BRAZIL

SOME CAUSE FOR SATISFACTION...AMIDST A FEW GREY AREAS

For his return at the helm of Brazil, Lula can look at his first year back in office with some contentment: macro-financial indicators boasted solid prints, social programs were given a new impetus, an ambitious change in direction was initiated on the environment and the government's capacity to reform ended up being much stronger than anticipated by most observers. This picture, nonetheless, conceals some imbalances most apparent in Brazil's growth profile, the dynamics of unemployment and the structure of its trade balance. The markets' renewed skepticism relative to the government's ability to balance its books (despite the new fiscal framework) constitutes another grey area. In 2024, economic growth, inflation and interest rates will be lower than in 2023. The refinement in recent months of the government's policy direction combined with the increased provision of financing for the green economy should help support a reprisal of investment.

2023 : A TRACK RECORD THAT EXCEEDED EXPECTATIONS...

Lula tallied a very respectable track record for the first year of his third term back in office. Yet this scenario seemed far from self-evident considering the government coalition's lack of majority in the lower house (fewer than 200 seats out of 513 representatives), and Lula's tumultuous inauguration and first few weeks in office (attacks against executive and legislative institutions in Brasilia, prosecutions against Bolsonaro, tensions with the Central Bank, market concerns following the sharp rise in social spending[1] , etc.).

But in the end, macro-financial results surprised positively with some honourable mentions: real GDP growth exceeded expectations by more than 2.5 points. In December, the unemployment rate (7.4%) fell to its lowest level since 2015 and disinflation was more pronounced than expected, with the annual change in the IPCA Index falling back into the Central Bank's tolerance band for the first time since 2020. The trade balance posted a record surplus (flirting with the USD 100 bn mark), allowing the current account deficit to shrink by a little more than one point of GDP. Portfolio investments by non-residents experienced a trend reversal, driven in part by attractive bond yields (net inflows of USD 19.7 bn in 2023 vs. net outflows of USD 4.7 bn in 2022 according to IIF data.) Solvency and external liquidity indicators remained satisfactory - bolstered by a USD 30 bn increase in foreign exchange reserves and a moderate increase in external debt.

On the market front, the B3-Ibovespa stock market index reached an all-time high (132,000 points in December) and registered a 34% increase in dollar terms – outperforming the MSCI Emerging market index by some 24 points. Meanwhile, the real – bolstered by carry trade flows – posted gains of almost 10% against the dollar. The disruptive shock to the corporate debt market caused by the default in Q1 of a systemic player (the retailer Americana) was, in the end, relatively short-lived – with issuances normalizing in Q2. Improvements in the perception of sovereign risk (embodied in the narrowing of the EMBI+ Brazil spread by 62 basis points and rating upgrades from BB- to BB by both S&P and Fitch) also enabled the government to issue its first ESG bond in November (USD 2 bn over 7 years) under relatively favourable terms (6.5% yield with a 182 basis points spread over the US Treasury, a 10-year record).

In addition, the government succeeded in approving a tax reform (30 years in the making) and a new fiscal framework while managing to maintain its social commitments (restart housing and 'fight against hunger' programmes, increase benefits under *Bolsa Familia*). The deployment of a household debt restructuring programme (*Desenrola Brasil*) and the renewal of programmes to support businesses (*Pronampe*) have also helped contain the rise in credit risk.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth, %	5.0	2.9	3.1	1.7	1.9
Inflation, CPI, year average, %	8.3	9.3	4.6	4.2	3.7
Fiscal balance / GDP, %	-4.3	-4.6	-7.9	-7.3	-6.9
Gross public debt / GDP, %	78.3	72.9	75.6	78.7	81.1
Current account balance / GDP, %	-2.8	-2.9	-1.3	-1.1	-1.5
External debt / GDP, %	42.0	35.8	36.7	38.0	39.0
Forex reserves, USD bn	362.0	324.0	355.0	342.0	350.0
Forex reserves, in months of imports	14.2	11.0	12.4	12.7	12.2

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

BRAZIL: NET NON-RESIDENT PURCHASES OF STOCKS AND BONDS

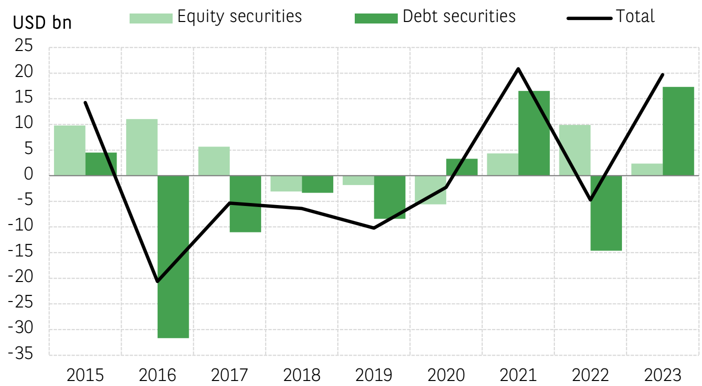

CHART 1

SOURCE: IIF, BNP PARIBAS

... WHICH NONETHELESS MASKS SOME IMBALANCES

The country's overall good performance, however, masks some areas of fragility: i/ the details of the national accounts show for instance a growth profile that is strongly unbalanced making the economy more

1 The cost of the social welfare programme, Bolsa Familia, was multiplied by 3 compared to the pre-pandemic period, i.e., almost 1.7% of GDP.

structurally vulnerable. Of the 3% growth expected in 2023, more than half has come from the agro-industry and extractive sectors with a contribution of around 0.8pp for the oil industry alone. ii/ We can, moreover, doubt the structural nature of the improvements in the labour market. Indeed, despite a very tight labour market, average real wages remained at their pre-pandemic level. The decline in the unemployment rate is largely attributable to the decline in the labour market participation rate. At a constant participation rate (end of 2019), the unemployment rate would have increased by a little over 2 points from its current level. iii/ The trade balance is less diversified than in the past (in terms of both partners and products), making the external accounts somewhat more fragile in the event of shocks. In 2023, agricultural products represented a significantly larger share of total exports (49% compared to 38% over the 2020-22 period), while China further strengthened its position as the country's leading trading partner (absorbing 31% of exports in 2023 compared to 26% over the 2016-22 period with a concentration in soya, crude oil, meat, iron ores and paper pulp). The dependence is reciprocal: 20% of China's agricultural imports today come from Brazil. Russia, and its cheap refined oil, has also become the country's second largest fuel supplier, meeting 50% of its diesel needs - highly sought after in the transport and agro-business sectors.

A BALANCING ACT BETWEEN ENVIRONMENTAL PRESERVATION AND ECONOMIC DEVELOPMENT

Brazil - currently the world's 7th largest emitter of greenhouse gases[2] - has been, throughout the year, put to the test of its contradictions on the environment: on the one hand, deforestation of the Amazon has fallen by half and Lula has made, both domestically and internationally, some ambitious pledges on the environment[3]. The country is also in the process of finalizing the launch of a national carbon market which intends - in addition to regulating carbon credits - to establish an emissions cap for around 4,000 companies emitting more than 25,000 tons of CO_2 equivalent each year. On the other hand, to give himself additional room to maneuver with the agricultural lobby – very influential with elected representatives – Lula promulgated at the end of 2023, a law speeding up the process authorizing new pesticides (of which the country is already the world's leading consumer absorbing 1/5th of global stocks, according to the FAO.) In contrast to the Amazon, deforestation in the Cerrado savannah (which is home to 5% of global biodiversity and where 45% of Brazilian agriculture and livestock farming takes place) has become more pronounced this past year. Oil exploration projects in the Amazon basin have also not been called into question. An investment plan in fossil fuels (BRL 335 bn) is expected to allow the country to increase its production to 5.4 mn barrels/day by 2030 compared to 3 mn currently. Brazil is expected to become one of the countries experiencing the strongest growth in oil production over the coming years, along with Guyana and the US according to the IEA.

BRAZIL: LOANS FOR INFRASTRUCTURE PROJECTS BY TYPE OF LENDER

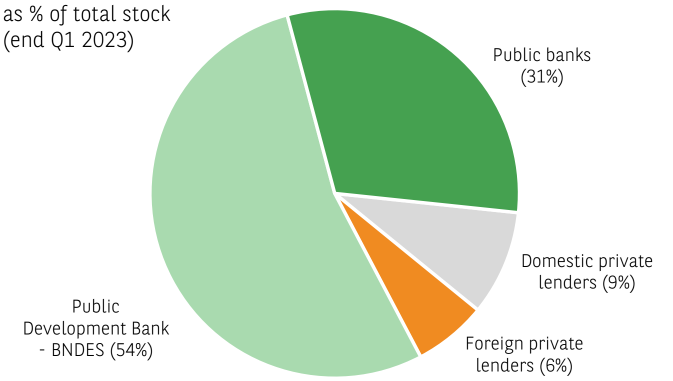

CHART 2 SOURCE: BCB, OECD, BNP PARIBAS

2024 OUTLOOK: STIMULUS OR RESTRAINT?

In 2024, economic growth should be close to its potential (between 1.5% and 2%). The statistical carry-over from 2023 growth will be low, at around 0.3 pp, on the back of a moderating economy in H2-2003. Due to climate events and large base effects, the contribution of agriculture to growth is expected to be negative after an exceptional year in 2023. Interest rate cuts are expected to carry on. Since August 2023, the BCB has made 5 cuts to the SELIC rate accumulating 250 basis points of adjustment (to 11.25% at the end of January). The further easing of monetary conditions should benefit sectors that are most sensitive to the credit cycle, including many which have had a harder time in 2023 (e.g., manufacturing sector, construction). The fall in rates should encourage local investors to return to the equity market and support the resumption of IPOs (3 to 5 anticipated) after a 2-year hiatus.

The authorities could be tempted to further stimulate economic growth. The market expects a revision of the primary deficit objective[4] in March/April (a move which risks undermining the credibility of the new fiscal framework). The authorities are expected to further lean on the public Development Bank (BNDES), already the largest provider of funds for infrastructure projects (54%). The latter plans to increase disbursements to around 2% of GDP by 2026 compared to 1.2% currently. The government also hopes to encourage more private sector investment following the recent adoption of the tax reform and the announcements in recent months of the new growth acceleration program and reindustrialization plan (August 2023 and January 2024, respectively). The green economy will benefit from preferential financing conditions and new hedging mechanisms to protect investors against currency risk – considered an important barrier to foreign direct investment.

Salim HAMMAD
salim.hammad@bnpparibas.com

2 According to the World Resource Institute, Brazil is responsible for 3% of greenhouse gas emissions. Around 40% of these emissions are linked to deforestation.
3 Within the framework of the Nationally Determined Contributions (NDCs) - in September revision of the targets for reducing greenhouse gas emissions (from 37% to 48% by 2025 and from 50% to 53% by 2030); a pledge to deliver zero deforestation by 2030 ; in his plan to reindustrialize the country, announced in January 2024 (USD 61 bn over 2024-2026, focusing on health, defence, agribusiness, transport and digital technology), Lula aims to reduce the carbon dioxide produced by industry by 30%, in particular by stimulating the production of biofuels and renewable energy.
4 Market participants are expecting the primary balance (excluding interest payments on public debt) to deviate by 0.8 points of GDP in 2024 from the government's 'zero deficit' target. Markets don't buy a large reduction in spending and/or a sufficient rationalization of revenues (through better collection, end of exemptions, reform of tax loopholes, etc.).