BRAZIL

A FRAGILE OUTLOOK DOMINATED BY CONCERNS OVER THE EPIDEMIC AND FISCAL WOES

An active economic policy has helped attenuate the magnitude of the recessionary shock in 2020. The recovery in Q3 was vigorous and was prolonged into Q4. However, the economy showed signs of slowing down towards year-end. Brazil's external vulnerability did not deteriorate despite high volatility of both portfolio and direct investments as well as a sharp depreciation of the real in 2020. In 2021, the economy will benefit from the recovery in commodity prices and the maintenance of accommodative measures on the monetary side. However, the resurgence of the Covid-19 epidemic coupled with delays in rolling out vaccinations as well as uncertainty regarding the fiscal consolidation process and the lack of progress on reforms are likely to be sources of stress in financial markets and potential destabilising forces for the recovery.

RE-ACCELERATION OF THE EPIDEMIC, DELAYED VACCINATIONS

The Covid-19 epidemic – after slowing down between late July and early November – accelerated again over the past two months or so. The number of daily confirmed cases reached a peak in mid-December at more than 70,000 cases and averaged over 49,000 cases before year-end festivities (from around 14,000 cases on average at the beginning of November)[1]. Meanwhile, the average number of daily deaths more than doubled over the same period (to over 700 deaths). At the beginning of January, Brazil accounted for around 10% of confirmed cases and deaths worldwide (at around 8 million and more than 200,000 respectively) and remains the second most death-stricken country after the United States.

This second wave was however not accompanied by new restrictive measures[2]. There has also been no evidence of increased social distancing. In fact, prior to the holidays, Google Mobility data showed a tendency for Brazilians' movements to normalize rather than to adjust to the renewed acceleration of the epidemic. Data from Datafolha surveys corroborated this trend showing that social isolation had reached new lows since the beginning of the pandemic.

Constrained by logistical and regulatory obstacles, Brazil's vaccination plan has so far lagged behind that of other countries in the region (e.g. Argentina, Chile, Costa Rica and Mexico.) The start of the vaccination campaign has been constrained by delays in approving the 4 vaccines currently under consideration by the regulator (Sinovac, AstraZeneca, Pfizer and Janssen). The authorities are planning to immunize just under a quarter of the population by June 2021 (i.e. 51 million people). But the issue of vaccination has become highly politicized with the President himself indicating that he will not get vaccinated. This decision could fuel a reluctance to receive the vaccine (which could affect as much as 25% of the population according to some surveys).

The spread of the epidemic, the greater transmissibility of certain variants of the virus, the lack of new measures to contain the mobility of people and delays in rolling out the national vaccination campaign are all factors which risk holding back the recovery.

FORECASTS

	2019	2020e	2021e	2022e
Real GDP growth (%)	1.4	-4.3	3.0	3.0
Inflation (CPI, year average, %)	3.7	3.2	5.1	3.1
Fiscal balance / GDP (%)	-5.9	-15.0	-7.3	-7.1
Gross public debt / GDP (%)	76	91	91	92
Current account balance / GDP (%)	-2.8	-0.3	-1.0	-1.6
External debt / GDP (%)	37	43	41	39
Forex reserves (USD bn)	357	356	350	346
Forex reserves, in months of imports	17	21	19	18
Exchange rate USDBRL (year end)	4.0	5.2	4.3	4.2

e: ESTIMATE & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

REBOUND IN THE EPIDEMIC (7-DAY MOVING AVERAGE)

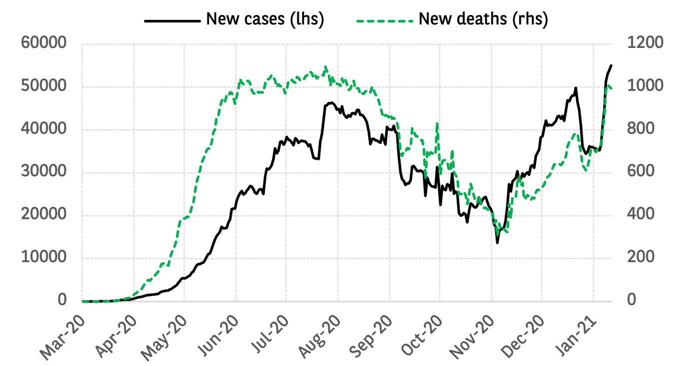

CHART 1 SOURCE : JOHN HOPKINS CSSE COVID-19 DATA

2020: THE ECONOMY REBOUNDS DURING THE SECOND SEMESTER…

The recovery in economic activity in Q3 was vigorous but not sufficient to offset the losses registered in Q2. The easing of containment measures, income-compensation policies, and the restart of production in many sectors allowed real GDP to rebound by 7.7% in Q3 (following a 9.6% contraction in Q2). Production volumes remained nonetheless 3.9% below their Q3 2019 levels.

Through November, monthly indicators continued to improve in industry and retail - two sectors which by August had already returned to their pre-pandemic (February) level of activity. In November, industrial production posted its seventh consecutive month of increase, helped by improved activity in real estate (in Sao Paulo in particular) and the good performance of retail sales (supported by the government's emergency aid programme). The reais' depreciation (-23% in 2020) also allowed for a greater share of domestic demand for industrial goods to

1 The big drop in cases registered over the holidays was solely due to a statistical artifact caused by a reduction in the number of tests carried out during this period.
2 With a few exceptions (e.g. the States of Sao Paulo and Amazonas). However, restrictions were limited and had only marginal effects on mobility.

be satisfied by internal production. Activity in services has also continued to improve in October but was still 6% lower than in February.

The balance of payments faced drastic adjustments – however, without leading to a weakening of the country's external vulnerability. The trade surplus strengthened in 2020 (+7% y/y), helped by (i) a nearly 10% slowdown in imports and (ii) the strength of Asian demand, which – by absorbing half of sales – helped to contain the decline of exports (-6% y/y). On the financial account, portfolio investment flows by non-residents resumed along with the economic recovery but were insufficient to compensate for the losses incurred over the first half of the year (USD 12 bn in net outflows from January to November). Foreign direct investment (FDI) also slowed down sharply (-49.6% y/y over period from January to November). However, net FDI flows have continued to comfortably cover the current account deficit, which – over the year – narrowed by around 2 percentage points of GDP. In addition, the country still has a very satisfactory external liquidity position relative to its imports and external liabilities.

… BUT SHOWS SOME WEAKENING SIGNS TOWARDS YEAR-END

The economy has nevertheless shown some signs of slowing down that have been concomitant with the resurgence of the epidemic and the acceleration of inflation (+4.3% y/y in November, the largest increase in 18 months.) The loss of momentum is most visible in PMI data, which showed either slower (manufacturing) or almost stable (services) rates of expansion towards year-end. There has also been a drop in vehicles sales in December (a first since April). Meanwhile some confidence indicators (households, construction and services) have yet to rebound since declining in October.

Despite year-end dynamics on both the economic and epidemic fronts, the equity market rebounded quite strongly in 2020. After hitting record highs in January, the equity market then lost 50% of its value in March before ending the year on a 3% gain. The year also ended with a record number of initial public offerings (26 IPOs and nearly USD 8 bn in funds raised – the highest level since 2007). Cyclical and structural factors help explain this bounce-back: liquidity injections at the global level, the development of vaccines, the increase in the number of local retail investors (which has more than quadrupled since December 2018, facilitated by the development of online brokers), and the large drop in the SELIC policy rate, which has encouraged the reallocation of portfolio investments into equities. A rather moderate economic growth outlook could spur some corrective adjustments in 2021.

2021: AN OUTLOOK CONTINGENT ON FISCAL DEVELOPMENTS

Economic growth in 2021 will benefit from a large carry-over effect (at least 2.5 percentage points). Production levels last seen towards the end of 2019 are not expected to materialize until mid-2022. Growth, but also inequality and poverty, are likely to be affected by the end of emergency aid payments, high unemployment (14.3% in October) and the absence of a fiscal stimulus plan. Growth will also suffer from the end of tax breaks and could be further penalized by a slower-than-expected execution of the immunization program. On the other hand, the economy should benefit from the recovery of commodity prices and the maintenance of monetary measures (key rate at an all-time low, reduction in liquidity and capital requirements for banks, etc.). Meanwhile, the renewal of the government's public guarantee program, intended to support small and micro-enterprises, should help support firms' cash flow. These measures have already fuelled the strong rebound in corporate credit (+18.2% y/y in real terms).

STRONG REBOUND IN CORPORATE CREDIT (NOMINAL GROWTH %, Y/Y)

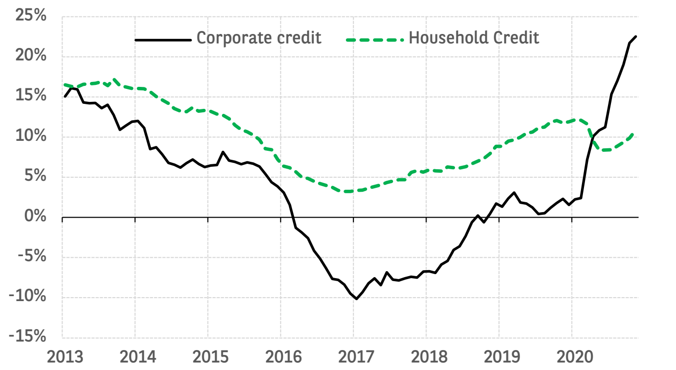

CHART 2

SOURCE: BCB

Finally, the new privatization and concession program, unveiled by the government (115 state assets targeted in 2021, including 22 airports and the 5G network), could support capital expenditure – provided of course that investors' appetite resumes rapidly.

Discussions over the design of the country's fiscal rules and whether or not they will be upheld are likely to dominate headlines in 2021. Despite a better than expected central government result in the last few months of the year (emergency aid payments being cut by half, reduction in the number of beneficiaries from 68 to 56 million, improvement in tax collection, resumption of activity, retention of certain discretionary expenditures) the budget deficit has soared to unprecedented levels and so has the level of debt. Further, the debt's average maturity has shortened and concerns over its sustainability have increased.

In 2021, maintaining fiscal policy credibility will be a key determinant for the performance of the reais, the evolution of capital flows and the yield curve. This may have important implications for the Treasury who will have substantial debt payments to rollover (around 25% of the debt stock falls due over the next 12 months). For the time being, the budget (presented at the end of the summer) has still not been approved and is unlikely to be so until February, after the end of the parliamentary recess[3]. Some governors in the country's northern states have called for an extension to the state of emergency (which suspends fiscal control mechanisms) for at least the first half of 2021. The local press reports that some members of the government would be favourable to such a development, particularly if the second wave of the epidemic does not abate.

In 2021, the Bolsonaro presidency will lose an ideological ally in the White House. The Biden administration – in its effort to strengthen the US' involvement in international fora especially on the environment – could challenge the Brazilian government over issues related to deforestation in the Amazon. In February, the elections to pick new Presidents for the Senate and the Chamber of Deputies will also have a key impact on reform progress (at this stage, no significant reform bills are close to being approved). On a positive note, the municipal elections in November showed stronger voter support for parties at the centre to the detriment of the extremes.

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3 Congress nevertheless passed a Budget Orientation Act, which allows public spending to continue in the early months of 2021, pending final approval of the budget.