

Brazil: Signs of a faster recovery emerge

When compared to its LATAM peers, recent data in Brazil suggest a relatively shallower recession is under way. Central bank officials have also sounded optimistic, but that has yet to translate into a firm resolve to end the rate-cutting cycle. In fact, lower-than-expected inflation increased the risk of a deeper easing cycle, weighing on the BRL



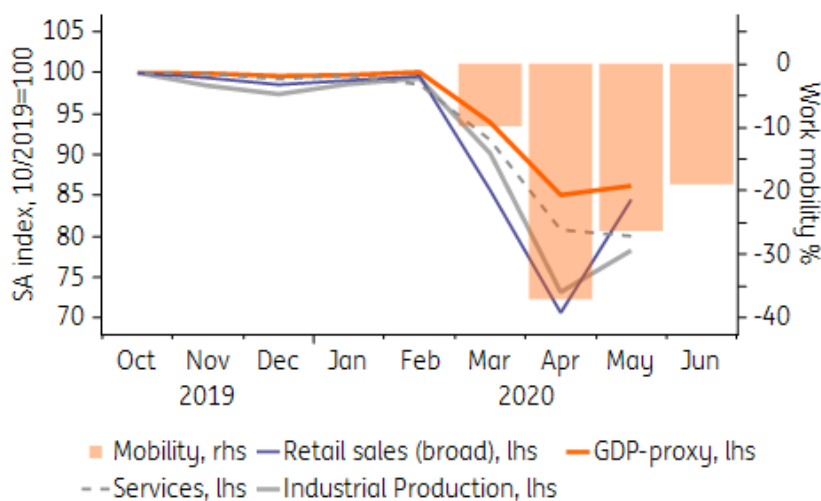
Central Bank of Brazil headquarters in Brasilia

Recent activity data has surprised on the positive side

Even though the recovery outlook remains far from certain, largely dependent on the trajectory of the Covid-19 outbreak and the eventual normalization of economic activities, recent data from Brazil bodes well for a relatively faster recovery than the one seen elsewhere in the region.

As seen in the chart below, the latest activity indicators suggest that April was clearly the bottom for economic activity. Moreover, when compared to the other large LATAM countries, the overall accumulated contraction in the March-May period appears to be markedly shallower in Brazil.

Services disappointed but other activities showed faster recovery

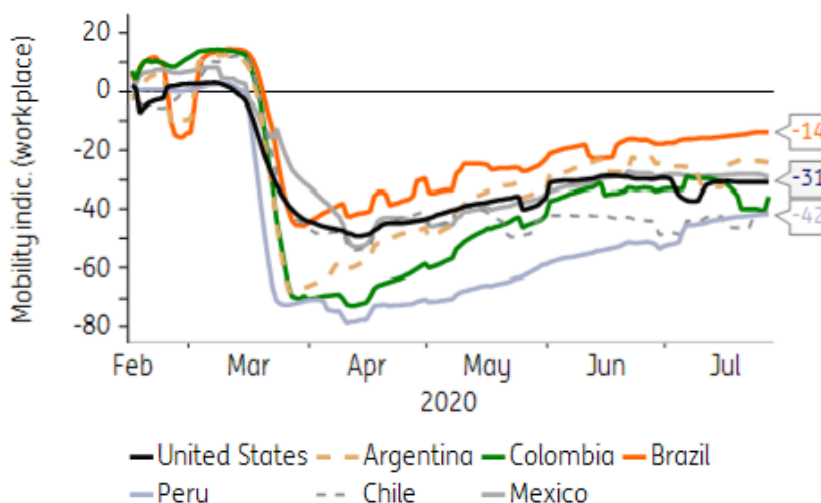


Source: Macrobond, ING

Some recent activity data has also surprised, coming in better than expected, and resulting in a rise in growth expectations, as captured in the central bank’s survey.

Brazil’s relatively better activity indicators are consistent with workplace-visit trackers, which also show that even though Brazil is not faring materially better than its neighbors when it comes to combating the spread of Covid-19, Brazil is further ahead than its neighbors in normalizing mobility indicators.

Brazil stands out for the faster normalization of workplace-visits



Source: Macrobond, ING

Overall, however, despite the initial optimism, there’s much reason for caution. The continued decline in service activities seen in May and the fact that the spread of Covid remains elevated

suggest that mobility restrictions or fear could hold back the recovery, especially if economic activities are not closer to normalized by the time fiscal transfers dry out.

A large counter-cyclical policy response

Brazil's faster recovery could, arguably, also reflect the level and efficacy of monetary and fiscal stimuli that has been implemented in recent months.

It's still hard to make a comprehensive comparative assessment of the policy initiatives adopted across the different countries in the region. In general terms, even though Brazil's fiscal stimulus program is substantial, with a household income-support program that appeared to have largely offset wage-income loss up until now, the overall package is considerably smaller than the one seen in Peru and Chile, for instance.

Instead, it is in its ability and willingness to deploy monetary stimulus that Brazil stands out, with one of the largest programs across EM.

It's too soon to say if aggressive rate cuts and credit-enhancing initiatives will be enough to ensure a V-shaped recovery. But Brazil's relatively larger financial system and the fact that stimulus measures are likely to stay in place in the foreseeable future bode well for a relatively shallower recession in Brazil.

Monetary policy guidance turns more cautious ...

Analyst surveys also show that inflation expectations remain firmly anchored for short and long-term tenors. In fact, inflation is expected to undershoot the target by a wide margin in the foreseeable future.

Low inflation suggests that scope for the central bank to maintain an expansionary monetary policy stance should remain firmly in place in the nearer term. In fact, low inflation could even justify additional monetary policy easing. The question is whether the SELIC rate has reached a "technical" lower-bound.

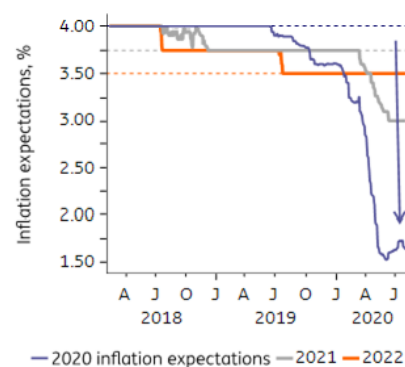
At its last monetary policy meeting, the central bank implemented a 75bp drop in the policy rate, to 2.25%. Post-meeting statements suggested that the rate cuts already implemented seem "consistent" (though, perhaps, not quite sufficient) to address the economic impact of the pandemic.

A deep, but shallower, recession in 2020



Source: Macrobond, ING

Low and fully anchored inflation trends



Source: Macrobond, ING

Bank officials also indicated that the large stimulus already implemented could be more effective than currently expected, resulting in a faster recovery than the market predicts. But officials also acknowledge the deep uncertainties they face in trying to assess both the depth of the economic impact of the Covid-crisis and the effectiveness of the myriad initiatives announced to mitigate its economic impact.

Ultimately, officials stated that an additional adjustment through rates is still possible, considering all the uncertainties they face (ie, 2.25% is not their “technical” lower-bound). However, they also acknowledge the limitations they face to lower the policy rate beyond 2.25%, by stating that any additional cuts would be “residual”.

This guidance helped solidify market expectations that the SELIC rate will be lowered by 25bp this week, to 2.0%. The big question is whether policymakers will keep the door open for additional cuts or not.

... but we don't expect BACEN to close the door to additional cuts

The debate over the lower-bound for the SELIC rate continues, and policymakers appear to be genuinely divided over that. Given that the policy rate is still materially above zero and economic cycle remains deflationary, some policymakers appear to favor extending the rate-cutting cycle.

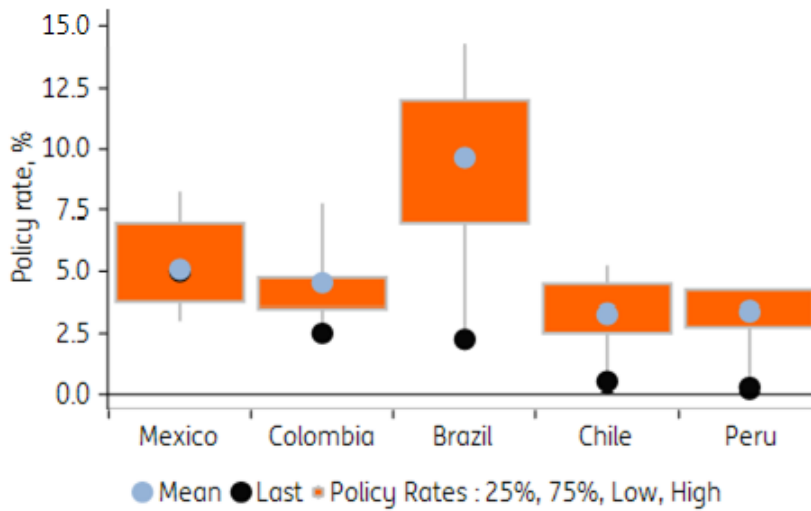
Other policymakers are more focused on the potential disruptions additional rate cuts could cause. For them, given Brazil's existing fiscal weaknesses and large risk premium, the effective lower bound for the policy rate is considerably higher than zero.

In practice, that lower bound is likely to be assessed in relation to its potential impact over local financial assets, especially FX. Rate cuts have, arguably, had a large detrimental impact over the BRL, which has followed an underperforming and highly volatile trajectory over the past year.

BACEN officials are typically vague about the impact FX dynamics have in their reaction function for rate decisions. In particular, given that inflationary dynamics remain largely benign, FX weakness is not, per se, a major concern for policymakers.

Brazilian central bankers also tend to adopt a more relaxed attitude to the BRL, and FX flows in general, when compared to its LATAM peers that are still considering rate cuts, ie, Colombia and Mexico. In both of those countries, policymakers have explicitly voiced a concern over FX flows as an important barrier for additional rate cuts.

Brazil appears more willing to test the lower-bound limits of the policy rate than Colombia and Mexico



Source: Macrobond, ING

The fact that the overnight rate has never been anywhere near this low in Brazil likely exacerbates the uncertainties over the debate regarding the effective lower bound for the policy rate and its impact over the BRL.

For Wednesday's meeting, two factors may tip the balance in favor of keeping the door open to additional rate cuts. The first is the lower-than-expected inflation seen recently and the second is the fact that the BRL has consolidated a stronger trading range, when compared to the lows seen in April-May.

Such an outcome would, necessarily, help keep FX volatility high and maintain an underperforming bias for the BRL.