BRAZIL

HIT HARD

While the Covid-19 epidemic continues to spread, restrictions have started to ease in parts of the country. A severe contraction of economic activity is anticipated in Q2 with the latest data indicating that a low point was reached in April. A rapid recovery of economic activity will be constrained by the economy's weak growth engines, especially investment. Fiscal and monetary policy measures have continued to be deployed or extended to help cushion the impact of the crisis. While the currency continues to exhibit weakness and fiscal balances keep deteriorating, continued monetary easing has helped boost the stock market.

A CONTROVERSIAL MANAGEMENT OF THE HEALTH CRISIS

Against a backdrop of escalating political tensions[1], the management of the health crisis on the part of the federal authorities has been highly controversial: temporary suspension in the publication of Covid-19 statistics, successive dismissal of two health ministers, lack of a clear health strategy at the national level, clashes between different levels of government over the easing of restrictions, presidential veto to water down parts of a law requiring to wear face masks in public spaces.

This context has accentuated the difficulties of controlling the progression of the epidemic which continues to wreak havoc. At the beginning of July, Brazil ranked second after the United States amongst the countries hardest hit by the Covid-19 pandemic. Over a month, its death toll doubled to nearly 65,000 and the number of confirmed cases tripled to more than 1.6 million – with the virus infecting the President himself. The cumulative number of deaths per million inhabitants at 313, has remained below that of neighbouring countries such as Chile and Peru, but also France (460), Sweden (540), Italy (577) and Belgium (844). Yet with the world's highest number of deaths per day (more than 1000 on a 7 day rolling average), Brazil will likely make its way to the top of this ranking.

At the national level, it will likely take several months to reverse the epidemic curve due to the virus' late progression in certain regions (notably in the centre-west and southern parts of the country). However, in the regions initially most affected, including the states of Sao Paulo and Rio de Janeiro — the country's two main economic engines (accounting for nearly 50% of GDP) — the spread of the virus has levelled off, and in some cases slowed down. As a result, state governors and mayors — who are responsible for deciding when to reopen their economies according to a ruling by the Supreme Court — have begun to ease restrictions and allow businesses to gradually reopen. Looking forward, the lifting of restrictions across states will likely remain very heterogeneous.

FORECASTS

	2018	2019	2020e	2021e
Real GDP growth (%)	1,3	1,1	-7,0	4,0
Inflation (CPI, year average, %)	3,7	3,7	2,6	3,0
Budget balance / GDP (%)	-7,1	-5,9	-16,3	-6,7
Public debt / GDP (%)	77,2	78,2	98,0	94,2
Current account balance / GDP (%)	-2,3	-2,9	-0,8	-0,8

TABLE 1

e: ESTIMATES AND FORECAST
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

CONSUMER AND BUSINESS CONFIDENCE INDEXES

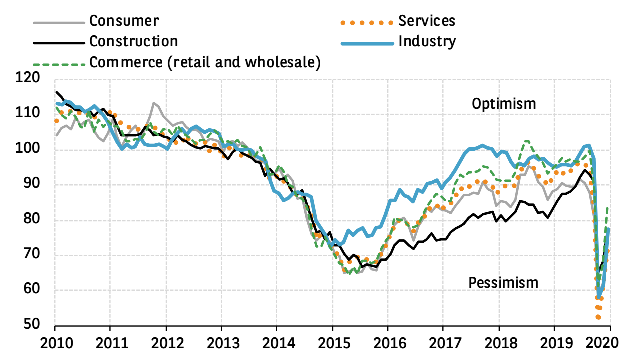

CHART 1

SOURCE: FGV

SUBSTANTIAL LOSSES IN TERMS OF ECONOMIC ACTIVITY

GDP results for the first quarter released at the end of May highlighted the first effects of the pandemic on the economy. GDP contracted by 6% q/q at an annualized rate (-0.2% y/y), and was marked by a decline in industrial activity and services also down 5% to 6% on an annualized basis. The correction was limited by the resilience of the agricultural and livestock sectors — which remain comparatively less affected by the crisis.

The magnitude of the recessionary shock in Q2 is expected to be substantial at around -35% q/q on an annualized basis, but could end up being less severe than expected. In April, during the first full month of containment measures, the Central Bank's leading GDP indicator (IBC-R) plummeted (-9.7% m/m; -15.1% y/y) reflecting the sharp fall in industrial production (-18.8% m/m; -27.2% y/y) and a record drop in activity in the services sector (-11.7% m/m; -17.2% y/y). Survey data show that activity and employment in services have continued to deteriorate throughout the quarter (the services PMI stood at 35.9 in June). The rebound in consumer and business confidence since May has so far failed to offset the historic plunge observed in April.

That said, the investment indicator produced by the IPEA for May shows a faster than expected recovery in investment (+28.2% m/m), driven most notably by higher spending in the civil construction sector.

1 Resignation of Sergio Moro, the very popular Minister of Justice who accused President Bolsonaro of meddling in a federal police investigation implicating members of his family and close collaborators for embezzlement; "Fake news" probe : investigation by the Supreme Court into an alleged disinformation and intimidation campaign orchestrated by a group of parliamentarians and other members of the President's inner circle, including his two sons, during the presidential elections; and fireworks attack on a Supreme Court building by a pro-Bolsonaro group and multiplication of threats against judges.

Also, the shorter-than expected interruption in the production of capital goods, intermediate goods and durable and non-durable consumer goods led to a rebound in industrial production in May (+7% m/m, 21.9% y/y) with 20 out of 26 sectors recording positive growth. At the same time, the flow of heavy vehicles on toll roads increased by nearly 10% in May and June, while broad retail sales (including vehicles and building materials) also strengthened (+19.6% m/m) ending a two-month decline. Thanks to liquidity support measures by authorities, corporate lending has also markedly increased swinging back into positive territory in real terms for the first time since 2014 (+8.5% y/y in May, vs. -1.6% y/y in February).

After four months of contraction, the manufacturing PMI also returned to expansion territory in June (51.6), driven in particular by an upturn in the new orders component. Lastly, the trade balance has performed well in recent months thanks to the recovery of Chinese demand while the prices of iron ore and certain agricultural commodities held up their ground (e.g. soybeans, orange, sugar, and beef). The solid performance in terms of export volumes coupled with the sharp slowdown in imports suggests that net exports should make a positive contribution to growth.

RULING OUT A V SHAPED RECOVERY

The strength of the recovery should be constrained by the absence of vigorous engines of growth. Stimulus through public investment will be limited by the fragility of fiscal accounts. At the same time, firms are likely to postpone investment decisions due to 1/ large excess capacity[2] 2/ weak demand and 3/ the need to honour financial obligations temporarily suspended during the crisis. Penalized by the weakness of the currency and an increase in debt, some companies, according to survey data, are already working towards reducing their costs (lower imported inputs and job cuts) and scaling back their planned investments. The suspension of a large number of auctions associated to the government's concessions and privatizations (USD 36 bn initially planned in 2020) programme should also contribute to the decline in foreign direct investment (representing 25.5% of gross fixed capital formation according to UNCTAD). Increased precautionary savings, prolonged social distancing practices and the deterioration of labour market conditions are also likely to strain the growth of private consumption. The hitherto limited rise in unemployment (12.6% at the end of May compared to 11.9% at the end of December) is actually distorted by the concurrent decline in the active population reflecting the sharp increase in the number of "discouraged" workers.

By keeping the labor force participation rate at the level observed at the end of 2019, the unemployment rate would reach almost 21% according to calculations by GSP. In view of these considerations, GDP is unlikely to return to pre-crisis levels before 2022 at the earliest[3].

ONGOING SUPPORT FROM ECONOMIC POLICY

In June, the Central Bank of Brazil (BCB) unveiled a new support program for micro-enterprises and SMEs which could extend credit up to USD 40 bn. In order to further increase corporate liquidity, the BCB will also purchase private debt securities on the secondary market. Meanwhile, the BCB has been authorized by Congress to intervene in the primary sovereign debt market. However, it does not intend to use this prerogative to flatten the yield curve (which has markedly steepened in recent months) but instead broadens its toolkit to intervene in the event of market dysfunctionalities. With inflation well below target, the BCB has made three cut to its key policy rate since March (by a cumulative total of 200 basis points with a SELIC at 2.25%). Monetary easing has helped fuel a rebound in the Brazilian equity market, which erased some of the losses suffered in March (-45% at the height of the crisis, vs -13% in early July compared to the start of the year). Despite a rebound in May and early June, the USD/BRL exchange rate is still down 25% year to date and remains since February the most volatile currency across emerging markets. Meanwhile, non-resident investors have still to forcefully return to local markets following massive net outflows of USD 32 bn over period March to May.

SOVEREIGN RISK PREMIA (BASIS POINTS)

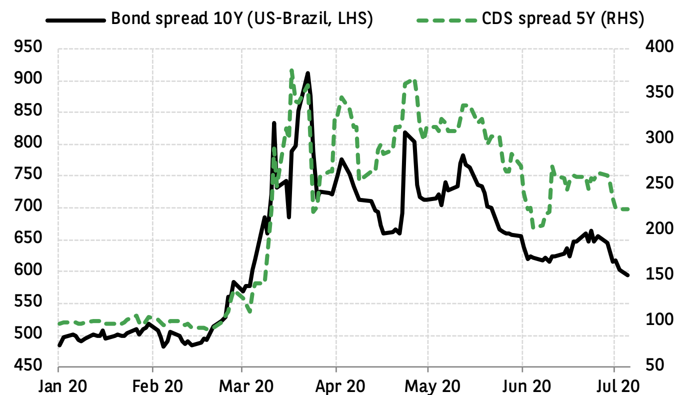

CHART 2 SOURCE: MACROBOND, DATASTREAM

The government has extended numerous measures to help support the most vulnerable populations, states and municipalities as well as businesses. The total fiscal impact of these measures is expected to however around 9 percentage points of GDP. This should bring the primary deficit to at least 11.5% of GDP and the public debt ratio close to 100% of GDP according to the latest estimates by the Ministry of the Economy. The deterioration of Brazil's fiscal balances has not yet translated into a lasting rise in sovereign risk premiums. After widening significantly in March, the spread on 10 year bonds between Brazil and the US as well as the 5 year CDS spread have both narrowed. They remain however around 100 and 150 basis points respectively above their pre-crisis level and the risk of witnessing a renewed widening remains high.

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2 The production capacity utilisation rate in industry was 60% in May and 66.6% in June, still well below its historical average of 80%. Inventories of semi-durable, non-durable and capital goods are high and will likely dampen output growth.
3 The level of uncertainty around projections remains high, as evidenced by the high dispersion of growth forecasts across official organizations: Brazil's Central Bank is forecasting -6.4% in 2020; the World Bank, -8% (+2.2% in 2021); and the IMF and OECD, -9.1% (based on the assumption—in the latter case—that there will be a 2nd wave of the pandemic in Q4). The IMF expects GDP to grow by +3.6% in 2021, while the OECD is forecasting a +2.4% rise.