to reduce inequality and accelerate the energy transition, the President unveiled the third act of his Growth Acceleration Pact (Novo PAC). Financing the investment programme, however, poses questions in the face of the recently enacted fiscal framework. To enhance its room to maneuver in Congress and help pass reforms (in particular the long-awaited tax reform), the ruling coalition has expanded further to the right.

BUSINESS CYCLE : SOME GOOD SURPRISES

In H1 2023, growth and employment held up much better than initially expected considering the Central Bank's aggressive fight against inflation – a cycle it initiated back in March 2021 (12 consecutive hikes of the SELIC policy rate which it held up at 13.75% for a year since August 2022).

After exceptional harvests in Q1 (driven by favourable climate factors, increases in arable land and productivity), economic activity once again surprised to the upside in Q2 (+0.9% q/q, 3.4% y/y). Meanwhile, the unemployment rate continued to retreat (down one point between March and August to 7.8%, the lowest since 2015). In contrast to Q1, however, domestic demand turned out to be the main driver of growth in Q2 supported by measures destined to protect households' disposable income. Growth was also supported by public spending and the recovery in tourism[1].

On the supply side, performance has been more heterogeneous. Challenges were more pronounced in the manufacturing sector while services surprised by their resilience. In livestock and commodity extraction, many sub-sectors are expected to register record production volumes this year (oil[2] and gas, soybeans, corn, wheat, meat). The dynamism of these sectors contributed to unprecedented trade surpluses in the first eight months of the year (USD 73 bn) spurring a reduction in the current account deficit[3]. The latter remains well covered by net FDI despite the decline in foreign capital flows this year[4]. Meanwhile, the unwinding by the BCB of a foreign-currency credit line granted in 2022 and the absence of intervention in the FX market have led to a strengthening of official foreign exchange reserves (+USD 20 bn since the end of 2022 to reach USD 340 bn at the end of September).

In Q3, activity showed signs of slowing down despite a good start to the quarter (increase in the Central Bank's IBC-BR indicator – a proxy for GDP – in July, expansion of the composite PMI in August). Business confidence rebounded in August (on the back of the BCB's first rate cuts). However, it remained fragile in industry driven down in part by the end of tax breaks in the automotive sector, the contraction of margins in the manufacturing industry and still high financing costs, in real terms. In the short term, investment is not projected to recover (survey data point to still large inventories of machinery and equipment, while unearmarked business loans have continued to slowdown since May). The slowdown in activity has also been more pronounced since September (contraction of the composite PMI, deceleration in job creation). In H2, the primary sector is projected to contribute negatively to growth as the bulk of crops were harvested in Q1.

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth, %	-3.3	5.0	2.9	3.1	1.8
Inflation, CPI, year average, %	3.2	8.3	9.3	4.7	4.2
Fiscal balance / GDP, %	-13.3	-4.3	-4.6	-7.6	-6.9
Gross public debt / GDP, %	87	78	73	76	78
Current account balance / GDP, %	-1.9	-2.8	-2.9	-2.0	-1.7
External debt / GDP, %	44	42	39	41	43
Forex reserves, USD bn	356	362	324	341	338
Forex reserves, in months of imports	19	14	10	16	15

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

BRAZIL: TRADE BALANCE BY CATEGORY (JAN.-SEPT., CUMULATIVE SUM)

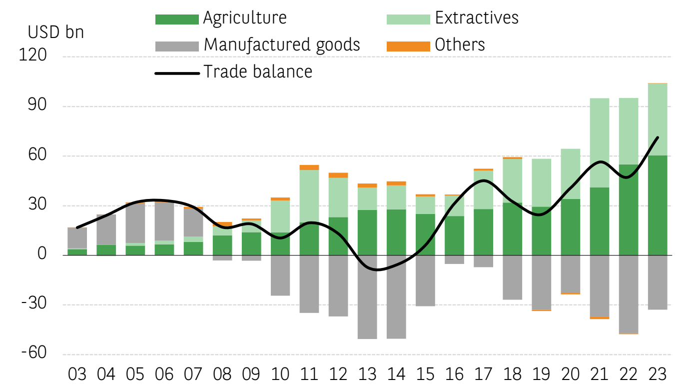

CHART 1

SOURCE: SECEX, BNP PARIBAS:

Due to the reinstatement of federal taxes on fuel, the disinflationary process at work across the economy is currently not visible in the headline inflation rate (+4.6% y/y in August compared to +3.2% in June). However, the monthly change in the IPCA index shows a decline in prices, particularly in transport and household goods.

1 Brazil received almost as many visitors in the first 6 months of the year (3.2 mn) as in all of 2022 (3.6 mn), according to Embratur.
2 The production cuts decided by Russia and Saudi Arabia during the summer were partly offset by rising outputs from producers (outside of OPEC+) such as Brazil, the United States, Norway and Guyana. In July, Brazil produced 3.51 mn barrels/day +18.6% y/y.
3 2.21% of GDP over 12 months in August compared to 2.9% of GDP at the end of 2022
4 From January to August 2023, non-resident inflows amounted to (1) USD 38 bn in net FDI inflows (compared to USD 56 bn over the same period in 2022); (2) USD 7.5 bn in net inflows for portfolio investments (vs. net outflows of USD 7.3 over the same period in 2022); (3) USD 15.2 bn in net inflows for other investments (compared to USD 25.2 bn over the same period in 2022).

The favourable trend in core inflation (excluding food and energy), the expected deceleration of the economy in the coming months coupled with the easing of inflation expectations have led the Central Bank to cut the SELIC rate twice by 50 bps since August (and to announce cuts of the same magnitude in the coming months). However, the BCB is on alert over (a) the internal risks weighing on inflation (the economy is growing at an annualized rate which is twice the growth potential, latent risks of budgetary / extra-budgetary slippage) and (b) external risks (effects of the *El Niño* weather phenomenon on food prices, more persistent rises in oil prices, rise in the dollar and long-term rates, renewed concerns over the Chinese real estate market). All in all, the successive declines in the SELIC have had less of an impact on the real than the rise in the dollar in recent months. The currency has lost 10% of its value against the USD since August, but is still up some 5% since January.

NEW MANDATE, OLD RECIPES

Lula's approval ratings have been on the rise (they have climbed back up to 60% according to a Genial/Quaest poll in mid-August from 52% back in April). The President's popularity has been bolstered both by a stronger economy (two additional points of growth expected this year; a drop in unemployment) but also thanks to social policies destined to support households' purchasing power and enhance living conditions for the poor.

The redeployment of flagship programmes such as *Minha Casa / Minha Vida* (housing), *Brasil sin Fome* (action against hunger, formerly *Fome zero)*, *Luz para Todos* (electricity in rural areas) - combined with the increase in conditional cash transfers (*Bolsa familia*), debt renegotiations for low-income households (*Desenrola Brasil*)[5] as well as increases in the minimum wage, scholarships and salaries for civil servants have collectively helped boost household confidence – which last September, had reached its highest level since February 2014. The historical increase in the volume of subsidized loans (+27% y/y) under the annual financing program for agriculture (*Plano Safra*), and the concurrent launch of a specific program for family farming have also helped attract the sympathy of small and mid-sized farmers, many of whom had tended to fly closer to *Bolsonarismo* in recent years.

In search of new growth drivers to help dampen social inequalities and accelerate the energy transition, Lula launched the third act of the PAC (a growth acceleration plan which both Presidents Lula and Dilma Rousseff had previously relied upon over the period 2007-2016). The government announced in August its intention to invest BRL 371 bn (USD 72 bn) over four years. By the end of Lula's term in office (2026), the program – which also includes spending by public enterprises and private investment – provides for a total of BRL 1400 bn in investments, or about 14% of GDP. The largest volumes will go to public buildings (social housing, schools, hospitals, etc.), energy (especially renewables) and transport. The government plans to generate 2.5 million direct jobs and 1.5 million indirect jobs.

FINANCING THE *NOVO PAC*...NOT A SLAM DUNK

PAC 1 and PAC 2 had mixed results due to a lack of funding and issues pertaining to governance. Will the *Novo PAC* (i.e. PAC 3) suffer the same fate? The share to be financed by the federal government has surprised to the upside given the constraints emanating from the recently enacted new fiscal framework (end of August).

BRAZIL: IPCA INFLATION INDEX BY MAIN COMPONENTS*

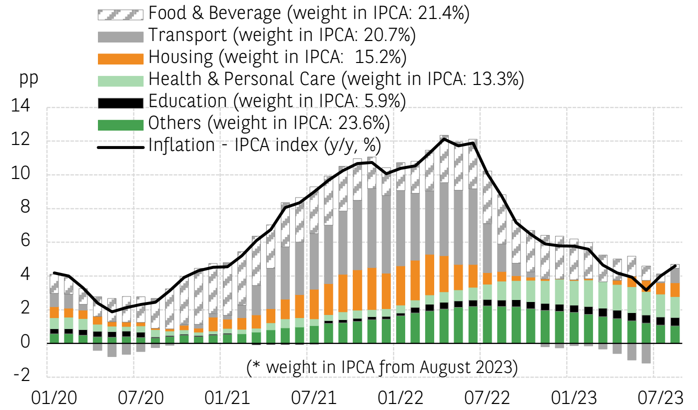

CHART 2 SOURCE: MACROBOND, IBGE, BNP PARIBAS

The latter determines a floor for public investment by the federal government (set at 0.7% of GDP, i.e. BRL 70 bn in 2023). Assuming that the government meets its primary balance target over the next 4 years, the fiscal framework would allow it to commit a minimum of BRL 280 bn in investment expenditure (a floor if we assume no increase in inflation). In this scenario, the federal funding gap for the PAC would be in the order of BRL 90 bn (this gap would fall to BRL 70 bn assuming nominal GDP growth of 5% per year over the period). Granted, the new rule provides for mechanisms to boost public investment above the floor, however, they are premised on the government registering primary budget surpluses over the period (which at this stage, appears to be a challenging task). If we consider 2024 alone, the government will likely require a fiscal adjustment of at least one percentage point of GDP to achieve its current target (a balanced primary budget). And if the target is not met with a tolerance of 0.25 points of GDP, discretionary expenditure (such as public investment) would be blocked until corrective actions are taken. To help meet its objectives, the government will not be able to rely on the tax reform currently being reviewed in the Senate as it is not intended to increase revenues *per se*[6]. The Ministry of Finance has therefore had to announce a new plan to increase revenues (estimated at some BRL 168 bn, or 1.5% of GDP). In addition to creating new taxes, the plan seeks to lift longstanding tax exemptions and deductions (e.g. dividends). The government also intends to rely on an income tax reform. The road ahead appears fraught with challenges and could result in a revision of the primary balance target. However, since the summer, Lula is better positioned to get the required majorities to help him pass reforms in Congress. To achieve that, however, he has had to hand large parliamentary grants, cede the management of the state-owned bank Caixa Economica – a major player in mortgage lending – to allies of the President of the Lower House and form an alliance with conservative parties leading to the first cabinet reshuffle of his mandate. The government now has 38 ministries from 11 political parties – a record.

Salim HAMMAD
salim.hammad@bnpparibas.com

5 The coronavirus (Covid-19) pandemic and high inflation have reduced household budgets and led to nearly 72 million Brazilians no longer being able to buy on credit.
6 Even if the bill provides for the creation of a selective tax (IS) for products that harm households' health and the environment, the reform is not intended to increase the country's tax burden (about 33.5% of GDP) but mainly intends to simplify the tax code to reduce significant compliance costs – an obstacle to the competitiveness of Brazilian products and a significant obstacle to investment. The reform, if approved, would only take effect from 2026 on and will provide for a transition period of 8 years.