Brazil
Delayed recovery

The hopes of seeing economic activity pick up following the election of Jair Bolsonaro have fallen. Some indicators point to a possible contraction in economic activity in Q1 2019 at a time where confidence indicators were seemingly improving. Meanwhile, the reform of the pension system – a cornerstone of President Bolsonaro's economic program – was presented to Congress in February where it is currently under discussion. Negotiations will likely be more protracted and be more difficult than originally expected. Indeed, since taking office, the popularity of the Brazilian president has sharply declined and relations between the executive and the legislature have strained.

■ A lethargic start to the year

In 2018, the economy grew at the same pace as in 2017, at an annual average rate of 1.1%. The year's growth performance was largely tainted by the truckers' strike and the general elections. Household consumption remained the main driver of growth thanks in particular to a rise in consumer credit, which spearheaded the recovery in credit growth (+5% in 2018) after two years of contraction in 2016 and 2017. Investment recovered some lost ground (+4.1% y/y) after declining for four years. Nonetheless, investment as a share of GDP remains well below its 2013 peak (17.4% versus 22.8% of GDP). Meanwhile, the contribution of net exports was negative (-0.5 pp) for the first time since 2013. The current account deficit (USD 14.5 bn) was contained (0.8% of GDP) and was largely covered by net FDI flows (USD 74.3 billion, or 4.1% of GDP). Due to the very slow pace of economic activity in Q4 (+0.1% q/q) the statistical carry-over for 2019 is weak.

Despite the upswing in confidence witnessed post-election, economic indicators have largely disappointed since the onset of the year. Industrial production remained flat over the first two months of the year (-0.8% m/m, in seasonally adjusted terms in January followed by + 0.7% m/m in February). Mining production fell sharply (-15% in February) following the break-up of the Brumadinho dam in late January. Idle capacities in industry remain high, which partly explains—alongside the drop in subsidized credit—why corporate credit growth is recovering only very slowly (+ 2% y/y in February). More surprisingly, retail sales have remained largely erratic despite the rise in real wages since November and the strong growth in consumer credit (+ 9% y/y in February). Against this backdrop, the labor market deteriorated (unemployment rose to +12.4% at the end of February against 11.6% in December). Finally, activity in the services sector has also slowed since January. More importantly, the central bank's leading indicator of economic activity (IBC-BR)— a monthly proxy for GDP—declined both in January and February (-0.3% and -0.7% m/m, sa), raising concerns about a potential contraction in GDP in Q1.

For now, financial markets have not yet adversely reacted to the weak performance of the economy. The stock market—which broke 100,000 points in March for the first time in its history—continues to perform well despite the sluggish business cycle. The risk premiums on sovereign debt remain around 250 basis points (bps) after dropping by nearly 100 bps since early September 2018. Meanwhile, the BRL which gained some ground against the US during Bolsonaro's first month in office (+ 6% in early February) has

1- Forecasts

	2017	2018e	2019e	2020e
Real GDP growth (%)	1.1	1.1	2.0	3.0
Inflation (CPI, year average, %)	3.0	3.7	3.8	3.6
Fiscal balance / GDP (%)	-7.8	-6.8	-7.2	-6.6
Gross public debt / GDP (%)	74	77	85	85
Current account balance / GDP (%)	-0.5	-0.8	-1.5	-2.4
External debt / GDP (%)	27	33	35	38
Forex reserves (USD bn)	373	374	380	377
Forex reserves, in months of imports	20.0	18.0	17.0	17.0
Exchange rate USDBRL (year end)	3.3	3.9	3.3	3.2

Source: National accounts, BNP Paribas

2- Monthly proxy for GDP (IBC-BR) has contracted

— Index of economic activity -IBC-BR (lhs)

••• Industrial production index IBGE (rhs)
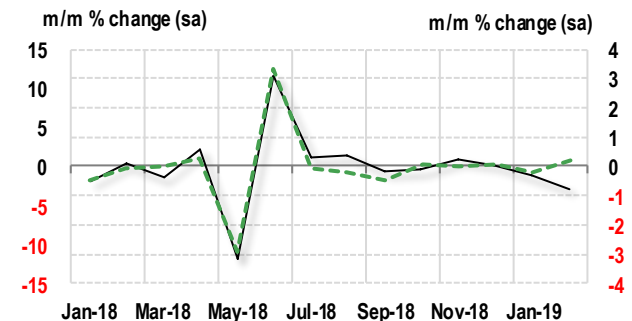
Source: Central Bank of Brazil, IBGE, BNP Paribas

since returned to its level at the beginning of January. The currency however remains down 12% compared to a year ago.

At this point, hopes of seeing economic activity accelerate strongly are limited. Fiscal consolidation leaves no room for increased public spending, while the climate of watchfulness resulting from the fiscal reform will likely hold back investment decisions. External factors are not also particularly supportive: in addition to the slowdown in the global economy the shortfall resulting from the recession in Argentina is weighing on exports of capital goods, particularly in the automotive industry. On the flipside, loose financial conditions and the process of disinflation remain favorable to private consumption and credit growth. The benchmark rate has been at a historical low

(6.5%) for a year now. Meanwhile, inflation should remain contained below the Central Bank's target in 2019.

■ A peak at the state of public finances…

Brazil's fiscal accounts have largely deteriorated since 2014 when the primary balance (excluding interest payments on government debt) turned negative after 10 years in surplus. Over period 2014-2018, the central government' fiscal deficit averaged 6.8% while the primary deficit averaged 1.7%.

The deteriorating trajectory of the fiscal balance owes to cyclical factors (meagre recovery, revenues collapsing during the recession in 2015, 2016) but is mostly symptomatic of large structural imbalances which have led spending to grow 3 times as fast as GDP in the past 10 years. Spending has remained rigid owing to the incompressibility of mandatory social spending in particular social security and pension benefits which entitlements are protected under the constitution. The wage bill has also grown rapidly. Central government payroll has increased by 8% on average over period 2010-2017 accounting for about 4% of GDP. Costly indirect or direct subsidies are also to blame and have yet to be phased out. While the offering of subsidized credit through BNDES is being gradually phased out, the concurrent reduction of energy subsidies has remained politically sensitive. Subsidies associated with the truckers' strike (May 2018) is estimated to have cost the equivalent of 0.2% of GDP in 2018.

Despite the adoption of the spending cap[1] in 2016, the inability to alter the course of mandatory spending (social spending and pensions in particular) has meant that limited progress in terms of fiscal consolidation has been made. Given Brazil's structurally high interest burden (~ 5% of GDP), recurrent primary deficits have led to a sharp increase in public debt (+25 pp of GDP since 2013 to 77% in 2018).

The public debt burden is high but its financing does not currently pose a problem. Moreover, the profile of the debt has improved over time (longer maturities, low foreign-currency debt, better amortization profile, gradual replacement of floating rate instruments with fixed ones). The government also enjoys good coverage of its large financing needs thanks to the presence of a liquid domestic capital market. 96% of the public debt is domestic debt and is mostly held locally with ~11% held by non-residents at end 2018. Non-residents have continuously reduced their sovereign exposure since May 2015 when holdings reached a high of ~21%. Meanwhile, the monthly average borrowing costs of the central government on its domestic debt have eased (17.5 % in 2015 vs 10.6% in 2018) enabled by disinflation and the drop in the benchmark SELIC rate.

3- Overview of public finances
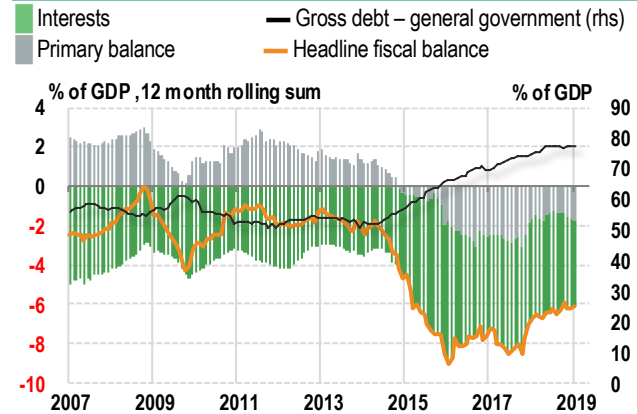
Source: Central Bank of Brazil, National Treasury, BNP Paribas

■ ….as the pension reform bill is examined

The pension reform bill - introduced by the government in February is currently under discussion in Congress. The reform[2] projects fiscal saving in the range of USD 300 billion over 10 years (around 1.5% of GDP per year). A recent Datafolha survey reveals that popular support for the reform has improved (51% rejection vs. 71% in April 2017).

In all likelihood, the size of the fiscal savings will be revised downwards by at least one-third after negotiations in Congress. Recent tensions between the executive and Congress however have cast doubts about the government's ability to find the necessary support to approve the reform. To make things worse, President Bolsonaro's popularity - the main lever for pushing a fragmented Congress to form a qualified majority (3/5) - has been significantly challenged. A poll conducted by Ibope in March reports a drop in the President's approval ratings from 49% in January to 34% in March.

At best, the reform should help reduce the primary deficit by 0.7 to 1 pp of GDP, which on its own will be insufficient to stabilize the public debt.

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[1] According to the law, the non interest part of central government expenditure (ie primary spending) cannot grow faster than inflation for a period of 20 years. Penalties for not complying with the cap include the prohibition to grant adjustments to civil servants' wages, hire new personnel or generate additional expenditure.

[2] The new pension system which seeks to narrow the gap between workers in the public and private sectors would be rolled out over a 12 year transition period. The current proposal would (i) set the minimum retirement age at 65 for men and 62 for women for both public and private sector workers (ii) increase the length of contribution to social security, (iii) make important changes to how retirement benefits are calculated, (iv) align the rules applied to federal government civil servants with those of states and municipalities (v) eliminate certain discrepancies across professions (ie. teachers, police, military for instance benefit from early retirement rules).