BRAZIL ECONOMICS

December 17, 2020

Macroeconomic Scenario

(Another) Challenging Year Ahead

Ana Paula Vescovi* and
Brazil Macroeconomic Team

anavescovi@santander.com.br
+5511 3553 8567

- **Amid a constructive global backdrop, recent developments in the FX market have reinforced our perception that a reduction of fiscal policy risks (via a firmer commitment to the fiscal consolidation process and the constitutional spending cap) could erode the premia in Brazilian assets in general and strengthen the BRL. We maintain our projections of 4.60 and 4.15 for the USD/BRL pair at year-end 2021 and 2022, respectively.**
- **The current account deficit continues to be in a falling trend in annual terms, reflecting the greater impact of the pandemic on imports than on exports. After having registered a USD50.7 billion deficit in 2019, we expect the current account gap to recede to a tame USD10.2 billion at the end of 2020 and USD12.3 billion at the end of next year. This means the balance of payments should not be a source of concern anytime soon (in scenarios of fiscal consolidation).**
- **On the fiscal side, discussions in Congress on structural reforms and the 2021 budget have been postponed, and we believe that the policy trajectory will become clearer only after the elections for the speakers of both houses of Congress. In our baseline scenario, the fundamental hypothesis continues to be compliance with the spending cap, despite the challenging conditions for 2021. Regarding our forecasts, we marginally upgraded the budget numbers for 2020: we now forecast a consolidated primary fiscal deficit of BRL770 billion (or 10.4% of GDP), as compared to BRL 879 billion (or 12.4% of GDP) previously.**
- **Preliminary information on the vaccination strategy against COVID-19 in Brazil indicates that immunizations should start in 1Q21. The agreements already signed by the government can guarantee vaccines for about 60% of the population. Based on this information, and considering a range of possibilities of vaccine efficacy, we simulated trajectories that indicate the possible achievement of herd immunity (i.e., for at least 60% of the population) in the final months of 2021. This would allow a broad-based reopening of the economy in 2H21, per our projections.**
- **The recent releases of economic activity indicators highlighted a gradual and heterogeneous pattern of recovery, but reinforced the likelihood of solid sequential growth in 4Q20, in our view. The recovery continues to be largely supported by temporary fiscal stimulus. Despite the fiscal cliff expected for 2021, our forecasts account for a “mechanical” effect from the reopening process (especially in the services sector) that should offset the expected drop in government transfers. We are revising our projections for real GDP growth to -4.1%, 2.9%, and 2.5% (from -4.8%, 3.4%, and 2.6%) for 2020, 2021, and 2022, respectively.**
- **Recent BCB data for October reveals credit to households has been recovering, with non-earmarked new loans back to pre-crisis levels. As for corporate credit, new loans decelerated, mostly due to a slowdown in the government’s programs of credit support. Bank lending is offsetting the effects of lower transactions in capital markets. We project total real outstanding credit growth of 7.2%, 4.3%, and 5.6% for 2020, 2021, and 2022, respectively.**
- **On inflation, we made a major upward adjustment in our short-term forecast, because the food and exchange rate shocks are lasting longer than expected and because energy regulator Aneel decided (unexpectedly) to raise the extra charge for energy in December 2020 (owing to hydrological risks). For the medium/long term, however, the scenario remains largely the same—that is, a benign one. We revised our IPCA 2020 forecast to 4.50% from 3.30% and IPCA 2021 to 3.0% from 2.9%, while keeping IPCA 2022 at 3.20%. Our 2021 and 2022 forecasts are both below the BCB’s target and with benign composition (in terms of core readings).**
- **Based on recent BCB communications, we expect the forward guidance (of no hikes under certain conditions) to be abandoned in March and now project a slightly earlier start to the normalization process, with the Selic rate ending 2021 at 2.50% (previously 2.00%) and 2022 at 4.50% (previously 4.00%). Yet our baseline scenario sees well-behaved fundamentals for monetary policy (assuming a still credible spending cap).**

Executive Summary: A Watershed Moment

In this report, we present our last scenario review of the year, with the expectation that 2021 will be especially challenging for the Brazilian economy. Policy decisions regarding the proposed fiscal and structural macro reforms will determine how effective they will be in reducing local idiosyncratic risks.

The external scenario tends to be a positive element, in our view, in the wake of reduced uncertainties with the expected fading of the impact of COVID-19 and, therefore, with lower risk aversion in the global economy. There is favorable news in the start of a massive immunization strategy in several countries, using vaccines with a reasonable level of effectiveness, based on clinical trials. The rapid development of vaccines and their dissemination to the public represents a remarkable response to the pandemic from the scientific community, which brings an expectation of gradual normalization of mobility and confidence and, therefore, of global economic activity over the next year.

We believe the reduced uncertainty will tend, to some extent, to normalize the flow of resources to emerging countries, which already started to occur at the end of this year. In terms of expectations and financial conditions, the credible prospect of a brief mass-vaccination program, albeit complicated to put into effect, overshadowed the risks of a second wave of the virus that could have affected the rhythm of recovery in Europe and the U.S. in 4Q20.

The second wave of contagions, resulting from a relaxation of measures to restrict people's mobility, also arrived in Brazil, with an increase of about 50% in new cases and deaths. With the vacation period and the height of the tourist season, it would not be reasonable to assume a rapid reversal of this process, in our view.

Developing a credible approach to mass vaccination in the country will be crucial for the recovery of the economy, in our opinion. Our simulations show that, if the national vaccination program starts at the end of 1Q21, and considering a hypothesis of average effectiveness of 70% (with underreporting of cases by 3x in the official statistics of COVID-19 cases), we would reach 60% immunity in the population (possibly, the minimum level for herd immunity) in December 2021. In this scenario, we believe that government restrictions on mobility would be fully lifted by the end of 1H21.

Another crucial element for the reduction of idiosyncratic risk in Brazil would be a credible program for achieving reforms capable of ensuring a sustainable trajectory for the public debt, which may reach a peak of 102% of GDP in 2027, according to our baseline scenario.

If both requirements are met—credible vaccination schedules and credible fiscal consolidation—we believe the recovery of confidence in the country could attract substantial international flows, in this scenario of massive international liquidity and a globally weaker USD. This could allow reasonable FX appreciation throughout the year to 4.60, which, in turn, would contribute to mitigate the pass-through effect of the strong inflationary shock in the tradable goods sector. We forecast the IPCA at 3.0% in 2021 and 3.2% in 2022, below the respective inflation targets of 3.75% and 3.5%. For GDP, we consider growth of 2.9% in 2021, after a contraction of 4.1% in 2020.

A more robust inflation convergence to the center of the 2022 target should make it possible for the BCB to start the normalization of monetary policy later rather than sooner, in our view. We expect Copom to increase the Selic rate at the October 2021 meeting (second to last meeting of the year), with two consecutive increases of 25 bps. In our opinion, low interest rates for a considerable time can be expected to stimulate a credit expansion in the private capital market, with an especially positive impact on the civil construction, auto, and infrastructure sectors. Recovery in these sectors, along with the normalization of services, could allow a gradual and sustained labor market recovery, in our view.

Otherwise, if either of the two requirements is not satisfied, Brazilian risk will continue to be high and increasing, in our opinion, causing an FX depreciation and meaning interest rates will be higher for longer. In other words, in this alternative scenario, we believe this risk would continue to be incorporated into domestic asset prices, causing further deterioration in financial conditions and disrupting the macroeconomic scenario—with a more intense impact from the current inflationary shock and a consequent early rise in interest rates. In our view, such policy-induced shocks would derail the economic recovery.

In this review, we continue to anticipate a benign baseline scenario but acknowledge significant risks in its execution that justify a careful observation of our alternative scenario, according to our most recent review published late in 3Q20 *(Scenario Revision: Reaffirming the Recovery but Recognizing the Risks,* September 25, 2020). Beyond the question of vaccination, here we discuss what would be the minimum measures and reforms that could support the reduction of idiosyncratic risks. Such measures, in our view, could support the constructive scenario that we have for the coming years, without encountering setbacks along the way. These developments will naturally shape the probabilities for the baseline and alternative scenarios, helping define the position we hold throughout the year 2021.

The (minimal) measures that we account for in our baseline scenario are as follows: budget law for 2021 in compliance with the spending cap rule, whose margin was compressed by the mismatch of inflation rates; minimum emergency fiscal measures, able to sustain the spending cap for a few more years; advances in the important privatizations process, indicating the maintenance of a pro-investment and productivity agenda; the new tax reform project, or CBS Law (Contribution on Goods and Services), if there is no consensus on broader tax reform for goods and services; the autonomy of the Central Bank; the continuity of the modernization of regulatory frameworks, such as the Gas and Cabotage laws, with rules that represent advances toward a more competitive, safe, open, and attractive market for private investment in infrastructure; a balanced auction for 5G in communication and data; and at least some positive signs about the direction of administrative reform.

We also discuss what we consider to be potential setbacks: possible creation of new mandatory expenses (without compensatory measures on the spending side), implying a continued deterioration of the fiscal framework, and also implying the creation of exceptions to the spending cap rule, given the lack of fiscal space in 2021; increases in the tax burden, outside the scope of a reduction of tax benefits, given the deleterious impact on expectations and productivity and, therefore, on the long-term growth of the economy; approval of a new digital tax (CPMF); approval of federal measures that imply leniency or moral hazard with fiscal adjustments in subnational entities and even encourage rolling back measures already approved, such as local pension reforms; allocation of revenue not linked to public funds for other primary expenditures, which creates pressure on sustaining the spending cap and implies potential mandatory expenses. In particular, we believe monies from unlinked funds should be used to improve the Treasury’s cash position, given the immense challenges of rolling over approximately BRL740 billion of public debt mostly in 1H21.

We recognize that achieving a benign path for the Brazilian economy will face immense challenges during 2021. Our main hypothesis already considers the announced end of fiscal incentives—emergency aid and benefits to sustain jobs, among others. We recognize that this process, although necessary due to the serious fiscal situation, will occur in an environment of acute hardship for a substantial portion of the population, with high prices of food (after recent shocks) and high levels of unemployment – the latter expected to peak at 17.6 million workers in the second quarter, according to our estimates. When the focus of attentions turns to the vaccination process, we expect significant social and political pressures, with a possible loss of popular support and of approval from governments and political leaders, amid lingering health and economic difficulties.

We also see a political environment with more fractured by disputes over elections for the speakers of both houses, the Lower House and the Senate. Such frictions could hinder the construction of political alliances capable of reaching consensus and the number of votes necessary for approval of constitutional amendments. In our view, this could imply risks to both maintaining and approving the agenda of fiscal and productivity reforms capable of leading to a fairer and safer path for the country's long-term growth.

Key Hypotheses in Our Baseline Scenario

We have made a few changes in the set of key assumptions conditioning our forecasts for Brazil.

These changes include the results of the U.S. elections, leading us to project a little less fiscal stimulus in the U.S. but an expansionary Fed stance for longer. It also reaffirmed expectations of an economic recovery in the U.S. as well as our forecast of a globally weaker USD down the road.

We also incorporate new developments regarding the evolution of the COVID-19 pandemic in Brazil and globally, with a spike in new cases leading to the adoption of brand-new (but predominantly targeted) mobility restriction measures in major economies and some Brazilian regions. In terms of the impact on financial conditions and economic expectations, this setback in the reopening process was partly offset by faster-than-expected progress in developing vaccines, which pushed forward the outlook for the start of a gradual global immunization process.

In Brazil, the discussion in the legislature of structural reforms and the 2021 budget were postponed, and we believe that the policy trajectory will become clearer only after the elections for the speakers of both houses of Congress. We continue to have confidence in our baseline scenario, whose key hypothesis is the maintenance of the credibility of the constitutional spending cap. Yet the probability of an alternative scenario (of fiscal slippage) remains high.

We list below the main hypotheses for our baseline scenario:

- We assume that the public health and economic effects of the pandemic will fade in 2021, following a gradual immunization process (starting in December in some countries and in Brazil in 1H21). We still assume that most economies will not see long and tight lockdowns as in the early days of the pandemic (Germany being a temporary exception). In Brazil, we assume scattered restrictions for a few weeks, but not a full-fledged reversal in the gradual reopening of the services sector. We assume that the reopening process will be such that mobility reaches something close to a “normal” level in 2H21, as a large-scale vaccination program goes into effect.
- Our scenario also assumes no escalation of tensions in the “trade war” between the U.S. and China, with the world’s largest economy likely taking a more multilateralist approach (i.e., in coordination with traditional trading partners) to address trade issues with China. We also assume the adoption of another round of fiscal stimulus in the U.S., helping spur a gradual cyclical recovery into 2021. Yet the mixed composition of the U.S. Houses of Congress diminishes the prospects for a sizeable new program.
- A smaller U.S. budget stimulus could mean it will take even longer for a change in the policy stance among key central banks (especially the Federal Reserve), so we continue to assume a global backdrop of low interest rates for longer, prompting relatively favorable financial conditions for emerging economies for some time, in our view.
- In what we see as the most important assumption of all, our baseline scenario for Brazil assumes a decision (by both the executive and legislative branches) to approve corrective measures in order to open new fiscal space to sustain a minimum of BRL100 billion in discretionary expenses. This should allow the basis of the current fiscal regime to remain in place, with no policy changes damaging the credibility of the constitutional spending cap.
- We continue to assume that the pandemic will generate neither widespread bankruptcies nor a labor market collapse, leading to no major breakdown in supply and keeping the economy relatively well positioned for a continued recovery amid a socially stable environment.
- Our inflation forecasts assume additionally that the exogenous (international) component of the upward price shock in food costs will lose steam in 2021, following a gradual recovery in the Chinese swine herd and high agricultural productivity (i.e., output per acre) in Brazil. The emergence of weather-related risks (La Niña) continues to mean risk for this assumption, however.
- Our scenario also contemplates a normalization of contracts for services that have been renegotiated during the pandemic (e.g., education, health care), as well as the postponement of tariff adjustments in regulated sectors. In most cases, we assume full compensation in 2021 (an exception: electricity).

COVID-19: Vaccines and Timing for Herd Immunity in Brazil

More details were released regarding vaccination plans against COVID-19 in Brazil. The São Paulo state government has presented a schedule in which immunizations begin at the end of January 2021. As for the federal government, the first plan released does not indicate specific dates for the beginning of the vaccination process, but so far, authorities have said that immunizations will start in March 2021. Both plans prioritize the vaccination of people in high-risk groups, such as the elderly and health professionals. The total number of vaccine doses with distribution agreements in Brazil is roughly 260 million. Since all vaccines purchased so far must be administered in two doses, the potential number of immunized is nearly 130 million people initially, about 61% of the population. In São Paulo, there is also a technology transfer agreement that will later on allow the domestic production of CoronaVac, a vaccine developed by the Chinese company Sinovac Life Sciences. Details of the agreements are shown in Figure 1-A.

Based on the information available about vaccination plans, we simulated some possible trajectories for the percentage of individuals in the Brazilian population who would be immune, either through vaccines or from having had the virus. For this, it was necessary to assume some hypotheses. First, we consider that the SARS-CoV-2 reinfection is a rare event and, therefore, those infected are considered immune, at least during the analyzed period. Additionally, it is important to account for the underreporting of cases since the beginning of the pandemic, as serological tests have shown that the percentage of infected people is higher than the official numbers indicate. Thus, it is necessary to assume numbers for this underestimation of cases, in order to calculate the average efficacy of the vaccines.

Figure 1-B shows the possible paths of immunity according to the simulations performed, together with the indication of three important percentages that can indicate herd immunity, according to preliminary studies (60%, 70%, and 80%). We consider São Paulo state's initial plan of an additional effort to vaccinate high-risk groups in the first few months, in addition to a uniform distribution of doses contracted by the federal government over time, starting in March. We also include the possibility of the CoronaVac's domestic production. In the proposed scenarios, the average effectiveness of vaccines varies between 50% (pessimistic) and 90% (optimistic), and underreporting implies a real number of immune individuals ranging between 1.5 and 5.0 times greater than the official data.

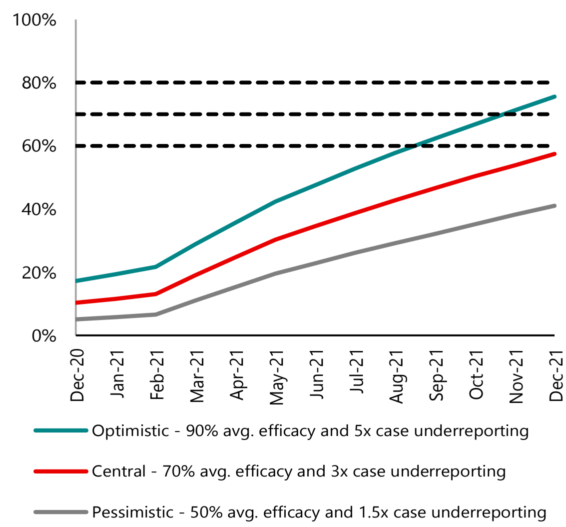
Considering (by hypothesis) the results from the "central scenario" for 2021, the numbers suggest a gradual immunization of a large percentage of the population, allowing the continuity of a gradual relaxation of social distancing restrictions throughout the year. So far, the available indications of vaccine effectiveness and underreporting of cases point to trajectories between the central scenario and the optimistic scenario. Thus, if the immunization programs run according to plan, the country could achieve herd immunity sometime in 2H21, which seems to support our assumption of "normalization" of economic activities and broader reopening of the (socially integrated) services in 2H21.

Figure 1-A. Overview of vaccine agreements in Brazil

	Doses purchased (millions)	Coverage	Status
AstraZeneca	100,4	National	Additional phase 3 trials taking place after dosing mistake. Efficacy can reach up to 90%
Covax	42,5	National	Global collaboration on the development of nine vaccines. Brazil will receive doses as approvals occur
Coronavac	46,0	São Paulo State	Phase 3 trials, still no official releases on the level of efficacy
Pfizer	70,0	National	Agreement not yet reached

Sources: Ministry of Health, São Paulo State Government, Santander.

Figure 1-B. Share of Brazilians immunized (scenarios)



Sources: Ministry of Health, São Paulo State Government, Santander.

Fiscal Policy

After an unprecedented deterioration in government finances this year, the government's measures to mitigate the economic and sanitary effects of the pandemic should be nearing the end in December, in our view. A crucial hypothesis of our scenario is that fiscal stimuli will be (almost entirely) limited to 2020, so that in 2021, government spending will once more be constrained by the constitutional spending cap rule.

Complying with the constitutional spending cap (Brazil's main fiscal anchor) for the medium term will be key to shaping the economic outlook, in our view. But for next year, it will be a major challenge: we estimate a budget shortfall of BRL11.3 billion in 2021—mainly caused by the mismatch between the inflation index used to readjust mandatory government transfers and the index readjusting the spending cap itself. We think compliance remains feasible; however, it will require a great deal of fiscal discipline, potentially leading to depressed discretionary expenses and government frictions, with the possibility of partial shutdowns of some public administration services. Amid difficult employment conditions in 2021, the government will also have face pressures for additional stimulus up to mid-year. For 2022, the opposite inflation mismatch occurs, leading to a positive margin of about BRL15 billion to execute the spending cap. In this scenario, and considering the approval of (even slightly diluted) fiscal reforms, we believe it opens up the possibility of spending cap compliance in 2023 and beyond, consequently reducing uncertainty about fiscal sustainability[1].

Regarding our fiscal performance forecasts, our revision follows two aspects: (i) a lower fiscal impulse in 2020; and (ii) the mechanical effect of a higher nominal GDP. In the primary balance, revenue performance has been improving with the gradual recovery in domestic activity, and with tax deferral payments (~BRL20 billion higher than we anticipated). On the expenditure side, the total related to the pandemic is expected to reach around BRL550 billion by the end of the year, lower than the BRL600 billion initially estimated. In our view, this lower than expected execution of emergency spending related to the pandemic possibly reflects a choice of a more conservative stance on the execution of the budget at the end of this year.

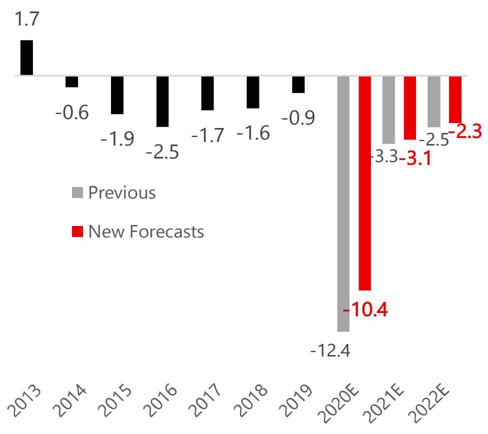
We estimate the central government primary deficit for 2020 at BRL810 billion (10.7% of GDP) from BRL880 billion in our last scenario report. We also revised the regional government's surplus to BRL39.3 billion (from BRL1.5 billion), improved by central government transfers. Consequently, we revised our forecast for the consolidated deficit to BRL770 billion (or 10.4% of GDP), as compared to BRL 879 billion (or 12.4% of GDP) in our previous scenario. For 2021 and 2022, we continue to expect primary deficits to gradually decline (Figure 2-A).

Regarding the effect of nominal GDP growth, there was an increase in the latest review of the GDP series by IBGE[2]. Beyond that, we revised the forecast for the deflator of nominal GDP, due to the inflation pickup. We now consider a deflator of 4.3% in 2020, vs. 3.0% in our previous scenario. Both factors increase the denominator of fiscal accounts and slightly shift down the debt numbers—yet they do not change the challenging outlook.

In light of this, we expect gross debt to reach 91.7% of GDP in 2020 (Figure 2-B), an increase of 16 p.p. from 2019. More importantly, we expect the indicator to peak only in 2027 at ~102%[3] of GDP, ~24 p.p. higher than the pre-pandemic estimate. Subsequently, our scenario estimates convergence toward ~98% of GDP by 2035.

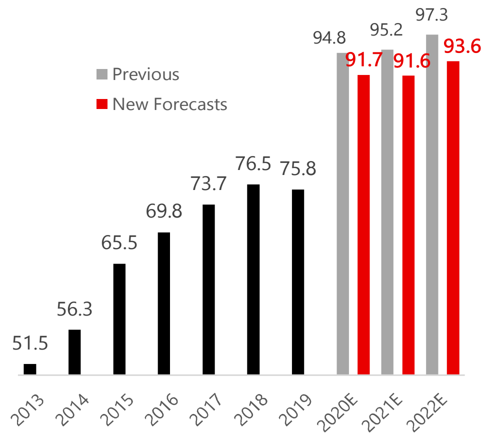
[1] For details, refer to our report (https://bit.ly/Sant-Spendcap-Dec20)
[2] IBGE revised the GDP growth trajectory in recent years: +1.8% in 2018 (from +1.3%), and 2019 to +1.4% (from +1.1%).
[3] According to our simulations, the stabilization of the gross public debt-to-GDP ratio at ~102% would require an equilibrium primary fiscal surplus of (at least) 1% of GDP.

Figure 2-A. Consolidated Primary Fiscal Balance (% GDP)



Sources: Brazilian Central Bank, Santander.

Figure 2-B. Gross General Govt. Debt (% GDP)



Sources: Brazilian Central Bank, Santander.

External Sector and Exchange Rate

In our view, the international environment has continued to provide favorable conditions for the BRL to strengthen, given rising commodity prices, a rapid recovery of international trade flows, a decline in the level of market participants' risk aversion, and the maintenance of ample liquidity in advanced economies. Despite the presence of these constructive elements in the previous months, we believed that idiosyncratic factors had prevented the BRL from strengthening, such as uncertainties regarding the maintenance of the fiscal framework in the coming years and the fear that the augmented demand for USD in derivatives markets, resulting from a change in tax rules, could exert a weakening pressure on the currency late in 2020 (the so-called "over-hedge issue"). Those factors created a sort of "risk premium" for the BRL, with the actual exchange rate largely (and atypically) topping the estimates of BRL models based on global financial conditions recently.

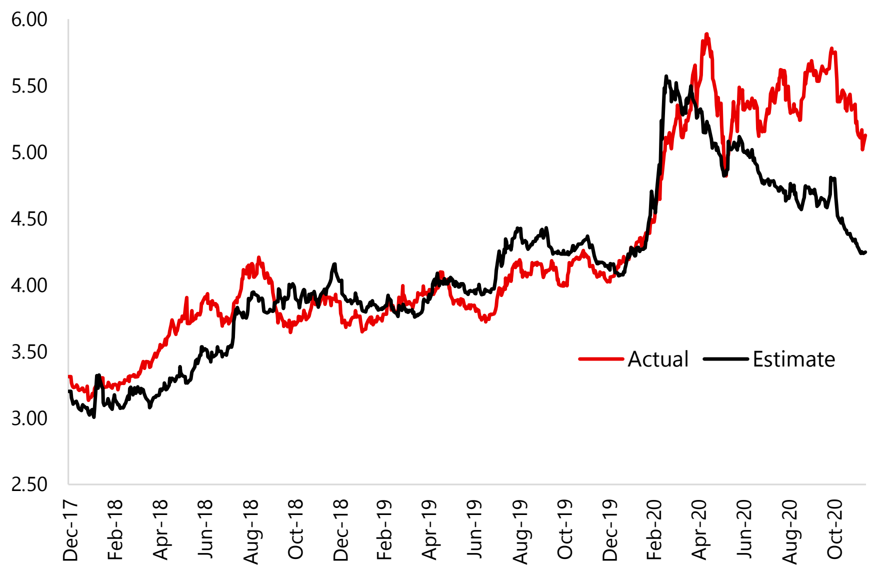
In order to address the "over-hedge demand," the BCB announced in late November that it would supply liquidity to the markets if necessary, which reduced the concern about a potential lack of supply to meet the augmented demand for USD-linked instruments at the end of this year. The approach gave more confidence to market participants that the FX market will not become dysfunctional in the coming days, thus contributing to part of the strengthening we have seen lately. Regarding the uncertainties regarding the maintenance of the fiscal framework, there have been several remarks from government officials indicating that the emergency measures introduced to deal with the economic fallout of the COVID-19 this year will not be extended into 2021, which reduces the execution risks for the public spending cap rule ahead. (For more details, see the "Fiscal Policy" section.)

We believe that market participants' favorable knee-jerk reaction to this latter indication reinforces our long-lasting perception that, assuming that the Brazilian government will not abandon its commitment to the current fiscal framework, as has been feared lately, the BRL could benefit from the favorable international environment that has led other currencies to fare much better. And this should make the BRL catch up with them. In other words, this would mean a reduction in this "BRL risk premium". Consequently, we maintain our view that the USD/BRL pair is likely to recede to 4.60 by the end of 2021 from 5.10 at year-end 2020 and to continue strengthening in 2022, thus reaching 4.15—a level close to that seen at the beginning of 2020 before the rise of the pandemic.

The BRL strengthening, combined with the expected extension of the economic recovery (see more details in the "Economic Activity" section), should lead the current account deficit to increase as years go by, in our view. Nonetheless, given our expectation for the maintenance of favorable price levels for commodities and an increase in the volume of international trade flows—which are already back to their pre-pandemic heights—we think that export revenue will help to partially counterbalance this deterioration, thus keeping Brazil's current account balance off the list concerns for market participants.

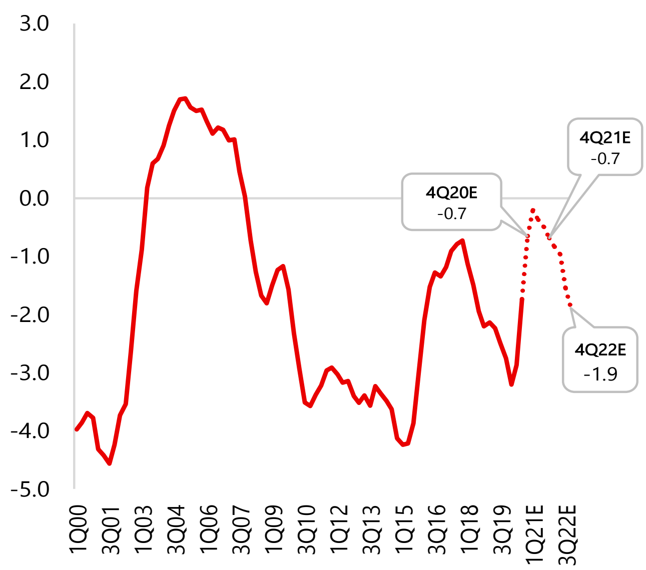
After having reached USD50.7 billion in 2019, we project the current account deficit to recede to USD10.2 billion by the end of 2020 due to a stronger hit on import and tourism outlays and remittances of profits than on export proceeds. For 2021, as the Brazilian economy should continue to recover gradually, in our opinion, we forecast the imbalance to reach USD12.3 billion. Then, for 2022, we believe that the combination of another year of economic expansion and a stronger currency should lead the current account deficit to climb to USD39.5 billion, as the expected return of economic activities to fully operational should foster larger remittances of profits and dividends by Brazilian firms. These projections contrast with our previous forecasts (deficits of USD2.5 billion, USD3.5 billion, and USD29.6 billion, for 2020, 2021 and 2022, respectively), but it is important to bear in mind that in November 2020 the BCB carried out a review of the historical series that led to an upward shift in the level of previous deficits. The trajectory remains qualitatively similar, and indicating the balance of payments should not be a source of concern for the BRL over the medium term in our baseline scenario (i.e., assuming fiscal reforms).

Figure 3. USD/BRL – Atypical Gap between Actual Levels and Forecasts



Sources: Bloomberg, Santander.

Figure 4-A. Current Account Balance (% of GDP)



Sources: Brazilian Central Bank, Santander.

Figure 4-B. Current Account Balance (USD billion)

USD billion	2019	2020e	2021e	2022e
Current account balance	-50.7	-10.2	-12.3	-39.5
Trade balance	40.5	47.3	57.3	44.5
Exports	225.8	210.9	248.4	263.1
Imports	185.3	163.6	191.2	218.5
Services	-35.1	-22.8	-26.2	-29.7
Tourism	-11.6	-5.3	-9.1	-12.0
Eq. Rental	-14.6	-13.1	-13.3	-14.5
Others	-8.9	-4.3	-3.7	-3.2
Income	-57.3	-37.0	-45.3	-55.9
Profits & Dividends	-31.9	-18.8	-26.3	-37.6
Interest payments	-19.9	-18.2	-19.1	-18.3
Transfers	1.2	2.3	2.0	1.5
Direct investment onshore	69.2	40.0	62.0	69.0
External funding (-ve=shortage / +ve=excess)	18.5	29.8	49.7	29.5
Brazilian direct investent abroad	22.8	0.0	0.0	0.0
Portfolio, Derivatives & Other investments	-21.7	-65.0	-45.0	-30.0
Reserves change	-26.1	-35.2	4.7	-0.5
International reserves	356.9	321.7	326.4	325.9

Sources: Brazilian Central Bank, Santander.

Economic Activity

The releases of economic activity indicators for the last four months highlighted the gradual and heterogeneous pattern of recovery presented by the Brazilian economy (see Figure 5-A). Reflecting the effects of the emergency aid and a shift of consumer spending out of services (directly affected by social distancing measures) and into goods, retail sales led this process, more than offsetting April's tumble and reaching multiyear highs; industry has also presented a strong resumption in activity, fully recovering from the drop caused by the pandemic earlier this year. On the other hand, the services sector has been the laggard, still running well below February's reading (pre-crisis mark).

Considering the development of the economic indicators at the end of the previous quarter and at the start of 4Q20, we see no evidence of a flat GDP, as we expected in our previous scenario. Indeed, the resumption in activity seen for key indicators (e.g., industrial production, retail sales, services sector) reinforces the likelihood of solid sequential growth in 4Q20, in our view.

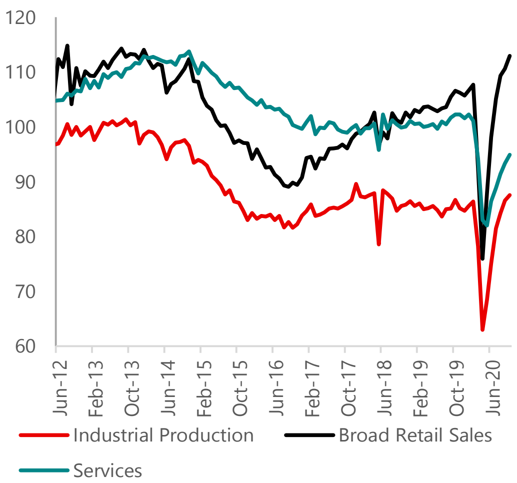
Regarding the labor market, the low participation rate is concealing the actual speed of deterioration in labor market conditions: in a simple counterfactual exercise, if we assume the workforce at February's level, the unemployment rate would reach more than 20%. On the heels of the easing of social distancing measures, we expect the labor force and participation rate to reach pre-crisis levels in 2Q21. In this context, a sharp increase in the unemployment rate is unavoidable, in our view (see Figure 5-B): we expect it to reach an annual average of 13.5% in 2020 and 15.9% in 2021, with a gradual decrease to 13.3% in 2022, as the services sector reaches full recovery. Regarding the unemployed population, after reaching 12.0 million at the end of 2019, we expect it to reach more than 17 million (2Q21), with a gradual decrease to 14.3 million in 2022. The conclusion is that labor market idleness is expected to remain high in the coming years, despite some uncertainty about possible increases in the economy's natural rate of unemployment after the pandemic.

In an analysis of the impact of emergency aid on the real wage bill, considering government stimulus to households during the pandemic, we forecast a 3.9% rise in the "expanded" (i.e., including social benefits) wage bill, adjusted for inflation for full year 2020. In a counterfactual simulation without the fiscal stimulus, we calculate a 6% drop in the real wage bill, so that the benefits more than offset the estimated cyclical drop caused by the pandemic. For 2021, we estimate the so-called fiscal cliff to lead to a drop of 6-8% in aggregate wages (i.e., including transfers), depending on the adoption (or not) of a new welfare program. In terms of GDP, the impact of the latter on the economy should be offset by the reopening process (especially in the services sector, the largest one in the Brazilian economy), in our view, prompting sort of a "mechanical" rebound.

In our baseline scenario, we expect that the social distancing measures will be eased gradually until around the middle of 2021, with the economy in "full operation" mode in 3Q21. We also assume that the pandemic will generate neither generalized bankruptcies nor a labor market collapse, with no severe and lasting supply constraints, thus keeping the economy relatively well positioned for a continued recovery in a socially stable environment. According to the recent data on bankruptcies, we believe this hypothesis still seems reasonable for now (Figure 5-D).

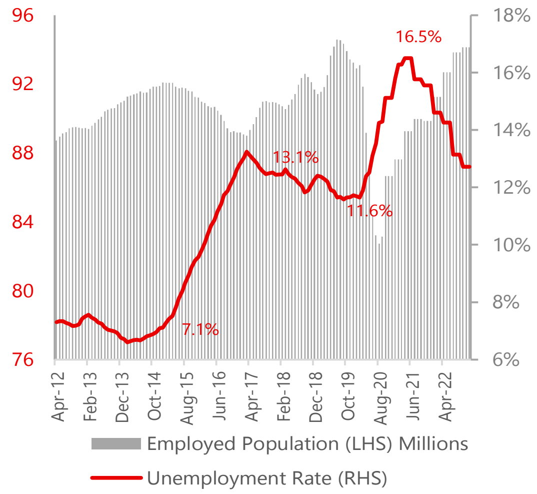
Considering all this, we are revising our projections for real GDP growth to -4.1%, 2.9%, and 2.5% (from -4.8%, 3.4% and 2.6%) for 2020, 2021, and 2022, respectively.

Figure 5-A. Economic Activity (2011=100, SA)



Sources: IBGE, Santander.

Figure 5-B. Labor Market Conditions (SA)



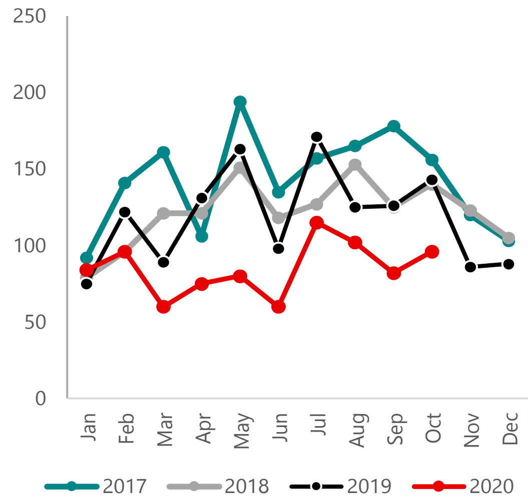
Sources: IBGE, Santander.

Figure 5-C. GDP Breakdown

GDP Projections					
Baseline Scenario					
	2018	2019	2020e	2021e	2022e
Total GDP	1.8	1.4	-4.1	2.9	2.5
Agriculture & Livestock	1.3	0.6	1.5	1.2	1.2
Industry	0.7	0.4	-3.7	3.8	1.6
Services	2.1	1.7	-4.9	2.9	3.0
Household Consumption	2.4	2.2	-4.3	2.1	3.1
Government Consumption	0.8	-0.4	-5.2	3.8	1.0
Investments	5.2	3.4	-5.3	4.8	4.4
Exports	4.1	-2.4	1.2	9.5	-0.3
Imports	7.7	1.1	-10.6	17.8	15.4
Memo (contribution)					
Domestic Absorption	2.5	1.8	-4.7	2.9	3.0
External Sector	-0.5	-0.5	1.7	-1.0	-2.5
Inventories	-0.2	0.1	-1.0	1.0	2.1

Sources: IBGE, Santander.

Figure 5-D. Liquidation (Bankruptcy) Requests



Sources: Serasa, Santander.

Credit Markets

Recent data (BCB) for October reveals that household lending has been recovering, helping support economic activity in recent months, in our view. Total outstanding loans in the National Financial System (SFN) posted inflation-adjusted growth of 10.6% YoY in October (BRL3.8 trillion). For households, new loans in the non-earmarked segment registered the sixth consecutive gain, and are now back to pre-pandemic levels. For companies, there was a decrease in new loans both in the non-earmarked segment and in the earmarked segment for October, the latter due to a slowdown in disbursements from emergency credit-support programs (*Pronampe*, *Pese*, and *FGI*).

Considering the total funding for corporates (new loans in the SFN, and debt and equity issuances in the capital markets) between January and October 2020, compared to the year-ago period, capital market issuances are 24% lower, while SFN concessions are 23% higher. As a result, total corporate financing is up 13.9% compared to the year-ago period, with an increase in bank lending for non-financial firms offsetting the retracement in capital market transactions (see Figure 6-A).

Importantly, we think it is possible that Brazilian companies may be more willing to hoard cash (for precautionary reasons) than to boost investment.

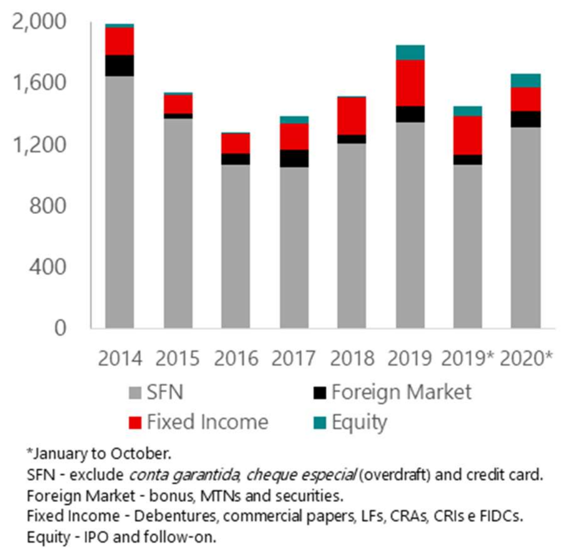
Credit cost indicators (ICC) and default rates continued their downward trend in October, while interest rates for both household and companies posted the first increase since January. In September, the household debt to income ratio was 49.0%, up +1 p.p. from August (+4.4 p.p. from September 2019), the largest monthly increase since 2005. This rise in consumer indebtedness is another indication, in our view, that NPLs are likely to rise in the coming months.

Housing market: In October, the volume of real estate financing hit its highest level in nearly five years. Looking ahead, we believe this market will remain robust, as shown in our recent study. For details see our report[4].

We revised our projections for total outstanding growth (inflation adjusted) to 7.2% in 2020, 4.3% in 2021, and 5.6% in 2022 (see Figure 6-B), from 7.5%, 5.3%, and 6.8%, respectively. The reasons for this include a slowdown in pandemic-related credit in 2021 and 2022.

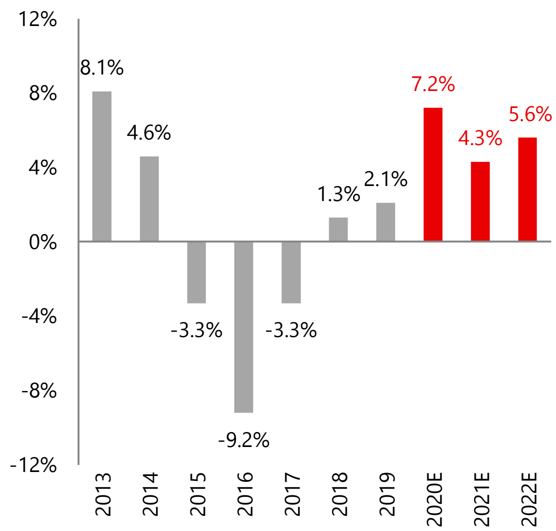
Risk factors for our baseline scenario: setbacks in the economic reopening could delay a recovery in personal income, while the end of temporary stimuli (e.g., *coronavouchers*) could lead to an increase in defaults and indebtedness of households. For non-financial corporations, the same setbacks could lead to liquidity problems and higher indebtedness.

Figure 6-A. Total Funding for Corporates (BRL billion, Inflation Adjusted)



Sources: Central Bank of Brazil, Anbima, Santander.

Figure 6-B. Credit Market Forecast – Growth in Total Outstanding Loans (%, Inflation Adjusted)



Sources: Central Bank of Brazil, Santander.

Inflation

Since our last scenario revision, we made a major upward adjustment in our short-term forecast, while for the medium/long term, the scenario remains largely the same—that is, a benign one.

For the short term, the food and exchange rate shocks are lasting longer than expected—in a context where the consumer's basket has temporarily changed owing to the social distancing measures and income is being supported by the government's emergency aid. Second, Aneel (electrical energy sector regulator) decided in December 2020 to resume the tariff flag system (contrary to its previous plan of doing so in January 2021), defining it as Red 2 (the highest additional cost for households) and pushing energy inflation upward. Finally, in industrial goods, scattered episodes of mismatches between supply and demand for some products is resulting in more exchange rate pass-through than we anticipated.

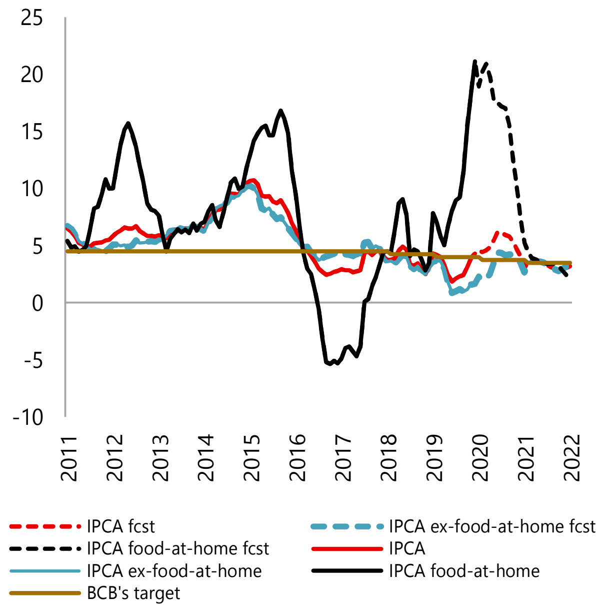
[4] **Santander Macro Brazil Credit – *Housing market Picking Up* –** December 9, 2020- Available on: https://bit.ly/Sant-credit-housing

Looking ahead, there are already signs that the main shocks are starting to fade. Food prices at the wholesale level are already decelerating (or falling in some cases) and, in addition, the BRL has appreciated almost 15% from its lows. We believe both trends are likely to continue, meaning a respite for food and industrial goods prices. Moreover, we also see signs that the mismatch between supply and demand at the industrial sector should normalize shortly, given the high levels of industrial capacity utilization worldwide, probably signaling a recovery in global supply chains after stoppages seen in early stages of the pandemic. In parallel, we expect services inflation to recover very gradually, because the job market should also slacken significantly. Finally, for administered prices, the upward impact generated by the Red 2 flag in energy for December 2020 should be reversed, in our view, as we expect Aneel to decide on a Green flag for December 2021, which could potentially help shave around 45bps off inflation in 2021, as compared to 2020.

With all these factors in place, we revised our IPCA 2020 forecast to 4.50% from 3.30% and IPCA 2021 to 3.0% from 2.9%, while keeping IPCA 2022 at 3.20%. Our 2021 and 2022 forecasts are both below the BCB's target of 3.75% and 3.50%, respectively, with a benign composition (low core measures).

On the balance of risks, we see it slightly tilted to the upside for the medium term, but not to the point of endangering the target achievement by the BCB. The main upside risks are: (i) the weather (La Niña), a risk for food and energy, (ii) a more intense and persistent exchange rate pass-through on industrial goods, and (iii) possible higher-than-expected adjustments in administered prices. However, we also see downside risks: (i) if the weather helps, food inflation is expected to follow its mean-reversal pattern and slow considerably, and (ii) the fiscal cliff (i.e., removal of emergency stimulus) may hit demand harder than we anticipate and result in lower industrial goods and services inflation.

Figure 7-A. IPCA Inflation and Forecast % YoY



Sources: IBGE, BCB, Santander.

Figure 7-B. IPCA Details % YoY

	2017	2018	2019	2020e	2021e	2022e
IPCA	**3.0**	**3.8**	**4.3**	**4.5**	**3.0**	**3.2**
Free prices	1.3	2.9	3.9	5.0	3.0	2.8
Food-at-home	-4.9	4.5	7.8	18.9	5.3	2.0
Industrial goods	1.1	1.1	1.7	2.7	2.5	2.7
Tradables	1.0	1.0	1.7	2.7	2.5	2.7
Non-Tradables	1.5	1.9	1.8	2.7	2.5	2.6
Services	4.5	3.4	3.5	1.6	2.4	3.2
Food-service	3.8	3.2	3.8	4.7	3.5	4.0
Airline tickets	3.1	16.9	2.3	-16.5	15.0	12.0
Economic activity	4.2	1.7	2.9	0.3	0.7	2.5
Education	7.6	5.5	5.0	1.2	5.0	6.0
Inertial	2.6	2.8	3.4	2.2	2.0	2.0
Salaries	6.3	3.7	3.2	2.3	1.8	2.5
Administered prices	8.0	6.2	5.5	2.7	3.5	4.0
Gasoline	10.3	7.3	4.0	-0.7	5.0	4.0
Energy	10.4	8.7	5.0	10.6	-5.9	4.0
Health insurance	13.5	11.2	8.2	2.5	13.1	4.0
Bus fares	4.0	6.3	6.6	1.4	6.0	4.0
Cores	3.6	3.3	3.5	2.8	3.0	3.2

Sources: IBGE, BCB, Santander.

Monetary Policy

At the December 8-9 meeting—when the COPOM held the Selic rate at the historical low of 2.00%—the authority introduced some hawkishness in its communication. A bit sooner than expected, the BCB paved the way for scrapping its forward guidance, whereby the authority has been signaling an intention not to "reduce the monetary stimulus as long as specified conditions are met."

The COPOM saw conditions for the forward guidance still holding for that meeting—with inflation projections seen below the target for the relevant horizon, no change in the fiscal regime, and well-anchored long-term inflation expectations. The willingness to change the flight plan is based two factors: (i) "inflation expectations reversed their declining trend relative to the target for the relevant horizon"; and (ii) "over the next months, the 2021 calendar year should become less relevant than the 2022 calendar year, for which projections and expected inflation are around the target." Under these circumstances, "the conditions for maintaining the forward guidance may soon no longer apply." If the past is a good guide, we interpret the BCB signals as an indication of a possible dropping of the forward guidance in the March 16-17 COPOM meeting.

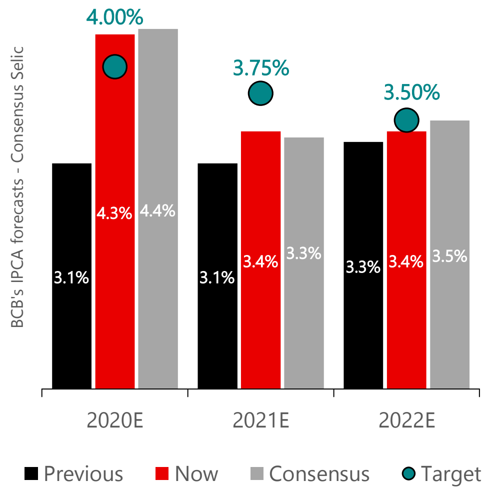
The BCB clarified that dropping the forward guidance "does not mechanically imply interest rates increases, since economic conditions still prescribe an extraordinarily strong monetary stimulus." Without the forward guidance, "monetary policy will follow the inflation target framework, based on the analysis of prospective inflation and its balance of risks"—meaning data dependency for subsequent policy meetings.

The evolution of official inflation projections helps us understand the BCB's thinking. The numbers suggest that, if current conditions and hypotheses hold in the future, mid-target achievement with the current policy stance is within reach for 2021 but not for 2022—that is, the numbers suggest the need for four hikes of 25-bp each in 2021 (starting in August) and further tightening up to 4.50% by year-end 2022 (Figures 8-A and 8-B).

In our baseline scenario—assuming reforms that maintain the credibility of the spending cap—we anticipate limited demand-led price pressures in the medium term. Despite a surprisingly strong pickup in headline inflation recently, the key fundamentals for monetary policy remain well behaved, as we project IPCA below the target and the economy below its potential for 2021 and 2022 (the latter largely influenced by the removal of emergency fiscal stimulus).

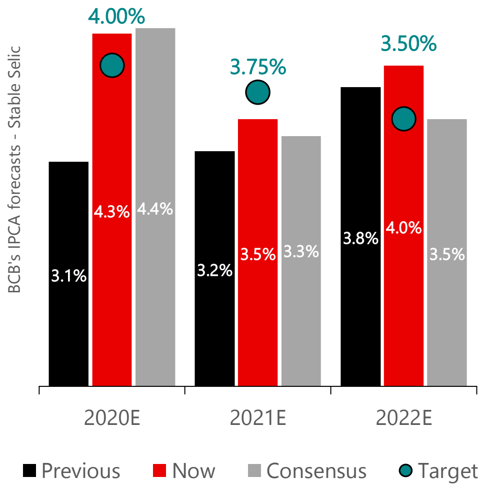
While we see room for downward revisions in the BCB's inflation projections at some point, given our view on the fundamentals, we acknowledge the authority's new tone. Based on that, we now project a slightly earlier start to the normalization process, with Selic ending 2021 at 2.50% (previously 2.00%) and 2022 at 4.50% (previously 4.00%).

Figure 8-A. BCB Inflation Simulations – Consensus Selic



Sources: Brazilian Central Bank, Santander.
Note: FX rate (USD/BRL) assumed at 5.25 and evolving according to the PPP

Figure 8-B. BCB Inflation Simulations – Stable Selic



Sources: Brazilian Central Bank, Santander.
Note: FX rate (USD/BRL) assumed at 5.25 and evolving according to the PPP

Figure 8-C. Assumptions Used in BCB Inflation Simulations

		SELIC ASSUMPTIONS	
		Previous	Now
Consensus Selic Rate	2020E	2.00%	2.00%
	2021E	2.75%	3.00%
	2022E	4.50%	4.50%
Stable Selic Rate	2020E	2.00%	2.00%
	2021E	2.00%	2.00%
	2022E	2.00%	2.00%

Sources: Brazilian Central Bank, Santander.

Figure 9. Santander's Projections for the Brazilian Economy

Macroeconomic variables		Previous	Current
GDP (%)	2020	-4.8	-4.1
	2021	3.4	2.9
	2022	2.6	2.5
IPCA (%)	2020	3.3	4.5
	2021	2.9	3.0
	2022	3.2	3.2
Selic Rate (% end of period)	2020	2.00	2.00
	2021	2.00	2.50
	2022	4.00	4.50
FX Rate - USDBRL (end of period)	2020	5.30	5.10
	2021	4.60	4.60
	2022	4.15	4.15
Current Account Balance (% of GDP)	2020	-0.2	-0.7
	2021	-0.2	-0.7
	2022	-1.4	-1.9
Primary Fiscal Balance (% of GDP)	2020	-12.4	-10.4
	2021	-3.3	-3.1
	2022	-2.4	-2.3
Gross Public Debt (% of GDP)	2020	94.9	91.7
	2021	95.3	91.6
	2022	97.4	93.6

Source: Santander estimates.

Figure 10-A. Brazil Forecasts: Santander vs. Consensus Estimates (2020)

	2020e					
	Consensus			Santander		
	A month ago		Last	A month ago		Last
IPCA Inflation (%)	3.0	↑	4.4	3.3	↑	4.5
GDP Growth (%)	-4.8	↑	-4.4	-4.8	↑	-4.1
Selic policy rate (%, year end)	2.00	→	2.00	2.00	→	2.00
Exchange rate (USD/BRL, year end)	5.45	↓	5.20	5.30	↓	5.10
Current Account (USD billion)	-6.0	↑	-4.3	-2.5	↓	-10.2
Primary Budget Balance (% GDP)	-12.0	↑	-11.5	-12.4	↑	-10.4
Net Govt. Debt (% GDP)	67.4	↓	65.7	67.1	↓	63.1

Note: Based on the BCB's Focus report as of December 11, 2020.

Sources: Brazilian Central Bank, Santander estimates.

Figure 10-B. Brazil Forecasts: Santander vs. Consensus Estimates (2021)

2021e	Consensus			Santander		
	A month ago		Last	A month ago		Last
IPCA Inflation (%)	3.1	↑	3.3	2.9	↑	3.0
GDP Growth (%)	3.3	↑	3.5	3.4	↓	2.9
Selic policy rate (%, year end)	2.75	↑	3.00	2.00	↑	2.50
Exchange rate (USD/BRL, year end)	5.20	↓	5.03	4.60	→	4.60
Current Account (USD billion)	-16.3	↑	-14.3	-3.5	↓	-12.3
Primary Budget Balance (% GDP)	-3.0	↑	-2.9	-3.3	↑	-3.1
Net Govt. Debt (% GDP)	70.0	↓	67.0	71.6	↓	66.8

Note: Based on the BCB's Focus report as of December 11, 2020.

Sources: Brazilian Central Bank, Santander estimates.

Figure 10-C. Brazil Forecasts: Santander vs. Consensus Estimates (2022)

2022e	Consensus			Santander		
	A month ago		Last	A month ago		Last
IPCA Inflation (%)	3.5	→	3.5	3.2	→	3.2
GDP Growth (%)	2.5	→	2.5	2.6	↓	2.5
Selic policy rate (%, year end)	4.50	→	4.50	4.00	↑	4.50
Exchange rate (USD/BRL, year end)	5.00	↓	4.95	4.15	→	4.15
Current Account (USD billion)	-27	↓	-29	-29.6	↓	-39.5
Primary Budget Balance (% GDP)	-2.0	↓	-2.2	-2.4	↑	-2.3
Net Govt. Debt (% GDP)	71.5	↓	69.3	74.2	↓	69.5

Note: Based on the BCB's Focus report as of December 11, 2020.

Sources: Brazilian Central Bank, Santander estimates.

CONTACTS / IMPORTANT DISCLOSURES

Brazil Macro Research

Ana Paula Vescovi*	Chief Economist	anavescovi@santander.com.br	5511-3553-8567
Mauricio Oreng*	Head of Macro Research	mauricio.oreng@santander.com.br	5511-3553-5404
Jankiel Santos*	Economist – External Sector	jankiel.santos@santander.com.br	5511-3012-5726
Ítalo Franca*	Economist – Fiscal Policy	italo.franca@santander.com.br	5511-3553-5235
Daniel Karp Vasquez*	Economist – Inflation	daniel.karp@santander.com.br	5511-3553-9828
Lucas Maynard*	Economist – Economic Activity	lucas.maynard.da.silva@santander.com.br	5511-3553-7495
Felipe Kotinda*	Economist – Credit	felipe.kotinda@santander.com.br	5511-3553-8071

Global Macro Research

Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@santander.pl	48-22-534-1888
Juan Cerruti *	Senior Economist – Argentina	jcerruti@santander.com.ar	54 11 4341 1272
Ana Paula Vescovi*	Economist – Brazil	anavescovi@santander.com.br	5511-3553-8567
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
Guillermo Aboumrad*	Economist – Mexico	gjaboumrad@santander.com.mx	5255-5257-8170
Piotr Bielski*	Economist – Poland	piotr.bielski@santander.pl	48-22-534-1888

Fixed Income Research

Juan Arranz*	Chief Rates & FX Strategist – Argentina	jarranz@santanderrio.com.ar	5411-4341-1065
Mauricio Oreng*	Senior Economist/Strategist – Brazil	mauricio.oreng@santander.com.br	5511-3553-5404
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778

Equity Research

Miguel Machado*	Miguel Machado*	Miguel Machado*	Miguel Machado*
Alan Alanis*	Alan Alanis*	Alan Alanis*	Alan Alanis*
Andres Soto	Andres Soto	Andres Soto	Andres Soto
Claudia Benavente*	Claudia Benavente*	Claudia Benavente*	Claudia
Walter Chiarvesio*	Walter Chiarvesio*	Walter Chiarvesio*	Walter
Daniel Gewehr*	Daniel Gewehr*	Daniel Gewehr*	Daniel Gewehr*

Electronic

Bloomberg	SIEQ <GO>
Reuters	Pages SISEMA through SISEMZ

This report has been prepared by Santander Investment Securities Inc. ("SIS"; SIS is a subsidiary of Santander Holdings USA, Inc. which is wholly owned by Banco Santander, S.A. "Santander"), on behalf of itself and its affiliates (collectively, Grupo Santander) and is provided for information purposes only. This document must not be considered as an offer to sell or a solicitation of an offer to buy any relevant securities (i.e., securities mentioned herein or of the same issuer and/or options, warrants, or rights with respect to or interests in any such securities). Any decision by the recipient to buy or to sell should be based on publicly available information on the related security and, where appropriate, should take into account the content of the related prospectus filed with and available from the entity governing the related market and the company issuing the security. This report is issued in Spain by Santander Investment Bolsa, Sociedad de Valores, S.A. (“Santander Investment Bolsa”), and in the United Kingdom by Banco Santander, S.A., London Branch. Santander London is authorized by the Bank of Spain. This report is not being issued to private customers. SIS, Santander London and Santander Investment Bolsa are members of Grupo Santander.

ANALYST CERTIFICATION: The following analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed, that their recommendations reflect solely and exclusively their personal opinions, and that such opinions were prepared in an independent and autonomous manner, including as regards the institution to which they are linked, and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report, since their compensation and the compensation system applying to Grupo Santander and any of its affiliates is not pegged to the pricing of any of the securities issued by the companies evaluated in the report, or to the income arising from the businesses and financial transactions carried out by Grupo Santander and any of its affiliates: Ana Paula Vescovi*.

*Employed by a non-US affiliate of Santander Investment Securities Inc. and not registered/qualified as a research analyst under FINRA rules, and is not an associated person of the member firm, and, therefore, may not be subject to the FINRA Rule 2242 and Incorporated NYSE Rule 472 restrictions on communications with a subject company, public appearances, and trading securities held by a research analyst account.

The information contained herein has been compiled from sources believed to be reliable, but, although all reasonable care has been taken to ensure that the information contained herein is not untrue or misleading, we make no representation that it is accurate or complete and it should not be relied upon as such. All opinions and estimates included herein constitute our judgment as at the date of this report and are subject to change without notice.

Any U.S. recipient of this report (other than a registered broker-dealer or a bank acting in a broker-dealer capacity) that would like to effect any transaction in any security discussed herein should contact and place orders in the United States with SIS, which, without in any way limiting the foregoing, accepts responsibility (solely for purposes of and within the meaning of Rule 15a-6 under the U.S. Securities Exchange Act of 1934) for this report and its dissemination in the United States.