BRAZIL

DISSONANCE

Brazil ended 2021 on a stronger footing than expected, but the economic picture remains fragile. Activity tends to progress in spurts, curbed by internal brakes (Omicron wave, climatic vagaries, elections) and a more degraded external environment (war in Ukraine, trading partners' economic slowdown, etc.). Meanwhile, inflationary pressures are building up and raise the specter of continued monetary tightening. Since the start of the year, the improvement in Brazil's terms of trade and wide interest rate differentials with developed economies have fueled the rebound of the equity market and spurred a strong appreciation of the real. Such developments highlight a form of dissonance between the real economy and assessments of financial markets.

ACTIVITY: A SEE-SAW PATTERN

A clear trend is struggling to emerge from the Brazilian business cycle. In Q4 2021, the economy recovered more strongly than expected after two quarters of decline. Sequential real GDP growth (+0.5% q/q) was driven by a rebound of the agricultural sector (hampered previously by weather-related problems) and growth in the service sector. But it was essentially the carryover effect from the rebound in H2 2020 and into Q1 2021 that enabled the economy to post growth of 4.6% in 2021. In contrast, the statistical carryover for 2022 is small at some 0.3%. Despite a strongly undervalued currency, the contribution of net exports to growth was surprisingly negative to the tune of 0.8 percentage points.

Since the start of 2022, the Brazilian economy has been confronted with several shocks. These have led to a slowdown in activity in January and the concurrent erosion of confidence indicators. Output in the extractive industry and harvests were affected by heavy rains in the South of the country, while the strong resurgence of Covid-19 cases, linked to the Omicron variant, slowed down activity in services (bars, restaurants, etc.) and caused a fall in automotive production (rise in absenteeism). The effects of the war in Ukraine are also starting to be felt. In industry, the additional costs induced by the rise in the price of raw materials and transport are coming on top of persistent problems regarding the availability of inputs – a lasting consequence of the Covid-19 crisis. This new supply shock, although mitigated this time by the appreciation of the real, is particularly detrimental to confidence and output in the manufacturing sector (the manufacturing PMI was below 50 on average in the first quarter of 2022). i/The sharp slowdown in credit to businesses (linked to the end of emergency programmes), ii/ the continued process of monetary tightening, iii/ the limited need for companies to rebuild inventories (unlike the situation at the end of 2020), iv/ rising inflation, and v/ the deterioration of the external scenario (economic deceleration in Europe, renewed lockdowns and slower growth in China, widespread increases in inflation across the world and rising geopolitical tensions) are all weighing on growth prospects.

However, some positive developments deserve to be underlined. The risk of electric power rationing has greatly diminished (heavy rains have replenished hydroelectric reservoirs). The rise in commodity prices, in addition to its positive effects on fiscal revenues (increased royalties and dividends), is also beneficial to the agricultural sector and extractive industries through its favourable impact on income. This should drive an increase in capital expenditure on machinery and equipment once uncertainty dissipates. The upturn in services in March (the only sector where confidence rose) could also help offset losses in activity in certain segments of industry. The service sector experienced a strong rebound in March helped by the significant improvement in the Covid-19 situation[1] and the further easing of mobility restrictions including on travels. Survey data shows a sharp increase in hiring in the month and a desire to expand capacity in the short term. Also, even if higher interest rates are starting to weigh on purchases of durable consumer goods, credit growth to households has yet to slow down (11.1% in real terms in January versus 6.3% a year earlier). Finally, the authorities announced in early March a support package to cushion the impact of the inflationary shock on households' purchasing power (BRL 150 bn or 1.7% of GDP, consisting primarily of regulatory adjustments on accessing allowances with no direct impact on the budget).

FORECASTS

	2019	2020	2021	2022e	2023e
Real GDP growth, %	1.2	-3.9	4.6	0.3	1.1
Inflation, CPI, year average, %	3.7	3.2	8.3	9.0	5.6
Fiscal balance / GDP, %	-5.8	-13.2	-4.4	-8.3	-8.6
Gross public debt / GDP, %	74	88	82	83	87
Current account balance / GDP, %	-3.5	-1.7	-1.8	-1.2	-0.9
External debt / GDP, %	37	45	43	40	38
Forex reserves, USD bn	357	356	362	356	350
Forex reserves, in months of imports	16	19	16	15	15

TABLE 1 e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

EXCHANGE RATE AND INTEREST RATE DIFFERENTIALS (BRAZIL / USA)

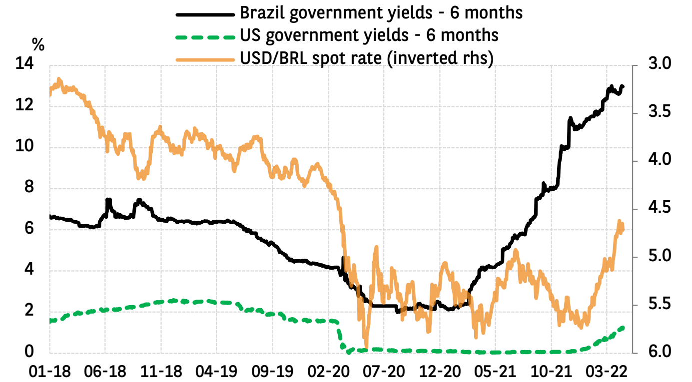

CHART 1 SOURCE: BRAZILIAN CENTRAL BANK, ANBIMA, US TREASURY

1Covid-19 cases peaked in late January, but both infections and hospital admissions have fallen sharply since then (with the exception of a slight increase around the time of Carnival). In early April, 86% of the population had received one vaccine dose, 76% two doses and around 36% a booster.

Combined with the increase in real wages since the start of the year[2], declining unemployment and higher spending by Brazil's federal states (election year), these measures could offer an upward bias to growth forecasts.

EXPOSURE OF THE AGRICULTURAL SECTOR TO RUSSIA

Brazil's trade exposure to Russia and Ukraine is limited but is not negligible due to the high concentration of certain products in trade ties. The combined share of Russia and Ukraine in Brazil's total imports and exports is just under 3% and 1% respectively. The strongest dependencies (measured as imports from Russia/Ukraine as a percentage of total imports of that product) are found in coal (14.9%), precious metals (13.8%), aluminium (10.1%) and fertilizers (23%, exclusively from Russia). Fertilizers alone account for around 60% of total imports from the zone[3] The agricultural sector – which also sources 7% of its imports of fertilizers from Belarus – has shown increased concern over prospective supply disruptions arising from the effects of the sanctions[4]. As a result, it has sought to secure greater supplies from countries such as Canada and Morocco over the next few quarters (import data already shows a strong increase in purchases in March). Disruption to Russian and Ukrainian cereal exports could create opportunities for Brazilian exporters of maize (3rd largest producer worldwide) and to a lesser extent wheat (1% of global sales in 2021/22).

A POSITIVE FINANCIAL SHOCK FOR NOW...

From a financial point of view, Brazil's dependence on Ukrainian or Russian investments is almost nil. However, the conflict, by prompting a rebalancing of investment portfolios on a global scale and fuelling the rise of commodity prices has helped support Brazilian assets. The equity market is made up of nearly 70% of commodity-related stocks (energy and materials) and banking/financial stocks. These are benefitting from the improvement in the country's terms of trade and the sharp rise in interest rates. Compared to other net commodity exporters, Brazil also stands out because it offers investors positive real interest rates[5]. The large interest rate differentials between Brazil and most developed economies are, in particular, incentivizing carry trade flows, (investors borrow where the cost of credit is cheap and invest where real yields are attractive). The strong momentum in portfolio investment flows[6] has allowed the Brazilian currency to appreciate rapidly against the dollar in the first quarter (+20% approximately). In the short term, still wide interest rate differentials with developed countries and the expected improvement in Brazil's external accounts (projection of a record trade surplus of over USD 70 bn and anticipated decline in the current account deficit in 2022) should continue to support the currency. However, the real's rally should lose momentum and be subject to increased volatility as the October elections approach. The incumbent president is still trailing Lula in the polls, but the gap is narrowing. It is worth noting that ex-president Lula has chosen a centre-right politician as his running mate (Geraldo Alckmin, former governor of São Paulo and former presidential candidate). Sergio Moro, former justice minister in the Bolsonaro administration and ex federal judge responsible for Lula's imprisonment, is pulling out of the race (he was 3rd in the polls).

... BUT ACCOMPANIED BY INCREASED INFLATIONARY PRESSURES

Despite the appreciation of the real and the easing of tensions over the electricity network, inflationary pressures remain well in place and are

BRAZIL: HEADLINE CONSUMER INFLATION AND SELECTED SUBCOMPONENTS

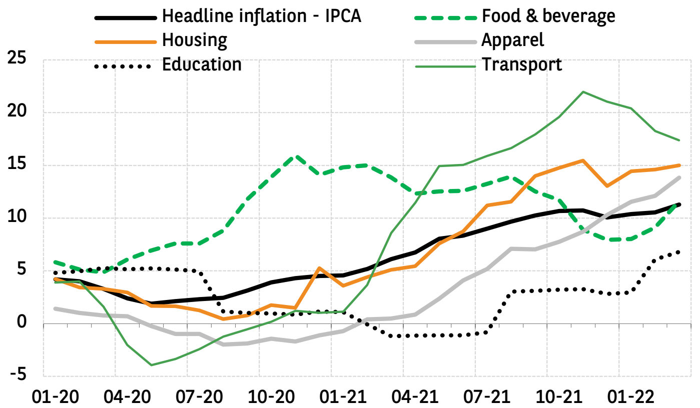

CHART 2 SOURCE: IBGE, BNP PARIBAS

being further exacerbated by the conflict in Ukraine (increased tension on the prices of industrial goods prices linked to disruptions in global supply chains, rise in the price of energy and food). The consumer price index (IPCA) thus reached 11.3% (y/y) in March – a peak since October 2003. Price increases are widespread but affect particularly the price of food goods[7] (24% of the consumer basket), due to the increase in freight and fertilizer costs as well as weather-related events (drought in 2021, heavy rains in early 2022). The recent increase in the price of energy (10% of the consumer basket) is not yet entirely visible due to a later (and often only partial) pass-through of international prices to domestic prices. However, it should not take long to fully materialize. Petrobras, announced in March a 19% increase in the price of petrol and around 25% for diesel – a first adjustment by the national oil company in over two months. In 2021, fuel had contributed for a third of the 10.06% increase in the IPCA and according to calculations by the central bank (BCB) a 10% rise in oil prices in local currency terms will likely push the IPCA up by 0.31 to 0.43 points in 2022. Core inflation is also accelerating under : i/ the relaxation of price caps in some sectors introduced during Covid-19 crisis most notably in healthcare (pharmaceutical products) and education (tuition fees) ; ii/ inertia effects related to widespread indexation practices (wages but also residential rents), iii/ the passing on of rising costs to the price of services in order to protect profit margins.

Faced with the persistence of inflation and the slight de-anchoring of inflation expectations relative to the targets for 2023-24, rate hikes could continue this year. The BCB initially announced its intentions to halt its monetary tightening cycle in May after a final hike in the benchmark rate, the SELIC, by 100 basis points (bps) to 12.75%. Given that a 100 bps hike in the SELIC tends to increase average sovereign borrowing costs by 45-55 bps according to Moody's, interest payments on sovereign debt could very well exceed 7% of GDP this year – the highest level since 2015.

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2Real incomes fell sharply in the second half of 2021. However, despite the fall in disposable income, consumer spending continued to rise, as consumers drew more heavily on savings.
3 Brazil is the world's 4th largest consumer of fertilizers. It also draws on the external market for about 85% of its needs. A quarter of the fertilizers it uses goes to produce soybeans, Brazil's top export.
4 Brazil could see a fertilizer shortage by October in the case of inaction to address the situation according to Agriculture Minister Tereza Cristina.
5 Policy rates discounted by 12-month inflation expectations.
6 In 2021, net non-resident portfolio flows were positive for the first time since 2015.
7 Price increases are particularly affecting flour, bread and oils, along with fruit and vegetables (+46% for carrots, +15% for tomatoes and +6.3% for fruits in March).