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DATA ANALYSIS – EXTERNAL SECTOR

A HEALTHY DETERIORATION

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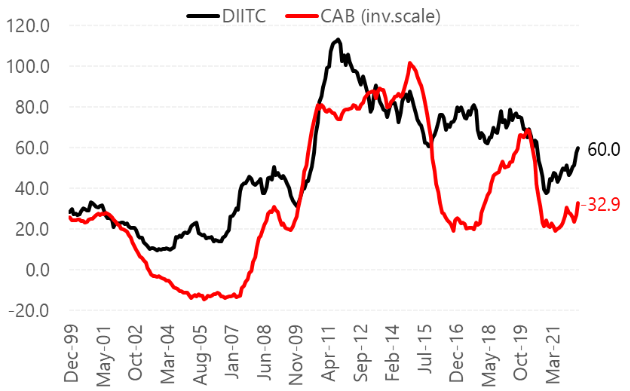
- **Today the Brazilian Central Bank (BCB) released April and May balance-of-payment (BoP) data, which unveiled a current account surplus of US$1.1 billion for the former month and a current account deficit of US$3.5 billion for the latter. Both figures exceeded our estimates of a US$0.3 billion surplus for April and a US$1.5 billion deficit for May, with May's BoP implying a larger current account deficit in 12-month terms than we were expecting: US$32.9 billion vs. US$31.6 billion, respectively.**
- **Although larger than expected, we do not see the current account deficit as worrisome, given that the deterioration stemmed mostly from larger remittances of profits and dividends rather than from a decline in the trade balance or from a significant increase in the services account deficit.**
- **Hence, the deterioration in the current account deficit is a response to the stronger-than-anticipated pace of the Brazilian economy in 1H22. Since we expect the lagged effects of prior interest rate hikes to become more visible and to slow economic activity in the coming months, we believe remittances of profits and dividends will decelerate as well. That is, we see the current account deficit as characterized by an endogenous mechanism of adjustment that should prevent it from following an unsustainable trend anytime soon.**
- **In addition to these favorable dynamics in the current account balance (CAB), we also continued to see sizeable investment flows into the country. The volume of direct investments in the country (DIITC) was US$15.6 billion in the two months, which led to a US$60.0 billion amount in 12-month terms (the highest level since July 2020). Therefore, the country continues to face a comfortable situation as far as external financing is concerned.**
- **Despite the soothing backdrop described above, we highlight that portfolio investments registered outflows in both April and May, thus leading to a three-month streak of negative readings on this line. The withdrawals came from both the equity and the fixed income market, which indicates, in our opinion, some concern among international investors regarding the trajectory of Brazilian financial assets in the coming months.**
- **All in all, we think the constructive view of the Brazilian external position is unlikely to be altered by today's figures, but the trajectory of portfolio investments flow will grab more attention in the coming releases, in our opinion.**

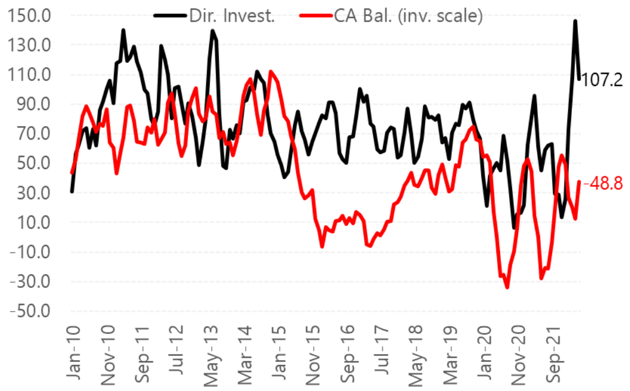
As we expected, the release of the (delayed) figures of the Brazilian balance-of-payments data for April and May showed a deterioration in the current account deficit in 12-month terms, to US$32.9 billion. Curiously, we saw our estimates (+US$0.3 billion for April and -US$1.5 billion for May) being exceeded by actual figures (+US$1.1 billion and -US$3.5 billion, respectively), but the negative surprise in the latter exceeded the positive surprise in the former. At a first look, one could assume that the Brazilian external sector could be turning less positive, in contradiction of our long-time view, especially as the current account deficit reached 1.9% of GDP — a threshold that usually triggers concerns among investors — and the 3MMA-saar gauge worsened significantly to a US$48.8 deficit (2.8% of GDP). However, as we outlined in our *Brazil Macro Compass* report last week (*An Additional Deflation Reading*, August 19, 2022), the bulk of the deterioration is associated with larger remittances of profits and dividends stemming from stronger-than-expected economic activity in 1H22 on the heels of fiscal incentives and the normalization of activities that were previously hit by the COVID-19 pandemic.

Figure 1. Current Account Balance vs. Direct Investment in the Country (USD billion, 12m)



Sources: Brazilian Central Bank, Santander.

Figure 2. Current Account Balance vs. Direct Investment in the Country (USD billion, 3MMA-saar)

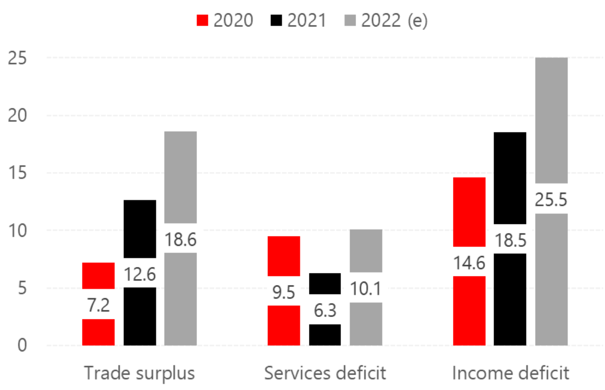


Sources: Brazilian Central Bank, Santander.

However, as we anticipate that lagged effects of prior interest rate hikes will start to take a toll on economic activity in the coming months, we believe that remittances will tend to lose steam ahead, which underpins the endogenous mechanism of adjustment that currently characterizes the current account balance. After all, despite the deterioration in the current account, the trade surplus has improved during the period, and the services account did not decline notably.

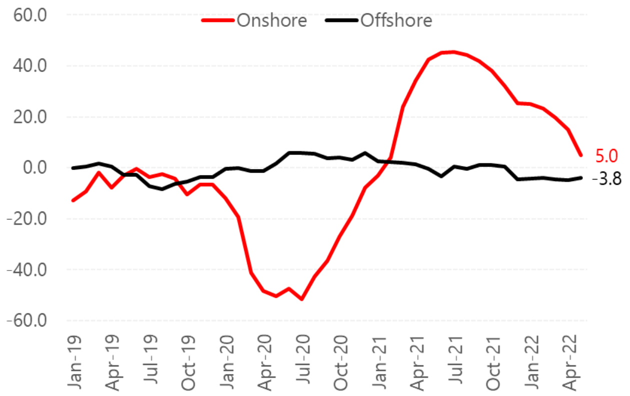
Therefore, we believe the temporary deterioration in the current account balance does not imply an unsustainable trend for the future, especially when we take into account the fact that direct investments in the country have continued to flow fairly freely. Given the US$15.6 billion recorded during April and May, the amount amassed in 12-month terms reached US$60.0 billion, which is the peak observed since July 2020. If we look at the 3MMA-saar gauge, the picture is even better, as it points to a three-digit figure for direct investments for the year. In sum, the Brazilian economy continues to be in a comfortable situation regarding its external source of funding, which we expect to keep the Brazilian balance of payments off the radar of market concerns.

Figure 3. Current Account Items – January to May (USD billion)



Sources: Brazilian Central Bank, Santander.

Figure 4. Net Foreign Portfolio Investments (US|D billion, 12-month)



Sources: Brazilian Central Bank, Santander.

Although the funding of the current account deficit is an undemanding task, in our view, and the backdrop for the Brazilian balance of payments does not cause significant worries, we highlight the fact that the volume of foreign portfolio investments in the domestic market continued to shrink in April and May, with withdrawals in both the equity and the fixed income market — which translated into a three-month streak of outflows. In our view, this is a sign of foreigners' caution regarding the price dynamics of Brazilian financial assets in the coming months, especially amid lingering uncertainties regarding the future of economic policy from 2023 onward. Therefore, although the constructive view of the Brazilian external position is unlikely to be changed by today's figures, we believe today's report provides additional evidence that there is limited room for the strengthening of the BRL in the near term.

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