Santander

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Brazil – Economic Scenario

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Truck Strike: A Preliminary Assessment

- **The 9-day (and counting) strike by truck drivers, accompanied by road blocks, led to shortages of supplies and frozen production at several industrial and agro companies. In this piece, we make a first attempt to estimate the impact of this event on the main macroeconomic variables.**
- **In our view, this event will have a significant impact on economic activity. Assuming the strike is over before the end of this week, we see reasons to revise our GDP forecast for 2Q18 to 0.2% q/q (from 0.8% q/q previously). The expected negative impact on business and consumer confidence may slow both investment and consumption in the second half as well, compared to our previous assumption.**
- **We estimate the total impact on 2018 GDP growth to be around 0.7pp (direct impact + indirect impact through confidence channel). As a result, and factoring in the weaker than expected 1Q18, we are revising our 2018 GDP forecast to 2% (from 3.2% previously), while maintaining our forecast for 2019 at 3.2%.**
- **According to our estimates, the concessions made to the truck drivers will cost the federal government BRL14.4 billion in the remainder of 2018, which should be only partially offset by the expected offsetting measures announced so far.**
- **Even more important than that, we estimate that lower than expected GDP growth this year could reduce revenue by an additional BRL20-25 billion (around 0.25% of GDP). We calculate that this would force the government to announce an additional cut in expenditures between BRL3.0 and BRL10.0 billion, in order to meet the BRL159 billion deficit targeted this year.**
- **In terms of inflation, we expect a temporary hike in several prices (highlighting gasoline and foodstuff) to be captured in the upcoming inflation readings, particularly June IPCA – which could be as high as 0.90% m/m. However, once supplies are normalized, we believe prices will likely return to levels seen prior to the crisis, wiping out the effect on full year inflation.**
- **Finally, we see no reason why the strike might entail risks of monetary tightening at this time. Our scenario assumes impacts on supply (disruptions of the production chain) and demand of roughly the same magnitude. Moreover, with inflation still below the center of the target, and the downside risks to economic activity, if anything the risks might be skewed to lower (not higher) rates upon the dissipation of uncertainties, according to our estimates. We continue to forecast the Selic at 6.5% for the coming four quarters at least.**

Figure 1. Fiscal Impact of Initiatives to Reduce Diesel Prices in 2018 and Compensating Measures

	Impact		Compensation Measures	
	MinFin (remaining 2018)	Santander 2018		
CIDE (-5 cents)	1.7	1.7	end of payroll exemption	4.0
PIS/Cofins (-11 cents)	2.3	3.2		
Subsidy to Petrobras (cut of 30 cents)	9.5	9.5	fiscal backlash	5.7
			spending cut	3.8
	13.5	**14.4**		**13.5**

Sources: MinFin and Santander estimate.

Figure 2. GDP: Forecast Change (%)

Real GDP Growth					
Components	**2015**	**2016**	**2017**	**2018 (previous)**	**2018 (current)**
Total GDP	**-3.5**	**-3.5**	**1.0**	**3.2**	**2.0**
Agriculture & Livestock	3.3	-4.3	13.0	-0.5	-3.0
Industry	-5.8	-4.0	0.0	3.4	2.8
Services	-2.7	-2.6	0.3	3.0	1.7
Household Consumption	-3.2	-4.3	1.0	4.3	3.0
Government Consumption	-1.4	-0.1	-0.6	0.3	0.1
Investments	-13.9	-10.3	-1.8	7.0	4.5
Exports	6.8	1.9	5.2	3.7	3.3
Imports (-)	-14.2	-10.2	5.0	9.4	8.7

Sources: IBGE and Santander estimate.

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What's Going On

Pressured by a 14% rise in diesel prices in a matter of ten months, and in the context of years of declining revenue due to soft growth and increased competition (as truck freight increased by 40% on strongly subsidized credit), truck drivers started a strike on May 22, demanding a reduction in diesel prices, cuts in toll tariffs, and a minimum freight price.

After 9 days of blocked roads, political temperatures rose on shortage of supplies (with the accompanying rise in prices), mobility problems (with no fuel for cars, buses and even airplanes) and freeze in activity at several companies. Eventually the federal government caved in to pressure and made a substantial list of concessions, summarized in Figure 1 – at a large fiscal cost, which may be hard to fully offset, in our view. In this piece, we look not only at the fiscal impact of the announced measures, but most importantly at the effect on growth, which we expect to be significantly negative. Inflationary effects are likely to be significant in the near term, but virtually irrelevant for the full year, in our view.

Adding Insult to Injury: Strike Expected to Slash GDP Growth by 0.7 p.p.

Effects on growth tend to happen on three different fronts: (i) activity lost during the days of the strike; (ii) activity lost during the period it takes for companies to fully resume and normalize their activities; (iii) reduction in investment and spending due to a negative shock affecting business and consumer confidence.

Note that the longer the strike, the more disruptive the effects on the whole production chain. Anecdotal evidence available so far points to significant disruption in livestock activities, with producers losing live animals either at the blocked roads or in the fields, for lack of food. This lost production cannot be offset over the coming months. A similar situation affects services — transportation itself, of course, but also other services to firms and household that experienced some interruption either on the supply or demand side.

In the case of industries, several companies halted their activities for most of the days of the strike and reported that it will take from days to weeks to normalize inventories of inputs, distribution channels and so on. It may be possible, however, to recover some of this lost production in the industry in the coming months, particularly in the context of low capacity utilization – whereas for agriculture, livestock and services, the possibility of offsetting the losses seems remote, in our view. All of these effects should tend to be captured by the activity readings for May and June and may cause GDP to nearly stall in the second quarter: we now forecast 0.2% q/q, significantly below our initial expectation of 0.8% q/q growth in the quarter. As mentioned previously, we expect some recovery in 3Q18, particularly in industry – leading us to revise our forecast to 1.3% q/q (up from 1.0% q/q previously).

The Demand Side

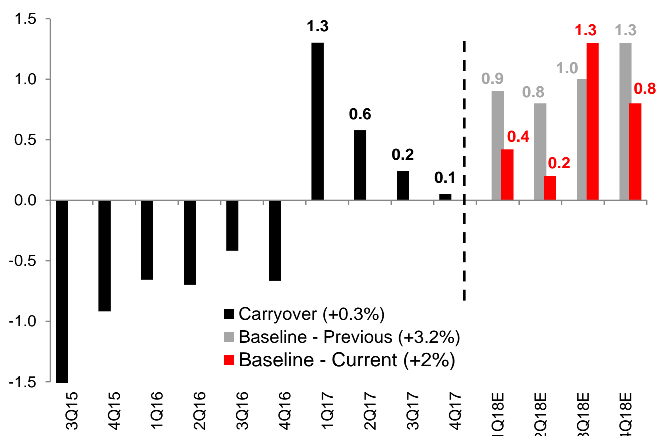
There is, however, one additional effect that should be accounted for: the loss of growth due to lower confidence levels. Based on previous events and on the relationship between confidence and other indicators (real interest rates, currency, growth expectation and labor market, for instance), we assume that both business and consumer confidence will experience a one-off, permanent drop (versus the original scenario) of 5% in the May/June readings, falling to the levels seen at the end of 2017 and consistent with the sentiment that the economy is growing, but not at full steam[1]. The lagged effect of lower confidence on investment and consumption decisions suggests that GDP may grow 0.8% q/q in the fourth quarter, less than our original expectation of a 1.3% expansion.

All in All

All these impacts add to what was already a disappointing 1Q18 GDP – we expect that the official reading, due out on May 30, will show a 0.4% q/q expansion, positive but significantly below market (and our) expectations at the beginning of this year (around 1% q/q). **Factoring in all these numbers, we now expect a 2% advance in 2018 GDP, significantly lower than our original 3.2% forecast. For 2019, we maintain our expectation of a 3.2% growth, based on the lagged and cumulative effects of monetary stimuli, and with the dissipation of some uncertainties as well as of the effects of the strike itself.**

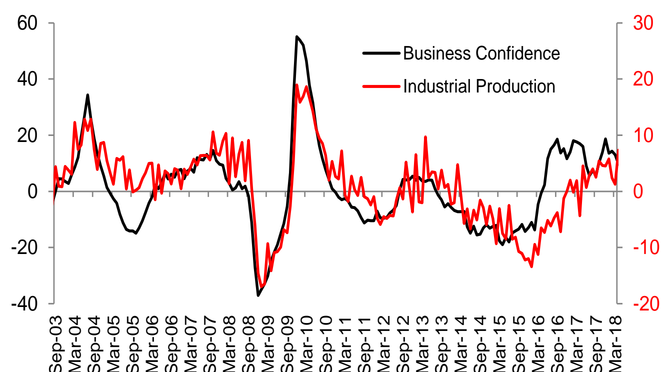
[1] We ran a Vector Autoregressive model in which Brazil GDP growth relates to: consumer and business confidence indexes; real interest rate; and world GDP growth.

Figure 3. GDP Growth (% QoQ) – Estimates for 2018



Sources: IBGE, FGV, and Santander estimate.

Figure 4. Industrial Production versus Confidence



Impact on Fiscal Accounts: Meeting the 2018 Target Becomes More Challenging

The federal government has announced a reduction of 46 cents/liter in the price of diesel fuel for the next 60 days. The breakdown of the price reduction is 16 cents by permanent tax cut (5 cents of the CIDE and 11 cents of the PIS/Cofins), and 30 cents by temporary (for 60 days) 10% cut in diesel price charged at the refinery (Petrobras's price).

Furthermore, the federal government added three measures: (i) end of toll collection on state and municipal highways for empty trucks; (ii) the requirement that 30% of CONAB's (National Supply Company) freight will be made up of independent truckers; and (iii) definition of a minimum freight price, to be adjusted twice a year.

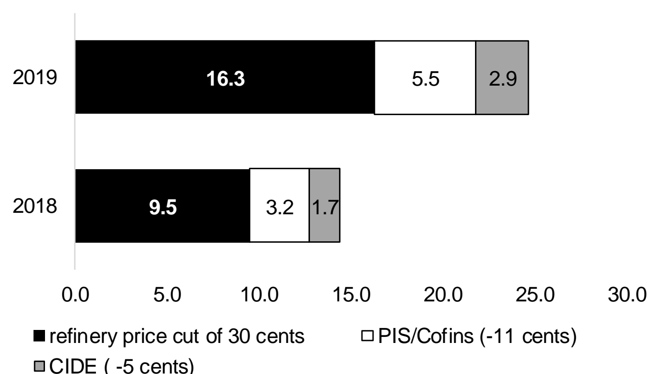
The fiscal cost of the tax cut and subsidy program[2] is estimated at around BRL13.5 billion (MinFin's forecast). The government announced that the impact on revenues and spending will be partially offset by the end of exemption in payroll for 28 sectors, the positive fiscal backlash of BRL5.7 billion estimated by MinFin in April, and an additional spending cut of BRL 3.8 billion. However, it is worth noting that the strike will impact economic activity and consequently revenue. **We estimate the total revenue loss could be between BRL20 billion (impact on tax collection) and BRL25 billion (if, in addition to tax collection, non-recurring revenues – such a concessions planned for the year – are also affected).**

Figure 5. Budget 2018 Impact (BRL billions)

	Santander Forecast (before crisis)	Santander Forecast (after crisis) *	Δ	Santander Forecast (after crisis) **	Δ
Total Federal Revenues	**1467**	**1447**	-20.3	**1441**	-25.9
Tax Collection	894	878	-15.6	878	-15.6
Contribution for RGPS	409	404	-4.7	404	-4.7
Non-recurring revenues	**73**	**73**	**0.0**	**69**	**-4.8**
Net Federal Revenues	**1223**	**1203**	**-20.0**	**1198**	**-25.6**
Total Federal Expenditures	**1363**	**1362**	**-1.3**	**1356**	**-7.0**
Mandatoy spending	1244	1244	0.0	1244	0.0
MP 540 (end of payroll exemption)	12	8	-4.0	10	-2.7
Subsidy to Petrobras		10	9.5	10	9.5
Discretionary Expenses	107	100	-6.8	93	-13.8
Primary Balance	**140**	**159**		**159**	

Source: Santander estimate.
* Strike affects only tax collection
** Strike impacts tax revenues and non-recurring revenues

Figure 6. Measures' Impact in 2018 and 2019 (BRL billions)



Source: Santander estimate.
Subsidy program (refinery price cut of BRL30 cents) estimate for 2019 is based on the oil price at USD 68/barrel and BRL/USD 3.50 (on average)

[2] Subsidy program is considered as extraordinary spending, i.e., it is not included in the spending cap.

Before the current fuel crisis, we estimated a deficit of BRL140 billion for the 2018 primary fiscal result, better than the target of BRL159 billion. Now we expect this windfall to be eroded by the cost of these measures. According to our estimate, factoring in the direct cost and the lost revenue from slower growth, the government will have to announce more spending cuts through the year. We estimate an additional spending cut between BRL3 billion and BRL10 billion.

Impact on Inflation: Strong in the Short Term and Probably Neutral in the Long Run

In the context of shortage of supply, some prices skyrocketed during the days of the strike, particularly those for fuel and fresh produce. This increase will probably be reflected in higher inflation readings over May and potentially June (as it may take some time for prices to normaliz, after the strike effectively ends). However, note that once the situation is normalized, there is no reason for prices to remain high: indeed, we expect them to return roughly to the levels we forecast prior to the crisis. This means that we are likely to see a surge in inflation in June, but a retreat (with a possible deflation in the month) in July. Our forecasts point to inflation of 0.25% m/m in May, 0.86% m/m in June and 0.08% m/m in July (from 0.22% m/m and 2.8% y/y in April), leading 12-month inflation to peak at 3.8% in June, retreating to 3.6% in the following months.

One could argue that the concessions made to strikers will cause a permanent shift in some prices and therefore should change the full year forecast. On the upward pressure, an increase in freight prices could contaminate prices of all goods; the 13% temporary decline in diesel prices and the reduction in toll tariffs would act in the opposite direction. We tend to regard the impact of these factors on the overall level of consumer prices as virtually negligible. Diesel prices account for a mere 0.16% of the consumer price index, and in any case the decline is deemed (at least for now) to be temporary, and therefore with no impact on full-year inflation. As for the rise in freight prices, it is important to note that the high economic slack will likely contain the pass-through of this factor (if it indeed comes to materialize) on final consumer prices.

Therefore, we maintain our 3.5% forecast for 2018 inflation, which already encompasses our assumptions on fuel prices and the exchange rate.

Impact on Markets: Fueling the Uncertainties

Finally, the strike adds another element to the perceived basket of uncertainties, and therefore we believe it tends to negatively impact some asset prices – as demonstrated by the significant weakening of the BRL and the steepening of the yield curve, for instance. Yet, it may be useful to take a step back and think about changes (if any) in fundamentals. There is a fiscal impact, but the fiscal target for the year is still feasible, in our view, and, in any case, the real fiscal challenge is reversing the structural deficit of 2% of GDP over the coming years – and the strike per se, as a short-term event, does not change the likelihood of achieving that, in our view.

In terms of the external accounts, while there may be a negative impact on exports (with lost exports during the strike days), we believe that slower GDP growth and, most importantly, a weaker BRL on average should also contain imports so that, at a preliminary analysis, a trade surplus in excess of USD 50 billion still seems feasible. Furthermore, with most of the external financing needs being covered by foreign direct investment, even a moderate widening of the current account deficit or a reduction of volatile capital inflows (portfolio investment and short-term capital) is unlikely to affect the low external vulnerability of the country.

For now, we see no reason to revise our forecast for the BRL, which stands at BRL3.50/USD at end-2018. In our view, despite the significant short-term effects, the strike per se does not change the strength of economic fundamentals in the medium term. Nevertheless, it fuels uncertainty and sensitivity to the news flow, which should keep asset prices volatile for the coming months.

Finally, we also see no reason why the strike might entail risks of monetary tightening at this time. Our scenario assumes impacts on supply (disruptions of the production chain) and demand of roughly the same magnitude. Moreover, with inflation still below the center of the target, and the downside risks to economic activity, we believe that, if anything, the risks may be skewed to lower (not higher) rates upon the dissipation of uncertainties.

Therefore, **our base case scenario is still the maintenance of the Selic at 6.5% for the coming four quarters at least** (potentially more, if activity disappoints and inflation remains subdued).

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