A DIFFICULT CALIBRATION OF THE POLICY MIX

Economic activity held up well in the first half of the year, but a slowdown in GDP growth is coming and expected to intensify over the second semester. The recovery of the labour market continues. However, the retreat of unemployment has come at the cost of a temporary drop in productivity. Inflation, which has registered double digits growth over the past nine months, is spreading more widely throughout the economy. Looking forward, monetary policy could be increasingly constrained by the announcement of new fiscal support. The latter coupled with the continued weakening of the main fiscal rule could weigh on risk premia and inflation expectations. The enthusiasm that prevailed earlier in the year for Brazilian assets is losing steam.

RESILIENT ECONOMIC ACTIVITY IN THE FIRST SEMESTER

Economic activity in Q1 held up better than expected considering the effects of the Omicron variant and the plunge in confidence. Real GDP increased by +1% q/q and +1.7% y/y. On the supply side, growth was driven by the service sector. Agriculture and livestock, on the other hand, experienced a decline in output in large parts due to the retreat of soybean and rice production. Output levels in industry virtually stagnated but showed some positive surprises. The manufacturing and construction sectors – despite being confronted with supply-side constraints and rising interest rates – managed to increase production ; these positive prints were however offset by the decline in output in the mining sector (third consecutive quarter of decline). On the expenditure side, external demand and household consumption were the main drivers of growth. On the other hand, investment fell sharply.

Available data for Q2 shows some signs of deceleration but overall depicts a story of continued economic resilience (expansion in April and May of the composite PMI, recovery in business confidence, progression of industrial production in May, resilient trade balance). This solid performance is in line with the positive developments in the labour market. Significant job creations in civil construction and more importantly in services have enabled unemployment to fall below the 10% mark in May (the lowest print since January 2016). The favourable dynamics in the labour market have however come alongside a temporary drop in labour productivity (value added has increased less than the addition of new workers to the economy). According to Bradesco, the good performance of the labour market could be explained by the fact that companies are taking advantage of the greater ease of hiring (a consequence of the labour reform of 2016) and the drop – since the pandemic – of unit labour costs in real terms, to allocate more workers than equipment to production.

Activity is expected to lose steam in the second half of the year (delayed effects of monetary policy, global deceleration, deterioration in Brazil's terms of trade despite the high level of agricultural commodity prices). The rise in Covid-19 cases and the risk of a diesel shortage (linked to global inventory problems) could also weigh on activity and household confidence – already shaken by the decline in purchasing power and the erosion of precautionary savings. However, these negative factors could be offset by restocking initiatives in industry and the government's latest stimulus efforts (income transfers and tax cuts).

FORECASTS

	2019	2020	2021	2022e	2023e
Real GDP growth, %	1.2	-3.9	4.6	1.5	0.0
Inflation, CPI, year average, %	3.7	3.2	8.3	11	7.1
Fiscal balance / GDP, %	-5.8	-13.2	-4.4	-7.0	-7.6
Gross public debt / GDP, %	74	88	82	80	82
Current account balance / GDP, %	-3.5	-1.7	-1.8	0.4	-0.8
External debt / GDP, %	37	45	43	40	38
Forex reserves, USD bn	357	356	362	356	350
Forex reserves, in months of imports	16	19	16	15	15

e: ESTIMATE & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

BRAZIL: CONTRIBUTIONS TO QUARTERLY GDP GROWTH

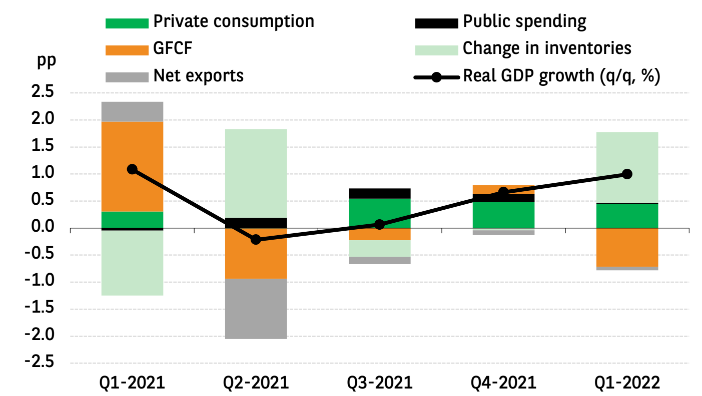

CHART 1 SOURCE: IBGE, BNP PARIBAS

INFLATION : THE POLICY-MIX PUT TO TEST

Inflation, despite a slight retreat in May, remains high (11.7% y/y) and continues to spread throughout the economy. The easing in the price of certain raw materials observed since the beginning of June and the tax cuts recently announced by the government could help to tame down the most volatile components of inflation in the short term[1]. However,

1 According to private sector estimates, government tax cuts could lower inflation by as much as 200 bps by the end of 2022. However, as these cuts expire in 2023, they are expected to have an inverse effect on the evolution of prices.

the process of disinflation is projected to be slow. It will be constrained by i/ generalized indexation practices, ii/ rising wage pressures in the private sector and iii/ the broad-based diffusion of price increases throughout the economy (72% of items in the consumer basket, excluding food items, saw their price increase in May, including in services which have experienced an acceleration in recent months).

Throughout the year and as the general election looms (October 2022), the authorities have become increasingly concerned with the rise in food insecurity and the threat of social tensions. Limited wage increases within the civil service[2] have already led to strikes (including within the Central Bank which halted the release of data and other reports several months ago). With that in mind, the authorities have unveiled several support packages. Measures (non-targeted at first), amouting to some BRL 150 bn (1.7% of GDP) were deployed in March to support households' purchasing power (e.g. authorization of early withdrawals from FGTS accounts – a severance indemnity fund for employees, early payment of certain retirement benefits, etc.). The government also announced a reduction in taxes linked to production (in particular to limit the rise in the price of imported inputs for the agricultural sector). The government more recently proposed tax cuts on fuel, electricity and telecommunications[3] (the cost of which is estimated at some BRL 17 bn, around 0.2% of GDP).

At the end of June, the authorities also proposed a string of new targeted initiatives destined to : i/ expand the list of beneficiaries of the *Auxilio Brasil* program (formerly *Bolsa Familia*) by some 1.6 million people as well as increase monthly transfers by 50% to BRL 600 per month, ii/ allow the elderly to benefit from free transportation, and iii/ increase once again the value of aid provided to truck drivers[4]. The cost of the support package is estimated at some BRL 40 bn (0.45% of GDP). But it could swell further as Congress has already proposed additional transfers for taxis and small farmers. The operation is expected to be financed primarily through privatization receipts linked to the sale of Electrobras as well as the payment of dividends by Petrobras. To enact the spending though, the government needs to first get approval of its constitutional amendment in Congress. This would allow to exclude the new expenditures from the spending cap — the country's main fiscal rule. The proliferation of fiscal measures (some of which are permanent) coupled with the erosion of the budgetary institutional framework (e.g. revision of the rules for calculating the spending cap in 2021, submission of recent constitutional amendment on the basis of a "state of emergency") could eventually weigh on financing conditions through a rise in real long rates (the latter are already almost twice as high as they were following the vote of the pension reform at the end of 2019).

The recently announced fiscal support package could impact the Central Bank (BCB)'s decision to tamper its actions going forward. In its last meeting in June, the BCB started slowing down the pace of monetary tightening. It raised its key rate (Selic) by 50 basis points (bps) to 13.25%. Since it started its hiking cycle, it was its first rise below the 75 bps mark (in 11 meetings). The tightening is expected to continue in the short term but the current situation could force the BCB to maintain its key rate at a high level for longer than initially expected. It is as least likely to do so, as long as inflation expectations for 2024 do not converge towards the target (3%).

BRAZIL: USD/BRL AND STOCK MARKET

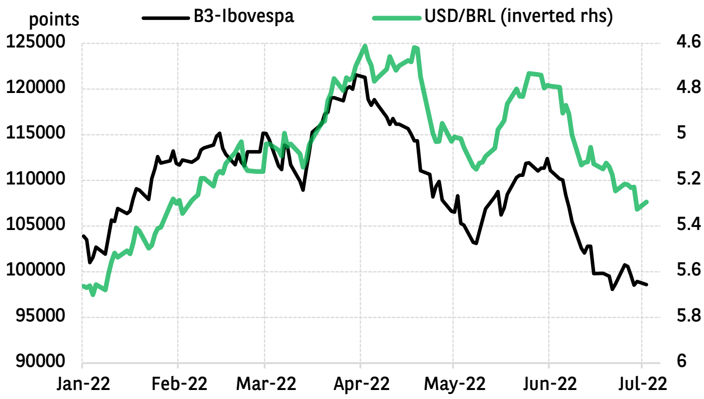

CHART 2 SOURCE: MACROBOND

COOLER WINDGUSTS ACROSS MARKETS

The collateral impact of US monetary tightening on capital flows has not spared Brazil. Despite the relative attractiveness of the Brazilian market (appealing valuations in the equity market, prime candidate for carry trade, undervaluation of the BRL, relative decline in sovereign risk, low current account deficit), the country has been subject – like many other emerging markets – to capital outflows since April. In early July, the main stock market index fell below its level from January (-5%). In a context of rising interest rates and increased risk aversion, many local investors have been turning their attention to less risky but still attractive asset classes (such as local government bonds). The real (which had outperformed its emerging market peers with gains of nearly 23% since the start of the year) has also weakened since late April. Markets at the moment seem less concerned with the October general election. However, this situation is likely to change as the month of August rolls around (start of televised debates, use of television advertisements, circulation of electoral programs). At that point, Brazilian assets are likely to reflect more closely the projected management of public finances over the next mandate.

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2 The law prohibits the government from granting wage increases higher than inflation in an election year.
3 Suspension until the end of the year of federal taxes (PIS, Cofins, Cide) on gasoline and ethanol. The Federal State would also reimburse the States for the loss of income associated with capping the rate of the value-added tax (ICMS) (which is normally at the discretion of the States) linked to so-called essential products and services such as gas for cooking, diesel or transportation.
4 Up to BRL 1000 per month. 750,000 truck drivers had already benefited since October 2021 from aid worth BRL 400. Since the national trucker strike in 2018, the price of diesel has more than doubled.