BRAZIL

A SURPRISINGLY RESILIENT RECOVERY

The Brazilian economy has been surprisingly resilient given the challenging sanitary situation it faced in Q1. A more supportive external environment, a stronger recovery in services and a rebound in confidence, should help support the short-term outlook – especially as the epidemic slows down with improving vaccination coverage. Accelerating inflation continues to be a concern and could lead to a more vigorous tightening of monetary policy at the end of the summer. While the currency and portfolio investments stand to benefit from more aggressive rate hikes, the latter also risk slowing down the recovery and adversely affecting public finances. So far though, the sovereign has recorded better fiscal metrics than expected, which have translated into lower risk premiums.

COVID-19: A THIRD WAVE AVERTED SO FAR

Brazil which passed the somber mark of 500,000 Covid-19 deaths in June, seems to have avoided a dreaded third wave of infections so far. The country – which experienced its pandemic peak in late March/early April, with daily death tolls exceeding 3,000 – saw some signs of resurgence in key epidemiological indicators again in early June, following the easing of restrictions in May. However, fears of a new wave have largely subsided with the acceleration of the vaccination campaign throughout June. This trend should continue in the short-term thanks in particular to vaccine deliveries scheduled for the second half of the year (with 42 million doses already expected in July.) These deliveries should help smooth out the pace of vaccinations. As of early July, 13.6% of the Brazilian population was fully vaccinated and 38% had received a first dose.

These relatively improved indicators have, however, been overshadowed in recent weeks by allegations of possible irregularities in vaccine procurement contracts. These revelations have emerged out of the Special Senate Covid Investigating Committee (CPI) – a commission of inquiry intended to shed light on the government's actions in managing the health crisis. Since the Committee's establishment, in April, the President's approval ratings have tumbled, popular protests have been on the rise while there has been a steady rise in the number of impeachment fillings with the head of the Chamber of Deputies. Against this backdrop, former President Lula continues to rise in the polls[1].

A RESILIENT ECONOMY IN THE FACE OF THE SECOND WAVE

Activity in Q1 surprised by its strength and led to significant upward revisions of growth forecasts in 2021. Despite a more virulent 2nd epidemic wave[2], the absence of a fiscal stimulus and the contraction of output in March, real GDP grew by 1.2% quarter-on-quarter (q/q) and 1% year-on-year (y/y). Private consumption held up better than expected, but it was above all the strong growth in investment (+ 4.6% q/q) and the accumulation of inventories that prevented GDP from falling over the period. In particular, commodity producers (agribusiness, mining sector, pulp and paper, beef industry) took advantage of a favourable external backdrop (high demand and prices, competitiveness of the currency) to invest.

Overall, economic activity fared well in Q2 despite a slow start to the quarter. The leading indicator of GDP produced by the Central Bank (IBC-BR) indeed posted a modest growth in April (+ 0.4%). However, in May, industrial activity recovered sharply after a notable drop in the pace of production between February and April, as a result of new restrictions in several States over the period. These signs of improvement were

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	1.4	-4.3	5.5	3.0
Inflation (CPI, year average, %)	3.7	3.2	6.5	4.0
Fiscal balance / GDP (%)	-5.8	-13.2	-7.2	-7.1
Gross public debt / GDP (%)	74	89	82	81
Current account balance / GDP (%)	-2.7	-0.9	0.7	-0.8
External debt / GDP (%)	35	42	51	47
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

STRONG IMPROVEMENT IN TERMS OF TRADE

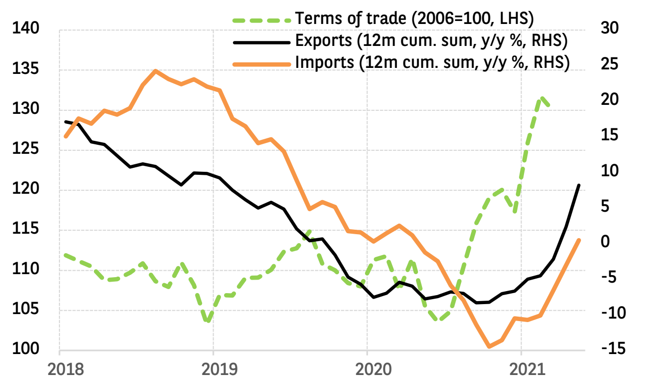

CHART 1 SOURCE: CAMEX, FUNCEX, BNP PARIBAS

confirmed at the end of the quarter in survey data with a more rapid expansion of production in the manufacturing sector (manufacturing PMI at 56.4 in June vs. 53.7 in May) and a marked rebound of activity in services with the PMI index returning to expansion territory for the first time since the start of the year (services PMI at 53.9 in June against 48.3 in May, i.e. the strongest monthly progression in almost 8 years). The acceleration of inflation has so far not dampened household consumption despite a slight decline in real wages and a still relatively high level of unemployment (14.7% in April). Retail sales posted a gain for the third consecutive months in May, thanks to excessive savings

1 In June, Lula's case for a possible running has been boosted after his acquittal by a federal judge in one of the corruption cases opened against him, for lack of evidence.
2 The epidemic claimed more lives in the first 4 months of 2021 than in the previous 9 months of 2020.

built up in H2 2020, emergency aid distributed since April and solid household credit growth (+ 7.8% y/y in May).

Short-term growth prospects should benefit from a still buoyant external environment and renewed optimism on behalf of businesses and households, as restrictions ease and vaccinations progress. Downside risks remain nonetheless: 1/ emergence of viral strains more resistant to vaccines 2/ drought perseverance 3/ a deterioration in the political climate 4/ a sharper acceleration of inflation. Some supportive measures have already been considered by the authorities to offset the effects of a lingering epidemic and rising prices. The government announced the extension for at least 3 months of the emergency aid package distributed to vulnerable households (from April to July initially). The authorities are also expected to increase the value of allowances under the Bolsa Familia program by some 60% by year-end. Credit lines of up to USD 50.7 bn will also be made available to farmers to stimulate agricultural output in 2021/22.

GROWING CONCERNS OVER INFLATIONARY PRESSURES

The stronger-than-expected recovery, the weakness of the real, the rise in commodity prices as well as climate-related factors are fueling persistent price pressures. In June, the IPCA consumer price index reached its highest level in nearly 5 years (+ 8.4% y/y), marking the 16th consecutive month of accelerating inflation. Since February 2020, the food component of the IPCA has increased by around 20% while the price of gasoline and cooking gas has increased by around 25%. Electricity bills have meanwhile jumped some 10% as a result of the drought which has affected the country for several months now[3].

Even if, for the moment, the transmission to core inflation remains limited (e.g. inflation in services is less than 2%), the departure of nearly 5 points of headline inflation compared to the target (3.75% +/- 1.5) suggests a faster than expected tightening of monetary policy in the second half of the year. The Central Bank (BCB) has already made three 75 basis point (bps) hikes in the SELIC rate since the start of the year and is projecting another 75 bps hike at its next meeting in August. A deterioration in inflation expectations could, however, prompt the authorities to tighten further at the end of the summer.

EASING OF SOVEREIGN RISK PREMIUMS

The fiscal balance and debt dynamics have improved despite the rate hikes in recent months as a result of 1/ stronger activity 2/ more dynamics revenues (due to the rise in inflation but thanks to significant gains on FX swaps recorded by the BCB), but also 3/ more limited expenditure (the late approval of the 2021 budget constrained spending). In May, the overall 12-month deficit stood at 9.1% of GDP (5.4% of GDP primary deficit + 3.7% of GDP interest charge), an improvement of 1.5 percentage points (pp) over a month, while gross debt meanwhile fell by 1.1pp to 84.5% of GDP, thanks in large part to higher nominal GDP growth.

The relative easing of tensions on fiscal accounts, coupled with progress over privatisations (eg. Electrobras, Cedae) as well as the presentation of the 2nd phase of the tax reform have favoured a reduction in sovereign risk premiums. Between March and early July, the 5-year CDS and EMBI + spreads fell by around 60 bps and 45 bps, respectively,

RATES: INFLATION, POLICY RATE, YIELDS ON GOVERNMENT BONDS

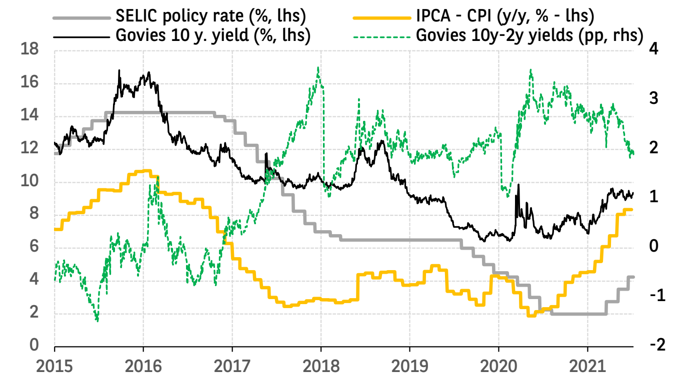

CHART 2 SOURCE: MACROBOND, BNP PARIBAS

while the spread between the 10-year and 2-year interest rates on government bonds fell by nearly 100 bps. The relative decrease in fiscal risks combined with the rise in the interest rate differential (SELIC-Fed Funds) and a weaker dollar also allowed the currency to regain some strength after its tumble in Q1 (~ 9%). The real, whose dynamics are increasingly decoupled from the commodity cycle and the country's terms of trade, reached its strongest level in a year at the end of June, falling below the 5 USD / BRL mark.

STRONGER EXTERNAL ACCOUNTS

A supportive external environment is helping to close the Brazilian current account imbalance. On a 12-month rolling basis, the current account deficit reached in May its lowest level in more than 13 years (USD 8.4 bn, 0.6% of GDP). This trend is expected to continue in the short term, as the country benefits from large trade surpluses, which since the start of the year, have been marked by a sharp acceleration of commodity exports, in particular iron ore and oil, but also meat. Unsurprisingly the price effect in exports data (+ 44% y/y in June) dominates the volume effect (+ 11% y/y in June). On the financial account, foreign direct investment (FDI) flows, which had fallen by around 50% in 2020 to stand at USD 34.2 bn (a 25-year low), have been relatively subdued over the first half of the year in part because repayments of inter-company loans have been higher than new disbursements. FDI should total around USD 50 bn in 2021 but are not expected to durably return to pre-crisis levels (USD 72 bn over the period 2015-2019) until at least 2023. On the other hand, portfolio investments have remained robust. Net flows from non-residents have been positive since August 2020 (with the exception of March) reaching USD 42 bn in May over 12 months – the highest level since 2015. Positive portfolio flows should be supported in the coming quarters by the rise in interest rates and the more broad-based recovery in economic activity. It is also worth noting that corporates – who a little over a year and half ago had bought dollars to deleverage abroad – are once again looking for external funding.

Completed on 9 July 2021

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3 Electricity in Brazil is produced mainly using hydroelectric plants. If water reservoirs reach low levels due to a lack of rain, as has been the case for the past few months, other, more expensive sources of energy must then be activated.