DIM GROWTH PROSPECTS AMID THIRD CORONAVIRUS WAVE, INFLATION SPIKE AND DETERIORATING FISCAL OUTLOOK

Brazil’s economy has weathered some of the storm, but there are more clouds on the horizon. After contracting 11.1% in the first half of 2020 as many cities and states imposed restrictions on economic activity, the economy has made significant progress thanks to expansionary monetary policy, substantial fiscal stimulus, and a recovering global economy. Brazil’s real GDP has risen 11.1% since its nadir in the second quarter of 2020, although economic output remained 1.2% below the pre-crisis level in the fourth quarter of 2020. The outlook remains highly uncertain, however, as the country grapples with a third and more deadly wave of coronavirus.

The Brazilian government has announced multiple fiscal stimulus measures since the second quarter of 2020, amounting to around 17% of GDP in 2020 and 0.6% of forecasted 2021 GDP so far for this year. The fiscal stimulus packages in 2020 included auxílio emergencial (emergency aid)—transfer payments to formal and informal sector workers of R$600 (about $110 dollars) per month between April and August, lowered to R$300 per month between September and December. The government relaunched the auxílio emergencial in 2021 to provide payments of R$250 per month between April and July 2021. After a severe wave of the pandemic began in the southern hemisphere’s fall, with new variants of the virus emerging, the government is likely to announce additional fiscal stimulus before the latest round of transfers expires. A rapid recovery of gross capital formation fueled most of the economic rebound in the second half of 2020 (see Chart 1). Relative to the pre-crisis level, industrial output fully recovered in the second half of 2020 from its 26% February-to-April plunge, capacity utilization has moved above pre-crisis levels, and retail sales are almost back to their pre-pandemic level. Real GDP likely recovered to its pre-crisis level in the first quarter of 2021 and is poised to grow around 2% in the fourth quarter of 2021 from a year earlier.

In addition to the massive fiscal stimulus, the Central Bank of Brazil (BCB) reduced the benchmark Selic rate 250 basis points to an all-time low of 2.0% in 2020, injected about R$1.3 billion into the economy, and expanded the糜bour credit line from R$500 billion to R$1.5 trillion.

CHART 1: BRAZIL’S ECONOMY HAS MADE PROGRESS THANKS TO THE RAPID RECOVERY OF GROSS CAPITAL FORMATION

Chart source: Brazilian Institute of Geography and Statistics
The central bank will likely lift the Selic rate by another 1.50 percentage points by December.

Brazil’s fiscal health deteriorated during the pandemic.

trillion (18% of GDP) of liquidity into Brazilian money markets, and changed macroprudential regulations to stimulate the recovery and stabilize the financial system. As economic conditions improved and prices of Brazil’s commodity exports and its domestic consumer basket rose, the BCB began to tighten monetary policy ahead of most other central banks, raising the Selic rate 0.75 percentage point in both March and May of this year. With economic indicators moderately improving in recent months, and headline inflation firmly above the BCB’s tolerance range of 3.75% plus or minus 1.50 percentage points and set to increase further in the near- to mid-term, the BCB will likely raise the Selic rate to 5.0% by the end of 2021. Headline inflation has overshot the upper bound of the BCB’s inflation target range since March 2021, although core inflation has stayed below the lower bound for almost two years. Domestic inflationary pressures are likely to persist through 2021, driven by supply chain dislocations and rising energy costs.

The BCB’s Selic rate hikes have supported a recovery of the real in the second quarter of 2021 after it depreciated 29% in 2020—one of the worst performances of Latin American currencies last year—then fell another 8% in the first quarter of 2021. Surging commodity prices also have supported the real. Prices for soybeans, Brent crude oil, and iron ore jumped 88%, 113% and 140% respectively in mid-May from a year earlier. Brazil is a major exporter of all three products. Even with the support of higher commodity prices and improving economic outlooks in Brazil and globally, the real is still down 1.5% year-to-date through mid-May. PNC Economics expects the real to appreciate about 2% by the end of 2021 (see Chart 2), supported by investors’ expectations for further monetary tightening and progress on reforms, the bullish commodities run, and further recoveries in Brazilian exports and the domestic economy. The real will likely continue its bullish run through 2022 supported by improving domestic fundamentals, increasing risk appetite and continued strength in commodities.

Political and fiscal uncertainties are prominent downside risks to Brazil’s recovery. Brazil’s fight to contain the coronavirus has gone much worse than its economic recovery; its death toll is the second-highest national total after the U.S. President Jair Bolsonaro replaced the health, defense and justice ministers in the past year as political turmoil increased during the pandemic. Bolsonaro faces a criminal investigation and potential impeachment over his pandemic response, and trails leftist former president Luiz Inacio Lula da Silva in polling ahead of the October 2022 presidential election. The nation’s fiscal health has worsened during the pandemic; net government public debt rose to 61% of GDP in early 2021 from 55% at the end of 2019, and the budget deficit will be almost 10% of GDP this year. The rising Selic rate will increase debt servicing costs, further worsening fiscal stresses.

**Chart 2: Hawkish BCB, surging commodity prices and improved exports should support the real.**

[Chart showing Brazilian real per U.S. dollar with a forecast line for PNC.]

**Chart sources:** Bloomberg, The PNC Financial Services Group

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