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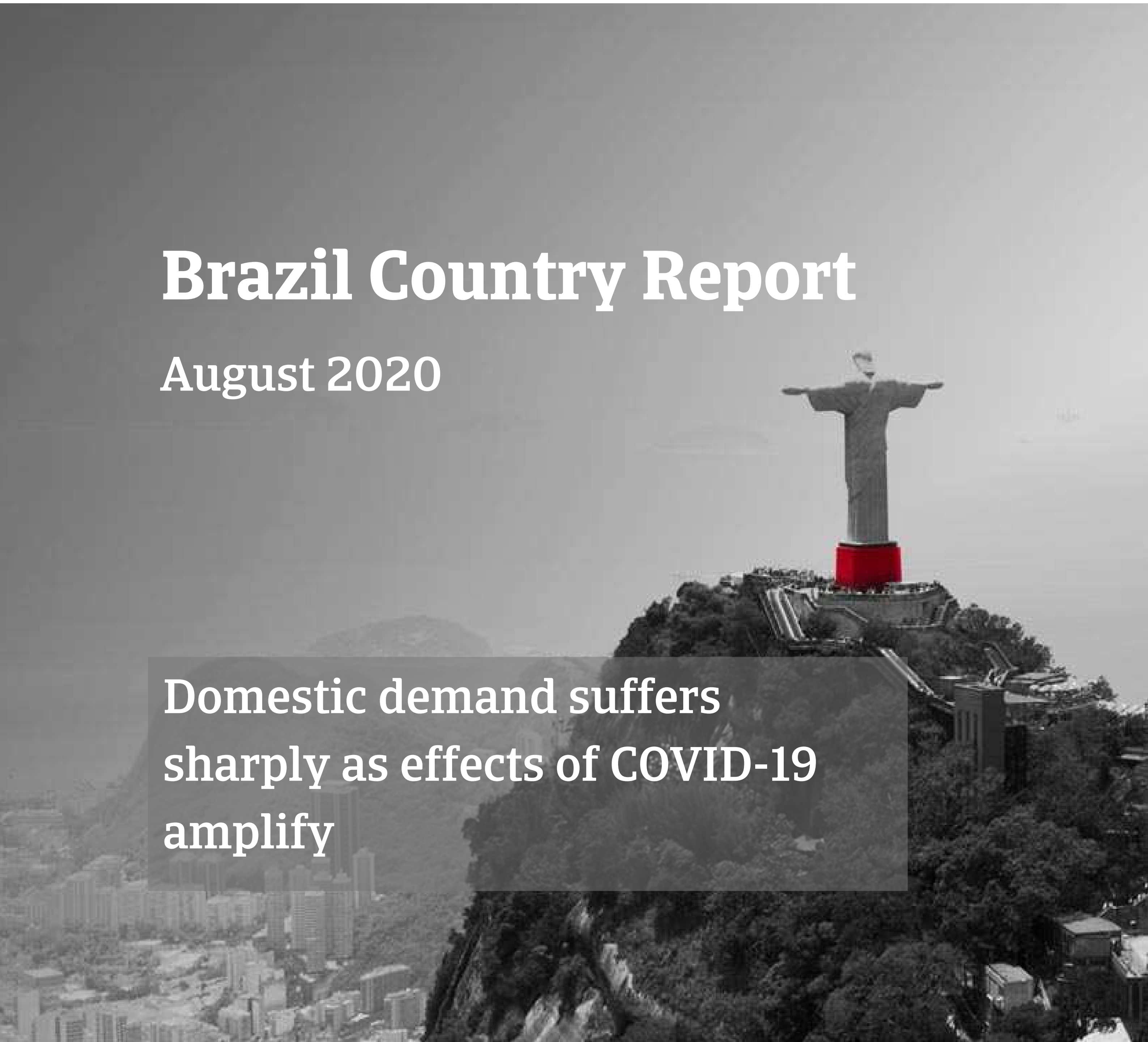


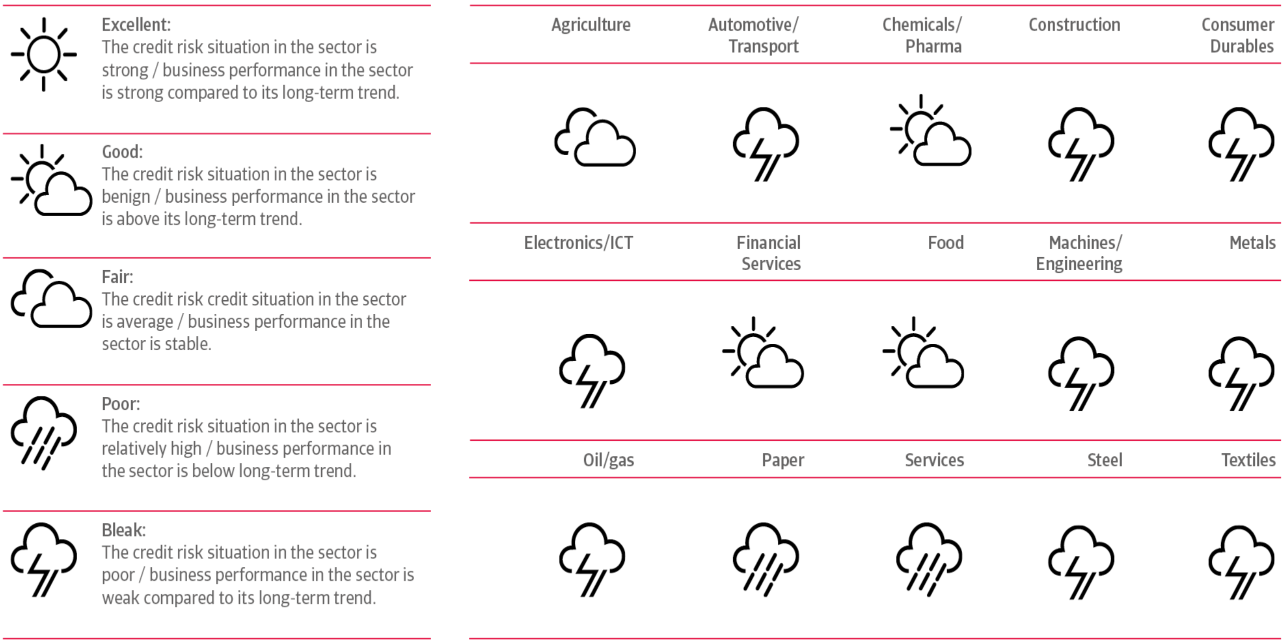
Brazil Country Report

August 2020

Domestic demand suffers sharply as effects of COVID-19 amplify

Brazil industries performance forecast

August 2020



Political Situation

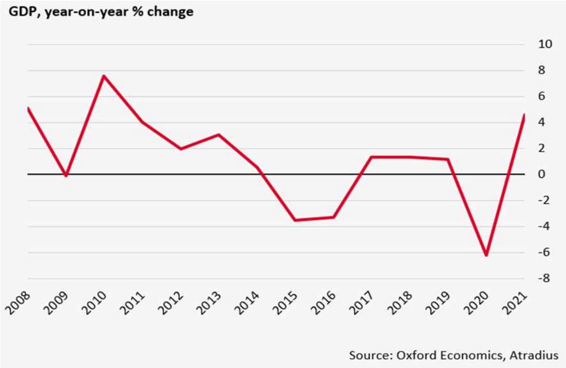
President's leadership style has increased political polarisation

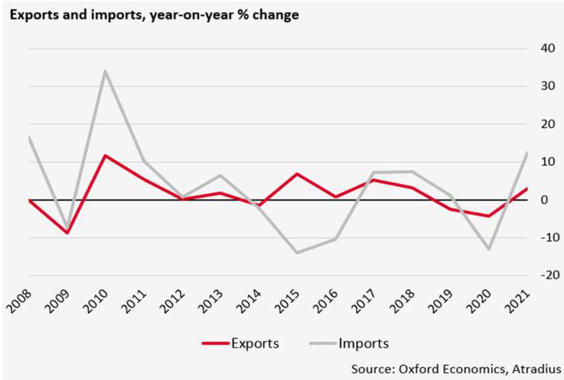
The administration under President Jair Bolsonaro pursues free-market and socially conservative reform policies, welcomed by the Brazilian business community and building on the market-oriented policies of the previous government. However, economic policymaking is hampered by a highly fragmented and polarised Congress, with 30 parties in the lower house and 21 in the Senate, and the ruling Partido Social Liberal having just 10% of the seats in the lower house. President Bolsonaro needs to build and manage working coalitions in order to pass major reforms, particularly those requiring constitutional changes.

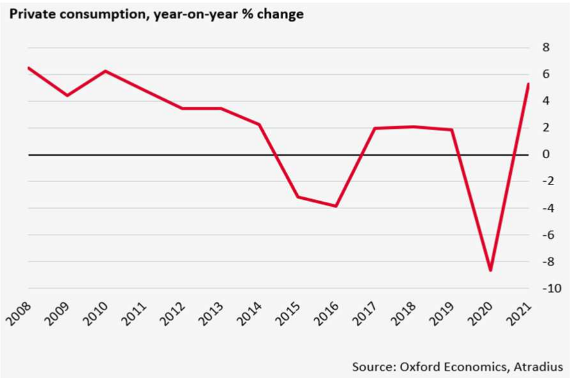
Political and social polarisation have increased due to President Bolsonaro´s confrontational leadership style, his socially conservative views, and his odd response to the coronavirus outbreak (while Bolsonaro disputed the seriousness of the disease, it was the regional governments that took containment measures).

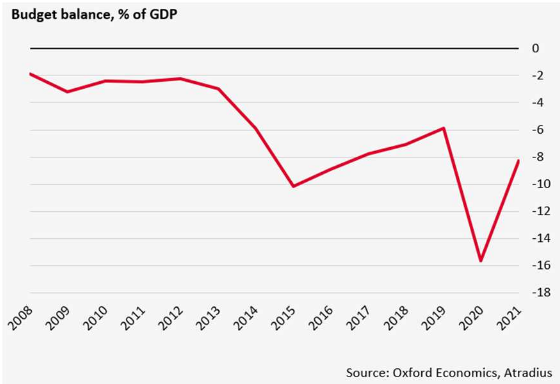
The administration is currently weakened and distracted by the dismissal of several key Ministers. Additionally, Bolsonaro has been accused of political interference in police work, and the Supreme Court has authorized an investigation into this allegation. Supporters of Bolsonaro have staged protests, demanding a military intervention in domestic politics and the closure of the Supreme Court and Congress.

Economic Situation









A severe contraction of domestic demand in 2020

The impact of the coronavirus pandemic has put an end to the modest economic rebound since 2017. The rebound followed Brazil's longest and deepest recession in 2014-2016, when GDP shrank by almost 9%. In 2020, GDP is expected to contract by 6.2%. The economy´s vulnerability stems from its relatively high dependence on the service sector and commodity exports, and on its high public debt.

The massive spread of the coronavirus in Brazil and subsequent lockdown measures have a severe impact on domestic demand, with each investment and private consumption expected to contract 10% and 8.6% respectively in 2020. Exports suffer from sharply decreasing demand (especially from China, the US and Argentina), and are forecast to shrink by more than 4% this year. The only positive exception are soybean exports, which hit a record high in April 2020, and sharply increased oil exports (mainly to Asia) in H1 of 2020.

Deterioration of industry performance and sharply rising insolvencies

The ongoing recession has a major impact on the business performance and credit risk situation of almost all key industries, and has led to many sector performance downgrades (see chart above). Automotive, consumer durables, electronics, services, and textile production and sales are deteriorating due to widespread lockdowns and rising unemployment, which is forecast to increase to more than 13% this year. Within the services industry mainly hotels and catering, restaurants, bars, entertainment and tourism-related businesses are severely suffering. Exports of several commodities are decreasing due to the global economic downturn, including much lower demand from China.

Deteriorated demand from the oil and gas and the construction sectors have a knock-on effect on demand for machines, metals, and steel, industries in which production is also impacted by the lockdowns. Across all industries, businesses that rely heavily on imports are negatively affected by the weaker real exchange rate.

The default risk across all major sectors has sharply increased, and business insolvencies are expected to increase sharply by about 20% in 2020.

Increased risk to fiscal sustainability

In order to support the economy, the Central Bank provided liquidity measures and lowered interest rates several times in H1 of 2020, to a historical low of 2.25% in June. Inflation is expected to remain below 3%, as the recession and low energy prices offset higher import costs resulting from a weaker currency. This provides the Central Bank with some room for additional monetary easing if needed.

The federal authorities announced a package of fiscal measures adding up to almost 10% of GDP, and additional measures are expected. Congress declared a “state of calamity” in March, which in 2020 allows the government to waive its obligation to comply to strict laws regulating public spending. Due to the additional fiscal measures and the economic contraction, the fiscal deficit is expected to increase to more than 15% of GDP in 2020, with public debt rising to 91% of GDP.

The sizeable fiscal deficit was already Brazil´s major economic weakness before the coronavirus outbreak, with persistently high annual budget deficits over the past couple of years. A constitutional amendment to eliminate automatic budget spending growth in line with rising inflation passed in 2016, and the adoption of a comprehensive pension reform in 2019 were necessary steps towards more fiscal sustainability. However, additional structural reforms (e.g. tax reforms) are needed to lower government debt in the medium-term. This is necessary to put government debt on a sustainable path, and to sustain investor confidence in the long-term. Three tax reform bills have been submitted to Congress, but any passing is not expected before mid-2021.

Refinancing and sovereign default risk are for the time being mitigated by the fact that most of the debt is financed domestically (87%), in local currency (95%), and the government is a net-external creditor.

Vulnerable to changing investor sentiment, but resistant to major shocks

Due to a relatively high level of portfolio investment inflows (more than 140% of international reserves) Brazil is vulnerable to shifts in investor sentiment. The increased risk aversion of global financial markets that triggered large capital outflows from emerging markets due to the coronavirus pandemic has also led to increased pressure on the real, which at late July had depreciated 23% against the USD (but has at least regained 15% since its lowest rate in mid-May).

However, a strong financial sector, sizeable official reserves, relatively low external refinancing needs, and the use of currency risk hedges enable the flexible exchange rate to act as a shock absorber. Under the condition that international risk aversion eases once the coronavirus pandemic abates, it is expected that the real will regain its losses.

Brazil´s external financial situation is expected to remain robust, keeping transfer and convertibility risks low. Liquidity is more than sufficient to cover imports (more than 15 months) and external refinancing needs. The current account deficit remains low, and fully financed by foreign direct investment.

Foreign currency debt increased in 2019, which was due to rising intercompany debt, but remains manageable. Non-financial businesses account for 63%, banks for 22% and the government for 15% of external debt. Most externally indebted businesses either have hedged their currency risk or have access to large foreign currency reserves. Refinancing risk is also mitigated by a large share of intercompany debt, which accounts for two-thirds of the non-financial corporate foreign currency debt.