BRAZIL

SOME DIFFICULT CHOICES LIE AHEAD

The epidemic remains in full swing, but has shown some signs of deceleration. The recovery in Q3 has been stronger than expected. However, the picture varies considerably from one sector to the next. The central bank has paused its monetary easing cycle for the first time since mid-2019. At the same time, it has adopted a more active communication stance through the embracement of forward guidance. The emergency aid programme – which will push the budget deficit to a record high – has meanwhile helped President Bolsonaro witness a resurgence in popularity. Negotiations over the 2021 budget are likely to crystallise tensions across the executive and Congress. Difficult choices lie ahead as the authorities will need to arbitrate between supporting the most vulnerable and resuming the process of fiscal consolidation. The currency, over and above its weakness, continues to suffer from considerable volatility. The return of foreign investors to Brazilian markets remains timid overall.

Six months after the start of the epidemic in the country, Brazil has seen more than 140,000 deaths (665 per million people) and more than 4.72 million confirmed cases. The toll is grim, but the epidemic has started to show signs of slowing down: the rolling 7-day average death tally has been falling for several weeks, after stagnating for a number of months. The contagion rate (R_0) has also returned to around 1 (the country had an R_0 of 2.81 in May, the highest rate in the world). This slowdown has come as the easing of containment measures has spread across the country. Schools are soon set to reopen in Sao Paulo and Rio de Janeiro.

A FASTER THAN EXPECTED RECOVERY BUT HIGHLY UNEVEN

National accounts data showed a heavy drop in economic activity in Q2, with GDP contracting by -9.7% q/q (-11.4% y/y). Output losses were however less pronounced than expected, and the recovery initiated in May has proved to be more vigorous than anticipated.

On the supply side, Q2 figures showed a sizeable contraction in industrial activity as well as in services. Agricultural output, on the other hand, expanded slightly over Q1. On the demand side, only net exports made a positive contribution to growth.

The economic recovery initiated in May has strengthened but is very unevenly spread across sectors. The grains[1] and mining sectors have performed well, benefiting from the weakness of the BRL, rising prices and the economic recovery in China. The partial suspension of poultry imports by China, following coronavirus outbreaks in a number of slaughter houses, have not yet significantly affected the performance of the cattle industry. Overall, strong commodity and livestock exports have contributed, amongst others, to the reduction of the current account deficit by nearly USD 30 bn over the period from January through August (12 months cumulative sum).

On the other hand, services, which account for around 70% of GDP and 47% of formal employment, are still struggling to forcefully recover (up 2.6% m/m in July, after falling by around 20% between February and May). The performance across the sector is however highly heterogeneous with the aggregate picture overshadowing some bright spots. Transportation services, the event industry, tourism and personal services are still facing substantial difficulties. By contrast, information and communication technology services have experienced more dynamic growth. Meanwhile, activity levels in industry are returning to pre-crisis levels (February). The bounce back has been generalized to all the subcomponents of industrial production (capital goods, intermediate goods, durable and non-durable consumer goods).

FORECASTS

	2018	2019	2020e	2021e
Real GDP growth (%)	1.3	1.1	-5.0	3.0
Inflation (CPI, year average, %)	3.7	3.7	1.5	3.0
Fiscal balance / GDP (%)	-7.1	-5.9	-17.3	-7.1
Gross public debt / GDP (%)	77	77	96	98
Current account balance / GDP (%)	-2.3	-2.9	-0.7	-0.8
External debt / GDP (%)	36	37	47	41
Forex reserves (USD bn)	374	357	360	350
Forex reserves, in months of imports	18	17	21	19
Exchange rate USDBRL (year end)	3.9	4.0	4.8	4.0

TABLE 1

e: ESTIMATES AND FORECAST
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

PORTFOLIO INVESTMENTS BY NON-RESIDENTS

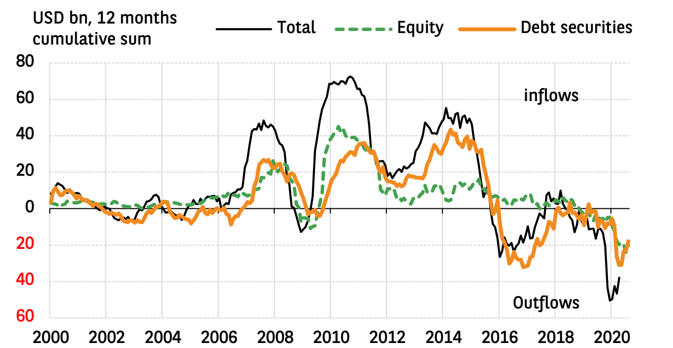

CHART 1

SOURCE: BCB

On the expenditure side, the government's emergency aid package has helped underpin strong retail spending especially on construction materials, household furniture and appliances. This has enabled broad

1 The national statistics agency, IBGE, estimates that 250.5 million tons of grains will be produced this year, a new record and a 3.8% increase compared to 2019. Rice, soy beans and maize crops are expected to account for more than 90% of the total yield.

retail sales to experience a V-shaped recovery with July's sales only 2% below those of February.

For the time being, the improvement in economic activity has yet to feed through to the labour market. The unemployment rate (13.8% in July) and the underemployment rate are still at peak levels, whilst the contingent of discouraged workers remains high at an estimated 5.5 million. In services, job losses have been reported in the last 6 PMI surveys. Some improvements are however to be noted: employment figures in manufacturing and construction have started to recover, new unemployment insurance claims fell by nearly 20% in August, while the labour market in July saw more formal jobs being created than being lost, a first since February.

END OF THE EASING CYCLE. FORWARD GUIDANCE MAKES ITS DEBUT

After proceeding to 9 consecutive cuts of its key policy rate, the BCB interrupted its easing cycle in September, holding the SELIC at 2% (from 6.5% in mid-2019). The monetary policy committee (Copom) also indicated its intention not to raise rates until its central inflation scenario converges towards its targets for 2021 (target of 3.8%) and 2022 (3.5%). This novel and more active communication stance on behalf of the BCB shows that it has embraced forward guidance as an additional monetary policy tool. The policy is intended to better guide market expectations at a time when the slope of the yield curve is facing upward pressure due to increased uncertainties surrounding the government's fiscal position.

Since July, the policy rate in real terms has been in negative territory following the slight rise in inflation. Indeed, the higher food and fuel prices, the stronger recovery of consumption supported by disbursements of government aid and the emergence of bottlenecks on the supply side due to insufficient inventories and logistical difficulties have jointly contributed to an increase in the consumer price index from 1.9% in May to 2.4% in August. At the same time, prices of inputs in industry have risen rapidly, as a result of shortages faced by suppliers and the enduring weakness of the BRL.

For the time being, the BCB does not seem to be too concerned about inflation risk as core inflation (excluding energy and food) has remained broadly stable and inflation expectations have remained well below the target. Nor does it seem to be concerned about the weakness of the currency (the BRL has been down 30% against the USD since January). On the other hand, the BRL's volatility continues to be a real challenge for the authorities (the BCB has intervened in the FX market some twenty times this year). Since June, there has been a measured return of portfolio inflows from non-residents. However, the weakening trend of the BRL, its volatility, as well as the structural fall in interest rates are all factors that contribute to keeping investors away from local markets. Between January and August, net portfolio outflows have amounted to USD 25 bn.

A RECORD HIGH BUDGET DEFICIT. DIFFICULT CHOICES LOOMING

The central government's budget deficit has more than doubled over the course of this year (11.9% of GDP in July, from 5.5% in January on a 12 months rolling basis). This increase reflects a sharp deterioration of the primary deficit (7.9% of GDP, from 1.1%) – as the interest burden has continued to fall over the period, dropping to 4% from 4.5% of GDP in January (*pro memoria*, the interest burden stood at 7.2% of

RECORD-BREAKING FISCAL DEFICITS

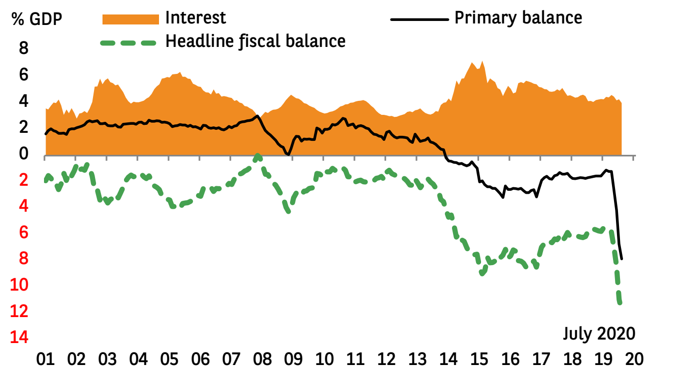

CHART 2 SOURCE: NATIONAL TREASURY, IBGE, BNP PARIBAS

GDP in January 2016). According to the IPEA's calculations, 70% of the increase in the central government's primary deficit relates to the increase in primary expenditure – the remainder being the result of a fall in revenues estimated at BRL 150 bn between January and July, representing some 2% of GDP. The budget deficit is likely to end the year at just over 17% of GDP, due in large part to the partial extension of the emergency aid programme through the end of the year[2]. The programme has helped President Bolsonaro witness a resurgence in popularity. This uptick could end up benefitting his government in the run-up to the municipal elections scheduled to take place later this year in November.

The negotiations over the 2021 budget (presented at the end of the summer) are likely to crystallise tensions between the executive and Congress over compliance of the constitutional spending cap[3]. Some parliamentarians are pushing for the abandonment or flexibilization of the fiscal rule. Adherence to the spending cap has also been a bone of contention within the executive, between supporters of fiscal discipline and those in favour of an increase in social spending[4] and public investment.

With a projected primary deficit of 3% of GDP, the proposed 2021 budget – in its current configuration – is in compliance with the spending cap but leaves practically no room for the government to support the economy through stimulus spending. In the coming months, the credibility of fiscal policy is likely to remain a hotly debated issue especially in light of the strong pressures exerted on the political class to maintain or further expand social safety nets.

On the reform front, the government has proposed to unify two federal consumption taxes (PIS and Cofins) into a single federal valued added tax. The executive has also presented its administrative reform, aimed at restructuring careers in the civil service and adjusting salary plans for civil servants. According to Minister of the Economy, Paulo Guedes, these reforms could generate savings of nearly BRL 300 bn over 10 years. However, the impact on public finances will only become visible over the medium term.

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2 The aid of BRL600 per person has been halved to BRL300; some 5 million Brazilians will also no longer qualify for the programme. Thus far, some 65 million people are estimated to have benefited from the programme, with an estimated cost of BRL45 bn or so. By way of comparison, the Bolsa Família programme cost BRL33 bn in 2019.
3 According to the cap, primary spending cannot increase faster than inflation. The fiscal rule, which was first introduced in 2016, was exceptionally suspended in 2020 as a result of the pandemic.
4 The President, for instance, wanted to introduce a new social programme, Renda Brasil, which was to take over from the emergency aid program at the end of 2020.