BRAZIL

A RECOVERY IN LOSS OF MOMENTUM

Despite the acceleration of the vaccination campaign, the anticipated rebound of growth in H2 2021 did not materialize. Instead, the economy fell into a recession in Q3 while available indicators for Q4 continued to show signs of weakness. Meanwhile, binding aspects of the spending cap have been called into question translating into an increased defiance of the market towards the sovereign. As the general election looms (October), economic prospects are expected to be very mild. Uncertainties regarding the evolution of the epidemic, the electoral cycle, the fiscal trajectory, the persistence of inflation and the tightening of monetary and financial conditions are all expected to act as potential brakes on the recovery.

RETREAT OF ECONOMIC ACTIVITY

Despite the acceleration of the vaccination campaign[1] the normalisation of activity in the service sector, and the retreat in unemployment, economic activity in Q3 recorded a decline for the second consecutive quarter, thereby plunging the Brazilian economy into a recession (-0.1% q/q in Q3 after -0.4% q/q in Q2). The decline in real GDP in Q3 has been driven by the fall in agricultural output (-8% q/q) due to i/ climate-related problems affecting the coffee, cotton, orange and sugar industries, but also due to ii/ the suspension of beef production following cases of mad cow disease. The progression of activity in both services and construction was not enough to offset the fall in production in the mining and manufacturing sectors.

The persistent pressures faced by the industrial sector (input shortages, high costs[2]) combined with weak data prints in the last few months of the year (fall in the Central Bank's advanced GDP proxy in October, drop in confidence indicators, slowdown in activity in services and the manufacturing sectors) raise fears that GDP in Q4 may have stagnated. The tightening of monetary policy (rise of 725 basis points in the SELIC rate between March and December 2021) in response to the acceleration of inflation (10.7% y/y in November, i.e. more than 8 points in one year) has concurrently led to a slowdown in real credit[3]. The stock market, which turned in June, continued its decline in the second half of the year, ultimately losing 11.9% of its value in 2021.

A GOOD RESILIENCE OF EXTERNAL ACCOUNTS

In 2021, the weakness of internal demand contrasted with the good performance of external accounts thanks to the improvement in the terms of trade and the weakness of the real effective exchange rate. The current account stabilised at a moderate level (1.9% of GDP over 12 months in November) thanks to a record trade surplus (USD 61 bn), driven by the solid performance of exports of iron ore, soybeans and crude oil)[4]. At the same time, portfolio investment flows from non-residents has returned into positive territory for the first time since the beginning of 2018 (cumulative USD 32.1 bn over 12 months in November), driven by the rise in interest rates and the increase in debt issuances in the local market. Meanwhile, external vulnerability did not deteriorate: external financing needs (current account and external debt amortization) remained in large part covered by net FDI flows, limiting the increase in external debt[5]. Official foreign exchange reserves consolidated at a high USD 362 bn.

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth (%)	1.4	-3.9	4.5	0.3	2.0
Inflation (CPI, year average, %)	3.7	3.2	8.3	7.4	4.2
Fiscal balance / GDP (%)	-5.8	-13.2	-4.9	-8.0	-7.4
Gross public debt / GDP (%)	74	89	80	81	84
Current account balance / GDP (%)	-2.7	-0.5	-1.7	-2.1	-2.5
External debt / GDP (%)	37	45	42	44	44
Forex reserves (USD bn)	357	356	362	356	350
Forex reserves, in months of imports	16	19	16	15	15

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

CONFIDENCE INDICATORS

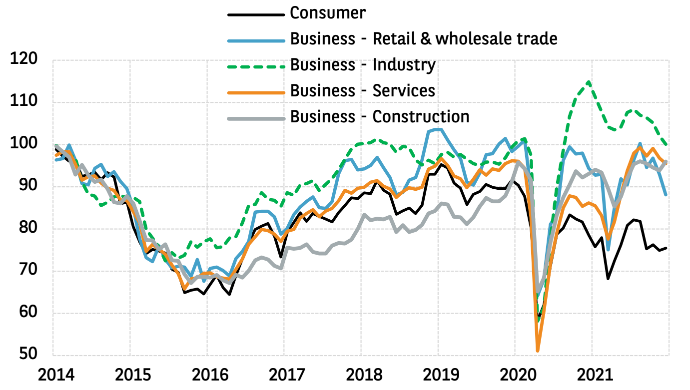

CHART 1

SOURCE: FGV, BNP PARIBAS

The BCB intervened in the FX spot market to the tune of USD 12 bn and expanded its portfolio of *cambial* swaps by nearly USD 25 bn to smooth out the volatility of the real[6] and meet the growing demand for FX hedging.

1 In early January: 78% had received a first vaccine dose, 67% were fully vaccinated and 10% had received a booster
2 The producer price index, IPA-IGP-M, although in retreat, remained at nearly 20% (y/y) in December
3 Nominal credit growth remained stable at around 15% over the year but slowed in real terms (4.9% y/y in November vs 11.3% in January)
4 For exports, the price effect dominated the volume effect (+28.3% vs. +3.5% respectively) and vice versa for imports (+14.2% vs. +21.8%)
5 The rollover rate on medium-long term external debt was 128% from January to November
6 The BRL lost 6.8% in 2021 against the dollar after falling 22.6% in 2020

The promulgation of a new law (which will enter into force in December 2022) authorising the opening of accounts in foreign currency in Brazil (and in real abroad) is expected to help enhance liquidity in the spot market and simplify capital movements abroad.

THE CREDIBILITY OF THE FISCAL RULE CALLED INTO QUESTION

Despite the improvement in the primary fiscal balance[7] and the decline in liquidity risk, the market has manifested increased concerns over the fiscal trajectory[8] as multiple developments over the past year contributed to weaken the spending cap[9] – the country's main fiscal anchor : i/ extension in March of emergency support up to 1.4% of GDP (not subject to the spending cap), ii/ change in November of the rule for calculating the spending cap[10], and iii/ suspension of parts of the payments due to honour *precatorios*[11] in order to accommodate an increase of BRL 89 billion (0.7% of GDP) in social spending in the 2022 budget (as part of the government's new social program, *Auxilio Brasil*). The markets are also worried about the rise in the cost of debt, the rise in the SELIC, inflation and long rates having led in 2021 to a rise of nearly 2 points of the implicit interest rate on the public debt. Added to this is the fear of a fall in tax revenues resulting from the anticipated economic slowdown in 2022. The institutional mechanisms governing fiscal policy should continue to fuel market concerns, with the current government making no secret of its desire to make the spending cap more flexible, if re-elected, while Lula would not be opposed to dropping it altogether.

OUTLOOK FOR 2022: MULTIPLE BRAKES CONSTRAINING GROWTH

Growth prospects are projected to be very mild in 2022 (+0.3%) given a still very uncertain macroeconomic and political backdrop (the country has been under the threat of the Omicron[12] variant for a few weeks now and the general elections are looming in October). This projection reflects the many constraints weighing on domestic demand: despite the deployment of social aid as part of the government's new social program[13], private consumption is expected to be held back by the decline in the purchasing power of wages, the increase in household debt and the new rate hikes planned in 2022. Election rules will also limit the increase in government spending. The tightening of monetary policy and electoral uncertainties are meanwhile expected to weigh on investment. External demand will, at the same time, be held back by the slowdown in China, the United States and Europe (the country's main trading partners). The possibility of a drought (as in 2021), and inflation-related strikes represent downside risks that cannot rule out a recessionary scenario.[14]

Inflation should decelerate somewhat due to i/ the normalisation of electricity prices (with the reduction in the risk of rationing), ii/ monetary tightening[15], iii/ weak domestic demand.

CENTRAL GOVERNMENT BALANCE AND DEBT RATIO (12-MONTH ROLLING SUM)

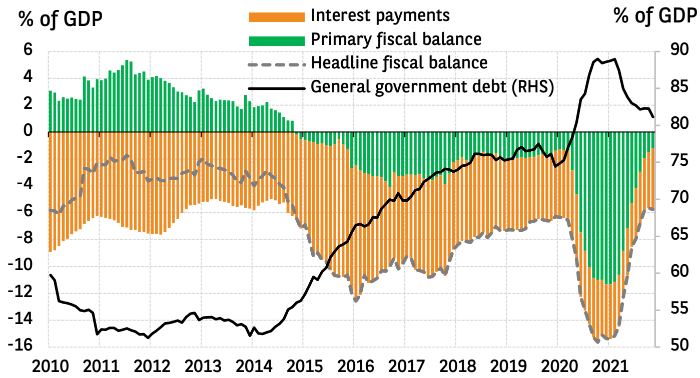

CHART 2 SOURCE: NATIONAL TREASURY, BCB, BNP PARIBAS

The 10% increase in the minimum wage in January could, however, maintain the rise in prices in the service sector. The food component of inflation should become an increasingly salient electoral issue due to its weight in households' budgets (approximately 25%).

Despite the overall expected slowdown, some sectors should fare better. Automotive production could increase by almost 10% according to the association of car manufacturers Anfavea (the lack of microprocessors resulted in approximately 300,000 vehicles not being produced in 2021). Certain services segments such as tourism, care and events should see a rebound with the increase in vaccination. The energy and infrastructure sectors should benefit from the several planned auctions destined to offer concessions across multiple areas (solar, wind, thermal projects as well as 12 ports, 7 highways, 4 airports and 1 railway for an estimated total amount of BRL 116 bn). This however will be contingent on foreign investors' appetite not being adversely affected by the general election.

The start of the election cycle means that some major proposals currently evaluated in Congress such as i/ the tax reform (designed to simplify taxation by unifying federal taxes and reduce the tax burden on companies) as well as ii/ the public administrative reform (aimed at improving the efficiency of public spending, containing the wage bill and easing hiring/firing rules in the public sector) will have a reduced chance of seeing the day of light. Political risks coupled with the anticipated rise in interest rates in some developed markets will, meanwhile, further fuel market volatility.

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7 The primary balance fell from a deficit of -9.9% of GDP at the end of 2020 to -1.1% of GDP in November 2021. At the same time, public debt fell from 88% of GDP to 81.1% of GDP.
8 The 5-year CDS and the EMBI+ increased by 60 and 66 basis points respectively over the year to stand at some 205 bps and 326 bps respectively at the end of December
9 The increase of primary spending is limited to the inflation of the previous year
10 Taking into account December inflation (+10.06%) rather than that of June (+8.35%)
11 Court-ordered mandates requiring the federal government to pay damages following lawsuits (disputes over pensions, wages, housing, disability or death benefits, expropriations, etc.)
12 60% of new infections in early January vs 40% for the Delta variant
13 *Auxilio Brasil* will expand coverage of low-income households to 17 million families (compared to 14.6 million for *Bolsa Familia*) reaching approximately 50 million Brazilians. The payment of at least BRL400 will be paid for each eligible family until December 2022.
14 The slight inversion of the yield curve (1-year yields are higher than 10-year yields) already signals market concerns over a potential recession.
15 A 100 bps rise in the SELIC drives the IPCA down 30 bps in one year according to BCB models