British Embassy
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BRAZIL ECONOMIC FOCUS: March 2016

Summary

Where is the bottom?

Brazil's GDP shrank 3.8% in 2015, the worst result since 1990, dragged down by poor performance in industry and services though mildly lifted by gains in agriculture. Inflation reached double digits; unemployment rose sharply, as did the public deficit. Ongoing political crisis means the government has not been able to pass sufficient reforms. Brazil lost its investment grade from all three major rating agencies. 2016 has begun with most of 2015's problems still unresolved. The question remains: Where is the bottom?

In Focus: What remains solid?

Solid economic variables such as high foreign exchange reserves, low sovereign external debt and no apparent liquidity crunch are still to be found in Brazil despite the grim scenario. They decrease the likelihood of default. Meanwhile, adjustment in trade due to the weaker Real reduces the risk of a balance of payments crisis. A banking crisis in Brazil appears some way off. Nonetheless, further prolonged recession will test the public banks and foreign investors.

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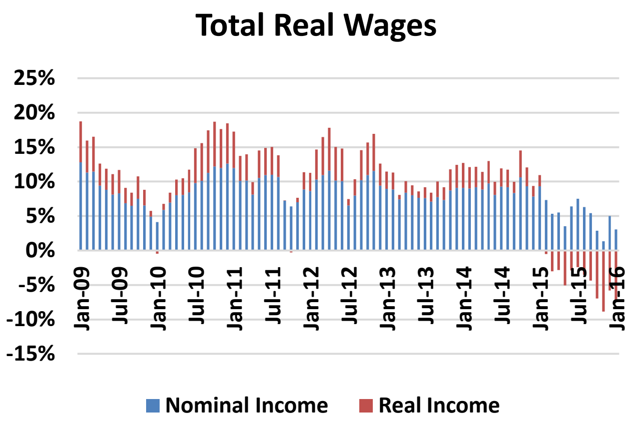
<u>Where is the bottom?</u>

1. **2015 GDP numbers were slightly better than expected, decreasing 3.8%,** but still the worst result since 1990. GDP per capita also suffered, shrinking 4.6% compared with 2014 figures when it fell by 0.8%. Projections for 2016 don't look brighter. Brazilian market analysts expect a 3.5% GDP contraction, while the OECD and IMF forecast -4% this year and stagnation for 2017.

2. **Last years' results were driven by a major contraction in industry, -6,2%,** led mostly by civil construction, manufacturing and extractives (reflecting the Samarco dam disaster and Petrobras woes). **Services, responsible for 70% of Brazil's GDP, registered the first fall in 25 years (-2.7%)**. Agriculture contributed the only positive news +1.8% growth driven by higher productivity gains and increase in trade volumes.

3. **On the demand side, household consumption fell by 4% after 11 years of uninterrupted rises.** Rising unemployment 6.5% to 9% and falling real wages -1.5% both hurt household spending.



4. **Gross fixed capital formation took the strongest hit, decreasing 14.1%.**. Political and economic uncertainty make investment much riskier. Meanwhile with efforts to improve the fiscal results, government consumption registered a mild 1% contraction with the sharpest fall in the fourth quarter – 2.9%.

5. **The 11.6% increase in the minimum wage could help consumption in 2016 if inflation falls fast enough.** Retail sales fell by 4.3% in 2015 and fell again by 1.5% in January. The Consumer Confidence Index indicates an improving scenario for consumption, reaching 68.5bp in February – the highest since September 2015 (70bp). However, any minimum wage increase has downside of raising government spending on welfare payments indexed to it.

6. **Stagflation beginning to give way to disinflation.** Inflation, having risen by 1.27% January driving the 12 month rate to 10.7%, slowed to 0.9% in February and the 12 month average fell to 10.36%. The recession and slower increase in regulated prices (expected +6% as against +18% last year) should contribute to a significant fall in inflation this year. A lack of a similar depreciation of the Real this year (expected -6%) to last (-33% against the dollar) will also help moderate inflation. Market analysts expect inflation to be 7.5% this year, and decline to 5.7%, under the 6.5% target ceiling, in 2017.

7. **The Central Bank kept interest rates unchanged and has not signalled the start of a loosening cycle**. The Bank is concerned that it will aggravate the recession unnecessarily should it raise interest rates further. President Dilma's Worker's Party is already calling for interest rates to be cut. That would be premature and the Bank in its recent meeting indicated this when it drew attention to high levels of indexation and expectations out of line with the target. However easing may begin in the third quarter of 2016.

8. **Achieving the current fiscal target seems impossible and markets reacted negatively to Finance Minister Barbosa's plans.** The primary fiscal target remains at +0.5%, as approved last

year. Neither the government nor markets see any chance of achieving it, even if planned tax increases are approved. Finance Minister Barbosa plans a fiscal band to allow for falling revenues claiming it will generate higher predictability. He wants to combine this with a cap on spending but it is not clear how binding that would be. Given Worker's party pressure to spend more, markets fear further fiscal laxity

9. **Reflecting this policy uncertainty, Brazil is not likely to be regain investment grade soon.** Standard and Poor's lowered Brazil's foreign currency debt by one notch on 17 February (from BB+ to BB), and downgraded local currency debt. Moody's finally followed 24 February and stripped Brazil's last seal of approval, two steps down from investment grade with a negative outlook. Agencies highlighted (1) further deterioration in the debt to GDP ratio, likely surpassing 80% GDP before 2018 and (2) political dynamics constraining fiscal consolidation.

10. **Government tries to adjust, but lacks support for needed reforms.** Rousseff's team is focusing on three fronts: short term tax increases ('only' the Worker' s Party is for), setting expenditure increase ceiling and pension reform (her Worker's Party campaigning hard against). All reforms need Congressional approval. So far, government has not tried to get these passed as it does not control Chamber of Deputies nor has it support for the tax increases in the Senate (where a debt rather than spending ceiling is being proposed).

11. **Meanwhile, corruption investigations get closer to ruling party and markets and large street protests root for change in government.** The Lava Jato corruption investigation is centre stage as the Federal Prosecutor's Office questioned former President Lula and his son for possible involvement in properties renovated by companies linked to the Petrobras corruption scheme. Leaked plea bargain testimony by the former government leader in the Senate appears to make allegations against President Rousseff. Markets reacted positively to the news, seeing greater chances of impeachment. The Bovespa stock exchange rose by 4% while currency gained 1.23%, to USD/BRL 3.75.

12. **Political uncertainty makes it very difficult to predict the bottom of the economic cycle.** Most market analysts see GDP falls decreasing to zero towards the end of this year. Falling inflation and interest rates could help. But investment and employment are unlikely to improve till Brazil finds a path forward in dealing with the fiscal imbalance.

In Focus: What remains solid?

13. **Solid economic variables are still to be found despite economic crisis and policy uncertainty.** Currency, balance of payment and banking crises, accelerating inflation and/or debt default all seem somewhat distant possibilities at present.

14. **Foreign exchange reserves at US$ 380bn remain substantially unchanged.** The Central Bank (BCB) continues to intervene to provide hedging in the FX market through swap operations settled in domestic currency. Worker's Party suggestions to use reserves to boost economic activity or lower the national debt were dismissed by the BCB's President and Finance Minister. High reserves obviate any need to introduce capital controls and lower the likelihood of sovereign default.

15. **Low sovereign external debt and no apparent liquidity crunch decrease the likelihood of default**. Only 0.51% of Brazil's national debt is external. Its nominal value is US$35.35bn, low compared to India's US$88.8bn and Mexico's US$146bn. Total net external debt is 10% of GDP. Corporate external debt is heavily concentrated in a few companies such as Petrobras, Vale and Eletrobras. They might require State support which would worsen the public finances, but they are already selling assets to reduce exposure. The high real interest rates on public bonds and political and economic costs of defaulting on domestic debt mean government continues to raise debt comfortably at home.

16. **There is little room for the government to "inflate its way out of debt".** Less than 50% of public debt is prefixed, the rest is linked to price indexes or the benchmark interest rate. Letting inflation "erode" the value of pre-fixed debt would be offset as non pre-fixed interest payments would rise along with rising price indexes and interest rates. The net effect would be practically zero. Memories of 1990s hyperinflation also make intentional inflation political suicide.

Opportunities in times of crisis

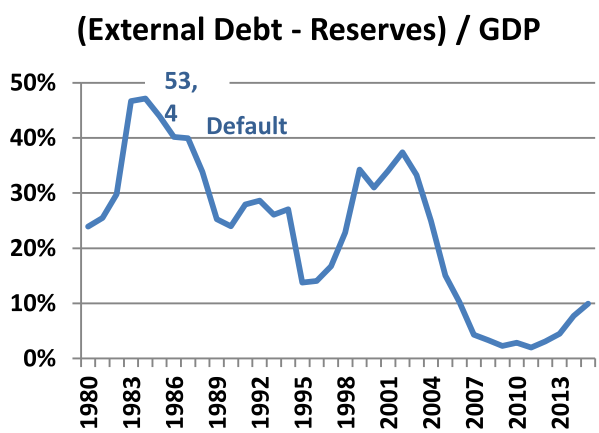
Initial changes point to positive policy direction. Measures such as decreased arbitrary subsidies, end of price controls and less exchange rate interventionism indicate move away from economic populism. Meanwhile, relaxation on rules to foreign participation in health, insurance and airline sectors, and relaxation of local content rules in oil and gas, demonstrate willingness to promote market-friendly reforms.

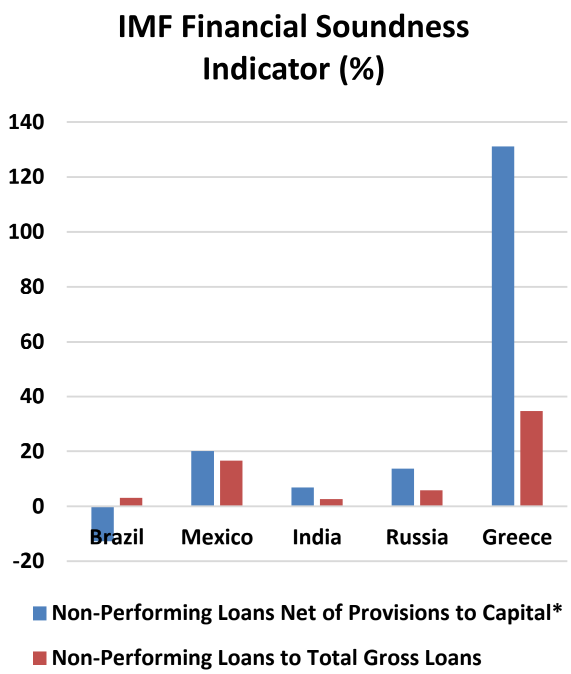
Downturn brings window of investment opportunities. Currency depreciation cheapens good quality assets and Mergers and Acquisitions (M&A) sector is flourishing. Foreign-led transactions grew by 5% in 2015. Investment appetite ranges from IT to pharmaceutical, insurance to mining, energy and oil and gas.The USA was the M&A leader in 2015. China increased investments by 222% in 2015. France didn't lag behind, with the billionaire acquisition of Brazilian Hypermarcas' cosmetic line by giant Coty.

Corruption investigations strengthen institutions and pave way for new players. Despite negative short term impacts, Lava Jato and related investigations reduce long-term risks in Brazil as oversight and judicial institutions grow stronger. Moreover, dismantling the cartel of Brazilian construction giants opens room for partnership opportunities with medium size business and entry of foreign competitors.

UK expertise in compliance may benefit from new anti corruption wave. Compliance is seen as increasingly important due to the anti corruption law (2013) and the Lava Jato investigation. Brazilian firms lack expertise, presenting opportunities for the UK compliance sector.

17. **Current account continues to improve.** In 2015, Brazil posted a trade surplus of US$ 19.6bn, the best result since 2011. Exports increased 30% in volume though value increased more modestly (6.1%) due to price falls. Imports fell by 14.3%, led by both fall in consumption and import substitution. UK goods exports, however, have proven, relatively, robust - falling by just 5%. External accounts are expected to show continued improvement. Annualising the past three month's average suggests a surplus of US$55bn for this year.





18. **Balance of payments crisis is unlikely, as foreign investment inflows remain relatively stable.** Despite sovereign downgrade, Brazil has not yet faced significant capital outflows. Portfolio inflows are more unstable but not strongly negative. FDI inflows remain strong, reaching 4.3% GDP net inflow last year and fully financing the current account deficit. Capital could stop flowing in if the crisis persists, however, the current account gap, that requires capital inflow coverage, is falling.

19. **The banking sector remains sound, at least in the short term.** Private banks move towards safer lines of credit and slow credit growth. Conservative provisioning funded by large spreads should compensate for increasing delinquency rates by corporate and households. Non-performing loans (NPLs) drifted up in 2015, but remained lower than expected. Profits remain stable with an 11% average increase in 2015 due to higher rates, fee income and recovery rates.

20. **Nonetheless, prolonged recession may erode profitability and public banks are a worry.** Contagion from public banks, where NPLs have increased more, draws attention. Caixa's (public) 7% profit in 2015 compared to 15% Bradesco (private) shows the difference. Government policy in recent years of lower rates, credit expansion and higher leverage weakened Caixa's positions. Any required capital injection into Caixa could significantly worsen the government's already strained balance sheet. The quality of assets in private banks is difficult to assess. Overexposure to at-risk sectors, like construction or energy, could result in heavy losses.

**Calculated: Non-Performing Loans – Specific Loans Provisions / Total Sectoral Capital and Reserves*

Key Macroeconomic Indicators							
Monthy	**Aug-15**	**Sep-15**	**Oct-15**	**Nov-15**	**Dec-15**	**Jan-16**	**Feb-16**
Inflation (12 mth. accum.)	7.06	7.64	8.52	9.62	10.67	10.71	10.36
Benchmark Interest Rate	14.25	14.25	14.25	14.25	14.25	14.25	14.25
Unemployment (%)	8.7	**	**	9	**	**	*
Trade Balance (US$ bn.)	2.7	2.9	2.0	1.2	6.2	0.9	3.0
Exports (US$ bn.)	15.5	16.1	16.0	14.0	16.8	11.2	13.3
Imports (US$ bn.)	12.8	13.2	13.8	12.6	10.5	10.3	10.3
Quarterly 2015	**Q1**	**Q2**	**Q3**	**Q4**			
GDP (% var. QoQ)	-0.7	-1.9	-1.7%	-1,4%			

*Quarterly data
** Yet to be released