BRAZIL

AN INCREASINGLY PREOCCUPYING SITUATION

The health crisis continues to worsen – undermining the economy to a point of entertaining a recessionary risk in the first half of 2021. In this context, confidence has plummeted and financial markets have retreated. The vaccination campaign – after facing significant logistical challenges – has finally begun to accelerate since mid-March and with the concomitant introduction of new restrictive measures, the hope is that the epidemic curve will reach an inflection point over the next two months. Faced with rising inflation and inflation expectations, the Central Bank launched its monetary tightening cycle, which – against a backdrop of slowing economic activity and a high sovereign interest burden – has exacerbated budgetary pressures and risks. Although weakened by the crisis, financial soundness indicators of the banking sector remain very favourable.

COVID-19: A CRITICAL SITUATION…

Confronted with the spread of the P1 variant of the coronavirus (emanating from the Amazon region) while simultaneously dealing with shortages of drugs and oxygen – Brazil has been experiencing its darkest hour of the pandemic so far. The epidemic continues to accelerate in most regions with the exception of a few states in the South where the situation has stabilized. The variant, which is between 1.4 and 2.2 times more contagious – is responsible for the majority of new cases and is increasingly affecting younger people (over 30% are under the age of 60). The mortality rate has doubled in a month to such extent that at the end of March, Brazil accounted for a quarter of new deaths worldwide. In 17 of the 26 states, the occupancy rate of intensive care units is higher than 90% including three states which no longer have any beds available. Recent studies show that the variant could be resistant to antibodies produced by (a) previous infections and (b) certain vaccines – thereby facilitating reinfections.

The deployment of vaccines – launched in mid-January – has so far been insufficient to slow the progression of the epidemic. At the end of March 8.5% of the population had received a first dose of a vaccine (about 2% had received two doses). Faced with vaccine shortages, several states have had to halt their vaccination campaign (including Rio de Janeiro). Since mid-March however, the pace of vaccinations has accelerated and is expected to ramp up in April as more doses become available (Brazil has called upon virtually all vaccine suppliers for doses and federal authorities have authorized local governments and private companies to place orders). Assuming the pace of vaccinations holds at some 600,000 shots per day and lockdown restrictions, recently imposed by local officials, are effective (including curfews, the closing of non-essential businesses, moving up school holidays) – the epidemic could reach an inflection point towards the end of May. Brazil is still aiming to vaccinate at least half of its population by the end of 2021.

…WITH POTENTIALLY HIGH POLITICAL STAKES

Faced with an increasingly dire health situation, rising inflation and the return on the political scene of former President Lula (2003-2011), President Bolsonaro has come under increased pressure and his popularity – once bolstered by a generous emergency aid package in the wake of the first epidemic wave – is eroding, even within parts of his own political base. Also, the decision in February by the Republic's Public Prosecutor to dismantle the anti-corruption operation *Lava Jato* (which sent Lula to prison), and the annulment of the former President's sentence[1] by a judge of the Supreme Court have revived speculations about a possible electoral battle between the two men in 2022.

FORECASTS

	2019	2020e	2021e	2022e
Real GDP growth (%)	1.4	-4.3	2.5	3.0
Inflation (CPI, year average, %)	3.7	3.2	6.5	4.0
Fiscal balance / GDP (%)	-5.8	-13.2	-9.4	-8.2
Gross public debt / GDP (%)	74	89	91	94
Current account balance / GDP (%)	-2.7	-0.9	-0.4	-1.9
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

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

DAILY COVID-19 VACCINATIONS

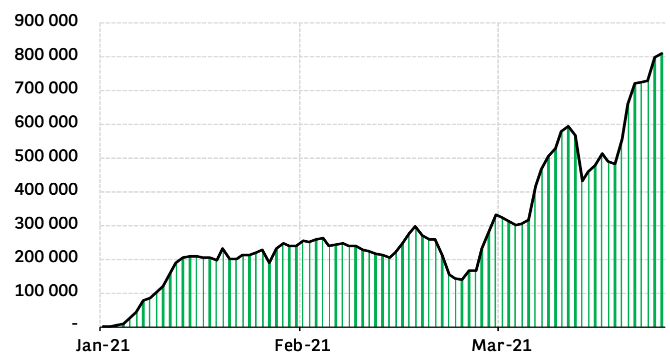


CHART 1 SOURCE: OWID

HEADING TOWARDS A CONTRACTION OF GDP IN Q1… AND Q2

Undermined by the worsening dynamics of the epidemic and the withdrawal of fiscal support measures, activity indicators in Q1 have lost steam and are pointing to a likely contraction of sequential GDP in the first quarter. January's resilient performance proved to be short-lived as industrial production reversed in February (-0.7% m/m) – contracting for the first time in 10 months driven by lower automotive and mining production. According to March PMI indices, activity conti-

1 Lula was however not exonerated and will be judged by a Federal court in Brasilia deemed "more competent" to examine the four existing cases against the former President.

nued to contract in the services sector for the third consecutive month, and manufacturing production also declined. On the demand side, the expiration of emergency support measures reduced the consumption capacity of households. Lastly, despite the depreciation of the BRL and large improvements in the country's terms of trade, net exports will likely make a more modest contribution to growth than originally anticipated owing to the faster increase in imports (largely due to purchases of oil rigs by Petrobras). As such, the Q1 trade surplus (USD 1.65 bn) was two times smaller than market forecasts.

The short-term outlook has also weakened and there is an increasing risk that the economy could experience a technical recession in H1. Granted, household consumption will get a boost from a new round of emergency aid voted in March, but the package will be much more limited in terms of size and reach. Also, rising inflation and plummeting household confidence (-10 points in March) point to increased caution on the part of consumers. On the supply side, although agriculture should continue to be resilient, the services sector will suffer from recently imposed mobility restrictions. Several factors are also likely to undermine industrial activity, including (i) slowing production in the manufacturing sector as new orders have declined, (ii) the likely continued slowdown in civil construction seen since January, and (iii) the temporary suspension of production by seven big automotive manufacturers in April. The automotive sector, which saw its sales collapse in 2020 (-21.6%), was also marked by the shut down in January of three Ford production plants – the company having decided to pull out of the Brazilian market. Economic prospects should be more favourable in the second half of the year (wider rollout of vaccinations, stronger global growth). The extension in time of lockdown restrictions will remain an important downside risk to growth (according to the Independent Fiscal Institute, when 50% of activity is paralysed, GDP falls by about 1 percentage point).

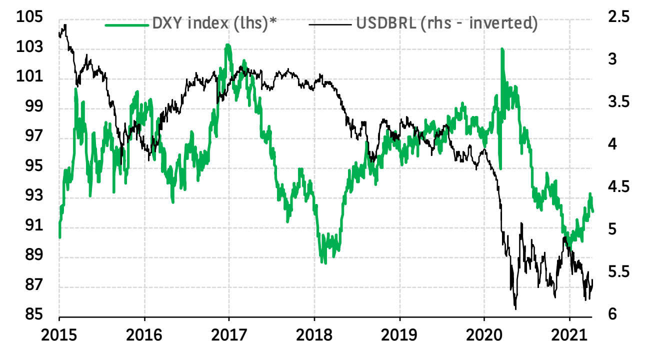
The weakness in the stock market (-6%) and the currency (~10%) witnessed since the beginning of the year are symptomatic of the concerns hovering over the economy. Such retreats are also a reflection of a rise in political risks due to (i) fears of greater state interventionism (the appointment by Bolsonaro of an army reserve general at the head of Petrobras has temporarily caused the oil giant's stock price to lose 20%), but also (ii) concerns over a rise in populism with increased risks of fiscal slippage. The market's perception of increased sovereign risk (the 5-year CDS has increased from 145 bps to 224 bps since January, while sovereign risk premia on 10-year yields are close to their 2015 peak) – has materialized just as BRL 350 bn (4.7% of GDP) of sovereign bond debt matures in April – a record.

MONETARY TIGHTENING CYCLE AND FISCAL PRESSURE POINTS

The faster-than-expected rise in the IPCA consumer price index (+5.2%, in February, driven by higher transportation costs in particular), has prompted the Brazilian Central Bank (BCB) to lift its policy rate in March – a first in 6 years. The 75 bps hike in the SELIC (previously held at 2% since August 2020) is the first of several tightening actions aimed at normalizing monetary conditions in the economy. The BCB foresees inflation at 5% at the end of the year, close to the upper range of its target (3.75%, +/- 1.5 pp).

The BCB wants to avoid a de-anchoring of inflation expectations in a context of the continued weakness of the BRL, rising commodity prices and higher risk premia –driven by increased fiscal uncertainty. The hike in rates also comes at a time when investors' appetite for emerging markets assets is somewhat waning with the rise in real terms of long

USD BRL VS TRADE-WEIGHTED DOLLAR INDEX



*A rise in the index indicates an appreciation of the USD

CHART 2

SOURCE: MACROBOND

rates in the US. The appreciation of the US dollar that it sustains could indeed incur a greater inflationary risk by increasing the price of imports. However, as the epidemic escalates and the economy slows down, rising rates represent an additional source of fiscal risk. A one percentage point (pp) increase in the SELIC represents an additional interest charge of about BRL 30 bn to 35 bn for the Treasury amounting to about 2/3rd of the emergency aid approved in March. This comes at a time when pressures on the spending cap have been mounting, culminating in a deadlock between congressional leaders and the government over final approval of the budget. The government's manoeuvring room to increase –already quite limited– discretionary spending (about 5% of the budget) will likely be even tighter this year[2].

BANKING SECTOR: STRONG RESILIENCE

In 2021, as repayments on loans (restructured during the crisis) progressively come due, banks will witness an increase in non-performing loans. A weaker repayment capacity on behalf of both households and corporates will in part drive this process. Household debt has risen and so has unemployment (14.7% s.a, in January); the labour market participation rate declined by some 5.1 pp in 2020 while the real wage bill continued to contract early in 2021 – pushing household debt service ratios to rise rapidly. Corporates – which have now experienced their third recession over the past 6 years – also report higher debt ratios. However, thanks to higher precautionary savings and emergency credit support programmes (Pronampe, PEAC), they exhibit better liquidity ratios, notably with respect to short-term debt.

Banks – despite experiencing sharp falls in profits and ROE– are still well positioned to absorb losses on their balance sheet as well as handle liquidity shocks. The banking system displays (i) high capital adequacy ratios (regulatory capital to risk-weighted assets of 16.7%) (ii) very good coverage of short-term liabilities by liquid assets (iii) low dependence on market financing, with a loan-to-deposit ratio of more than 90% (iv) relatively low non-performing loans ratios (90-day delinquencies have oscillated between 3% and 4% over the past five years) and (v) banks' balance sheets tend to have little exposure to currency risk. Even if they have declined, banks' intermediation margins remain high (interest rate spreads of 15.6 pp). Finally, the BCB's stress tests also demonstrate a good resistance of banks' portfolios to a rise in interest rates.

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2 The Treasury and the Independent Fiscal Institute noted that the budget approved by Congress in March significantly underestimated mandatory spending. Once adjusted, this will lead to a further decline in discretionary spending (the budget in its current form would otherwise break the spending cap, the Federation's main fiscal rule).