BRAZIL

QUARRELS AT THE TOP

The Executive's calls for monetary authorities to lower rates are fuelling debates on the appropriate inflation target, the permanence of the Central Bank's independence and the right calibration for the policy mix. The opposition between both parties is weighing on inflation expectations due to uncertainty over the path of economic policy. To help create favourable conditions for monetary easing, the government has accelerated the presentation of its new fiscal framework. Following the downturn in activity in Q4 2022, the economy should temporarily return to growth in Q1 2023, driven by the strong performance of the agricultural sector. The deceleration - which began in the second half of 2022 - is however expected to resume its course for the remainder of the year. Local financial markets and the banking sector have been facing increased pressure on the back of rising investors' risk aversion and increasing credit risks exemplified by the bankruptcy of one of Brazil's largest retail players.

THE INFLATION TARGET DEBATE AND THE NEW FISCAL FRAMEWORK

Since Lula's inauguration last January, relations between the Executive and monetary authorities have crystallized the attention of both market participants and public opinion. The government has made multiple calls to ease monetary policy highlighting i/ the decline in real GDP at the end of 2022 (-0.2% q/q in Q4), ii/ waning confidence levels in services and industry, iii/ the high cost of disinflation (at 8%, real rates are about 4 times higher than potential growth) as well as the iv/ noticeable slowdown in credit since last June. The government is particularly concerned about the effects of tighter credit conditions on investment (-1.1% q/q in Q4). Maintaining Lula's social commitments depend indeed largely on the government's capacity to bolster growth in particular by reviving investment in infrastructure. To authorize rate cuts, the President and his allies defend the idea of raising inflation targets. The National Monetary Council (composed of the Finance Minister, the Minister of Planning, Budget and Management as well as the Central Bank's Governor) is due to meet in June to discuss the target for 2026. The President will also be able to appoint two members to the monetary policy committee (COPOM) next year.

For its part, the Central Bank (BCB), whose benchmark rate (SELIC) has remained unchanged since August 2022 (at 13.75%), has indicated that it will not consider rate cuts as long as observed inflation does not durably slow down and as long as medium-term inflation expectations are not anchored around the target. For the time being, inflation remains widespread, even if food inflation has been slowing down. In addition, headline inflation is expected to rise in the short term with the partial reinstatement of federal taxes on fuel (which could cause an increase of nearly half a percentage point of the CPI rate according to local bank estimates). The rise in energy prices, following OPEC's recent decision to cut production could also delay any near-term easing. The BCB is meanwhile not buying the argument of a credit crunch (it expects nominal credit to rise by 8.2% in 2023 compared to 14% in 2022; in real terms, the growth of credit is expected to be in line with the monetary cycle and the growth of the economy). In parallel, it has been monitoring the impact on inflation expectations and the yield curve of official statements and other measures announced by the executive. In recent months, both have been strongly affected by challenges to the Central Bank's independence, personal attacks against its Governor, calls to revise the inflation target, and the perceived lack of credibility of fiscal consolidation measures presented in early January.

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth, %	-3,3	5,0	2,9	1,5	0,5
Inflation, CPI, year average, %	3,2	8,3	9,3	5,5	5,5
Fiscal balance / GDP, %	-13,3	-4,3	-5,3	-8,8	-9,5
Gross public debt / GDP, %	87	78	73	76	80
Current account balance / GDP, %	-1,9	-2,8	-2,9	-2,3	-2,0
External debt / GDP, %	44	42	39	41	43
Forex reserves, USD bn	356	362	324	335	340
Forex reserves, in months of imports	19	15	13	14	13

TABLE 1 e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

BRAZIL: GROWTH RATE OF CREDIT OPERATIONS (INFLATION-ADJUSTED)

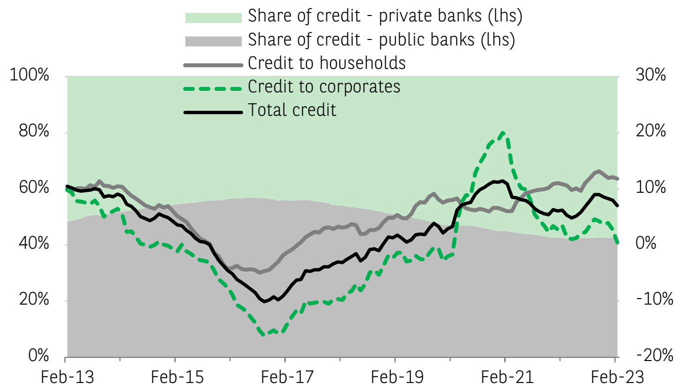

CHART 1 SOURCE: CENTRAL BANK OF BRAZIL, BNP PARIBAS

In an effort to create more favourable conditions for a prospective relaxation of monetary policy, the government accelerated the presentation of its proposal for a new fiscal framework (intended to replace the spending cap – the main fiscal rule introduced in 2016). The proposal provides i/ target ranges for the primary balance whereby the primary result would be reduced to zero in 2024 and have a surplus of 0.5% and 1% of GDP, respectively in 2025 and 2026, each time with a tolerance of +/- 0.25% of GDP and with the underlying objective of stabilizing the federal government's debt ratio at some 77% of GDP by 2026. The proposal also imposes ii/ constraints on expenditure growth (the extent of which will vary depending on compliance with the primary balance objective from the previous year but will, in any case, be less than revenue to enable a prospective consolidation of public accounts), iii/ to set up a minimum for public investment and iv/ to allow recourse to counter-cyclical measures in the event of a downturn.

This announcement was overall well received by market participants and rating agencies – however with the caveat that they will wait and see what measures will accompany these objectives to fully assess their credibility (the government is due to present a complementary plan in H2 to increase fiscal revenues). The role of quasi-fiscal actors as a central piece of the government's agenda remains, however, a point of concern. Public companies such as Petrobras and the development bank BNDES operate outside the fiscal rule but their actions can influence estimates of the neutral interest rate, an important tool for calibrating monetary policy.

AN EXPECTED DECELERATION OF ECONOMIC ACTIVITY

In the first quarter of 2023, the available indicators point to a temporary upturn in activity. The very strong agricultural production and the good performance of external trade should compensate for the declines observed in other sectors (slowdown in private consumption, decline in industrial production).

Despite favourable prospects in the agricultural sector[1] and household income holding up well[2], the deceleration that took hold in the second half of 2022 is expected to resume its course for the remainder of the year. Private consumption will be held back by i/ the partial elimination of tax exemptions on fuel and ethanol[3], ii/ the decline in job creations in the informal sector (especially in services), as well as by iii/ the slowdown of credit to households.

In January, arrears on revolving lines of credit cards reached 44% while non-performing loans on household credit reached 6.1% of total non-earmarked credit – its highest level since June 2016. The most fragile households have been experiencing payment difficulties for several months now because of the rise in interest rates and food inflation. To remedy this situation, the government has put in place tax exemptions and debt restructuring schemes for households living on less than two minimum wages per month.

On the supply side, highly credit-sensitive sectors such as retail or manufacturing are meanwhile expected to continue to slow down. The reopening of the Chinese economy, the revival of Lula's social housing programmes (which entails the construction of 2 million new homes by 2026) and the consumption of public services (an important growth driver in previous Workers' Party government) should help limit the slow down in growth.

BRAZIL: GOVERNMENT BONDS YIELDS VS INFLATION

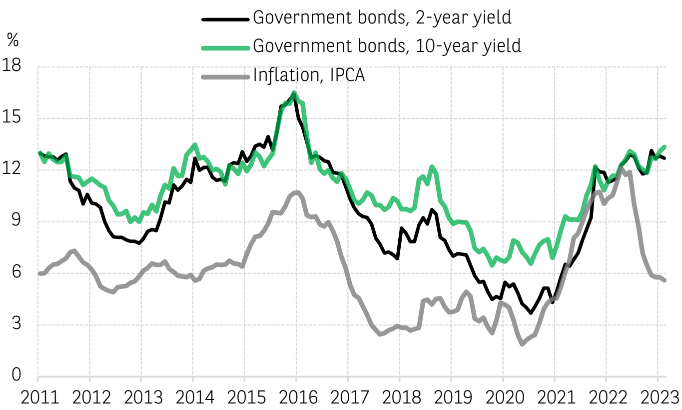

CHART 2 SOURCE: MACROBOND, IBGE, BNP PARIBAS

RISING INVESTORS' RISK AVERSION

In January, the filing for bankruptcy protection of one of Brazil's retail giants - Americanas[4] - sent major shockwaves to the corporate debt market and the banking sector. The episode temporarily halted the sale of local bonds, but also led to widening corporate spreads and fuelled an increase in bank provisions.

As a result, companies have had to cope with higher debt financing costs on the back of more expensive bond and bank debt. Given more difficult market conditions, the largest companies have, since February, increasingly turned to international capital markets for financing. This marked a reversal of the trend observed in 2022. With only USD 10bn in new offerings, 2022 was indeed the second least active year (after 2008) for Brazilian corporate debt issuances in the international market, according to Dealogic. The local market had, in contrast, a record year with bond issuances totaling BRL 271bn (USD 55bn) in 2022, according to Anbima.

In light of a more turbulent local environment (rising household and corporate credit risks, uncertain trajectory of economic policy, projected economic slowdown, etc.), foreign portfolio investors have reduced their allocations to Brazil. Non-residents have been net sellers in the stock market since the start of the year, reversing the trend observed since June 2022 (during which foreigners allocated about BRL 120bn, or USD 25bn, to the local stock market). These movements have been largely accentuated by the Fed's interest rate hike and the episodes of banking instability in the United States and Europe. The stress tests conducted by the BCB's Financial Stability Committee indicate nonetheless a high level of resilience of the Brazilian banking system to these shocks. Liquidity, provisioning and capital adequacy ratios remain well above minimum requirements.

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1 The National Agency for Agriculture (CONAB) forecasts record harvests of cereals and oilseeds this year, boosted by the increase in cultivated land and favourable weather conditions earlier in the year. Meanwhile, poor harvests in Argentina, Ukraine and the United States should also benefit exporters. Brazil is expected to become the world's lead exporter of corn and account for nearly 55% of soybean exports, according to the latest forecasts from the USDA.
2 Aided by the government's social transfers, the rise in the minimum wage, strong job creations in 2022 (about 3 mn) and due to wages still growing faster than inflation.
3 The exemptions for cooking gas and diesel were maintained until the end of the year, in particular to avoid a truckers' strike.
4 The Group filed for bankruptcy after disclosing a BRL 20bn hole (approx. USD 3.6 bn) on its balance sheet due to accounting inconsistencies. The company has been trying to renegotiate its debts for approximately USD 8.5 bn.