Brazil

On a slippery slope

The Brazilian economy has hit a wall. Real GDP contracted in the first quarter and signs of weaknesses are accumulating: investment and exports have retracted, while consumer spending – despite being supported by credit – has slowed down. Business and consumer confidence have been hit by the slow progress of the reform agenda as well as the government's increasingly tarnished image. In a context marked by fears of recession, growth forecasts have been largely adjusted downwards. On a positive note, the Lower House approved the main text of the pension reform bill after a first round of voting. A final and second vote to approve amendments to the bill is expected to take place shortly. The bill is due for analysis in the Senate by August.

Cyclical air pocket

The slowdown of the Brazilian economy witnessed towards the end of 2018 has given way to a contraction of economic activity in Q1 2019 for the first time since Q4 2016. In seasonally adjusted terms, real GDP shrank by 0.2% q/q while it more than halved on a sequential year-over-year basis (0.4% in Q1 2019 vs 1.1% in Q4 2018).

On the demand side, this contraction was due to a fall in investment (-1.7% q/q) and a negative contribution of net exports (-0.4 pp). Consumer spending provided the main support to growth although it has slowed down over the past two quarters. The trade balance suffered particularly from a fall in mining exports as well as from the economic slowdown in Argentina (Brazil's 3rd largest trading partner). Investment continues to be affected by ongoing low capacity utilization rate at production facilities as well as uncertainty regarding the pace of reforms. The lack of dynamism in private investment is particularly problematic given the structural decline in public investment (less than 2% of GDP at present, from 4% in 2013).

On the supply side, the poor performance of the economy is primarily imputable to a drop in agricultural and industrial output. The fall in industrial production reflected the difficulties encountered in: (i) the mining sector (interruption of operations following the collapse of the Brumadinho dam; legal difficulties faced by global mining giant Vale), (ii) the manufacturing sector (weak internal demand and slowing global trade), and (iii) the construction sector (slow fall in inventories of residential and commercial property; decline in public infrastructure spending). The latest economic indicators do not currently show tangible signs of improvement such that the materialization of a recession at the end of the first semester cannot be ruled out.

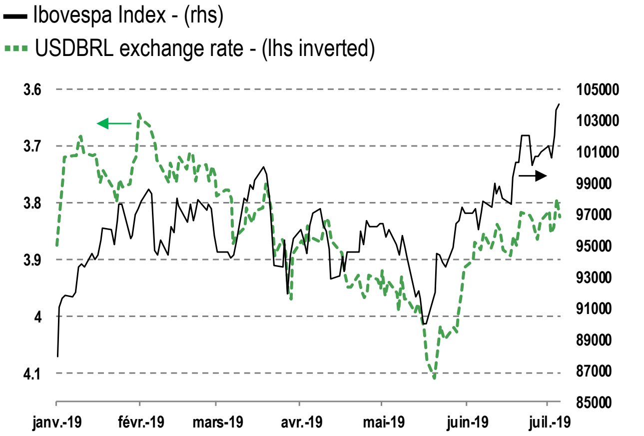
When looking at advanced economic indicators, the IBC-Br Index from the Brazilian Central Bank (BCB) was down 0.5% in April, while the TCB/FGV Brazil LEI index from the Conference Board and the FGV was down 0.9% in May. While services and the automotive sector have experienced some improvements since April, order books in the manufacturing sector have continued to weaken. The slowdown in global trade should continue to weigh on industrial production, particularly given the resurgence of trade tensions between the USA and China. Even if business and consumer confidence indices have witnessed a slight uptick in June, they have broadly deteriorated since the beginning of the year on the back of the slow reform agenda and perhaps more plausibly as a result of the government's increasingly tarnished image. In this context, the BCB has recently cut its growth forecast for 2019 to 0.8% from 2%.

1- Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	1.1	1.1	0.8	2.5
Inflation (CPI, year average, %)	3.0	3.7	3.9	3.9
Fiscal balance / GDP (%)	-7.8	-7.1	-6.9	-6.2
Gross public debt / GDP (%)	74	77	82	82
Current account balance / GDP (%)	-0.5	-0.8	-0.9	-1.4
External debt / GDP (%)	27	33	35	38
Forex reserves (USD bn)	373	374	385	380
Forex reserves, in months of imports	20	18	19	18
Exchange rate USDBRL (year end)	3.3	3.9	3.5	3.4

e: BNP Paribas Group Economic Research estimates and forecasts

2- Currency and equity markets



Source: Datastream, BNP Paribas

Monetary easing in the works?

In June, the BCB held its policy rate unchanged at 6.5% for the 16th consecutive month. Inflation experienced a rise over the first half of 2019, with a reading at 4.7% y/y in May, from 3.8% in December. This increase was however largely cyclical. It was primarily driven by supply shocks which affected food and gasoline prices. The effects of these shocks have now largely dissipated and inflationary risks tied to economic activity remain largely contained.

The yield curve at the end of June suggested that the markets are expecting a monetary easing in the order of 75 to 100 basis points (bps) by the end of the year. Any rate cut from the BCB could, however, be contingent on the approval of the pension reform.

Foreign investors: surprisingly serene

Despite the cyclical downturn, the equity market has been riding a bullish trend since mid-May, gaining 14% (chart 2). This comes after the market experienced bouts of volatility through the first five months of the year. The BRL has also gained ground against the dollar since late May. Until then, the BRL had witnessed a steady depreciation against the USD during which it broke the 4 BRL per USD barrier for the first time since the pre-election period. Overall markets have continued to benefit from a steady flow of foreign investment. Foreign Direct Investment (FDI) – which intercompany loans represent an increasingly larger share – rose markedly over the first five months of the year (USD 35bn in 2019 from USD 27 bn in 2018). They continue to largely cover the current account deficit, which incidentally has stabilized at low levels (0.7% of GDP). Meanwhile, net portfolio investments by non-residents have also held up well, standing at around USD 4 bn over period January through May. *Pro memoria*, in 2018, non-residents were net sellers of Brazilian equities and bonds to the tune of USD 8.4 bn.

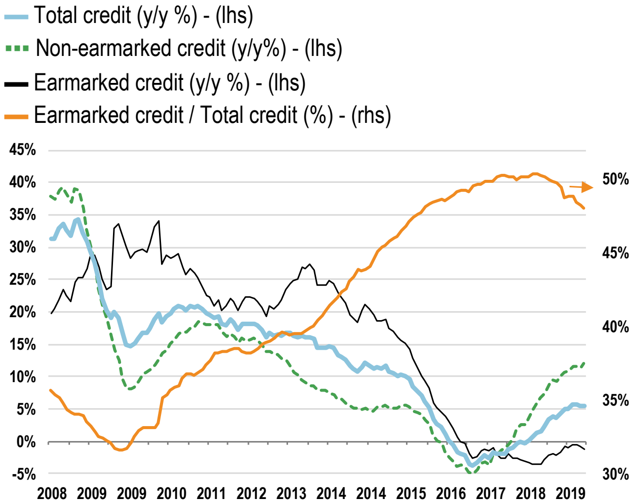
Credit market: differentiated dynamics.

Despite favourable monetary conditions, credit growth has remained somewhat constrained. Since September 2016, the benchmark SELIC rate has been cut by 775 bps (from 14.25% to 6.5%). In real term the rate has also sharply fallen (from 7.7% in June 2017 to 1.8% in May 2019). In addition, in 2018, the BCB cut its reserve requirements on demand deposits from 40% to 25%. Yet, bank spreads have narrowed only slowly and remain elevated (19.2pp in May compared to 13.4pp in December 2013) and the average lending rate has in fact increased (from 23.2% in December 2018 to 25.2% in May). Since December, credit has been growing at an average pace of 5.5% (y/y). However most of the growth has been driven by households (+9.9% y/y in May) as lending to corporates remains very weak (1.7% y/y in May).

The growing share of household loans in banks' loan portfolios[1] is largely due to a contraction of earmarked credit[2] (45% of total credit). The latter has experienced a steady fall since Q4 2016 (chart 3) disproportionally affecting corporates (earmarked credit to corporates was down -9.6% y/y in May). This trend is also explained by corporates' increased reliance on the local bond market to access financing. With historically low interest rates, and abundant liquidity, corporates have taken advantage of investment funds and insurance companies' search for yield. The greater appetite for corporate bonds has resulted in higher corporate debt issuance volumes over the past two years.

[1] In May 2019, loans to households accounted for 57% of total outstanding loans, up from 47% at the onset of 2016.
[2] Earmarked credits are loans with regulated allocations and lower interest rates (subsidized lending). Interest rates are a function of a complex set of eligibility criteria.

3- Banking : credit growth



Source: BCB, BNP Paribas

An eventful political climate

The President's popularity as well as support for the government have continued to fall through June (Ibope survey). The government's image was particularly dented by accusations of collusion directed against Sergio Moro, the current Justice Minister and arguably the most central figure of the *Lava Jato* anti-corruption operation. In particular, recent revelations have called into question the impartiality of the judgment pronounced against former President Lula by Mr Moro during his time as a Federal judge. Meanwhile, the country has witnessed its first wave of mass demonstrations, most notably following budget cuts in education. The government has also faced its fair share of turnover. Three ministers have already lost their job, and Joaquim Levy, a former Finance Minister under Dilma Rousseff, left his position at the development bank, BNDES.

In recent weeks, aside from the free trade agreement between the European Union and Mercosur, the political newswire has been marked by notable progress regarding the pension reform. In particular, the amendments – proposed in June by the parliamentary rapporteur – to the original text were approved during a first vote on July 10th at the Chamber of Deputies (379 for and 131 against). Under the revised text, the overall fiscal result of the reform, including savings, would amount to BRL 910 bn over 10 years as opposed to BRL 1,200 bn under the government's original proposed bill (submitted in February). The text will now have to undergo a second round of voting (to approve amendments), either prior to the parliamentary recess (18th July) or sometime in August. The text will then go to the Senate where the same rules will apply (2 rounds of voting and required support from 2/3 of the senators, ie 49 out of 81). Better days – hopefully – await Brazil.

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