

### Brazil – Economic Activity

#### Economic Derby – Rivals or Teammates?

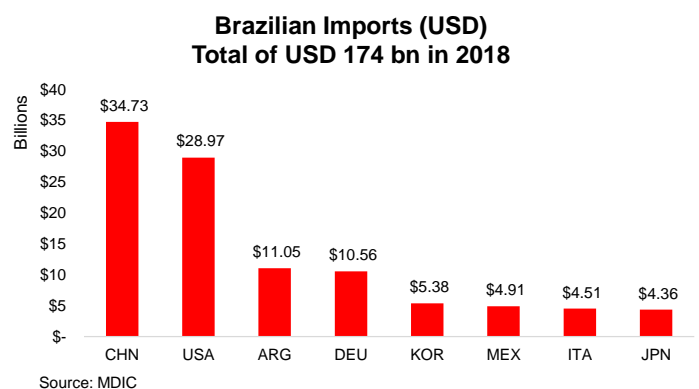
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- Brazil and Argentina are important partners in external trade that benefit from each other's economic growth. Trade relations between Brazil and Argentina are especially important for the automotive sector.
- From the Argentine perspective, Brazil's GDP growth in 2019 could have a favorable impact, in our view. We believe the Brazilian economy will gain momentum and provide some relief to Argentina this year, although not enough to reverse its recessionary trend.
- On the other hand, we believe the recession in the Argentine economy will continue to have a considerable negative impact on Brazilian industry. We estimate that the contraction of Argentina's GDP will reduce Brazil's manufacturing industry GDP by 0.3 pp in 2019, after having subtracted about 0.5 pp in 2018.
- Regarding Brazil's total GDP, we estimate a limited direct impact of -0.05 pp in 2019 (following an impact of -0.1 pp in 2018). However, we should not dismiss the indirect effects of the Argentine crisis on the Brazilian economy, since lower investments in the automotive sector, higher risk aversion (contagion between emerging economies), and a decline in confidence levels (particularly in business confidence) will likely exert a non-negligible influence, in our view.
- Therefore, the deterioration in the Argentine economy is another factor that leads us to assign a downward bias to Brazil's GDP growth in 2019 (our current forecast is 3%).

#### Brazil and Argentina

It is well known that Brazil and Argentina are major global rivals. The neighboring countries have a lot in common besides their geographic proximity; both have rich cultures and history and show the same passion for soccer. Argentinians argue that the tango is better than the samba, while Brazilians will assure you that Pelé was a much better player than Maradona. Such rivalry results in endless debate, but on one point both agree: they are fascinating countries.

**What about their economic relations? Brazil and Argentina are important partners in external trade that benefit from each other's economic growth.** Argentina was the third largest destination for Brazilian exports in 2018, accounting for more than 7% of all exports (in value). From another perspective, Brazil is both the main destination and the main origin for Argentine exports and imports, respectively. In the economic realm, the two countries act as teammates rather than rivals.



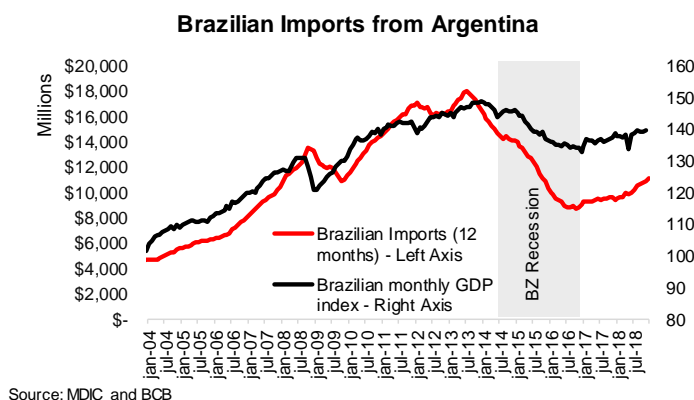
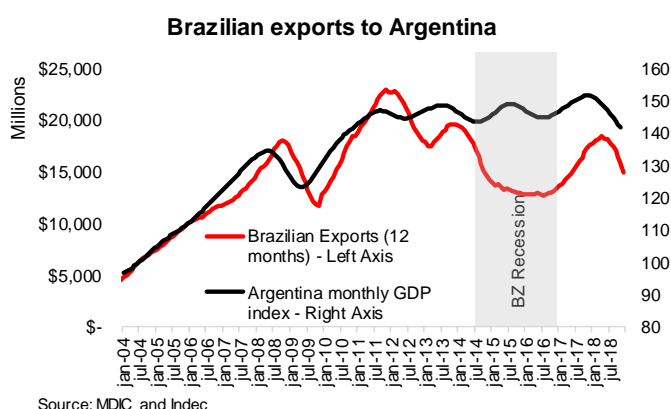
**Trade relations between Brazil and Argentina are especially important for the automotive sector.** For instance, approximately 45% of all Brazilian exports to Argentina are vehicles or correlated goods (e.g., auto parts). In 2018, 22% of



Brazil's vehicle production was exported, of which half went to Argentina. We note that the automotive sector directly represents more than 11% of Brazil's industrial production.

Brazil suffered its worst recession a couple of years ago (from mid-2014 to late 2016), and the economy in Argentina has been marked by high inflation, fragile external accounts, and a sharp currency devaluation. Nevertheless, the 2019 macroeconomic outlook for the two countries is different: while Brazil is already in a cyclical recovery that, in our view, should gain momentum, Argentina will probably face considerable difficulty emerging from recession this year. **On the one hand, the Argentine economy may benefit from the faster growth of Brazil's GDP in 2019; on the other hand, Brazilian industry could be severely hit by lower Argentine demand, partially offsetting gains from the cyclical domestic recovery (exports account for about 15% of total industrial production in Brazil).**

Hence, this report aims to evaluate the impact of Argentine GDP growth on Brazilian industry (and on Brazil's GDP), and vice versa.



## Brazil Helping Argentine Economy, but the Reverse Is Not the Case

In our view, trade relations between Brazil and Argentina are the main factor that is affected by each country's growth. Thus, we have estimated how imports and exports would respond to different scenarios—in other words, how each country could benefit from the economic growth outlook of the other. As noted previously, our baseline forecast for 2019 Brazilian GDP growth is 3%. Regarding the Argentinean economy, our baseline scenario assumes a decline of 0.5% in 2019 GDP.

**From the Argentine perspective, Brazil's GDP growth in 2019 could have a favorable impact, in our view.** We estimate an expansion of 8.5% in Brazilian imports from Argentina, which represents an increment of USD290.3 million in revenue for Argentina. For this estimate, we ran an econometric model that considers: Argentine exports to Brazil; Brazil's GDP growth; the Argentine real exchange rate; and quarterly seasonal dummies (seasonal dummies in this econometric model are used to better predict any seasonal influence on the variable).

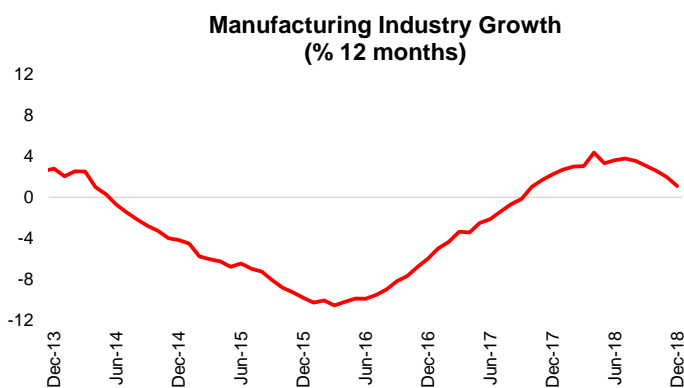
**In short, we believe that the Brazilian economy will gain momentum and provide some relief to Argentina this year, although not enough to reverse its recessionary scenario.**

Impacts of the Brazilian GDP growth on the Argentine exports in 2019			
Scenarios	Brazilian GDP (%)	Brazilian Imports from Argentina - Annual Growth (%)	Brazilian Imports from Argentina - Variation in USD million
A	1.8	4.7	160.5
<b>B*</b>	<b>3.0</b>	<b>8.5</b>	<b>290.3</b>
C	3.7	10.8	368.8

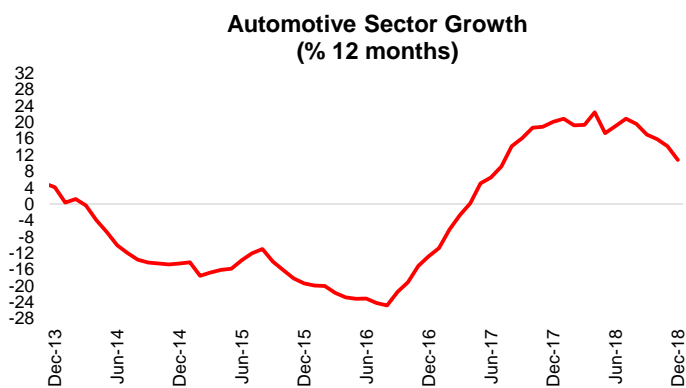
Source: IBGE, MDIC, INDEC, and Santander estimates

\* Baseline Scenario

**On the other hand, the recession in the Argentine economy (we expect GDP to fall 0.5% in 2019, as shown in the following table) should continue to exert a considerable negative impact on Brazilian industry.** According to our estimates for the baseline scenario, Brazilian exports to Argentina should decline by USD1.3 billion (-9.5%) this year, severely affecting the automotive sector. For this estimate, we ran an econometric model that considers: Brazilian exports to Argentina; Argentina's GDP growth; Brazilian real exchange rate; and quarterly seasonal dummies. Accordingly, **we calculate that the contraction of Argentina's GDP will reduce Brazil's manufacturing industry GDP by 0.3 pp in 2019, after having subtracted 0.5 pp in 2018.**



Source: IBGE



Source: IBGE

Regarding total GDP, we estimate a small direct impact of **-0.05 pp** this year (following an impact of **-0.1 pp** last year). It is worth bearing in mind that manufacturing accounts for around half of total industry GDP, which represents 19% of Brazil's GDP (explaining why the direct impact is not significant). **However, we should not dismiss the indirect effects of the Argentine crisis on the Brazilian economy, since lower investments in the automotive sector, higher risk aversion (contagion between emerging economies), and a decline in confidence levels (particularly in business confidence) should exert a non-negligible influence.**

Therefore, **the deterioration of the Argentine economy is another factor that leads us to assign a downward bias to the performance of Brazilian GDP in 2019.** We have emphasized that the slowdown in the global economy (especially in developed countries, such as the U.S. and the euro zone) could have a significant impact on Brazil this year and next, although not sufficient to reverse its cyclical recovery trend (for details, see *Substantial Challenges and Risks in the Global Outlook: How Do They Affect Brazil?* January 29, 2019). **Taking all these considerations into account, we are not changing our positive view on Brazilian economic activity this year (we forecast an expansion that is higher than in the last five years, at least), but we acknowledge that the risks of frustration with regard to the pace of growth seem larger than before.** We are awaiting the release of 4Q18 GDP results (due out February 28) to assess our projection for Brazil's GDP growth in 2019 (currently at 3%).

#### Impacts of the Argentine GDP growth on the Brazilian economy in 2019

Scenarios	Argentine GDP (%)	Brazilian Exports to Argentina - Annual Growth (%)	Brazilian Exports to Argentina - Variation in USD billion	Impact on Brazil's Manufacturing Industry GDP (pp)**	Impact on Brazil's GDP (pp)***
A	-2.0	-18.3	-2.6	-0.56	-0.07
<b>B*</b>	<b>-0.5</b>	<b>-9.5</b>	<b>-1.3</b>	<b>-0.28</b>	<b>-0.04</b>
C	1.0	4.5	0.6	0.13	0.02

Source: IBGE, MDIC, INDEC, and Santander estimates

\* Baseline Scenario

\*\* Santander forecast for Manufacturing Industry GDP growth in 2019 = 3.3%

\*\*\* Santander forecast for total GDP growth in 2019 = 3%



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