Euler Hermes Economic Research

Economic Insight

Brazil did not need more drama right now

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Executive summary

- Brazil's president Dilma Rousseff was suspended for a period of up to 180 days after the country's Senate voted to put her on trial. Vice president Michel Temer assumed the role of acting president.
- This political stalemate is yet another major challenge for the Brazilian economy and adds up to the pile. Even if some see an opportunity to initiate much needed reforms, prolonged political uncertainty will inevitably exacerbate an already challenging economic situation.
- Brazil will remain in recession: GDP will contract by -3.5% this year, after -3.8% in 2015. Falling demand, strong inflationary pressures, growing deficits are on Brazil's list of ailments. Though the situation eased slightly in the past months, tough policy choices are yet to come.
- Falling demand and tight financing conditions weigh on the private sector: insolvencies are expected to increase by +22% this year, after soaring by +25% in 2015. More social unrest remains a major risk.

Perfect storm inside out

Retail sales fell by -7.9% y/y in March 2016 and consumer confidence is at record low levels (see Figure 1). Though inflationary pressures have slightly slowed down (from 10.4% y/y in February 2016 to 9.3% y/y in April 2016), they remain a major drag on households' purchasing power.

From September 2014 to January, the Brazilian Real (BRL) depreciated by 46% and the stock market (BOVESPA) has lost 40%. Though it is now only 13% below its peak, volatility is a symptom of the lack of confidence from the private sector.

Amid falling commodity prices (industrial metals and food prices) and the slowdown in China (18% of exports), nominal exports fell by -15% in 2015 and have decreased by more than -40% since mid-2014. Imports have decreased even more (-25% in 2015), adjusting to plummeting demand. Consequently, Brazil switched to a trade surplus in August 2015 that has improved since then and reached USD31bn in March over the past 12 months.

Figure 1 – Business and consumer confidence

Sources: IHS, Euler Hermes

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The current account deficit narrowed to -2.4% of GDP in March 2016, from -4.5% in April 2015.

The deteriorating credit profile of Brazil also led to ratings downgrade. The first agency to act was S&P in September 2015, followed by Fitch in December. This is a structural change: a borrower falling in speculative grade needs 6 to 8 years to rebuild its investment grade status on average. In the meantime, attractiveness is on hold.

As a result, capital flows came to a sudden stop. Portfolio flows melt completely from USD47bn in April 2015 to -4.8bn in March 2016 (over the 12 past months). But external solvency is not at stake: (i) direct investment is resilient. Net FDI flows stood at USD72bn in March over the past 12 months, more than the current account deficit (174% coverage, vs 60% a year ago); and (ii) the level of FX reserves covers more than 20 months of imports.

Credit crunch and insolvencies: still more pain for the private sector

Anemic demand caused industrial production to fall dramatically, by 13.2% y/y in April (20% below its last peak of mid-2013; see Figure 2). The capacity utilization rate has improved slightly to 74% in April but remains far below its long-term average of 83%. As a consequence, investment is not expected to recover anytime soon. Q4 2015 marked the tenth consecutive quarter of decline: -18% y/y. Investment is now back to early-2012 levels.

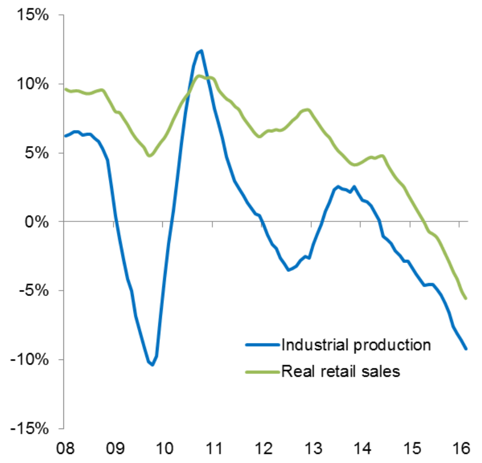
Domestic financing conditions have tightened further (see Figure 3). National credit outstanding for non-financial corporations has slowed strongly: +3.3% y/y in March, vs. +11.2% a year earlier and +15.8% in 2013. At the same time, bank interest rates have increased strongly and now stand above 20% on average for companies (above 30% for non-earmarked resources and close to 10% for earmarked resources). Liquidity is scarce, making debt redemptions more difficult. As of February 2016, arrears of non-financial corporations on banking loans reached 4.0% of the total non-earmarked credit to NFC, while non-performing loans reached 4.7%. Both indicators are at their highest level since 2013 and could rise further.

After a surge of +25% in 2015, business insolvencies are thus expected to increase strongly again in 2016 by +22% (see Figure 4). Along with China, Brazil will experience the most significant increase in insolvencies in 2016. The trend for large companies is particularly worrying: +92% y/y over the 12 months rolling to March 2016.

Major policy decisions needed

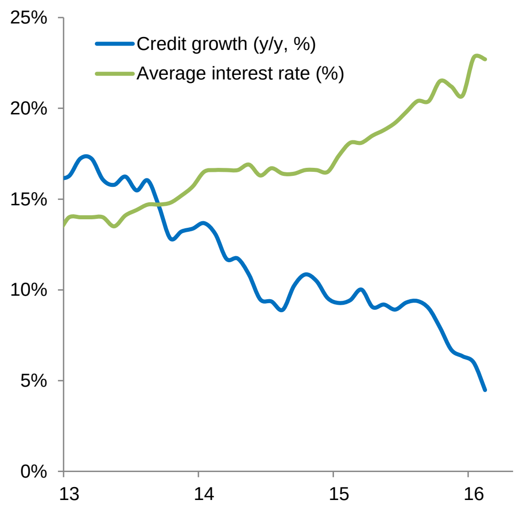
The country's fiscal accounts have deteriorated sharply in the last two years (see Figure 5). The fiscal deficit widened to -10.3% of GDP in 2015 from -6.0% in 2014 and -3% in 2013. This deterioration is mainly explained by interest repayment (8.5% of GDP in 2015 vs. 5.5% in 2014). Foreign exchange interventions explain about 1/3 of the interest burden in 2015. The recent improvement of the fiscal deficit to -6.1% of GDP in March 2016 was achieved by fewer foreign exchange transactions on the back of the appreciation of the BRL. If this trend holds, the fiscal deficit should improve in the months to come.

Figure 2 – Industrial production and retail sales growth (12m/12m, %)



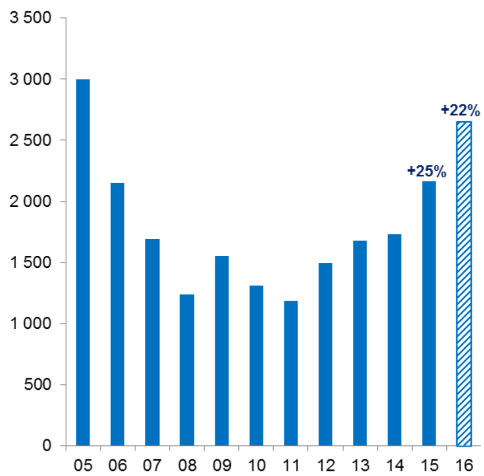
Sources: IHS, Euler Hermes

Figure 3 – Banking credit : Banking credit conditions to Non-financial corporations



Sources: IHS, Euler Hermes

Figure 4 – Corporate insolvencies



Sources: Euler Hermes

Similarly, the primary fiscal balance switched to a deficit at the end of 2014 for the first time in history, and still deteriorating in Q1 2016. Public debt is still increasing at a strong pace: +9pp from December 2014 to date, standing at 67% in March 2016. Political turmoil could also mean increased financial volatility including an increased cost of financing for Brazil on the international market.

Inflationary pressures are decreasing but are still there (see Figure 6). The inflation rate moderated to 9.3% y/y in April 2016 – mainly from a base effect – after having reached 10.7% y/y in January 2016 (9% in 2015 on average), a 13-year peak. We expect inflation to gradually ease in 2016, averaging 8.3% and returning to Central Bank's target range (4.5% +/-2pp), by the end of the year.

The Central Bank increased the key interest rate by +300bps between October 2014 and July 2015, to 14.25%, and has maintained it at this level ever since.

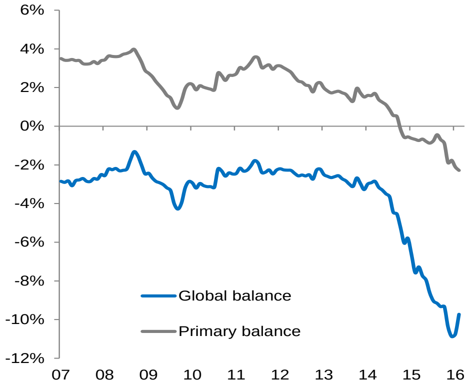
Reforms have been halted for the past couple of years, especially those that could restore Brazil's competitiveness. The interim government could aim at a shock therapy to win over the 2018 elections.

Social unrest is a key risk going forward

Employment continues to deteriorate (-3.6% y/y in February) and the unemployment rate reached 8.2% in February vs. 5.8% a year earlier and a low of 4.7% in October 2014 (see Figure 7). Nominal wages slowed strongly over 2015 and have been decreasing since September 2015 (-1.0% y/y in December 2015). On average, they grew by only +0.5% in 2015, after +5% in 2014 and +7.5% in 2013 (as a result, real wages are receding).

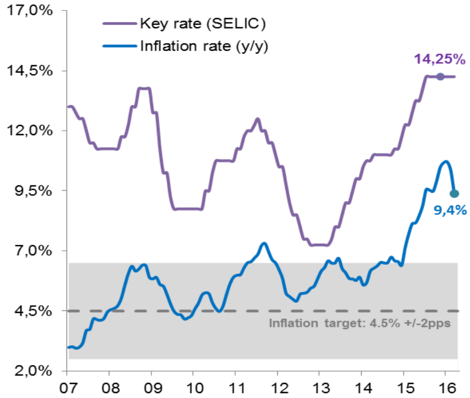
Inflation, depreciation of the real and unemployment are worrying signs for purchasing power, especially since more cuts in fiscal spending are expected (subsidies e.g.) to balance fiscal accounts. This austerity could trigger another wave of discontent, especially as Brazil will be in the limelight this summer as the host of the Rio Olympics.

Figure 5 – Primary and global fiscal balance (% of GDP)



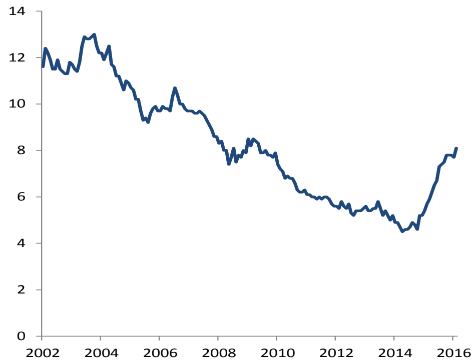
Sources: IHS, Euler Hermes

Figure 6 – Inflation and key rate (%)



Sources: IHS, Euler Hermes

Figure 7 – Unemployment (%)



Sources: IHS, Euler Hermes

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