VIRAL PANDEMIC AND POLITICAL HEADWINDS PUSH BRAZIL INTO ECONOMIC AND POLITICAL CRISES

The pandemic is increasing Brazil’s political instability

The coronavirus pandemic has pushed Brazil into economic and political crises. President Jair Bolsonaro has downplayed the risk of coronavirus, encouraging Brazilians to disregard shelter-in-place orders issued by state and city governments, and has encouraged his supporters to go to work and use medically unproven treatments. The result is a public health disaster that continues to worsen: Brazil surpassed the United States as the country with the most daily coronavirus deaths in late May, and both cases and deaths continue to trend higher.

This public health crisis is intensifying a political crisis that was already simmering before the pandemic. The president is being criticized both for his response to the coronavirus as well as for allegedly interfering into a federal police investigation of his sons’ alleged misconduct. The justice minister, head of the federal police and two health ministers have either been fired or resigned in recent months. A coalition of leftist opposition political parties has introduced over two dozen impeachment petitions in Congress.

The pandemic ended the Brazilian economy’s sluggish recovery from the 2014 to 2016 recession, which had gained traction after pension reforms were enacted in late 2019. The pandemic is both hurting Brazil’s economy directly by forcing businesses to close, and indirectly by causing the prices of Brazil’s major commodity exports—iron ore, oil, and soybeans—to plunge. Recent economic data have been dreadful. Real GDP fell 1.5 percent in the first quarter on a quarter-over-quarter basis, the first contraction since the fourth quarter of 2018. The economy has lost over 1 million jobs in March and April combined; the decline in April of 861,000 was the biggest monthly fall in employment on record. The April readings of the Markit manufacturing and services purchasing manufacturing indices were the lowest on record. PNC Economics forecasts the Brazilian economy to contract by 7.0 percent year-over-year in 2020 as exports, domestic demand, and business fixed investment all plunge. Brazil’s dire outlook has spurred a severe reaction from financial markets. The Brazilian stock market’s Ibovespa index fell 49 percent in

CHART 1: BCB HAS REDUCED RATES TO AN ALL-TIME LOW AS BRAZIL DEALS WITH THE SUDDEN DECLINE IN OUTPUT

Chart sources: Central Bank of Brazil, Brazilian Institute of Geography and Statistics
the year through May 21 in US dollar terms, making it the world’s worst performing major stock market; the Brazilian real plunged to a record low of R$5.96 per dollar in mid-May. Continued mishandling of the public health response or an extended political crisis could worsen capital flight and further exacerbate Brazil’s financial market volatility.

Like all other major economies, Brazil’s policymakers have responded to the crisis with aggressive monetary and fiscal support. The Banco Central do Brasil (BCB) reduced the Selic policy rate by 0.75 percentage point at each of its last two monetary policy decisions, in March and May. The BCB also injected R$1.2 trillion of liquidity, equivalent to 17 percent of GDP, into credit markets through lower reserve requirements and new rules for deposits and loans to financial institutions; the central bank also relaxed regulations to ease access of credit to households and corporates, and Congress has temporarily authorized the BCB to purchase public and private bonds in the secondary market. The fiscal response has been equally aggressive; the Ministry of Economy extended R$800 billion, 10.5 percent of GDP, in relief to informal sector workers, micro-entrepreneurs, the self-employed, and the unemployed.

Unlike in previous Brazilian economic crises, inflation is no obstacle to stimulus: Headline inflation as measured by the benchmark IPCA index slowed for four consecutive months through April (Chart 1); April’s 2.4 percent year-over-year inflation undershot the 2.5 percent lower bound of the central bank’s 2.5 to 5.5 percent target range. PNC Economics expects slower inflation to persist in the second half of 2020 and in 2021, providing the BCB room to cut the Selic rate an additional 0.75 percentage point at the June meeting, to a new record-low of 2.25 percent. The ongoing political crisis adds another element of uncertainty to Brazil’s outlook, forcing the government to defer reforms of trade and tax policies, and privatizations of state-owned enterprises. The fiscal response to the pandemic will far outweigh the savings generated by 2019’s pension reform, putting gross national debt on course to reach a record-high 94 percent of GDP in 2020.

A worsening pandemic and rising political uncertainty will likely keep the real’s exchange rate volatile in the second half of 2020, and the record-low Selic rate could make the real less attractive for carry trades. If the Brazilian economy continues to contract until the fourth quarter as PNC’s forecast expects, the real should depreciate to R$5.88 per US dollar (Chart 3) by year-end. The BCB is likely to draw on its ample international reserves (Chart 2) to support the real’s exchange rate should it depreciate further than its mid-May level.