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Brazil: Economic Update and Outlook

Economist(s)

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Summary

Brazil's economy may be entering a difficult period. Last week, activity indicators revealed a more pronounced slowdown in the economy as fiscal stimulus wears off; however, inflation continues to climb toward the upper end of the central bank's inflation target range. As far as economic activity, we assumed the tapering of fiscal stimulus would result in a sharp slowdown in the economy and revised our 2020 GDP forecast lower a few months ago. As fiscal stimulus wore off we believed inflation would cool as well; however, inflation keeps rising, and as a result, we believe the Brazilian Central Bank will look to tighten monetary policy in the near future. Policy rate increases could disrupt the local economy even further, especially at a time when the economy is already fragile and struggling to gather momentum.

Brazil's Economy Running Out of Gas...

Relative to most emerging market peer countries, Brazil's economy outperformed for much of 2020. With Q4 GDP data still forthcoming, we forecast Brazil's economy contracted around 4.5% last year. Compared to an annual decline in Mexico (9%), Colombia (7%), Peru (11%) and another sovereign debt default and deep recession in Argentina, Brazil arguably weathered the COVID storm quite well, at least in comparative terms. We can point to aggressive fiscal stimulus from the Bolsonaro administration as rationale for Brazil's economy performing better than peers, as the government moved forward with stimulus worth over 8% of the country's total output. Not only has fiscal support in Brazil been the most aggressive in Latin America, but direct checks and cash handouts have pulled a significant amount of households out of poverty across the country.

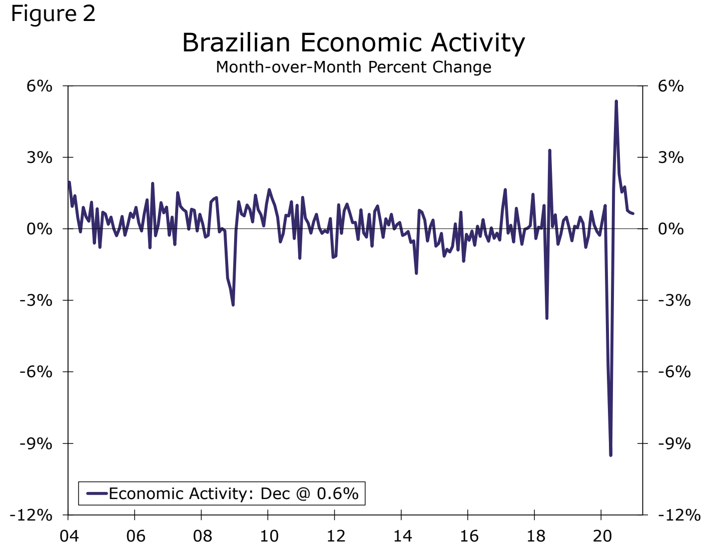
Powerful fiscal stimulus has supported the economy; however, it has also pushed Brazil's fiscal position into significant deficit. At the end of 2020, Brazil's fiscal deficit widened to 17% of GDP, a notable widening from 6% at the end of 2019. In order to fund this deficit, the government was forced to borrow from international capital markets. As a result, the government's debt burden jumped to 101% of GDP from a pre-pandemic ratio of 89%. Brazil's fiscal and debt dynamics are expected to improve this year, as the IMF forecasts the fiscal deficit to fall back to pre-COVID levels and for the public debt burden to also stabilize. One of the key assumptions of the IMF's forecasts is for President Bolsonaro and his cabinet to adhere to the constitutional spending cap, a key pillar of Brazilian public finances. Over the last few months this assumption has materialized as Brazilian authorities have exercised fiscal austerity. Direct payments and other forms of fiscal stimulus have been scaled back significantly in an effort to defend the spending cap.

Fiscal stimulus supported the economy early in the pandemic, however, the tapering of fiscal stimulus is having an adverse impact. Activity indicators over the last few months have deteriorated, highlighting just how fragile the Brazilian economy is without government support. Data released last week further revealed the slowdown as retail sales data missed consensus estimates by a wide margin. On a month-over-month basis, retail sales contracted 6.1% against estimates of only a 0.8% decline (Figure 1). In addition, the broader economic activity index, typically used as a monthly proxy for GDP, rose a modest 0.6% month-over-month; however, the trend has been on a downward trajectory for the last six months (Figure 2). We were early to identify the slowing economic activity across the country, and given our working assumption for the spending cap to remain in place and adhered to, we revised our 2020 GDP forecast lower a few months ago. Q4 GDP will not be released until early March; however, we expect modest growth and for annual GDP to contract 4.5%.

Figure 1

Source: Bloomberg LP and Wells Fargo Securities

Figure 2



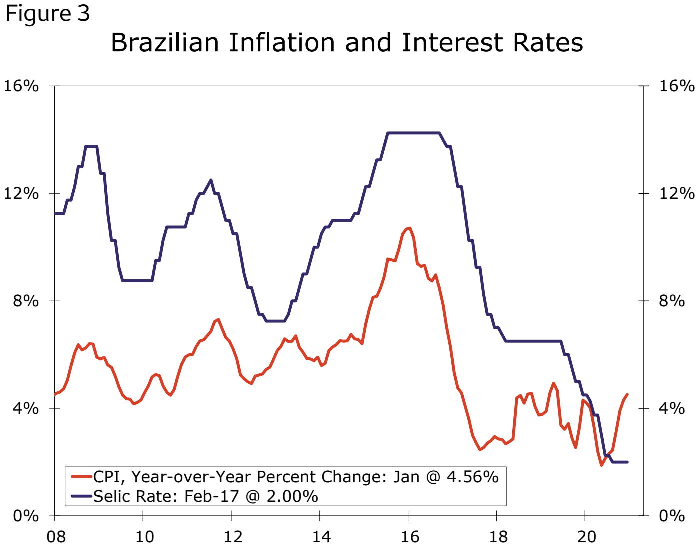
Source: Bloomberg LP and Wells Fargo Securities

...And Elevated Inflation Complicates the Picture

Given the deceleration in the economy, ideally, monetary policy should remain as accommodative as possible for the time being. However, rising inflation may complicate accommodative monetary policy, and in turn, add headwinds to an already slowing economy. The effects of COVID resulted in CPI inflation plummeting to an all-time low of 1.88% year-over-year in May 2020. As the economy opened up and households utilized the fiscal stimulus, inflation rose to 4.56% by January 2021, approaching the upper end of the Brazilian Central Bank's (BCB) inflation target range (Figure 3). In addition, the one year breakeven index, an indication of where inflation could be in the next twelve months via inflation linked securities, is currently 5.07%. Should inflation rise above 5% as the breakeven levels suggest, the CPI would be above the central bank's 5% upper bound of its inflation target.

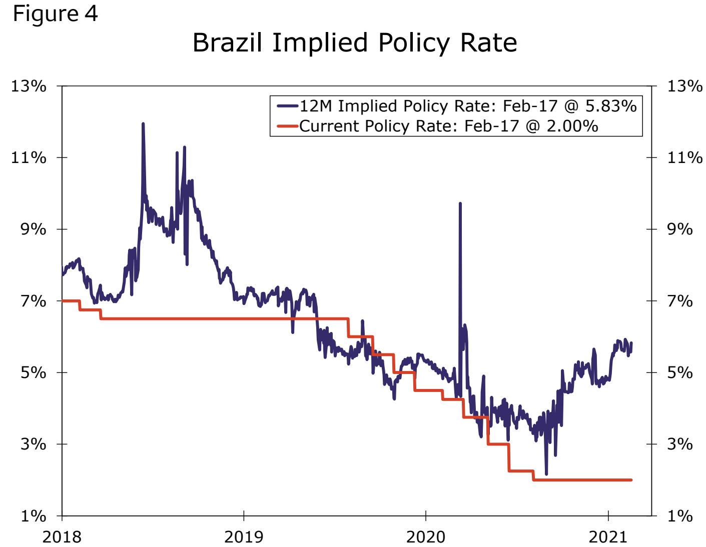
The rise in inflation has certainly caught the attention of the BCB as monetary policy officials have discussed the possibility of interest rate hikes to stem price growth. Recently, minutes from BCB meetings have indicated policymakers explicitly discussing tightening monetary policy, while officials have also lifted guidance on rates remaining at historic lows for an extended period. As inflation began its upward trajectory, we incorporated policy rate hikes into our BCB forecast; however, given the BCB's new guidance and commentary we have pulled those rate hikes forward. We now expect a 25 bps hike in Q1-2021 and another 25 bps in Q2-2021, rather than two 25 bps hikes in the second half of this year. Economists alike seem to agree on the direction of interest rates as well, while financial markets have also priced in tighter policy from the BCB. As of mid-February markets have about 350 bps of tightening priced in from the BCB over the next 12 months. Admittedly, markets may be overly aggressive, but nonetheless, the direction of policy rates in Brazil is clearly higher than where rates are today (Figure 4).

Figure 3



Source: Bloomberg LP and Wells Fargo Securities

Figure 4



Source: Bloomberg LP and Wells Fargo Securities

Obviously, tighter monetary policy at this time would weigh on the prospects for the Brazilian economy. As of now, we forecast subdued growth of 3.9% in 2021; however, the risks around our forecast are tilted to the downside. It is certainly possible the Bolsonaro administration looks to provide more fiscal stimulus to the economy and possibly disregard the spending cap completely. Additional fiscal stimulus would likely support the economy; however, another year of elevated fiscal spending could result in financial markets cooling on Brazilian prospects. Should markets sour on Brazil, the Brazilian real would likely sell-off significantly and force the BCB to hike policy rates in-line with market expectations in an effort to defend the value of the currency. Even tighter monetary policy would likely offset any fiscal stimulus, while capital outflows from Brazil can also contribute to a more aggressive economic deceleration.

Cautious Optimism for the Brazilian Real

Despite a bearish view on Brazil's economy, we maintain our cautiously optimistic stance on the Brazilian real over the medium-term, although longer-term we believe the currency may eventually come under some pressure. Over the next six to nine months, we believe a global economic recovery and widespread vaccine deployment should create positive sentiment toward emerging market currencies more broadly. In this context, the Brazilian real can strengthen as capital flows return to the emerging markets, while a global economic recovery can also support commodity prices. Brazil is a sizeable exporter of energy and agriculture commodities, in turn which currency moves are correlated to. Sustained demand for commodities and further rises in prices should also support the currency and help it strengthen over the medium term. Perhaps most important for the path of the Brazilian real over the medium-term is the trajectory of public finances. As mentioned, we assume Brazil will adhere to the spending cap and the fiscal deficit will return to pre-COVID levels in 2021. Maintaining some fiscal discipline will demonstrate to market participants that Brazil is conscious of its reform agenda and its need to place public finances on a more sustainable trajectory. If our assumption is accurate and fiscal discipline is exercised, the Brazilian real can rally as concerns regarding the government's ability to implement fiscal discipline ease.

Longer-term challenges do remain, however. Aside from keeping the spending cap in place, Brazil has an extensive reform agenda that it will need to make progress on to keep markets satisfied. Reforms include privatizing state-owned assets, tax reform and changes to public sector wages, among others. We believe the reform agenda will stall as Presidential elections are around the corner in 2022 and implementing reforms on this scale could be unpopular. President Bolsonaro's approval rating has dropped since fiscal stimulus has dwindled and his re-election risks could be rising as Brazil has also struggled to contain COVID. Our assumption for a pause on reforms should weigh on the longer-term prospects for the Brazilian real as markets turn cautious on the ability and willingness of the government to implement change.

We will update our USD/BRL forecasts in our February *International Economic Outlook;* however, readers can expect to see a profile for the Brazilian real similar to what we have previously published. We expect Brazilian real strength through the later quarters of 2021 and as we approach the end of the year and head into 2022, we expect pressure to start to build on the currency.

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