Brazil

Tough luck

The massive economic shock resulting from the coronavirus sanitary crisis will delay Brazil's economic recovery, suspend the process of fiscal consolidation and stall progress on reforms. While the extent of the recessionary shock remains highly uncertain, measures – both fiscal and monetary – have been taken to mitigate the impact of confinement measures on economic activity, prevent a sharp upturn in unemployment and ensure that tensions over liquidity do not materialize into solvency problems. Intervention capacities on the monetary side are ample and contrast with those on the fiscal side, which are more limited due to the fragilities of public accounts. Brazil's financial markets, which came under significant stress in Q1, will continue to be challenged.

Stopped abruptly in its tracks

The coronavirus pandemic will halt Brazil's three-year long economic recovery in its tracks. The economy – which experienced a slight slowdown towards the end of 2019 – is expected to fall back into recession in 2020, a highly regrettable situation in light of the economy's encouraging signs in recent quarters.

The spread of the virus within the country's borders since March together with the deployment of confinement measures[1] is expected to lead to a contraction in economic activity in Q2 (simultaneous internal supply and demand shocks). The effects of the virus on the economy have already started to be felt towards the end of Q1. The PMI in the service sector fell by 16 points (34.5 vs 50.4 in February) – its largest drop since the inception of the time series. Meanwhile, the PMI in manufacturing fell below 50 for the first time in eight months (48.2 vs 52.3 in February) with subcomponents indicating lower levels of production, employment, and new orders as well as accelerating drops in foreign sales. Disruptions in global supply chains throughout Q1 have also resulted in longer delivery times and work backlogs comparable in magnitude to those which occurred during the truckers' strike (May 2018). Layoffs in the sectors have also reached a three-year peak. The automotive sector has also shown signs of weakening: alongside car sales which have dropped by 33% (m/m, sa) in March, car registrations have also retracted (-21% m/m).

Increasing pessimism on behalf of economic agents is palpable in survey data. The FGV confidence indicator in industry fell by almost 4 points in March (97.5) after increasing for four straight months while the FGV confidence indicator in services collapsed by 12 points (82.8). According to a Datafolha survey published on March 24, 79% of respondents believe that the Brazilian economy will be "strongly affected by the crisis", 57% that their income will decrease in the coming months while half believe the pandemic will hurt the economy "for a long time."

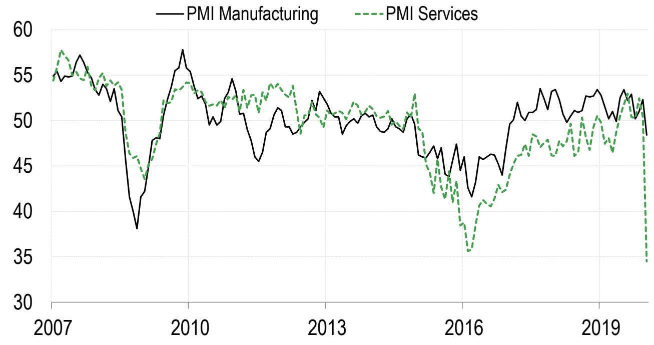
The recession is forecasted to reach -4% on an average annual basis. This forecast assumes a gradual recovery of economic activity in Q3 and a strong bounce back in Q4 without however returning to pre- crisis levels (asymmetric U type scenario).

1- Forecasts

	2018	2019	2020e	2021e
Real GDP grow th (%)	1.3	1.1	-4.0	4.0
Inflation (CPI, y ear av erage, %)	3.7	3.7	3.2	3.2
Budget balance / GDP (%)	-7.1	-5.9	-12.5	-4.3
Current account balance / GDP (%)	-2.3	-2.9	-2.5	-3.4

e: BNP Paribas Group Economic Research estimates and forecasts

2- PMIs dropped in March



Source: IHS Markit

This scenario would allow the economy to benefit from a strong growth carry-over in 2021. Nonetheless, the forecast remains highly precarious reflecting the lack of precedents in assessing sudden stops and the significant uncertainties at this stage regarding i/ the capacity of the health infrastructure to cope with the epidemic, ii/ the actual effectiveness of confinement measures – given the high level of heterogeneity in the health response across states so far – as well as iii/ the magnitude of the impact of the crisis on the informal economy (54 mn workers, 41% of employment). Once the epidemic is under control, firms weakened by the crisis could also notably reduce their investment spending possibly weighing down the recovery.

External accounts : a cascade of shocks

The external demand shock brought about by the Covid-19 crisis alongside the unprecedented oversupply in the oil market is expected to keep commodity prices depressed and slowdown sales abroad. Brazil – a net oil exporter – whose exports of commodities

[1] The state of Sao Paulo, which represents approximately 40% of GDP, has implemented confinement measures since March 24th until April 22nd. Recent studies (e.g. OECD) show that some economies across the globe could lose the equivalent of 2 to 3 percentage points of GDP on average per month of strict confinement.

account for around 50% of foreign sales – will suffer from a deterioration in its terms of trade with the fall in oil prices (-61%), the price of sugar (-21%), corn (-14%) and cotton (-27%). The depreciation of the BRL – which dynamics closely mirror that of the commodity cycle and has, in recent months, suffered from appreciation in the USD – has meanwhile mechanically increased the cost of imports further eroding the purchasing power of exports. That said, the reduction in the trade surplus is expected to be limited by the concurrent decline in import volumes due to the recession and a weakened BRL. The trade balance could also benefit from certain commodity prices holding up their ground as seen in Q1 (e.g soybeans, coffee, beef, wheat, and iron ore). In 2020, the current account deficit should fall (-2.5% of GDP) with the decrease in the services balance deficit (-1.9% of GDP in 2019) and that of the primary income balance (-3.1% of GDP in 2019) which should benefit from the slowdown in transferred profits and dividends.

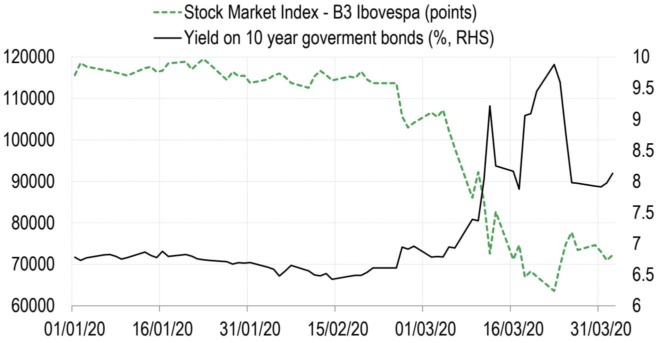
The pandemic has led to a strong surge in risk aversion triggering i/ significant capital outflows (non-residents have cumulatively pulled around USD 14bn from the stock market since January according to data from the IIF) as well as generating ii/ significant shocks to asset prices. From January to the end of March, the depreciation of the BRL reached -23% against the USD (reaching an all-time low of 5.25), the stock market suffered heavy losses (-45% at its lowest) and financial conditions in the secondary corporate and sovereign debt markets tightened sharply (the sale of government securities to generate liquidity pushed 10-year yields up by +310 bps at their highest point over the period). Despite the tightening of financial conditions and the drop in the BRL, rollover risks in foreign currency in the short term remain limited : i/ redemptions of USD denominated debt (bond debt + syndicated bank loans) is moderate in 2020 (~ USD 40 bn), ii/ open FX positions of corporates are limited, iii/ corporates with foreign currency debt are predominantly exporters and hold liquid assets offshore, iv/ FX reserves are abundant (~ 345 bn at the end of March), and v/ the BCB reinstated in March a USD 60 bn precautionary swap line with the Fed.

The authorities' response to the crisis

A number of steps were taken by political authorities to curb the spread of the virus. Borders were shut down and several states have declared a state of emergency and have put in place measures to reduce the mobility of people. However, containment measures have only been partial for the most part. They have also been a source of political tension between the various levels of government. Most state governors have pushed for tougher measures and have also asked Congress to take the lead in the fight against the pandemic given the failure of President Bolsonaro to recognize the gravity of the health situation.

Monetary authorities – through a combination of monetary easing and prudential measures – have taken significant steps to help contain systemic credit risks associated with the macroeconomic shock. Measures were deployed to alleviate tensions on BRL liquidity, facilitate the refinancing of banks and encourage them to renegotiate payment terms with households and businesses on roughly BRL 3200 bn of outstanding credit. Authorities have i/ cut the policy rate (7th consecutive) by 50 bps to 3.75% ii/ relaxed the reserve requirement ratio on term deposits from 30% to 17%, iii/ relaxed capital and provisioning requirements iv/ bought back in –partnership with Treasury – sovereign debt securities in the secondary market v/ allowed riskier securities (corporate debt) to qualify as collateral in transactions with banks vi/ extended guarantees for certain types of deposits. The liquidity injection is estimated at BRL 1200 bn (16.7% of GDP) and the reduction in capital requirements at BRL 1150 bn (16.1% of GDP). At the same time, the BCB will continue to provide liquidity to the FX market via its swap cambial, repo programs and its spot interventions (USD 9.7 bn in March).

3- Dislocations across domestic financial markets



Source: B3, Macrobond

On the fiscal front, numerous announcements were made in the form of tax / financial relief, direct support and guarantees. Communication over the support provided has at times lacked clarity. By some estimates, measures amount so far to BRL 490 bn (6.8% of GDP)[2] and have been deployed to: i/ protect employment and the most vulnerable populations (BRL 268 bn): ii/ combat the pandemic (BRL 11.5 bn) iii/ alleviate the financial pressures of states and municipalities (BRL 85.5 bn) iv/ strengthen the working capital / cash flow positions of companies (BRL 123 bn).

By voting a "state of public calamity", Congress authorized the government to suspend its deficit targets and fiscal rules for 2020. The primary deficit (excluding interest payments) should thus largely exceed the BRL 124 bn (-1.6% of GDP) originally forecasted in the 2020 budget settling instead around BRL 515 bn (-7.3% of GDP, accounting for the contraction in GDP), which would bring the headline budget deficit to 12.5% of GDP. Current measures do not even take into account a possible post confinement stimulus package. Needless to say that concerns over the sustainability of Brazil's public debt – which could flirt in the neighborhood of 90% of GDP – cannot yet be put to rest.

Salim Hammad
salim.hammad@bnpparibas.com

[2] Other estimates evaluate total support to around BRL 700 bn (9.8% of GDP). The minister of the economy, Paulo Guedes, estimates that support could reach north of BRL 800 bn.