

Brazil

In the spotlight

The world's projectors have descended on Brazil following raging fires in the Amazon forest. President Jair Bolsonaro has come under pressure for his lack of engagement and commitment to protecting the environment. The pace of economic growth is still struggling to accelerate. Confidence indicators are ambivalent while investment remains weak. In the wake of a much less buoyant external environment and low inflation risk, the Central Bank has lowered its policy rate by a cumulative 100 basis points since August. The pension reform was approved in the Senate (first round) but was subject to revisions. Throughout the fall, a number of major reforms should be deployed and privatizations and concessions should accelerate.

■ Downplaying environmental concerns

In recent months, President Jair Bolsonaro has attracted attention for his management of the Amazon rainforest fires, his noted absence from the United Nations Climate Action Summit as well as his lively exchanges with French President Emmanuel Macron. In keeping with environmental concerns, Germany and Norway have meanwhile suspended their donations (USD 30 million each) to the Amazon Fund, citing the Brazilian government's lack of engagement and goodwill in fighting deforestation.

These diplomatic spats as well as financial sanctions have cast new doubts regarding the future endorsement and ratification of the already contested free trade agreement between the European Union and Mercosur. If ratified, countries party to the agreement will have to comply with international standards and treaties regarding environmental protection (including compliance with the Paris Agreement). The Amazon crisis and Brazil's shortcomings in terms of environmental protection have also sparked a reaction from multinational companies, asset management firms, pension funds and insurance companies. To that effect, a group of 230 institutional investors totalling USD 1620 bn in assets under management published a joint statement demanding that companies ensure that their supply chains exclude any activity that contribute to deforestation in the Amazon. In response to these pressures, Brazil has launched a campaign to improve its image abroad. First, through social media but also by mobilizing several ministers, sent on assignments – primarily to the United States and Europe – to convince businesses and foreign investors that in order to protect the rainforest, fight against the activities that threaten it (illegal farming, grazing, logging etc.), and reduce poverty, it is necessary to leverage the region's natural resources and foster its economic development.

■ A (still) fragile recovery

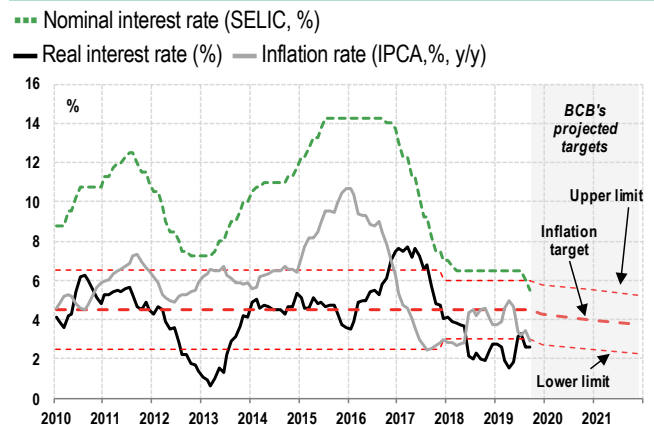
The economy is still struggling to find solid growth drivers. On a positive note, fears of recession through the first semester were dispelled as GDP growth in Q2 proved to be stronger than expected (0.4% q/q). The year-on-year print was even stronger at 0.9%, however it reflected in large part a significant base effect resulting from the impact on economic activity of the truckers' strike in Q2 2018. On the supply side, growth took advantage of a relative bounce back in activity in the industrial sector (notably in manufacturing and construction) which overall contributed 0.14 percentage points (pp) to quarterly GDP growth following two quarters of negative contributions.

1- Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	1.1	1.1	0.5	2.0
Inflation (CPI, year average, %)	3.0	3.7	3.1	3.5
Fiscal balance / GDP (%)	-7.8	-7.1	-6.7	-6.8
Gross public debt / GDP (%)	74	77	82	82
Current account balance / GDP (%)	-0.5	-0.8	-1.1	-1.7
External debt / GDP (%)	27	33	35	38
Forex reserves (USD bn)	373	374	365	360
Forex reserves, in months of imports	20	18	18	18
Exchange rate USDBRL (year end)	3.3	3.9	3.8	3.4

e: BNP Paribas Group Economic Research estimates and forecasts

2- Rates dynamics



Source: IBGE, BCB

So far, the indicators available through Q3 point to relatively weak growth. The Central Bank's IBC-BR leading indicator of economic activity fell 0.2% m/m in July, despite better performances in services (0.8% m/m, seasonally adjusted) and stronger retail sales (1% m/m and 4.3% y/y). Industrial production could be losing steam as year-on-year figures show a fall of -3.3% for July-August on average with a sharp decline in the production of intermediate goods. Growth prospects in the industrial sector remain fragile due to the global slowdown and the recession in Argentina. These concerns appear to be corroborated by confidence indicators (FGV and CNi indices) which all around showed no improvement in September. On another note, Petrobras announced in September a 3.5% increase in gasoline prices as well as a 4.2% increase in



diesel prices. Besides weighing on household consumption, these changes could fuel social discontent. Truck drivers have not yet reacted to the increases for the moment.

In the short term, the economy is unlikely to find an engine of growth in public spending. The 2020 draft budget calls for public investment to contract by about BRL 7 bn compared to 2019. Total planned capital expenditure is estimated at BRL 19.4 bn (0.3% of GDP), the lowest figure in ten years. In contrast, private consumption and residential investment should benefit from a temporary measure allowing for the release of funds from FGTS¹ accounts totalling around BRL 42 bn over the next two years. Such funds will also be allowed to qualify as collateral for mortgages. This move along with other measures is expected to help jump start growth in mortgage loans which has remained stagnant since the end of the recession.

■ External accounts : jostled but no major risks

The current account deficit has widened but remains moderate at 1.8% of GDP in August (over 12 months) compared to -0.8% at end 2018. The persistent weakness of sugar and coffee prices (of which Brazil is respectively the 1st and 2nd global exporter) have adversely weighed on exports in value. While exports to Argentina continue to suffer from the country's economic adjustment, current account receipts have on the flipside benefitted from an upsurge in beef exports to China (up 15% yoy over the January-August period due in large part to the swine fever epidemic affecting the Asian giant). So far, the current account deficit remains largely covered by net foreign direct investment (2.8% of GDP over 12 months) and, in general, capital flows largely cover the country's external financing needs. Foreign exchange reserves have continued to increase over the first 8 months of the year (USD 386 billion at the end of August against 374 billion at the end of 2018) but fell in September to USD 376 billion following the Central Bank's intervention in the spot market following a recent policy change.

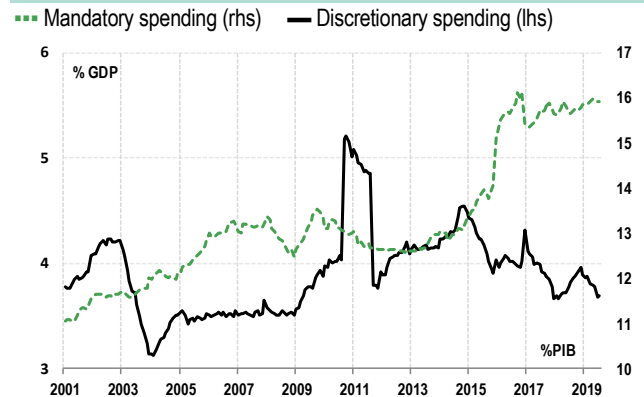
After gaining some ground against the dollar between May and July, the BRL plunged sharply in August (-9%) and has hovered north of BRL 4 to the dollar ever since. Despite a large surplus basic balance, the BRL's weakness is a good reminder of Brazil's sensitivity to net outflows of portfolio investment (USD 5.1 billion in August over 12 months), even though the country is not the most vulnerable emerging economy in this respect. Monetary policy easing is currently accentuating this sensitivity.

■ Low interest rates: the new normal?

The Central Bank of Brazil (BCB) has lowered its key policy rate (SELIC) by 50 basis points (bps) twice since August, bringing the rate down to 5.5%, after holding it at 6.5% since March 2018. For the moment, inflation remains contained below the BCB's target for 2019 (2.9% y/y in September vs 4.25%). According to BCB's monthly survey, the market consensus anticipates a SELIC rate of 4.75% by year end before rising back to 5% by the end of 2020.

¹ Fundo de Garantia do Tempo de Serviço is a workers severance fund account funded by employer contributions equivalent to about 8% of wages that protects against the risk of unemployment among other factors. The funds are deposited in an account at Caixa Federal, a government-owned bank.

3- Central government : evolution of spending (% of GDP)



Source: National Treasury

The current low interest rate environment is generating new market dynamics. Local investors accustomed to high bond yields are shifting asset allocations which are particularly beneficial to the equity market. Interest rate cuts in recent years coupled with the stripping of Brazil's investment grade rating in 2015 also triggered a sharp drop in non-resident holdings of government bond in the local debt market (from 21% in 2015 to 12% in 2019). The fall in the SELIC has also reduced the attractiveness of carry trades strategies for some international investors. Conversely, lower domestic rates are encouraging some Brazilian companies to exchange foreign currency debt for BRL denominated debt.

■ Some progress on the reform agenda

The Senate has approved the pension reform bill through a first round of voting (a second vote is expected by the end of the month). The fiscal savings achieved through the reform should ultimately amount to about BRL 800 bn over 10 years versus BRL 910 bn following the vote at the Chamber of Deputies in August. Over the course of the fall, the government is expected to present its fiscal reform as well as roll out its privatizations and concessions programme. A third of the 130 state-owned enterprises (SOEs) could be affected. According to a Supreme Court decision in June, subsidiaries (half of the SOEs) will not require Congressional approval to be sold. New measures have also been adopted to help liberalize the economy and support entrepreneurship: i/ improved access to credit for small and micro enterprises², ii/ new regulatory framework in the telecommunication sector, iii/ reduced tariffs on 2300 products. In the next 4 years, the authorities hope to increase trade openness to 30% of GDP from 22% currently.

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² A new law voted in April 2019 allows for the creation of *Empresas simples de credito* (ESC), a structure analogous to a microfinance company which provides small and micro enterprises access to credit at very low interest rates and require less red tape. Since April, 350 ESCs have already been created.

