BRAZIL

A WIND OF OPTIMISM

A wind of optimism is currently blowing over Brazil. Brazilian assets recovered strongly in Q2 2023 on the back of reform progress and positive surprises from growth, inflation, the labour market and external accounts. The short-term outlook has also improved. New fiscal measures combined with a softening of energy prices and the prospects of monetary easing in H2 has helped mitigate the expected economic slowdown this year. However, flashing green lights conceal the underlying weaknesses of internal demand as well as differentiated performances across sectors. In the absence of higher revenues, the primary result targets defined by the new fiscal framework is expected to be difficult to achieve.

THE UPTURN IN FINANCIAL MARKETS ....

Since the end of March, Brazilian assets have experienced a notable upturn. The stock market posted a 16% gain while the real appreciated some 10% against the dollar at the end of June. The yield curve also fell. The yield on two-year sovereign bonds fell from 14.2% at the end of December 2022 to 10.5% in June. Real interest rates on long-term inflation-linked government bonds have also eased by almost 100 basis points since the announcement of the new fiscal rules in April. Foreign investors' appetite for Brazilian debt securities has also firmed up (between January and May, non-residents have been net buyers to the tune of USD 4 bn, according to the IIF data).

... REFLECTS POSITIVE SURPRISES ON THE MACROECONOMIC FRONT...

In addition to the role played by exogenous factors (falling dollar, Chinese recovery, easing of financial stability risks, decoupling of emerging markets with advanced economies), the wave of optimism across Brazilian markets reflects above all the good performance of growth and prospective rate cuts anticipated some time towards the end of the summer (the policy rate, the SELIC, has been kept at 13.75% since August 2022). Growth surprised strongly to the upside in Q1 (+1.9% q/q and 4% y/y after a 0.1% q/q decline in Q4 2022) on the back of exceptional harvests of soybeans, corn and other grains (agricultural output jumped 21.9% in the quarter, a record). Economic activity continued to show signs of resilience early in Q2 amidst continued strength in the labour market. At the same time, inflation has continued to slow down helped by still large base effects resulting from the war in Ukraine as well as the real appreciation. In May, the IPCA price index fell to its lowest level since October 2020 (3.94% y/y vs. a 3.25% target); the diffusion index also declined (the share of items whose price rose during the month dropped to 56% from 66%). Core inflation also retreated (6.19% versus 9.12% at end-2022). On the external front, the trade balance logged a record surplus in the first five months of the year (USD 35 bn, a 37% increase y/y) despite retreating commodity prices. The result was driven by strong volume growth on the back of higher oil production and an exceptional harvest as well as lower imports. Meanwhile, the current account deficit continued to decline (-2.5% of GDP in May compared to -3% at end-2022) remaining fully covered by net FDI flows (+2.8% of GDP).

Such flashing green lights, on an aggregate level, nevertheless hide the underlying weaknesses of domestic demand as well as widely differentiated performances across sectors. National accounts show indeed a weakening of domestic consumption and investment over the last four quarters. Also, had it not been for strong inventory accumulation, the contribution of domestic demand to GDP growth in Q1 would have been negative. Moreover, the strong performance in agriculture and livestock year to date conceals declining outputs in most sectors of industry as well as the strong retreat in service activity in April (transport and storage services remain outliers boosted by bumper harvests since the start of the year). Activity in manufacturing / processing industries as well as civil construction have meanwhile continued to suffer from high interest rates.

In the short term, the easing of energy prices and new fiscal measures should support activity and thus help mitigate the economic slowdown expected this year.

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth, %	-3.3	5.0	2.9	2.5	0.5
Inflation, CPI, year average, %	3.2	8.3	9.3	4.7	4.0
Fiscal balance / GDP, %	-13.3	-4.3	-5.3	-8.9	-8.2
Gross public debt / GDP, %	87	78	73	77	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	341	338
Forex reserves, in months of imports	19	14	10	16	15

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

BRAZIL: CONTRIBUTIONS OF THE COMPONENTS OF GDP TO QUARTERLY GROWTH

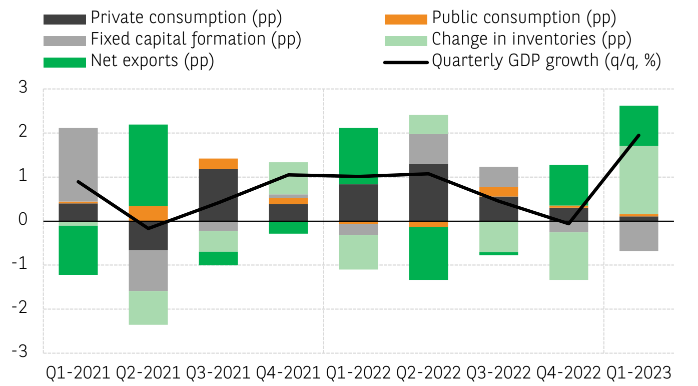

CHART 1 SOURCE: IBGE, BNP PARIBAS

BRAZIL: TRADE BALANCE (GOODS)

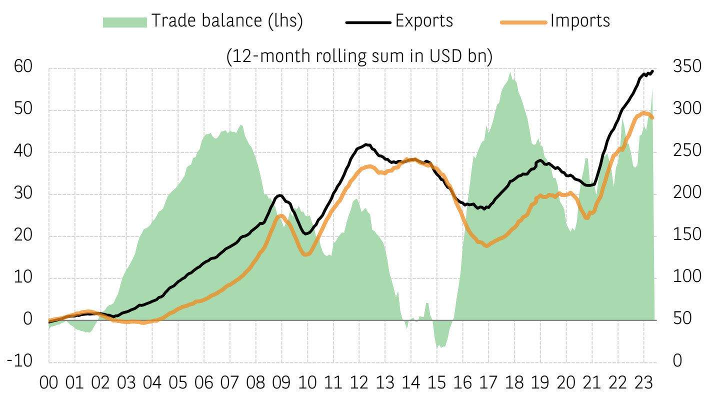

CHART 2 SOURCE: BCB, BNP PARIBAS

The government has announced tax breaks to support the automotive industry ("popular car" program) and a 27% increase in funding for the agricultural sector for 2023/2024. The development bank, BNDES, has also announced increased financing to support industry over the next four years. On the demand side, in addition to the social transfers approved in the 2023 budget, the poorest households will benefit from the increase in the minimum wage (which came into force in May), the widening of the tax exemption brackets, as well as falling prices resulting from Petrobras' new fuel pricing policy (which henceforth will also better insulate the domestic market against volatility in international markets). The implementation of the new debt restructuring program ("Desenrola Brasil"), aimed at countering the rise in households' defaults, should, meanwhile, benefit a larger number of recipients than initially expected (nearly 70 million Brazilians).

... AS WELL AS PROGRESS ON THE REFORM FRONT

The approval, at the end of June, of a more restrictive version of the new fiscal framework [1], combined with the presentation of the long-awaited tax reform[2] as well as the easing of tensions between the government and the Central Bank have contributed to lower both medium-term inflation expectations as well as risk premia (75 bp drop in Brazilian 5-year CDS since March). Other initiatives were also well received by the markets: i/ new cooperation agreements with China[3] , ii/ decision to change the time frame when assessing inflation against the target (starting in 2025[4]), iii/ advances (despite some negative developments[5]) on the energy transition and environmental protection fronts. In addition to the presentation of a BRL 56 bn investment plan to further develop electric transmission lines, the government announced the forthcoming creation of a carbon market, as well as its intention to extend the protected area in the Amazon region by some 30,000 km², i.e. the equivalent to the size of Belgium. Farmers who adopt more sustainable practices will meanwhile have access to financing at preferential rates. Other actors are also involved: BNDES, the development bank, has reinforced its consideration for key environmental performance indicators (KPIs) in allocating its loans; Petrobras has committed to ensuring that 100% of the electricity used in its activities – whether industrial or administrative – will be produced from renewable sources. Finally, Brazilian banks have adopted a new protocol to combat deforestation in the beef industry. Brazil has, meanwhile, experienced a 31% drop in deforestation over the first five months of the year compared to the same period in 2022.

Dissipating fears of witnessing a reversal in reforms undertaken since 2016 have also contributed to further investors' optimism. Lula, whose popularity has stagnated since the beginning of the year, has faced difficulties in countering the privatization of Electrobras; Congress also rejected a bill authorizing greater government control over the governance of state-owned enterprises (SOE law).

STRUCTURAL CHALLENGES AND BUDGET EXECUTION

Brazil's solid run so far – which culminated in June in S&P revising its rating outlook from stable to positive – should nonetheless not overshadow the many challenges still facing the country i/ on the social front (increasing polarization, rising hunger and poverty), ii/ on the demographic front (ageing population, declining birth rate), and above all, iii/ on the economic front – with low potential growth in large part due to a complex and costly business environment. According to a recent study carried out by the Movement for Competitiveness (MCB) in partnership with the think tank FGV, the additional cost borne by companies to produce in the country (Custo Brasil) compared to the average cost in the OECD is estimated to some BRL 1,500 bn, or approximately 20% of GDP. The cost of employment, logistics, financing, regulatory and tax requirements, as well as low integration into global supply chains are believed to be responsible for 80% of this additional cost. In an attempt to help remedy this, the MBC/FGV and the Ministry of Development, Industry, Trade and Services (MDIC) will launch, in the second half of 2023, the Custo Brasil Observatory which will monitor and update, on an ongoing basis, various projects to report on their impact on the Brazilian economy.

In the immediate future however, the more pressing challenge, arguably, will be to meet primary results targets set out in the new fiscal framework (0% in 2024, +0.5% in 2025 and +1% in 2026). Compliance with the targets will ultimately condition the leeway authorities have to lift structural obstacles to growth. Indeed, according to the new fiscal rules, the increase in spending will be capped each year at a minimum of 0.6% and a maximum of 2.5% in real terms depending on the primary result of the previous year. Given the economic scenario and the upward trajectory of spending, attaining the target appears, for the time being, highly unlikely in the absence of new sources of revenues. Increased receipts from the proposed tax reform appear to be the most likely avenue to sustainably generate higher revenues. However, it still needs to be approved by Congress - a challenge that spans 30 years.

Salim HAMMAD
salim.hammad@bnpparibas.com

1 Stricter sanctions are provided for in the event of non-compliance with the primary balance targets. The new fiscal rules excluded some social, health and educational spending and defined a floor for investment spending each year (around BRL 70 and 80 bn, i.e. approximately 0.6% of GDP per year until 2025).
2 In particular, it intends to replace indirect taxes on production and consumption (IPI, PIS, Cofins, ICMS and ISS, the levels of which can vary by state and municipality) with a dual value added tax.
3 Lula traveled with more than 200 business leaders, in April, concluding some about twenty commercial agreements with his Chinese counterpart (in mining, agriculture, energy, information and communication technologies). Chinese investment in Brazil, through agreements to construct bridges, railways, ports and car factories, among others, is expected to help boost Brazilian industrial production (which has fallen by around 6 points in 20 years).
4 The target was maintained at 3% but inflation will be evaluated on a 12-month rolling window rather than at the end of the calendar year as in the current format.
5 Driven by the agrobusiness and conservative interest groups, Congress passed Bill PL490 drastically limiting the recognition of land claims by indigenous groups made after 1988. Congress also stripped the Ministry of the Environment and the new Ministry of Indigenous Peoples of part of their powers. Lula has also showed little opposition to an oil exploration project at the gates of the Amazon.