

Brazil: Growth deferred and hard choices

Rising concerns over the coronavirus outbreak intensified demands for government action to mitigate its economic impact. Monetary policy is part of the solution, but fiscal measures look unavoidable at this stage. Given the binding fiscal constraints, savvy political management is needed to avoid a permanent damage to fiscal credibility



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A complex balancing act at this week's monetary policy meeting

As the economic damage of the coronavirus outbreak becomes clearer, policymakers continue to struggle to define what's the best policy response.

At its last meeting, the Brazilian central bank (BACEN) cut the policy rate by 25bp, to 4.25%, and clearly signalled that it intended to halt the cycle, at least temporarily.

Since then, on 3 March, the bank has tweaked that guidance slightly, acknowledging the deeper impact of the coronavirus on local financial conditions and the Brazilian economy. The bank stated that its upcoming policy decisions would have to balance the impact of the crisis on two fronts: on economic activity and on financial assets (e.g. FX).

At the time, the assessment was that “the impact over the Brazilian economy stemming from the global deceleration was dominant over the eventual deterioration of financial asset prices”.

That resolve to counter the impact of the crisis through monetary policy was also evident in the actions and the tone of the statement released by the national monetary council (CMN) on Monday.

In a bid to ease the ongoing tightening in local financial conditions, the CMN relaxed banking capital requirements and reduced provisioning requirements for bank-lending in the context of renegotiations. The statement also highlighted regulatory measures and reserve requirement tools that BACEN still has to ensure the stability of the local financial market and, “especially at this moment, support the economy”.

We expect a 50bp rate cut this week, with the risk skewed towards a larger adjustment

Policymakers acknowledge that the sharp drop in the policy rate has been the chief underlying factor behind the underperformance of the BRL in recent quarters. Therefore, the recent FX volatility could impose some constraints on the central bank’s ability to cut rates further.

Having said that, policymakers are indicating that, in their upcoming rate decisions, they will continue to focus on the more traditional monetary policy drivers such as the outlook for growth and inflation, rather than financial market prices, such as FX. Alternative tools, i.e. FX policy and the bank’s USD358bn in FX reserves, will be used to help cushion FX volatility.

FX has some impact over inflation dynamics, but that impact has reduced materially in recent quarters, probably reflecting the ample spare capacity in the local economy.

As a result, consistent with the ongoing drop in inflation and growth expectations and despite the extreme market volatility seen in recent days, BACEN should cut the policy rate by 50bp this Wednesday, to 3.75%, and keep the door open to further policy action.

This is an incredibly tough call for the central bank, as several alternative scenarios, from no cut to a US Fed-style 100bp frontloaded adjustment, could reasonably be justified. Given the fast-moving situation, the risk of intermeeting policy adjustments should remain elevated in the near future.

Rate and FX policies are set independently

As discussed above, even though BACEN acknowledges the FX impact of its rate decisions, they believe that rate policy decisions should be taken independently from FX policy decisions. Eventual disruptions in FX markets, as seen in recent weeks, should be dealt with directly, through FX intervention.

The central bank seems prepared to deploy all its intervention potential and appears to view its discretion to announce intervention as an asset. As a result, the announcement of a large pre-announced FX intervention program, as some have suggested, still seems unlikely.

There are no set criteria for FX intervention, except for the assessment by monetary authorities that the FX market is malfunctioning due to a lack of liquidity, which is often manifested in the fact that currency is underperforming other assets, such as the Brazilian CDS.

In addition, as seen last week, the bank “has no prejudice”, to quote monetary policy director Bruno Serra, in the choice of instruments used in the intervention. Last week was instructive in this respect, as quick-moving markets led the bank to provide USD liquidity in three different instruments: FX swaps, spot and FX-repo lines.

A wide range for the BRL in the nearer term

This heavy battery of intervention seems to have been effective to improve the overall performance of the BRL, relative to its EM peers. Having said that, forecasting EM FX should remain as especially perilous exercise in the near term, with 4.5-5.5 possibly acting as a trading range in the nearer term.

Additional policy rate cuts would be BRL-negative, but the currency’s trajectory should depend mainly on the evolution of global risk aversion, while deep US Fed rate cuts should eventually translate into a weaker USD, bringing some support to EM FX at a later stage.

One new BRL-positive development is the fact that one important source of USD-demand in recent quarters has weakened sharply. Given the sharp sell-off in local equity/bond portfolios, demand for FX hedge to offset those long positions should likewise drop, as the size of those portfolios have collapsed. The fact that at current levels, i.e. close to 5.0, demand/supply conditions for USDBRL should, arguably, also become more balanced, should also bring some support to the BRL.

Given the stock of FX reserves of USD358bn and the stock of (short-USD) FX swaps at USD46bn (vs a maximum of USD115bn in March 2015), the central bank still has ample capacity to intervene in FX markets.

Fiscal initiatives need close monitoring

Monetary policy action alone is unlikely to be seen as sufficient restore confidence and to counter the full impact of the virus outbreak on the Brazilian economy. As a result, the Economy Ministry will be facing rising pressures to announce short-term fiscal stimulus measures.

The administration’s initial instinct was to call for the faster approval of the structural reforms that are already in debate in Congress. These include a wide range of initiatives from fiscal proposals that help curb the rise of public sector wages to pro-growth privatization initiatives and the central bank independent bill.

It’s unlikely, however, that Congress will be willing to advance structural reforms without first addressing the immediate demands that are likely to arise from the crisis. Among the initiatives envisaged so far, the administration has announced the advance payment of the year-end bonus to retirees and the flexibilization of some payroll-lending facilities.

The eventual relaxation of the fiscal target seems reasonable, in light of the unexpected drop in tax collection that is likely this year. This can be done without causing material harm to Brazil’s fiscal trajectory. Targeted stimulus spearheaded by state banks and some fiscal relief for the states would also help prevent a more permanent damage to fiscal metrics.

But pressure for more aggressive changes to the fiscal framework should also intensify. Here, the chief goal is preserving the centrepiece of Brazil’s fiscal consolidation program, the fiscal spending cap.

Government officials are adamant that the administration would strongly push against any effort to weaken the spending cap. But the decision may ultimately rest with Congress. And in light of the more conflicted relationship between the administration and Congress seen lately, close monitoring is warranted. Savvy political management, especially by Economy Minister Paulo Guedes, will be needed to overcome the challenges of the next few months without damaging hard-won fiscal credibility.

Reassessing the economic activity outlook

The extent of the damage from the ongoing crisis is still unknown, but from the disruption in trade and tourism to the likely widespread service-sector closures, the impact on economic activity is likely to be substantial.

For now, we will assume that the damage is likely to be temporary, and that the tighter financing conditions and the liquidity constraints faced by households and businesses are not likely to turn into large-scale solvency problems. Already-announced initiatives by monetary authorities to alleviate the credit crunch and facilitate debt renegotiations should help limit those solvency concerns.

GDP growth forecasts are hardly high-conviction assessments at this stage, but it is safe to say that 2Q will now show a contraction. For the full year, we are now pencilling in a 1.1% expansion, matching 2019's results, but sharply lower than the 2.3% consensus estimate seen early in January.

The fact that the banking system is well-capitalized and that debt-levels have undergone a deep deleveraging process in recent years also suggest that, once market sentiment stabilizes, the recovery can be smoother than in the aftermath of the 2014-15 Brazilian crisis.

Lastly, FX instability will take a toll on business sentiment, but Brazil remains a net-creditor in USDs, thanks to its outsized stock of FX reserves, while the widespread use of hedging for FX-liabilities by corporates and the fact that the FX pass-through onto local prices is likely to be contained, allowing for monetary stimulus, should help limit the overall macro impact of the FX sell-off.