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Emerging Insight

Brazil - Credit Markets: the worst is behind

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GEM Fixed Income Strategy & Economics
Global

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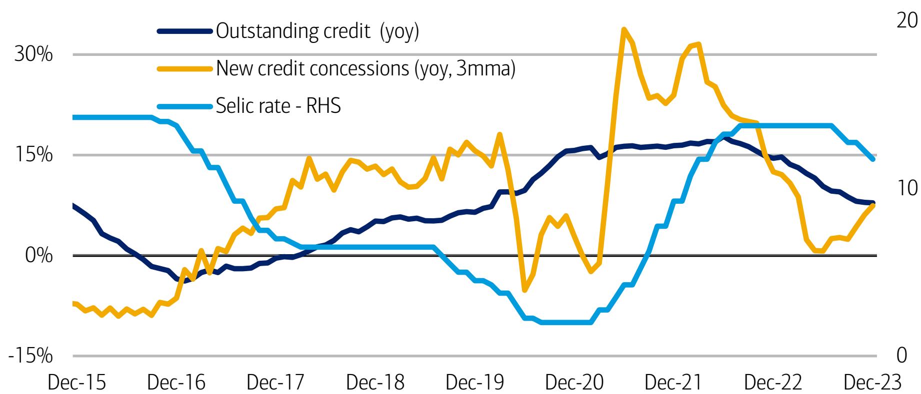
Key takeaways

- After a period of tightness, the Brazilian credit market should feel the effects of the monetary easing.
- New credit concessions and non-performing loans already started to recovery.
- Current credit conditions support our monetary policy view. We expect the terminal rate at 9.50% in 2024.

By David Beker and Natacha Perez

Chart of the Day: Outstanding credit decelerated; new grants suggest a recovery
The lagged impacts of monetary easing should be felt this year



Source: BofA Global Research, BCB

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Recovery around the corner

Total outstanding credit was on a downward path since early 2016, but after Covid-19´s liquidity injection and GDP contraction, credit-to-GDP ratio resumed an upward trajectory, reaching a record-high of 54.2% of GDP in December 2022. However, the pace of credit growth started to slow down by June 2022, after over one year of monetary tightening and more than 1000bp of interest rate increases. This scenario led to record indebtedness levels for both families and companies. New credit concessions turned more conservative and decelerated from 26.4% yoy growth in May 2022 to 1.9% yoy in July 2023. The Central Bank of Brazil (BCB) decided to start cutting the selic interest rate in August 2023. With the ongoing monetary easing, new concessions and non-performing loans are already improving, but the lagged effects of monetary easing are yet to be fully felt by the economy throughout 2024.

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Credit market experienced tightness

The Brazilian credit market has experienced significant shifts, fueled by economic fluctuations and policy adjustments. From the early 2000s, it thrived, with credit growth hitting double-digit rates for over a decade. However, the tide turned during the 2015-16 recession, leading to a cautious and contractionary market environment.

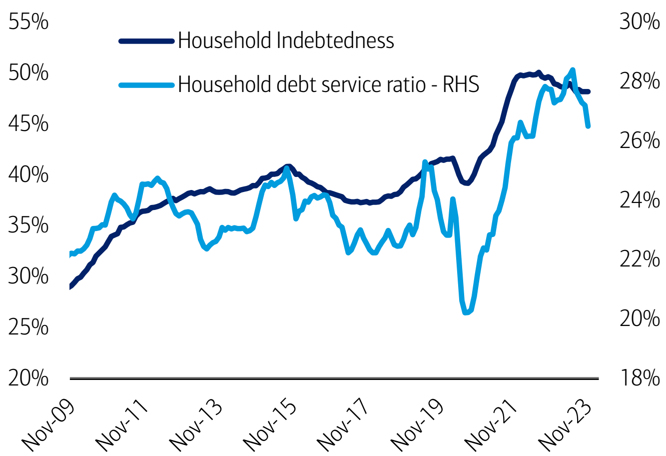
The COVID-19 pandemic in early 2020 was a turning point, prompting the Brazilian Central Bank (BCB) to implement measures such as injecting over 13% of GDP of liquidity into the market and reducing interest rates to a historic low of 2.0%. These actions boosted credit availability, leveraging both households and corporates.

Post-pandemic, however, Brazil faced new challenges: rising interest rates, high inflation, and economic slowdown, which pressured the credit market and led to a deceleration in new credit issuance. Household Indebtedness level reached its record in 2022 and remained high (see: Exhibit 2).

Last year, Brazil's credit market reached its lowest point, prompting the government to launch initiatives to counter the downturn. The main one, namely *Desenrola Brasil*, was a debt renegotiation program, which helped to reduce non-performing loans (see: Exhibit 2). This effort, combined with the inflation deceleration, is likely to bring some relief for the households' balance sheet. New credit operations are slowly increasing. With the effects of the Central Bank's interest rate cuts starting to emerge, the worst seems to be behind us. One evidence is the evolution of credit impulse to GDP from household loans measure by the BCB, which has left its most bottom in October 2023 (of -2p.p. of GDP), though it remains in a negative camp (-1.8p.p in December2023).

Exhibit 1: Household indebtedness reached record levels

It already started to improve



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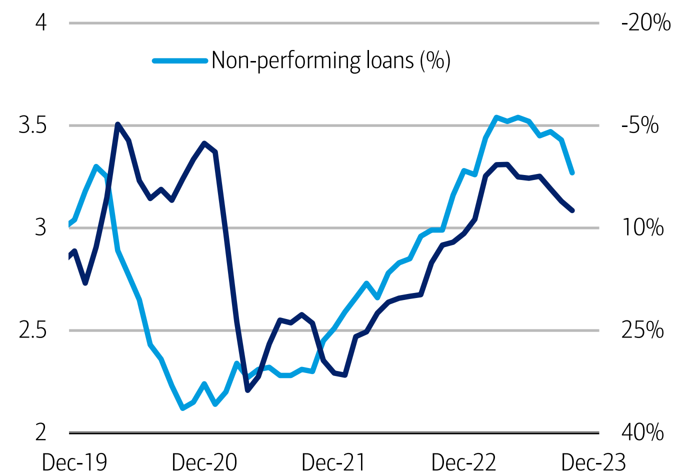
Household Indebtedness: Household debt to income in the last 12 months (Households gross disposable national income)

Household Debt Service Ratio: Proportion of household gross disposable income required to meet debt obligations (interest and principal) to be paid in 30 days or less

Exhibit 2: NPLs and new credit concessions tend to mode together

Desenrola program can accelerate the pace of improvement



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Recovery ahead

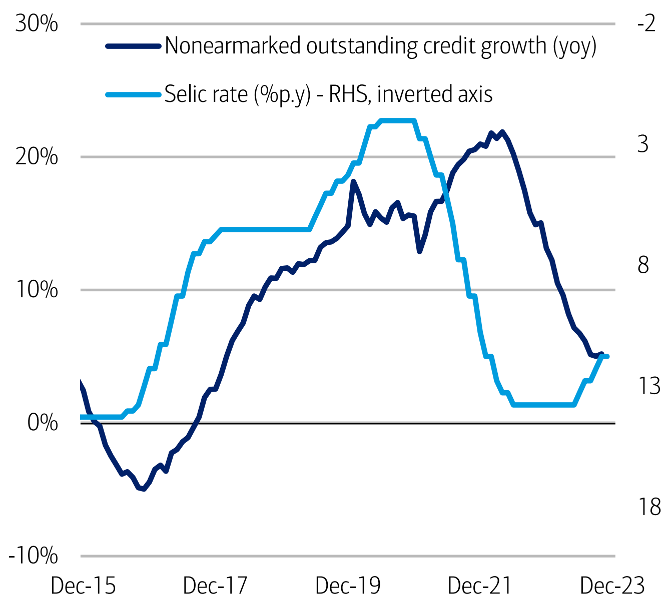
The non-earmarked credit segment is expected to see a recovery, directly benefiting from the Central Bank's interest rate cuts (see: Exhibit 3). Lower interest rates reduce borrowing costs for both consumers and businesses, thereby stimulating demand for new credit. This environment, in conjunction with controlled inflation, can boost consumption and create a positive feedback mechanism for the economy. Though the preferred driver for sustainable economic growth is investment, larger consumption can stimulate the economy and, therefore, labor and wages. Despite the risk it poses to inflation, the positive momentum for economic growth and increased disposable income can reduce the banks' risk perception leading to higher credit supply.

The perspectives are also favorable for earmarked loans. The monetary easing effects are milder in these types of loans, due to lower interest rate sensitivity. Still, agricultural credit remained strong with doble-digit growth during 2023, despite decelerating due to the base-effect of the previous administration stimulus policies for this sector. Additionally, real estate credit showed strength in 2023. Public policies such as the "Minha Casa Minha Vida" program, which improves housing credit accessibility for lower-income families, are behind the resilience of this line of credit. On the Brazilian Development Bank (BNDES) side, funding activities are set to expand, with plans to increase disbursements to R$130-160 billion in 2024, from R$115-120 billion in 2023.

Even with an improvement in credit conditions, the high indebtedness level should continue to pressure credit markets. Nonetheless, measures are being undertaken to mitigate this issue. In force since January 2024, the revolving credit card bill introduced a limit on how much interest can be charged on the unpaid balance of credit cards, capping it at an annual rate of 100%. This is a substantial decrease from the previous situation, where interest rates could soar above 400% per year.

Exhibit 3: Non-earmarked credit responds to the lagged effects of monetary policy

It is expected to accelerate ahead



Source: BofA Global Research, BCB

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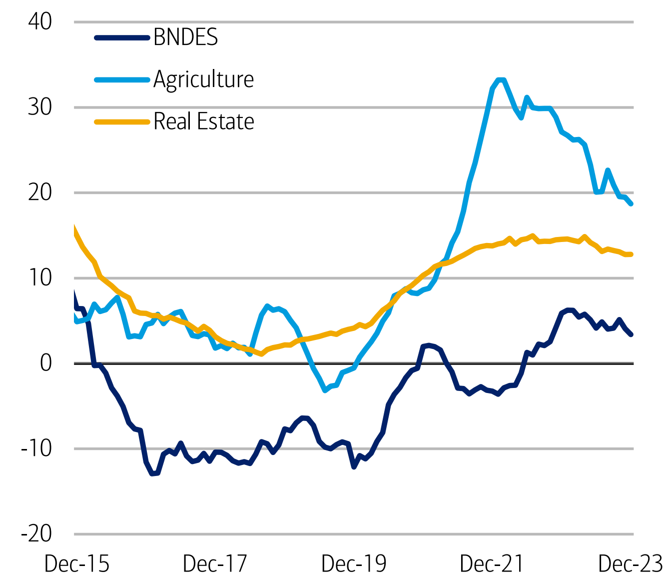
Exhibit 4: Earmarked credit deceleration guided by agriculture credits

BNDES and real state credits with deceleration in lower scale; outstanding credit growth yoy



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Shifts in broad credit dynamics

The broad credit to the non-financial sector, which includes debt securities, external debt and loans, has been strong over the years. Since 2015, there has been a notable shift in the sector's dynamics, with a growing emphasis on debt securities. Despite this shift, traditional loans continue to play a crucial role. Recall that, by this metric, debt securities issued by federal government but not held by the BCB are accounted for. It includes securitized debt and it does not include securities held by nonresidents, which are classified under external debt. The fight against the pandemics elevated govt borrowings in Brazil, as elsewhere in the rest of the world. Nonetheless, the increased appetite for local debt securities can be seen as a move to a more developed Brazilian capital market: indeed debt securities issued by Non-Financial Corporations share increased from 14.5% in December 2007, to 25% of the total amount in December 2023.

The outstanding broad credit growth, however, experienced a downturn, declining to 4.3% yoy in December 2023, a significant drop from the 9.3% registered in the beginning of the year (see: Exhibit 5). This deceleration was attributed to a decline in loans, in a context of dual pressure over borrowers: the widespread indebtedness and high interest rates. The easing of monetary policy is expected to positively influence the sector's trajectory.

Recently, the National Monetary Council of Brazil revised its policies on the issuance of private debt securities, with a particular focus on those connected to the real estate and agricultural sectors. The goal is to guarantee that these financial instruments are utilized in alignment with their foundational objectives. Those modifications are expected to generate a contraction in the issuance volume of such securities, which could indicate an upcoming shift in the overall composition of broad credit.

Exhibit 5: Broad credit decelerated trough last years
Year-over-year growth

Source: BofA Global Research, BCB

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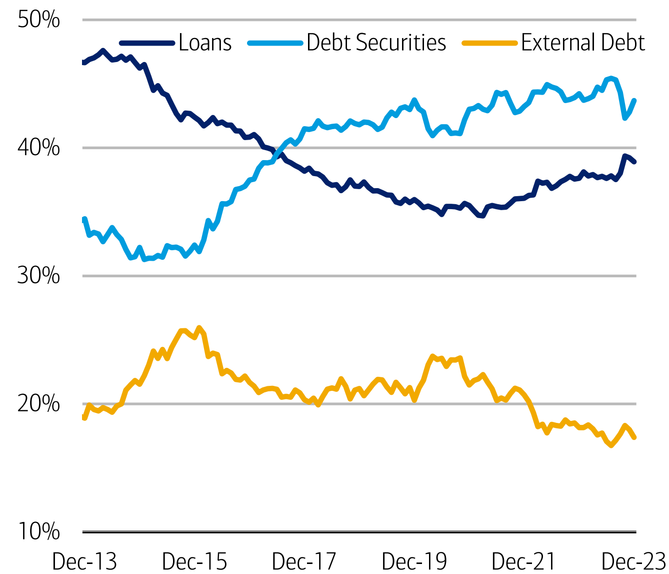
Exhibit 6: Debt securities gained ground since 2015, mainly through corporate
% of Broad Credit



Source: BofA Global Research, BCB

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Reinforcing our Selic rate forecast

As risks to the credit market decline and credit concessions increase, economic activity could benefit from the boost in domestic demand. However, the level of indebtedness remains high and is unlikely to decrease significantly. Therefore, the current credit scenario supports our outlook for monetary policy: we expect that the BCB to maintain a 50bp monetary easing pace per meeting in the Selic rate in the upcoming meetings, with a final adjustment of 25 basis points in July, culminating in a terminal rate of 9.50% in 2024.

News and Views

Mexico: Mexico received US$36.1bn of FDI in 2023, according to Economy Ministry

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Mexico received US$36.1bn of FDI (foreign direct investment) in 2023 (BofA US$40.0bn), according to Ministry of Economy's preliminary data. This represents an increase of 27% yoy, if Televisa-Univision merger and Aeromexico restructure are excluded (+ 2.3% yoy if included). 2023's print is the highest of the past 17 years, above 2022 (US$35.3bn if Televisa-Univision merger and Aeromexico restructure are included) and 2013 (US$35.2bn if Grupo Modelo sale is included). Nonetheless, FDI as a % of GDP fell to 2.0% (according to our GDP estimates for 2023) from 2.4% in 2022. By components, reinvested earnings accounted for US$26.7bn (74%) of the FDI, while the rest was evenly distributed between new equity investments (US$4.8bn, 13%) and debt transactions (US$4.6bn, 13%). By country of origin, the larger investors were the US (US$13.8bn), Spain (US$3.8bn), Canada (US$3.5bn), Japan (US$2.9bn), Germany (US$2.4bn), and Argentina (US$2.2bn). These accounted for US$28.6 (79% of total FDI). With regards to FDI destination, Mexico City and Jalisco where the States that received the most in the central region (US$11.2bn and US$2.2bn, respectively), while Sonora (US$2.7bn), Nuevo León (US$2.5bn), and Chihuahua (US$2.0bn) had the largest inflows in the Northern border. By industry, FDI flowed mostly to manufacturing (50%), financial services (20%), mining (10%), temporary accommodation (7%), and transportation (6%).

- **To follow:** This print gives additional support to the nearshoring narrative, with investment flowing to States in the northern border (i.e., industrial companies) and the central region (i.e., logistics companies). Looking forward, we believe elections in Mexico and in the US could temporarily decelerate FDI flows into Mexico in 2024, but no elections and potentially a weaker USD/MXN could help to give FDI an extra boost in 2025.

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