BRAZIL

FRAGILE CONSOLIDATION OF THE RECOVERY

The recovery has failed to consolidate in Q2 2021, with production stalling over the quarter despite the dynamism of external demand and the normalization of activity in the service sector. The slowdown of the epidemic since the summer and the acceleration of the vaccination campaign, however, point to a rebound in the second half of the year. But upside risk to growth will be challenged by the persistence of supply constraints in industry, the risk of electricity rationing, the slowdown in China and aggressive monetary tightening to counter soaring inflation. Against this backdrop, the real is still struggling to appreciate despite the rise in rates and the good performance of external accounts. The currency's weakness make the process of controlling inflation more difficult. The threat of fiscal slippage ahead of the 2022 Presidential election is yet another downside risk to the inflation outlook.

STAGNATION OF ECONOMIC ACTIVITY IN Q2

In the second quarter, the Brazilian economy was unable to capitalize on its good performance from the beginning of the year. Real GDP recorded a slight decline (-0.1% q/q, in seasonally adjusted terms) due to a downturn in agricultural production (due to drought and frost) as well as a decline in industrial activity (supply chain disruptions and higher production costs, especially in the manufacturing sector). These losses were only partially offset by the normalization of activity in the service sector, induced by increased mobility in the wake of the 2nd wave of Covid-19. On the demand side, supply constraints weighed on investment decisions and greatly accelerated the drawdown of inventories (especially in the automotive sector, still challenged by the global shortage of semiconductors). The reversal of gross investment alone helped cancel out the positive contribution of net exports to sequential GDP (+1.4 pp).

The rebound in activity in the second half of the year could be more moderate than expected. On the one hand, the progression of the epidemic has slowed down sharply since the end of June (despite a higher prevalence of the Delta variant), allowing a wider reopening of the economy and an increase in economic activity (the IBC-BR, a leading indicator of real GDP, rose +0.6% in July). The strengthening of services (+4% in July above its level of February 2020) helped bring about a fall in the unemployment rate (drop by one point to 13.7% in July compared to April). The improvement in the labour market was primarily driven by micro and small businesses responsible for nearly three quarters of the 1.8 mn formal jobs created between January and July. The acceleration of the vaccination campaign (at the end of September 70% of the population had received one dose, and 40% were fully vaccinated, vs. 38% and 14%, respectively, in early July) has helped Covid-19 related deaths and hospitalizations drop to levels last seen in November 2020. In the short term, the economy should continue to benefit from high commodity prices, the gradual rebuilding of inventories in the manufacturing sector and a broader recovery in the service sector.

On the other hand, the indicators available in Q3 show that supply constraints in industry, in particular weighing on costs, have not eased (BRL depreciation, delivery delays, increase in the price of electricity and freight costs). These persistent difficulties have begun to erode confidence in the sector (the FGV-industry index fell 1.4 points between July and August and has continued to deteriorate in September). In surveys, companies worry about the risk of electricity rationing that could cause production stoppages this year and next (the thermoelectric plants, which form part of Brazil's emergency system, are operating at full capacity and the country has had to increasingly rely on electricity and gas imports from Argentina and Bolivia).

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	1.4	-4.3	5.0	1.5
Inflation (CPI, year average, %)	3.7	3.2	8.0	7.0
Fiscal balance / GDP (%)	-5.8	-13.2	-6.4	-7.2
Gross public debt / GDP (%)	74	89	82	84
Current account balance / GDP (%)	-2.7	-0.9	0.5	-1.5
External debt / GDP (%)	37	45	42	44
Forex reserves (USD bn)	357	356	368	361
Forex reserves, in months of imports	16	19	16	15

TABLE 1 e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

COVID-19 : SLOWDOWN OF THE EPIDEMIC AMIDST RISING VACCINATIONS

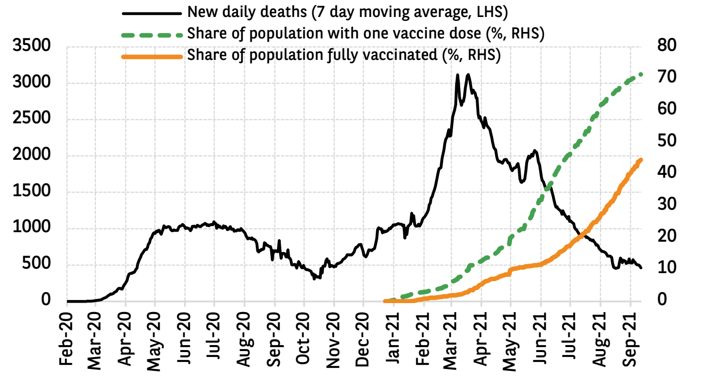

CHART 1 SOURCE: OUR WORLD IN DATA, BNP PARIBAS

In 2022, the recovery should continue, but at a slower pace (1.5%). Household consumption will be constrained by slow wage growth, accelerating inflation, high unemployment and tightening credit conditions. At the same time, the start of the electoral cycle ahead of the October 2022 Presidential election should be less favourable to private investment. The normalization of supply conditions in industry as well as recent regulatory changes destined to provide SMEs with better access to credit, are not expected to weigh significantly in the balance of risks (dominated by the threat of the emergence of new variants affecting the vaccine effectiveness and the risk of an energy crisis). Finally, it is important to note that the economy will benefit from a significantly smaller statistical carryover effect next year compared to this year (some 0.3 pp estimated vs. 3.7 pp). Medium-term growth will depend above all on improving the business environment — a keystone for stimulating private investment, increasing productivity and offsetting the effects on the economy resulting from the country's demographic transition (*cf. Eco conjoncture, August 2020*).

INFLATION IS SPREADING

Inflation has continued to accelerate through August. The IPCA index rose at an annual rate of 9.68%, the highest rate since February 2016 and 1.1 pp higher than the BCB's central scenario last June. The IPCA mainly came under pressure from food products, but also from industrial goods due to supply chain bottlenecks and higher input prices. Price increases are also spreading to the service sector. By 2022, the pressure on drinks and food prices are expected to dissipate. In contrast, the rise in price for electricity and fuel are likely to be more persistent. Core inflation is estimated at the moment to be some 4 percentage points lower than headline inflation. According to the BCB's survey of market participants, inflation expectations for 2022 remain above the BCB's target (4.1% vs. 3.5%). Market expectations for 2021 are meanwhile running at 8.45%.

Against this backdrop, the BCB has continued to raise its key rate (5th increase in September of the SELIC, up 425 basis points since March). The monetary authorities' task of controlling inflation is being made all the more difficult by the persistent weakness of the real: the currency has struggled to appreciate despite the rise in the SELIC, the fall in the current account deficit and the resumption of portfolio investment flows. The currency has in particular fallen prey to a more tense political environment (accusations of corruption in the purchase of vaccines, President's repeated attacks on institutions, increased tensions with the Supreme Court, threats of cancelling next year's Presidential election, multiplication of requests for impeachment etc.).

THE RISK OF FISCAL DOMINANCE

The anchoring of inflation expectations is also being obstructed by fiscal uncertainties (as of late, loss of visibility over the government's reform priorities, fears that in the last year of its mandate, the authorities could free themselves from budget constraints to stimulate domestic demand). These fears are not totally unfounded. Already in 2021, fiscal manoeuvring had helped circumvent the spending cap. Also, according to a note by the IIF, Brazil is not typically accustomed to reducing primary spending during election years. Lastly, the President intends to launch a new social programme (*Auxilio Brazil*) to replace *Bolsa familia* (although this programme will be partly financed by a temporary tax increase on financial transactions in Q4 2021).

Fiscal uncertainties tend to raise risk premiums and weaken the real, forcing the Central Bank to tighten monetary policy (imported inflation). The resulting increase in the cost of debt induces a rise in spending (as it is very difficult to change the composition of fiscal expenditure as nearly 95% of it is protected by the Constitution). In this scenario, monetary policy is almost entirely dominated by fiscal policy (fiscal dominance). This vicious circle would maintain the gap between the effective interest rate on government debt and the rate of growth of the economy (which has been slow in recent years) – resulting in a mechanical deterioration of public debt dynamics.

RESORPTION OF THE CURRENT ACCOUNT DEFICIT AND REVERSAL OF PORTFOLIO FLOWS

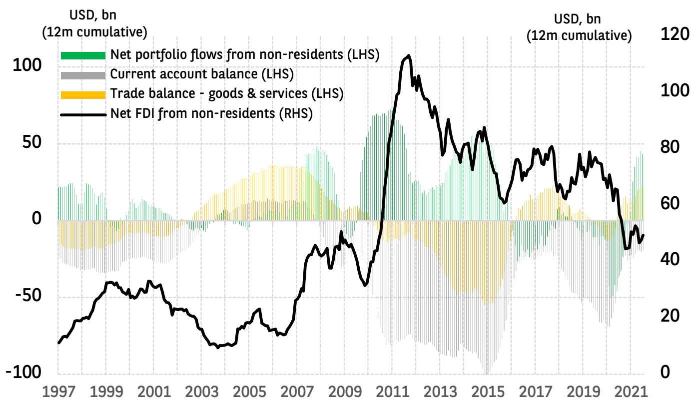

CHART 2 SOURCE: BCB, BNP PARIBAS

So far, fiscal ratios have not deteriorated, if only because of strong nominal GDP growth. The deficit is also contained thanks to the payment of deferred taxes (25% increase in tax revenue in the first half of the year). The tightening of financing conditions and the turmoil associated with approving the 2021 budget (*cf. EcoEmerging Q3*) have also, for the moment, not hampered the government's ability to refinance itself (debt rollover, which has amounted to more than 10% of GDP since the start of the year, has occurred relatively smoothly). Yet the recent improvement in fiscal balances does not reflect a fundamental consolidation of public finances, which are still subject to major rigidities.

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