BRAZIL

BUCKING THE TREND

Accelerating growth, slowing inflation, falling unemployment and the interruption of monetary tightening differentiate Brazil from most of the world's major economies. These developments, which are largely attributable to fiscal stimuli (higher social transfers, reduction in taxes and fuel prices), are complicating the task of monetary authorities by partially diluting the restrictive effects of their policy. In the second half of the year, the maintenance of fiscal stimulus should again help limit the slowdown in activity. Brazil's solid economic performance has allowed financial assets to hold up well despite the general elections and a deteriorating global environment.

GENERAL ELECTIONS: SOME SURPRISES

The general elections held on October 3rd 2022 delivered several surprises: i) no candidate was able to obtain an absolute majority in the presidential election (a second round will take place on October 30th), ii) the gap between the two main candidates – Luiz Inacio Lula da Silva and Jair Bolsonaro (48% vs. 43% of votes, respectively) – was much smaller than the polls predicted. Since the return of democracy, the leading candidate following the first round has always won the presidential election. Finally, iii) the right-leaning and centrist coalitions – allies of Bolsonaro – will have more power in the Senate and the Lower House than during the last term.

RESILIENT ECONOMIC ACTIVITY

Growth defied expectations considerably in the first half of the year. After an increase of 1% (q/q) in Q1, real GDP grew by 1.2% (q/q) in Q2 (3.3% y/y), marking a third consecutive quarter of strong growth. Activity was driven by an upturn in investment and a strong increase in consumer spending fuelled by the expansion of household disposable income, largely attributable to the Government's stimulus measures[1]. The drop in « Covid » savings, the increase in household debt and the good performance of the labour market also boosted demand. On the supply side, agricultural and iron ore production recovered (the drought in 2021 led to low soybean harvests at the beginning of the year, while heavy rainfall limited extraction activities in Q1). Construction grew by almost 9% in H1 (y/y) reaching a level of activity almost 11% higher than that in Q4 2019. However, services remained the main driver of growth.

Activity in H2 should also be better than previously predicted with the economy benefiting from measures introduced by the Government in June to help preserve households' purchasing power (temporary reductions in energy prices and other regulated prices, 50% increase in benefits to the poorest households under *Auxilio Brasil* as well as exceptional transfers to truck and taxi drivers). These measures and the drop in unemployment – which reached its lowest level in August since Q3 2015 – led to a rebound in consumer and business confidence in August/September. Production in the manufacturing sector should also benefit from the recent drop in input costs – which is encouraging companies to rebuild inventories despite the anticipated easing of demand. Meanwhile, concerns over the provision of fertilizers in the wake of the war in Ukraine have largely subsided – the country having managed to triple its purchases over the course of the year.

FORECASTS

	2019	2020	2021	2022e	2023e
Real GDP growth, %	1.2	-3.9	4.6	3.0	0.5
Inflation, CPI, year average, %	3.7	3.2	8.3	9.4	5.4
Fiscal balance / GDP, %	-5.8	-13.2	-4.4	-8.4	-9.5
Gross public debt / GDP, %	74	88	82	81	86
Current account balance / GDP, %	-3.5	-1.7	-1.8	0.4	-0.8
External debt / GDP, %	36	44	42	39	40
Forex reserves, USD bn	357	356	362	340	350
Forex reserves, in months of imports	16	19	15	12	13

e: ESTIMATE & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

BRAZIL: UNEMPLOYMENT VS. INFLATION

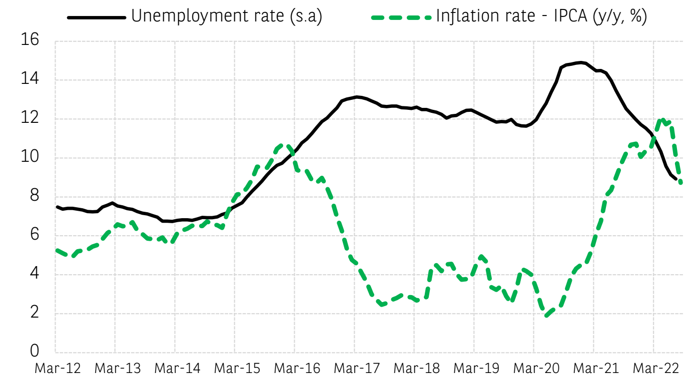

CHART 1 SOURCE: IBGE, GSP, BNP PARIBAS

That said, signs of deceleration are apparent in some sectors. Construction survey data are pointing to activity losing steam in the sector. The agricultural and bovine sectors are also more heavily impacted by the slowdown in global trade, the easing in the price of certain commodities (soybeans, iron ore) and the slowdown in China (the latter absorbed

1 Taking into account salary bonuses (all paid from January to March), authorisations to withdraw from FGTS accounts (a workers' insurance fund), early payments a) of the "13th salary" to INSS beneficiaries (National Institute of Social Security) and b) pension benefits to retirees, a total of almost BRL 110 bn was injected into the economy according to GSP.

close to 30% of exports since January). The difficult situations in Argentina and Chile are also weighing on the volumes of manufactured exports, which have been on the retreat since May. In H2, the slowdown in credit should help cool domestic demand, while the reduction in exports and the concurent increase in import volumes should meanwhile translate into a negative contribution of net exports to growth. In 2023, GDP growth is expected to be close to equal to the statistical carry-over from 2022 (around 0.5%).

INTERRUPTION IN THE MONETARY TIGHTENING CYCLE

Inflation has slowed sharply since the summer (8.7% y/y in August compared with 12.13% in April). However, this drop is not widespread (inflation in services remains high). Disinflation is mainly the result of tax cuts, particularly on electricity and gasoline. The easing of bottlenecks in supply chains is also contributing to the slowdown.

The Central Bank, which has had a restrictive monetary policy since Q4 2021 (cumulative rise of +1,175 basis points) kept its key rate unchanged in September at 13.75% for the first time since the beginning of the tightening cycle, in March 2021. In their decision, the authorities integrated the ongoing disinflationary process, the desire to smooth out fluctuations in the economic cycle and promote employment. Going forward, uncertainties surrounding the fiscal scenario will continue to limit the monetary authorities' degrees of freedom. The latter have to factor in: the likely redesign of the fiscal framework, the budgetary cost of disinflation, the rise in the real cost of debt, the likely roll-out of a tax reform as well as increased (social) pressures on public spending (the two candidates have already stated that they would maintain the BRL 600/month benefits as part of *Auxilio Brasil* while Lula is also favourable to raising the minimum wage[2]). Another concern for the authorities is that inflationary pressures in services could take more time than expected to ease, with the actual unemployment rate getting increasingly close to the structural unemployment rate as measured by NAIRU[3].

As a result of the rise in interest rates, there has been a rise in delinquincies by households (from a low base) in recent months as well as greater difficulties for corporates in raising financing in the local market. Corporates have cut back on their local currency debt issuances since the end of 2021 and are finding it more difficult to finance themselves using bank credit[4] – the rates of return on their projects having become much lower than the cost of financing, especially in real terms.

Companies are therefore turning to less expensive sources of financing: offshore arrangements (EUR-BRL swaps), intercompany loans or debt issuances in international markets (in particular an increasing recourse to sustainable bond issues, for which notional amounts have tripled in 2020-2021 compared to the period 2015-19, reaching more than USD 20 bn). In recent months, the authorities have introduced new measures to attract foreign investors and reduce the financing costs for local companies: tax exemptions on capital gains for corporate debt dealings[5], simplification of the procedures to issue debt, broadening of collateral eligibility requirements and facilitation of the process to convert debt into marketable securities).

BRAZIL: PRIVATE CREDIT GROWTH (CORPORATES AND HOUSEHOLDS)

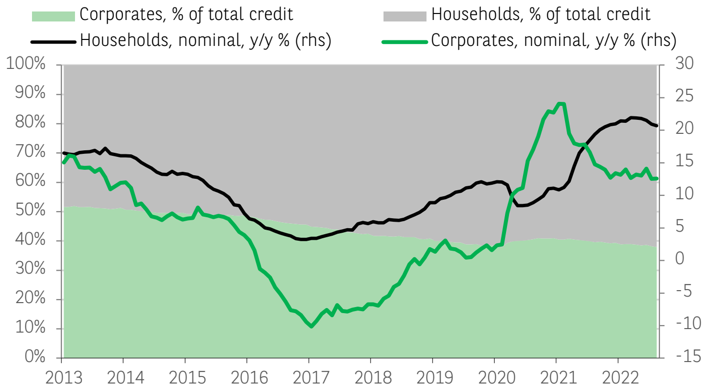

CHART 2

SOURCE: CEIC, BCB, BNP PARIBAS

ASSETS HOLDING UP WELL AMIDST MORE FORGIVING MARKETS

Brazilian assets have held up well since the beginning of the year given the electoral cycle, the global rise in investors' risk aversion and the strengthening of the US dollar. The reais posted one of the best performances against the dollar this year (+8% at the end of September), while it lost around 20% against the dollar before the elections in 2018. In dollar terms, the stock market has meanwhile outperformed its regional counterparts, with the exception of Argentina.

A number of elements help to explain this performance: upside surprises on growth, falling unemployment and inflation, rising and positive real yields ; meanwhile equities are attractive as stocks are trading at a sharp discount relative to their historical average. Brazil is also expected to post its first primary budget surplus since 2013 (helped by sizeable dividend transfers from Petrobras and a windfall resulting from the privatisation of Electrobras). Also, the country's external vulnerability remains low: FDI cover the current account deficit three times over, the external debt burden is moderate and external liquidity is abundant. Brazil's high energy independence is also a strength[6]. Finally, the formalization of the Central Bank's autonomy in 2021, coupled with the strengthening of the centrist and right-leaning coalitions in Congress as well as the extension of support for Lula by Henrique Meirelles – former governor of the Central Bank, architect of the country's main fiscal rule and a likely frontrunner to head the Ministry of Finance if Lula is elected – have collectively helped to reassure the markets – concerned with the implementation of unorthodox economic policies if the presidency changes.

Salim HAMMAD
salim.hammad@bnpparibas.com

2 According to the National Treasury, a BRL 100 wage increase would increase federal spending by BRL 34 bn (0.3% of GDP).
3 Non-accelerating inflation rate of unemployment. A drop in the actual unemployment rate below the NAIRU leads to greater inflationary risk.
4 This is less true for small businesses that continue to benefit from the National Microenterprise Support Programme (PRONAMPE) and the Emergency Credit Access Programme (PEAC).
5 Foreigners were paying 15% tax on capital gains on corporate debt (exemptions applied on stock market and public debt gains).
6 85% of its energy mix comes from renewable sources – the highest proportion in the G20.