

INFOCUS

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Challenges and priorities for Brazil

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CHALLENGES AND PRIORITIES FOR BRAZIL

Brazil has been impacted by the same issues affecting other emerging economies: the US Federal Reserve tightening cycle, global inflationary pressures, the effects of China's zero-Covid policies and the geopolitical and economic consequences of the Russia-Ukraine conflict. In the presidential election, Lula Da Silva prevailed over Jair Bolsonaro by less than 2%, the narrowest margin ever. In this edition of *Infocus*, Joaquin Thul reviews the main challenges for the Brazilian economy in 2023 and what the key priorities might be for the incoming government.

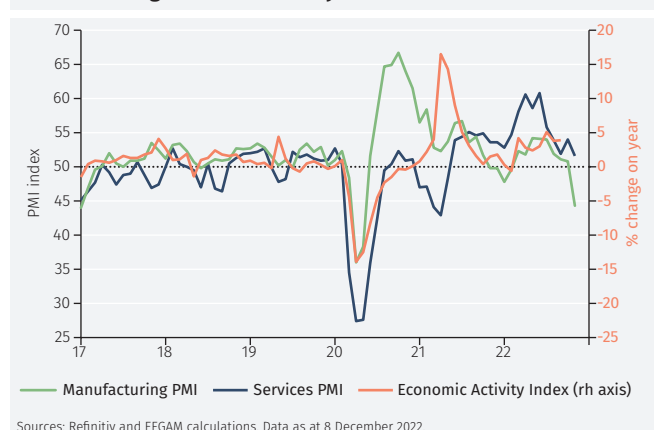
A slowing economy

According to market expectations, Brazil's GDP growth is expected to slow from 2.8% in 2022 to between 0.2% and 1.0% in 2023.¹ Growth this year is due to private consumption and a boost to exports of energy and agricultural commodities, benefiting from the rise in prices following geopolitical events in Q1 2022.

The economy is projected to enter a recession in Q1 2023, following two consecutive quarters of negative growth. This is expected to be driven by a deceleration in private consumption, as household finances are affected by high borrowing costs and the cumulative effects of a hawkish Brazilian Central Bank (BCB).

Manufacturing activity is already in contraction as captured by the PMI index, while services have weakened since the second half of 2022, see Figure 1.

1. Decelerating economic activity

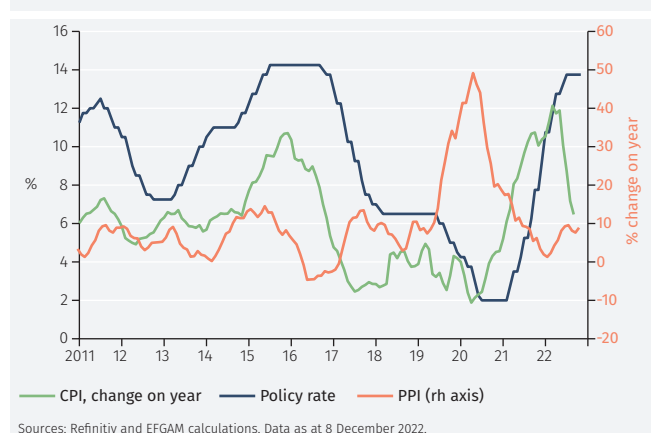


Inflation and policy interest rates

The BCB was one of the first central banks to start tightening monetary policy in March 2021 in response to the increase in inflationary pressures. Since then, interest rates in Brazil have increased from 2% to 13.75% in August 2022. Inflation accelerated from 2% YoY (year-on-year) in 2020 to over 6% YoY

at the beginning of the tightening cycle and peaked at 12.13% YoY in April 2022. Since then, it has decelerated back to 6.5% YoY in October 2022, although it remains above the 3.5% target, see Figure 2. The cumulative effect of the monetary policy tightening on economic activity, together with the decline in global commodity prices should help to continue reducing inflationary pressures next year. Although the BCB stated it will need to remain vigilant on inflation, the current level of interest rates could allow the central bank to start easing monetary policy next year.

2. Interest rates and inflation



This increase in borrowing costs has started to weigh on consumers, triggering a rise in non-performing loans to 4%, the highest level of delinquencies on loans to individuals since 2020. If this were to become a bigger issue for the credit market it would magnify the effects of the recession on the Brazilian economy.

Fiscal policy

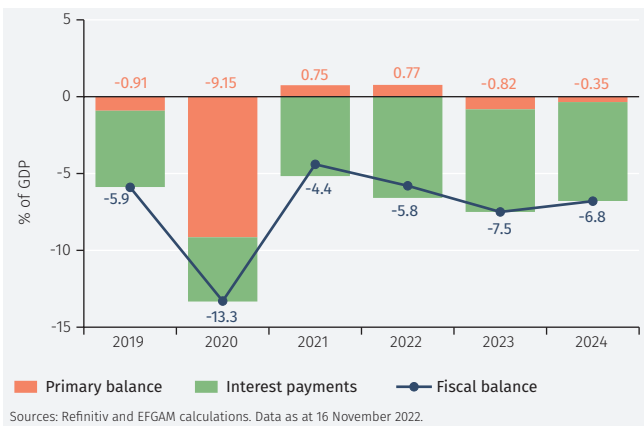
The incoming government will inherit a complex fiscal situation. Brazil underwent a strong fiscal consolidation following the large government support deployed during 2020 at the beginning of the Covid-19 pandemic, equivalent to 14.5% of GDP. The general government fiscal deficit improved from 13.3% of GDP in 2020 to 4.4% of GDP in 2021, see Figure 3. This

¹ Data from Factset consensus and IMF. Data as at 8 December 2022..

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was achieved by withdrawing the emergency fiscal support and better revenue collection as a result of higher nominal GDP growth, a larger proportion of consumer spending made on goods over services and the positive impact of higher commodity prices on exports. All of these allowed the government to achieve a primary fiscal surplus of 0.75% of GDP in 2021.

3. Post-pandemic fiscal consolidation in Brazil



One of the main challenges in the near term for the Brazilian Congress is to agree on the budget for 2023, which should be voted on before the end of this year. Lula wants to pass a constitutional amendment to allow an extension of the fiscal spending cap to provide additional support to Brazil's welfare program and increase the minimum wage, two of his campaign promises.²

Analysts close to Lula's PT party estimate the government would need an extension of the spending cap equivalent to approximately 2% of GDP to meet its fiscal plan. The bill under consideration excludes welfare programs and, in some circumstances, public investment in healthcare and education from the spending cap. This is expected to be funded by increasing public debt, which declined from over 88% of GDP in 2020 to just under 75% of GDP in 2022.

This is unlikely to be received positively by markets and opposition parties, meaning the bill is expected to be modified. Markets anticipate that Congress will finally agree on extra-cap spending between 1.2%-1.5% of GDP, limiting the deterioration of Brazil's primary fiscal result, to a deficit of close to 1% of GDP in 2023.

Fewer, but deeper, reforms

Although in the short-term the outlook for Brazil remains negative there are a series of factors to remain optimistic for the second half of 2023. The new government will need to deal with two pending reforms, an administrative and a tax reform. However, given the opposition in Congress is stronger than in previous PT administrations, this is not expected to be a reformist government. This removes the extreme tail risks associated with the return of a left-wing party to power in Brazil.

On the administrative side, Bolsonaro's government had set an ambitious agenda to privatise state-owned companies and raise over USD 300 billion over a period of ten years. In the last four years, the government raised USD 77.2 billion through privatisations and concessions.³ Petrobras, Brazil's state-owned oil production company, sold its participation in oil derivatives and biofuels distribution companies, and on a natural gas transportation company. However, future privatisation plans of Eletrobras, the country's largest electricity generation company and Correios, the national postal service, will not be a priority for Lula's government.

The tax reform bill, already under discussion in the Senate, aims to simplify the tax system for companies and individuals by consolidating nine federal taxes into one value-added tax at the federal level, and unify state and municipal taxes. This is likely to be one of the most important reforms in Brazil in the coming years, and will be a priority for Fernando Haddad, who is expected to be nominated as Finance Minister.⁴ President Lula is likely to back the current bill and will aim to pass a separate bill to modify current levels of income tax paid by households and companies.⁵

Implications for financial markets

Brazil has not escaped the negative issues affecting the global economy: the tightening of monetary policy in the US, the rise in global inflation, the effects of China's zero-Covid policies and the geopolitical consequences of the Russia-Ukraine conflict.

On the domestic front, Brazil will endure a deterioration of macroeconomic conditions as a result of tighter financial conditions following successive interest rate hikes by the BCB to contain inflation. Higher borrowing costs will continue to put pressure on households while expanding fiscal support

² The current spending cap limits the growth of public expenditures to the previous year's inflation rate. That is, there is no increase in expenditure in real terms.

³ Surpassing by 15% the amount raised through privatisations between 1980 and 2018. <https://tinyurl.com/2k6cukwp>

⁴ The appointment of Fernando Haddad as Finance Minister will create uncertainty in the short term, as he is not well-known to investors. He is known in Brazil for his political career as the PT's previous Presidential candidate, a former mayor of Sao Paulo between 2013 and 2016, and Minister of Education between 2005 and 2012, in Lula's previous governments. He will be backed by a team of more moderate economists.

⁵ According to the World Bank's Business Enabling Environment project, Brazil ranks poorly on the efficiency and bureaucracy of its tax system, identified as one of the hurdles to attract foreign investment to the country.

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will require a special approval by Congress. On the external front, the boost from high commodity prices will fade, while the global deceleration of growth will be a headwind for the Brazilian economy which is likely to be in recession in Q1 2023.

The outlook for the Brazilian real will remain challenging. Although the US dollar is expected to weaken in the next few months, the short-term outlook will not be supportive for the real. Lula's government is expected to be less fiscally responsible, but spending will be limited which will eventually support capital inflows. Moreover, the decline in commodity prices will affect Brazil's terms of trade next year which will also weaken the real. The current account deficit is expected to reach over 2.0% of GDP this year, funded by foreign direct investment, which increased to over USD 40 billion in 2022, representing around 4.0% of GDP.

However, in contrast to other developed and emerging economies, inflation seems to have peaked in the last few months, following a combination of strong tightening from the BCB and a deceleration in economic activity and commodity prices. Uncertainty around the election, which initially discouraged investors, has now passed and will support Brazilian equity markets in the new year. An improvement in domestic scenario for 2023 could bring opportunities not only in exporting sectors, such as energy and materials, but also in more growth-orientated sectors such as fintech and information technology.

Additionally, the potential reopening of China could be the silver lining for Brazil given their close trade links. As an exporter of commodities such as oil, iron ore and soybeans, trade with China remains highly important. Exports to China alone represents almost 30% of Brazil's total exports. Therefore, as China starts to relax some of its restrictive policies, Brazil could benefit from stronger exports to Asia.

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