Brazil

Trying to build momentum

Despite a more challenging global environment and a deterioration in the country's external accounts, Brazil's economic recovery is gaining some traction on the back of a strengthening domestic demand. In 2020, GDP growth is forecast to improve but questions remain nonetheless regarding the economy's ability to build up and keep up momentum. The easing of monetary and financial conditions should help support the credit market but should continue to have a weakening impact on the currency. During his first year in office, President Jair Bolsonaro's losses in terms of approval ratings contrast with his government's notable gains on the public finance front.

Shifting gears?… not just yet but promising

Brazil's internal engines of growth are strengthening. In the third quarter of 2019, real GDP grew by a robust 2.5% (q/q) in seasonally adjusted annualized terms (saar) and by 1.2% year-on-year (y/y), even though net exports continued to act as a strong drag on growth.

The growth figure – which surprised most observers to the upside – benefited from (i) a sharp rebound in production in the mining sector (+57.4% q/q saar) and (ii) a salutary upturn in activity in the construction sector. Heavily affected by the crisis, the construction sector posted two successive quarters of growth for the first time since 2013. On the demand side, growth was driven by consumer spending (0.5 p.p) and investment (0.4 p.p) – the latter confirming its healthy progression observed in Q2. Meanwhile, public spending fell (-1.7% q/q saar) in line with the government's continuous fiscal adjustment. It is worth noting that a breakdown of economic activity by state and by region shows that growth tends to be more dynamic in areas where – on the supply side – public services make up a smaller share of local GDP. Regions where growth is less reliant on public sector spending are currently expanding at rates of 2.5% or more while their more dependent counterparts are growing by 0.5%. This observation supports the thesis that Brazil is undergoing a two-speed recovery which also raises questions about the evolution of regional inequalities over time if the gap does not close.

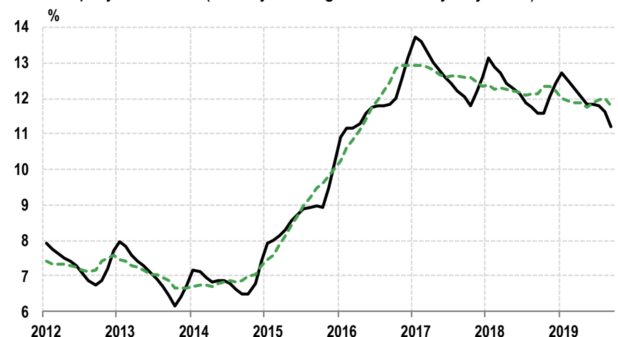
While the economy is showing more concrete signs of recovery, the latest available indicators do point to a slight deceleration of the economy in the last quarter of 2019. Indeed, if retail sales remained solid in November (+ 0.6% m/m, sa), posting yet another positive print since May 2019, services slowed down (-0.1% m/m) while industrial production fell again (-1.2% m/m) after three consecutive months of increase (driven in large part by mining giant Vale resuming production and Petrobras registering record petroleum output in Q3). It appears that industrial production may have suffered from a slowdown in the manufacturing sector (~11% of GDP). The manufacturing PMI – while still in expansion territory in December (50.2) – has indeed fallen since September (53.4) despite improving confidence indicators in the sector. Finally, while the Central Bank's IBC-Br index (a proxy for GDP) shows an expansion of economic activity in both October and November there is a noticeable slowdown in pace compared to the previous two months. Increased spending during the year-end holidays, the release of funds from FGTS accounts (cf EcoEmerging Q4 2019) and the relatively steady production in mining should nonetheless help contain the slowdown.

1- Forecasts

	2018	2019e	2020e	2021e
Real GDP growth (%)	1.3	1.0	2.0	3.0
Inflation (CPI, year average, %)	3.4	3.7	3.4	3.7
Fiscal balance / GDP (%)	-7.1	-6.0	-5.4	-5.7
Gross public debt / GDP (%)	77	77	80	81
Current account balance / GDP (%)	-2.2	-3.2	-3.5	-3.4
External debt / GDP (%)	36	38	42	45
Forex reserves (USD bn)	374	357	340	333
Forex reserves, in months of imports	18	17	17	16
Exchange rate USDBRL (year end)	3.9	4.0	4.0	3.8

e: BNP Paribas Group Economic Research estimates and forecasts
Note: The national statistical office, IBGE, has revised growth figures for 2017 and 2018 from 1.1% to 1.3% for both years.

2- Labour market



Source: IBGE, GSP

Monetary policy : the main lever of growth

In 2020, monetary policy will remain the main lever to stimulate economic activity. The easing cycle initiated in the summer (the SELIC has been cut by 200 basis points since August 2019) should help offset the unfavourable effects on growth of continued fiscal austerity and a less buoyant external environment. The lagged effects of monetary policy are indeed expected to manifest themselves more strongly over the next few quarters, and allow for a more vigorous expansion of credit. For the time being, credit growth continues to be driven by households (58% of total lending and 10.8% growth y/y in November), but there has been an uptick in

lending to businesses (2.5% y/y in November). Meanwhile, the gradual decline in unemployment (11.8% in seasonally adjusted terms in November, from 12.3% in January), the recent increase in formal employment and the rise in real wages (1.2% y/y in November) should help boost consumer spending, while the flattening of the yield curve through its effects on long term rates should help support investment.

External accounts : under pressure

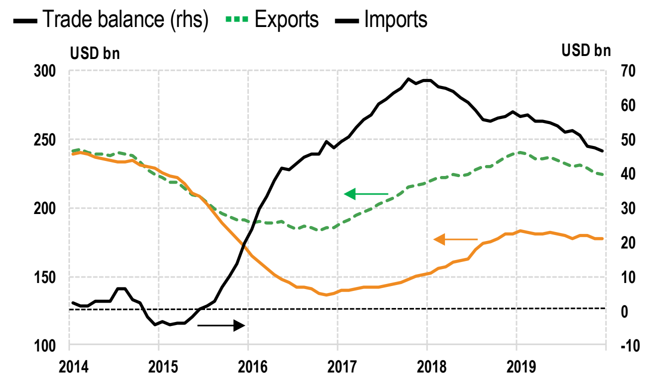
In 2019, the Central Bank of Brazil (BCB) made important methodological changes to the country's balance of payments statistics. Following the revisions, a somewhat darker picture of Brazil's external accounts has emerged. The current account deficit for 2018 rose from USD 15 bn (-0.8% of GDP) to USD 42 bn (-2.2% of GDP) due to a larger than expected deficit on the income balance (USD 19.6 bn). In 2019, the current account deficit widened further (-2.8% of GDP over 12 months in November) as a result of the sharp decline in the trade surplus which fell by 20%.

The trade balance suffered from a fall in the country's leading export, soybeans (-21% y/y), due to a drop in Chinese demand following an epidemic of swine flu. China - which absorbs around 80% of Brazilian soybean exports and uses the plant primarily as a source of animal feed – has in the intervening time stepped up its imports of Brazilian pork, beef and chicken. The resulting increase in meat exports combined with that of iron ores was however not sufficient to offset the decline in soybeans and petroleum exports as well as the sharp drop in vehicle sales (-27.5% y/y). In 2020, a less favorable external environment, marked by the deceleration of two of the country's main trading partners (China and the United States), should adversely weigh on Brazilian exports. In addition, the latter (i) should continue to suffer from the continued macroeconomic adjustment in Argentina (whose imports fell by USD 5.2 billion in 2019), and (ii) could end up benefitting only marginally from a weak BRL, according to a study by the IIF. [1]

Turning to the financial account, the flow of foreign direct investment (FDI) was also revised downwards (on the basis of new survey data) from USD 88 bn to USD 78 bn. In 2019, FDI held steady (USD 77 bn in the 12 months to November), but their composition changed: intercompany loans fell sharply (down USD 17 bn), whilst greenfield investments and other mergers and acquisitions increased (up USD16 billion). While net FDI continues to finance the current account deficit, the coverage ratio has shrunk (2.9% GDP in November vs 4% of GDP in 2018). Meanwhile, the net selling position of non-residents in portfolio investments has increased (USD 10.9 bn over 12 months in November 2019 compared to USD 6.4 bn at the end of 2018) in large part due to narrowing interest rate differentials with developed markets. Therefore, while the B3-Ibovespa stock market index gained 31% in 2019, the participation of foreign investors in the equity market dropped from 52% in 2018 to 44% in 2019. Non-resident holdings of sovereign debt in the local market also fell to a new low in November, at just 11.1%.

[1] *Weak currencies are failing to lift exports*, November 2019, Institute of International Finance.

3- Trade balance



Source: BCB

More generally, net FX outflows reached a record USD 44.8 bn over the year, helping to explain some of the downward pressure on the BRL. The currency, which hit a historic low against the dollar at 4.27, missed out on some upside towards the end of the year: first, the weak interest from foreign companies in the auctions of oil rights in Q4 limited FDI flows compared to what was initially expected. Meanwhile, companies with exports earnings held offshore accelerated the amortization of their liabilities to non-residents rather than repatriating the hard currency. To contain the pressures on the currency and reduce its volatility, the BCB sold USD 36.9 bn on the FX spot market in 2019. The USA – whose agricultural sector is in strong competition with Brazil – accused Brazil of "massive devaluation" and in response has since reinstated tariffs on imports of Brazilian steel (25%) and aluminium (10%).

Jair Bolsonaro: year 1

Jair Bolsonaro's first year in office as Brazil's President has been marked by a rapid deterioration of the head of state's image. President Bolsonaro's approval ratings have dropped to 30%, the lowest ever figure for a president during his first year in office. President Bolsonaro's government can nonetheless claim some important improvements in terms of the state of public finances. When finalized, the consolidated public sector's primary deficit for 2019 will be cut, in all likelihood, by at least 0.4 points of GDP compared to 2018 (-1.6% of GDP). Also, after carrying out an ambitious pension reform, additional fiscal measures were presented to Congress in early November (the so-called *Mais Brasil* plan) destined to stem the growth of mandatory spending, reform the public service, decentralize revenues in favour of regions, simplify the tax system and strengthen fiscal responsibility at all levels of government. As a result, the rating agency S&P raised its outlook on its sovereign debt rating (BB-) from stable to positive, suggesting that an upgrade for Brazil may be in the cards in the near future – the first time since 2011.

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