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Brazil, Late to Impose Emergency Measures, Faces a Crisis Wide and Deep

Introduction

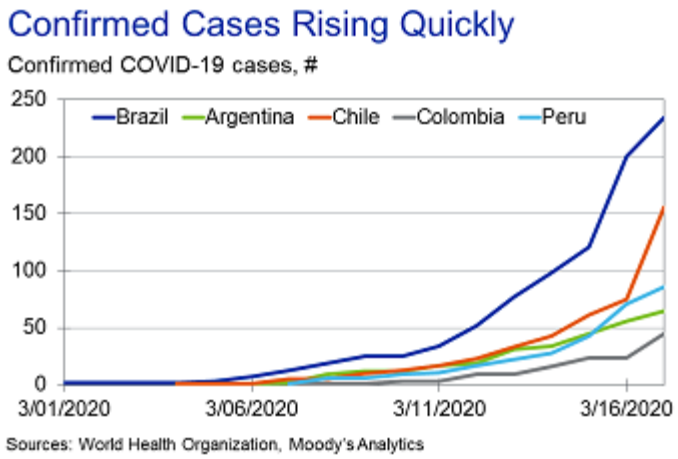
Almost every sector of Brazil's economy will be hit hard by the abrupt decline in global economic activity, from agriculture and manufacturing to transportation and energy.

The COVID-19 pandemic couldn't come at a worse time for Brazil's economy. After a debilitating two-year recession and listless recovery, the economy finally seemed to recapture some of its former magic. Though job market conditions were improving only slowly, a landmark pension reform supercharged financial markets in the second half of last year and appeared to strengthen business sentiment. A more robust recovery seemed within reach, although we were under no illusion that Brazil would return to growth rates sustained over the course of the commodities boom.

This is no longer the case. Almost every sector of Brazil's economy will be hit hard by the abrupt decline in global economic activity, from agriculture and manufacturing to transportation and energy. The rout in oil and other commodity prices will be compounded by consumers' caution. While the Brazilian government has been slow to respond to the crisis, commercial activity in Brazil's largest metropolitan areas has ground to a halt.

From the top

Brazil is less vulnerable to an external shock than other countries in Latin America, but the government's tardy response to the coronavirus pandemic introduces a heavy dose of economic and humanitarian risk. As late as Tuesday, President Jair Bolsonaro publicly downplayed the threat posed by the virus, greeting thousands of supporters at a rally and criticizing governors of Brazil's largest states for curtailing business activity and taking other emergency measures. A national state of emergency was declared later in the day as the number of confirmed cases topped 200.



The scramble to prepare for what will almost certainly be an exponential spike in cases stands in direct contrast to yeoman efforts by the Brazilian government to combat the HIV/AIDS epidemic in the 1990s, when the government made anti-retroviral drugs universally free and widely available. The much-lauded campaign is often cited as a model for emerging markets facing public health crises. This time, however, Brazil seems to be behind the ball. According to public health officials, an additional 8,000 Brazilians are expected to be asymptomatic carriers and could cause the total number of infections to rapidly spike.

Brazil has also been slow to impose emergency measures taken by most other countries in the region, such as closing national borders and quarantining nationals returning from abroad. Instead, the country has closed the border with Venezuela, a country with few confirmed cases but with a leader Bolsonaro has sustained a long-running political dispute.

Bolsonaro has argued that a national lockdown would have devastating economic consequences. He is not wrong, and the tenuous state of Brazil's recovery makes this especially so. But the risk to public health may be even greater given densely packed cities and conflicting state guidelines on how to contain the crisis.

Where we go from here

In our March baseline we held fast to the storyline of Brazil as Latin America's comeback kid. Though the rest of Latin America showed signs of strain as global financial markets teetered and commodity prices extended their rout, Brazil's large internal market makes it slightly less vulnerable to global ructions. With pension reform under the belt, the reactivation of domestic demand by lower interest rates, a pro-market government, and soaring business confidence made for a convincing case. We missed clear signs that the coronavirus pandemic would hit Brazil hard.

Brazil Forecast Changes
Real GDP, annualized % change

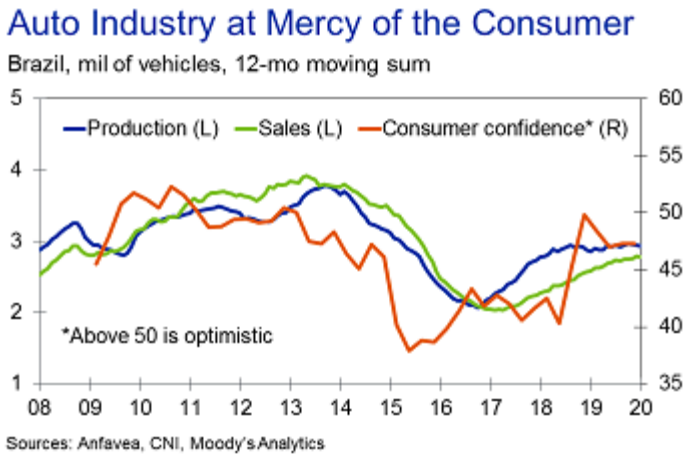
Vintage	2020Q1	2020Q2	2020Q3	2020Q4	2021Q1	2021Q2	2021Q3	2021Q4	2020 avg	2021 avg
March	1	2	2	3	3	3	3	3	2	3
February	2	2	3	3	3	3	3	3	2	3
Diff (ppt)	-1	0	0	0	0	0	0	0	0	0

Source: Moody's Analytics

In our March baseline, we expected growth of near 2% in 2020, a slight markdown from the previous month, and of 2.6% in 2021, unchanged from the February projection. Our April baseline will turn significantly more cautious. Whether we adopt a recession as our baseline outlook rides on how fast the COVID-19 pandemic spreads in the next two weeks and how able Brazilian officials are at playing catch-up. But judging from the virus' progression so far, if we do not forecast a recession, we will come awfully close.

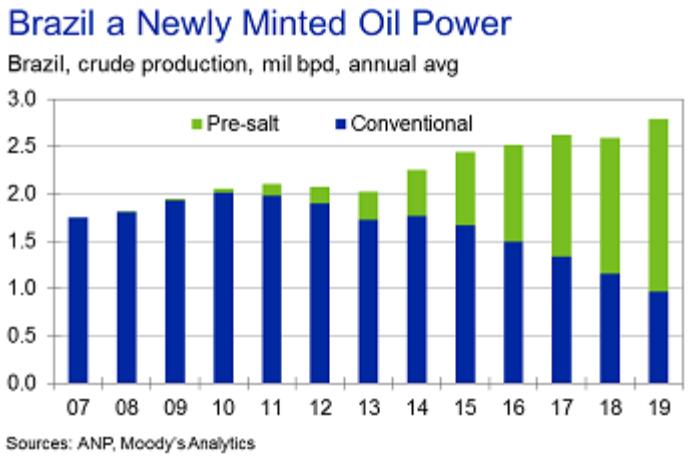
Out of gas

Nowhere is the vulnerability of Brazil's economy more evident than in the eyes of the domestic consumer. Though three years of recovery have reduced household debt burdens, job market conditions are hardly favorable. Brazilians have spent on household necessities and smaller discretionary items, but the recovery in auto sales—long a barometer of the health of the Brazilian consumer—has been cut short by slow job and wage gains.



Brazil's large domestic market is its greatest strength, but unlike Mexico—the only other economy in Latin America of similar heft—exports do not make up a large share of production in manufacturing industries. In the early stages of a recovery, when consumers are still cautious and employment gains are not broad-based, spending on larger discretionary items such as autos can be fickle.

The energy industry has emerged as a counterbalance to consumer-reliant manufacturing. Brazil became a net oil exporter last year as production in deep water deposits finally began to live up to lofty expectations. A tangle of regulations put in place by prior governments makes bidding on pre-salt fields less attractive than their bountiful reserves and reliable production would otherwise indicate. But Brazil's emergence as the world's seventh largest oil producer helped smooth the domestic consumer's still-rough edges.



Following the rupture in the Saudi-Russian agreement to limit global oil supply, Brazil's energy industry is now at risk. Extraction costs in pre-salt fields, so named for their location almost 1 mile below the seabed, is now about even with the cost of Brent crude. The oil price collapse will also do no favors for Petrobras, the state-owned juggernaut that is also the world's most indebted energy producer.

Monetary support

Helping things somewhat will be additional monetary stimulus. The rate-setting committee of the Central Bank of Brazil delivered a 50-basis point cut this week in a bid to pump some adrenaline into the economy. But monetary conditions were already relaxed before the latest shot of the bow, and it is difficult to see consumers growing more motivated by lower interest rates alone. With the economy still in low gear, a rate cut is akin to pushing on a string: There is no guarantee it will spring ahead.

Another concern is inflation. Currency depreciation has pushed up consumer prices, although they still remain well within the bank's target range. This could quickly change should global investors flee emerging markets, as they have for much of this year. With Brazil's benchmark Bovespa index down about 35% in March alone, bank officials may have bet that the worst is over. It likely is not. Given the bank's inflation-fighting mandate, it may confront the same dilemma it has in crises past: a choice between cheaper credit and capital flight.