

# Brazil Country Report

October 2022



A tight presidential run-off election among high inflation and fiscal policy issues

# Brazil industries performance forecast

October 2022

**Excellent**  
The credit risk situation in the sector is strong / business performance in the sector is strong compared to its long-term trend.

**Good**  
The credit risk situation in the sector is benign / business performance in the sector is above its long-term trend.

**Fair**  
The credit risk situation in the sector is average / business performance in the sector is stable.

**Poor**  
The credit risk in the sector is relatively high / business performance in the sector is below long-term trend.

**Bleak**  
The credit risk situation in the sector is poor / business performance in the sector is weak compared to its long-term trend.

Agriculture	Automotive/ Transport	Chemicals	Construction	Consumer Durables
Electronics/ ICT	Financial Services	Food	Machines/ Engineering	Metals/Steel
Oil/Gas	Paper	Pharmaceuticals	Services	Textiles

## Political Situation

### A tighter than expected presidential run-off election ahead

On October 2, general elections were held in Brazil in order to elect all seats in the lower house of Congress, one-third of seats in the Senate, all 27 state governors and the president.

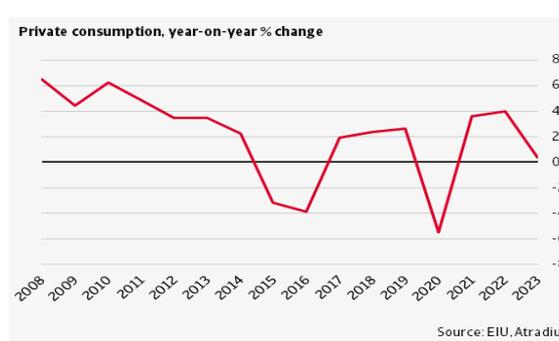
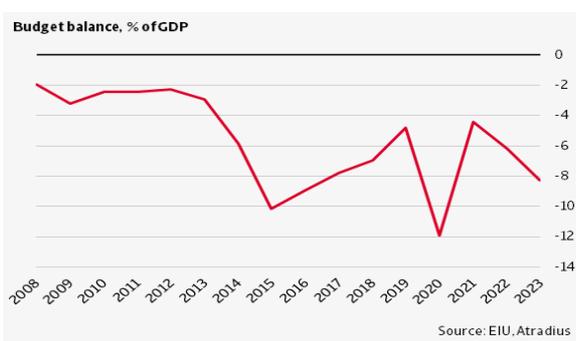
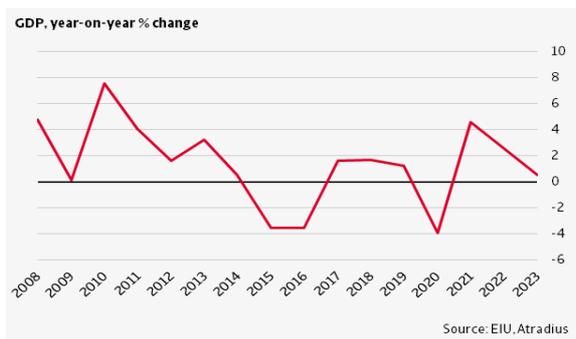
The race for president will be decided in a run-off on October 30, featuring incumbent far-right Jair Bolsonaro and left-wing former President Luiz Inacio Lula da Silva. In a polarised first round campaign Lula attracted 48% of the votes, but failed to secure the majority needed for an outright victory. Bolsonaro won 43%, outperforming previous expectations of most opinion polls. Additionally, Bolsonaro's right-wing Partido Social Liberal (PSL) gained 99 seats in the 513-member lower house, up from 77, and PSL candidates won 13 of 27 seats that stood for election in Senate.

We expect that the campaign of the presidential run-off election will be polarised again. The election could even provide a test for Brazil's

institutions, in particular if Lula ends up winning by a narrow margin and Bolsonaro refuses to accept the result. In the run-up to the first round Bolsonaro has repeatedly put in doubt the integrity of Brazil's electronic voting system and suggested he may not concede if he loses.

Ongoing political uncertainty could weigh negatively on investor sentiment. Whatever will be the outcome of the run-off elections, we expect that deep divisions within Brazil's society and a steep polarisation between leftist and rightist political forces will remain serious issues for the time being.

## Economic Situation



### High interest rates remain a major issue

Brazil's economy returned to pre-Covid levels in Q1 of 2021, sooner than previously expected. With a 3.2% year-on-year increase in Q2 of 2022, GDP growth surpassed forecasts. Private consumption increased by more than 5%, due to rising employment and augmented social transfers, while higher investments in infrastructure also supported economic activity.

However, the economic recovery since last year and rising energy and food prices (partly due to a severe drought in 2021) resulted in rapidly rising inflation. The war in Ukraine and increased public pre-election spending additionally fuelled the surge, with inflation rising from less than 2% in mid-2020 to more than 12% in April 2022. Therefore, the Central Bank has aggressively hiked the benchmark interest rate (Selic) since March 2021, from 2% to 13.75% in August 2022.

Meanwhile consumer prices seem to have passed their peak, decreasing to 8.7% in August. This allowed the Central Bank to pause the tightening cycle, keeping rates

unchanged in September. However, we expect that interest rate cuts will not happen before H2 of 2023, as uncertainty remains high, and inflation will only gradually converge towards the central bank target range of 1.75%-4.75% for next year.

### An economic slowdown expected in 2023

Tight credit conditions, lower external demand and increased political uncertainty should dampen economic activity in the coming months. We forecast 2022 GDP growth to reach 2.6%, supported by pre-election spending (e.g. cash transfers to consumers) and temporary tax cuts (mainly on energy). However, the economic expansion will decelerate to 0.5% in 2023. Persistently high interest rates should slow down domestic demand and increase debt servicing costs for consumers and businesses alike. Private consumption, which accounts for about 60% of GDP, is forecast to increase only 0.4% next year. Fixed investments will stagnate, as margins of businesses are squeezed by high prices for energy and other inputs.

### **Rising non-performing loans, but a solid banking sector**

In 2021, non-performing loans (NPLs) increased only slightly to 2.3% from 2.1% in 2020, partly cushioned by restructuring of loans and debt moratoria. With the expiry of those measures NPLs rose to 2.7% in June 2022. With 1.5%, corporate NPLs were lower than those of households (3.5%). Due to increased interest rates and a slowing economy we expect NPLs to rise further in Q4 of 2022 and next year. However, provisions are adequate.

The banking sector (37% of assets state-owned; 16% foreign-owned) is well regulated and supervised. A low dollarization of domestic credit (15%) and low dependency on wholesale financing shield the system from adverse shocks. Banks have well-developed credit risk assessment systems and lifted provisioning before the pandemic. Capitalisation remains sufficient (capital adequacy ratio of 16.2% in Q2 of 2022 compared to 16.8% in 2020).

### **The sizeable fiscal deficit to widen further in 2022 and 2023**

A 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. That said, additional structural reforms are needed to put government debt on a sustainable path, and to sustain investor confidence in the long-term. The next administration will face this challenge.

Fiscal developments were positive in 2021, as higher revenues, the withdrawal of most Covid-related support measures and wage restraint sharply reduced the government deficit to 4.4% of GDP, down from almost 12% of GDP in 2020. However, we expect the deficit to widen again in 2022 and 2023, to 6.2% of GDP and 8.3% of GDP respectively. This is due to higher interest costs (40% of public debt is linked to the Selic benchmark interest

rate), as well as pre-election tax reliefs and spending measures.

Therefore, we expect government debt to increase from 80% of GDP in 2021 to 87% of GDP in 2023. For the time being, the currency, refinancing and sovereign default risks are being mitigated by the fact that most of the debt is financed domestically (89%), in local currency (94%) at an average maturity of more than five years, and that the government is a net-external creditor.

### **Fiscal policy and the next administration – concerns remain**

Concerns of investors about the fiscal framework have increased, in particular that a temporary waiver to comply with public spending rules could be extended. Even Bolsonaro's pro-business government announced that if he were to be re-elected, he would support a "more flexible" fiscal rule.

If Lula wins the run-off election, we expect him to pursue less market-oriented policies, with higher social spending and more state interventions. While he seems to support the idea of a new fiscal framework that allows for more short-term borrowing, he has also shown a good record of pragmatism during his previous presidency. At the same time, the fragmented composition of Congress, where a group of centrist parties (centrão) traditionally hold the balance of power, will limit the risk of a comprehensive shift in economic policies. The success of Bolsonaro's PSL and allied parties in the Congressional elections would additionally limit Lula's room for major policy changes, should he become the next president.

Whoever wins the presidential election will face the challenge to rebuild fiscal credibility in order to strengthen the sentiment of businesses and investors.

### **Vulnerable to changing investor sentiment, but resistant to major shocks**

Brazil is vulnerable to shifts in investor sentiment, due to a relatively high level of non-resident portfolio investment flows. 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.

The currency exchange rate has been quite volatile this year on the back of political uncertainty, fiscal concerns, and an adverse global risk environment. After a strong depreciation in 2020 and into 2021, the Brazilian real remains undervalued, despite appreciating again on balance in 2022 (supported by high commodity prices and increased domestic interest rates). We expect that currency volatility will continue for the time being, in particular ahead of the presidential run-off elections. Additionally, a narrowing interest gap with the US will prevent any further strengthening in the short-term.

#### **Solid external finances and manageable foreign currency debt**

Brazil's external financial situation is expected to remain solid, keeping transfer and convertibility risks low. Despite a decrease in official reserves in the course of 2022, liquidity remain more than sufficient to cover imports (more than 12 months) and external refinancing needs. The current account benefits from high commodity export prices, and should show only small deficits of 0.7% in 2022 and 0.9% of GDP in 2023. Foreign direct investment flows, averaging 3.1% of GDP in 2022-2023, will fully cover those deficits.

Corporates account for 63%, banks for 20% and the government for 17% of foreign currency debt. This year foreign currency debt will slightly increase in nominal terms. The ratios are low, and should decrease to 30% of GDP and about 140% of exports of goods and services in 2023, down from 36% and 164% respectively in 2021. Most externally indebted businesses have hedged their currency risk. 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.

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