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Brazil Macro Compass

A Weaker Q2, a Stronger Q3

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- **In our opinion, the behavior of the BRL this week confirms that progress on the reformist agenda should lead the BRL to strengthen against the USD (for further details, see our June 25 report, *Updating Our Inflation, FX and Interest Rate Forecasts*). On the heels of constructive news regarding fiscal discipline on the part of members of the legislature and the executive, the BRL is about to end the week as one of the top performers among major currencies.**

- **The local yield curve has bull-flattened this week, reversing part of the bearishness seen recently. That movement followed a similar pattern in U.S. Treasuries, as these were also influenced by optimism toward the reforms, after the government sent Congress a draft bill on administrative reform. We continue to anticipate volatility and premia for Brazilian assets until we have greater clarity on the ability and willingness to keep the constitutional spending cap viable for the coming years.**

- **This week IBGE released the second quarter's GDP, and the headline confirmed the expectations of a sharp drop in economic activity. Brazilian GDP fell 9.7 % (QoQ s.a.) in 2Q20 (all-time low), worse result than our forecast (-8.2%) and consensus (-9.2%). The headline returned to the level seen in 3Q09. IBGE has also released the first hard data relative to the third quarter (July). Industrial Production has confirmed the expectations of a third gain in a row after April's sharp drop. The headline index pointed to growth of 8.0 % MoM (s.a.) in July, a better result than our forecast (5.5%) and market consensus (5.8%). Mining and manufacturing industries posted monthly gains of 6.7% and 8.6%. This positive result for July means that 77.7% of the drop seen between March and April have already been recovered, with the current level now 6.0 % below the reading in February.**

- **In terms of perspectives, the activity figures released up to now point to a strong recovery at the beginning of the third quarter. Making use of this figure for Industrial Production, we have upgraded our July IBC-Br (BCB's monthly activity index) projection to +3.2% MoM s.a. (up 0.6 p.p. from our previous estimate). Our tracking for 3Q20 GDP is now standing at the neighborhood of +8.0% QoQ s.a.**

- **This Monday (August 31), the government presented the budget bill (PLOA) for 2021. The proposal came without major surprises, reinforcing the notion of limited space for new permanent expenses. Given the lack of a formal primary deficit target, the primary result of 2021 will depend on the cyclical behavior of revenues, while the expenses are limited by the spending cap. The government's initial forecast is a deficit of BRL234 billion, not far from our estimate (BRL249 billion). Debates over the 2021 budget and post-pandemic policies are likely to intensify in the coming weeks.**

- **On Thursday (September 3), the government announced its proposal for administrative reform. The proposal focuses on the federal administration, and seeks to rationalize and modernize HR policies for newly hired government workers. It proposes the creation of different categories, restrictive tenures, reduced starting salaries, and curtailment of automatic promotions and bonuses. The proposal also implies limited short-term fiscal savings, as it would not affect current public servants, having more of an effect on long-term expenses. The impact on the long-term budget remains uncertain, as details must be sent in future complementary legislation. We expect this proposal to be extensively discussed in Congress in the coming weeks and months.**

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- **July's fiscal performance was slightly better than expected, yet the numbers continue to show a substantial impact from the COVID-19 crisis on government finances. The figures reinforce our forecast that the 2020 public sector primary fiscal deficit will amount to ~13% of GDP, leading the gross general government debt to nearly 96% of GDP, on the heels of massive spending measures, deferrals of tax payments, as well as a cyclical revenue downturn.**

- **The result of the trade balance in August was slightly better than we anticipated (USD6.6 billion vs. our forecast of USD6.4 billion), reinforcing our expectation of a larger surplus in 2020 than the one seen last year (our forecast points to USD60.5 billion vs. USD48.0 billion in 2019).**

- **Next week, IBGE will release retail sales and services volume for July; these are important figures for tracking activity conditions early in the third quarter. Due to the gradual reopening of the economy and the massive government stimulus, we expect continued activity recovery. Our projections for the core and the broad concepts are 4.4 % MoM (s.a.) (+3.7 % YoY) and +7.9 % MoM (s.a.) (+3.4 % YoY), respectively. This result will imply that all the points lost between March and April will have been recovered, and the concept will be above the reading of February. For Services Volume, our projection is at -10.3 % YoY.**

- **On Tuesday, IBGE releases the IPCA inflation for August. We expect a reading of +0.28% MoM (+2.48% YoY); this reading will be pressured, again, by administered prices, while free prices should be muted (although with considerable heterogeneity: food-at-home and industrial goods rising, with services falling). More importantly, we continue to anticipate a muted pace for core prices, as economic slacks are expected to remain high for a considerable period.**

Local markets—FX: After having breached the USDBRL5.60 threshold in the last week, the Brazilian FX rate is about to end this week below the USDBRL5.30 level, and we expect it to be one of the top performers among major currencies in the period. In our view, the reason for this performance is related to a favorable news cycle recently regarding the prospects for fiscal policy. In addition to a budget bill for 2021 that suggests limits on extra spending in the next year, the executive has also sent to the legislature a proposal outlining a plan for rationalize the public administration in an attempt to enhance efficiency in the supply of services and to curb the growth of public expenditures in the long run. The combination was welcomed by market participants, which led the BRL to perform better than would have been indicated by international conditions. As of this writing, the FX rate was quoted at USDBRL5.29, which translates into a 1.8% strengthening compared with the closing level a week ago.

This FX behavior reinforces our view that progress on the reformist agenda that indicates stricter fiscal discipline is likely to lead the BRL to strengthen further. However, we think this process is unlikely to be a steady one, which means that volatility can be expected to continue in the FX market. Notwithstanding, we continue to see room for appreciation of the BRL as long as the favorable flow of news on the fiscal front continues. For now, we keep our forecast of USDBRL4.95 for the end of this year, assuming further signs of commitment to fiscal discipline after the pandemic.

Local markets—rates: By the time of writing (Friday around noon), the weekly change in nominal yields looked poised to reverse part of the bearishness seen in the previous weeks. In the front end, the Jan-22 DI future was standing at 2.75% (-7 bps from last Friday). In the back end, the Jan-27 DI future was trading at 6.67% (-11 bps from last Friday). This week's bull-flattening pattern drove the steepness in this segment to ~390 bps, compared to ~400 bps in the previous week and ~150 bps before the arrival of the pandemic in Brazil (late February).

Once again, the local yield curve seems to track the movement in U.S. Treasuries, which also experienced a respectable bull-flattening pattern in recent days. Local factors also played a role, nonetheless, as the markets apparently enjoyed the signs of good intentions on the reforms front, as the Brazilian government sent to Congress a draft constitutional amendment for administrative reform, revising personnel rules for the next generation of government workers in the executive branch (see details in the fiscal policy section below).

While this initiative helps produce a much needed push for greater productivity in the public sector, it does not contribute toward solving the key fiscal issue of the moment: the capacity to keep the constitutional spending cap feasible for the coming years amid growing pressure for more government spending (especially in social policies). Given the tight leeway to execute the budget within the constitutional cap as early as 2021, but especially for 2022, we continue to see significant execution risks for the fiscal adjustment process once the COVID-19 pandemic has passed. Thus, despite this recent respite for Brazilian assets, we continue to anticipate a sea of uncertainties and a good deal of volatility for local assets in coming weeks and months.

Fiscal policy: This Monday (August 31), the government presented the budget bill (PLOA) for 2021. The proposal came without major surprises, showing little room for maneuvering in the budgetary framework given the limits imposed by the main fiscal rules in place, especially the constitutional spending cap. Even so, we think the proposal seems feasible for the current conditions of current policies. The great source of uncertainty is the possibility of creating a new income transfer program (already known as *Renda Brasil*), details of which have not yet been presented nor contemplated in PLOA 2021. This new program aims to replace (but with even greater reach) the *Bolsa Família* program, whose budget was increased to BRL35 billion in 2021. *Renda Brasil* will create permanent expenses for the coming years, and if not offset by reductions in other expenses, it would be incompatible with the spending cap limit, since its compliance would imply a partial shutdown of the federal public administration.

Given the lack of a formal primary deficit target, the primary result of 2021 will depend on the cyclical behavior of revenues, with the submission of expenses compliant with the constitutional spending cap as a limiting factor. The government's initial forecast is a deficit of BRL234 billion, not far from our estimate (BRL249 billion). In addition, to fulfill another fiscal rule, called “Golden Rule” – that establishes that the government can only get into debt to finance capital expenses or refinance public debt – the Congress would have to approve an additional credit of BRL453.7 billion, well above the BRL343.6 billion approved in 2020.

These figures reinforce the notion of limited space for new permanent expenses. Discretionary expenses (investments and administrative costs) are predicted to approach the lowest level in history, around BRL108 billion. This amount is close to our estimate of the minimum limit for the good functioning of the public sector administration (around BRL100 billion).

When opening the accounts, we estimate that central government revenues will be below forecast (see Table 1). The main difference stems from the 2020 revenue estimates, considering that we project a GDP contraction of 6.4% while the government forecasts a decrease of 4.7%. Despite our GDP forecast for 2021 (+4.2%) being higher than the government's (+ 3.2%), the estimated revenue in our 2021 forecast is still BRL44 billion below the official forecast. The opening of the numbers shows the biggest difference is in the line “Administered by the Federal Revenue,” which is more dependent on the cycles of economic activity.

In terms of expenses, the values we project are closer to the official figures. Without considering changes in the spending ceiling, expenses tend to be close to BRL1.5 trillion in both scenarios. The details show little divergence in discretionary expenses, about BRL110 billion both in our scenario and in the official projection. The biggest difference is due to personnel expenses, where the government's estimate is BRL12 billion higher than ours, probably incorporating some additional degree of conservatism.

In general, we believe that next year's primary deficit will depend more on the evolution of revenues than on the spending scenario, whose variability tends to be limited due to the high proportion of mandatory expenses and the proximity to the constitutional spending cap. It is important to note that revenues may still be more impacted by an eventual tax amnesty program (*Refis* type), possibly focused on tax exemptions granted during the pandemic. In addition, the uncertainty is great about the strength of the resumption of activity in the next year, and this factor should greatly influence the evolution of revenues in 2021.

In our opinion, after the executive’s proposal, debates over the 2021 budget and post-pandemic policies are likely to intensify in the coming weeks. And the market will be aware of the conditions for maintaining the effectiveness of the current fiscal regime and the capacity to fully implement the constitutional spending ceiling — which we see as the main anchor for long-term macroeconomic stability expectations in Brazil.

The Constitutional Amendment (Portuguese acronym, PEC) for administrative reform was presented to Congress on Thursday (September 3). It ends what is known as the *Regime Jurídico* (the current rules for hiring public servants) and restricts stability in some careers. The proposal would not affect current public servants and would be limited only to the new generation of staff. Also, it does not propose changing the rules for judges, members of parliament and the military. For them, changes would need to be proposed by leaders of each branch.

The reform aims to modernize public administration and reduce mandatory personnel expenses — these represent the second largest allotment in the budget. Data from the Ministry of Economy indicate that expenditure on active public servants from the Federal Executive Branch totaled BRL109.8 billion last year, jumping from BRL45 billion in 2008.

The proposal is divided into three phases. The first, the PEC presented on September 3, institutes the new regime, and reduces promotions and automatic bonuses, among other provisions. Further changes are planned in the institutional

working arrangements of the employees. Finally, the regulatory framework includes the formal parameters of starting salaries and the formal rules of career progression that will also be addressed in a future law.

Key aspects of the reform include the possibility of creating positions that do not have stability (e.g., for a fixed term or experience). It would end the rule of tenure for most public servants, creating five groups of careers, only one with stability, and allowing temporary labor contracts. It further eliminates some peculiarities of the current regime: the prohibition of vacation periods above 30 days per year, and the reduction of working hours without a reduction in salary. The proposal also removes additional remuneration, promotions and career progression by length of service.

The reform must pass still be debated in Congress before the final version can be approved. Also, it is not possible yet to calculate the reform's fiscal impact, as those parameters must be sent in the future law. Yet, in the short term, the impact would be quite limited, as the reform does not affect current public servants, thus it does imply new mandatory expenses on the spending cap in the near term. However, the proposal is an important step forward in the process of improving public sector productivity and containing the second largest source of expenditures in the federal budget, thereby suggesting significant savings in the long-term. It is important to note that 30-40% of public servants will be eligible to retire in the next five years, according to the Ministry of Economy, which could mean significant upward cost pressure if the public administration does not discipline itself to do more with less.

According to data published this Monday by the BCB, the public sector posted a primary budget deficit of BRL81.1 billion in July, better than our forecast (BRL85.1 billion) and market consensus (BRL89.8 billion). The main surprise was in the Regional Governments result that posted a surplus of BRL6.3 billion, probably impacted by the emergency aid effects on local economies - improving tax collection - and transfers from the Union to compensate the fall in tax collection during the first months of the Covid-19 in the domestic activity.

The consolidated primary balance headline for July 2020 compares with a full-2019 gap of BRL61.9 billion (0.9% of GDP). It is the fourth consecutive result that the monthly deficit is higher than a full year in recent years. So far in 2020, the public sector's primary fiscal balance is negative in BRL 483.7 billion (11.6% of GDP), the worst mark in the entire historical series. The 12-month primary deficit also points in the same direction, standing at BRL458.8 billion (6.4% of GDP), the lowest balance ever recorded.

The BCB numbers show a relatively "better" performance from subnational entities (in comparison with the central government) year to date. Altogether, regional governments post a primary fiscal surplus of BRL16.1 billion (0.22% of GDP) over the last 12 months. Government-owned firms post a primary fiscal surplus of BRL14.9 billion (0.21% of GDP) for the last 12 months. Given the considerable headwinds for the economy and tax collection, we expect a deterioration of the fiscal position of subnational entities—particularly states and municipalities—in coming months.

The bulk of the ongoing budgetary deterioration is seen in the federal government accounts, where the contributions (for the public sector) and the amount of information are usually larger than in subnational counterparties. According to data by the National Treasury Secretariat (with a slightly different approach compared to the central bank calculations), published August 27th, the central government's primary deficit totaled BRL87.8 billion in July 2020, better than our forecast (BRL93.4 billion) and market's estimates (BRL97.6 billion). Basically, the main difference came from lower-than-expected discretionary expenses in July. Excluding Covid-19 measures, the primary deficit would have been close to BRL25.0 billion, compared to BRL5 billion deficit in July 2019.

On the revenue side, the central government's primary revenue tumbled 20.2% YoY in July (adjusted for inflation), following both a cyclical economic deterioration as well as the effects of temporary tax reliefs, but improving from -30.1% YoY in June. Based on official estimates pointing to deferrals of BRL18.7 billion last month, we can deduce that tax compensations accounted for nearly 70% of the YoY tumble in total revenue in July. The government estimates tax compensations adding to BRL77.8 billion for the year, suggesting that companies are using tax credit to compensate the lower activity during the pandemic.

On the federal spending front, July saw an expansion of 45% in real terms from the year-ago level, on the heels of government support programs in the wake of the pandemic (totaling a full BRL 63 billion for the month). Those include the emergency aid to households (adding BRL45 billion in July). So far in 2020, real federal outlays are jumping by 41% from the year-ago level, boosted by the various government initiatives to fight the effects of the pandemic, both from a health and an economic standpoint. Official numbers indicate that the expenses related to fighting the effects of COVID-19 totaled nearly BRL273 billion year to date, which is almost the half of the total announcement of spending measures so far (close to BRL600 billion, considering the extension of emergency aid until the end of the year). This means that the next few months should continue to see a significant widening on the federal (and consolidated) fiscal deficit.

Year to date, BCB calculations indicate that the central government's primary fiscal deficit stands at BRL505.4 billion (12.4% of GDP), by far the worst-ever first half of the year for the fiscal accounts since the series 1997 inception. Before 2020, the worst primary balance for first half of the year had been in 2017 (-1.7% of GDP). In 12 months, the central government's fiscal gap (from the standpoint of the BCB estimates) is now BRL568 billion or 7.9% of GDP, also the worst number on record.

In addition, the Gross debt reached 86.5% of GDP in July, an increase of 10.7 percentage points over the end of last year. Meanwhile, the Net debt rose to 60.2% of GDP, 4.5 percentage points higher on the same basis of comparison. Both are expected to continue deteriorating in the coming months.

Economic activity: This week IBGE released the second quarter's GDP, and the headline confirmed the expectations of a sharp drop in economic activity. Brazilian GDP fell 9.7 % (QoQ s.a.) in 2Q20 (all-time low), considerably worse result than our forecast (-8.2%) and consensus (-9.2%). The headline returned to the level seen in 3Q09. The annual reading was -11.4 % (YoY), considerably below our estimate (-10.0 %) and consensus (-10.6%), and the rolling-four-quarter growth declined to -2.2 % (from +0.9% in Q1), which was the worst reading since 4Q16(-4.6%).

The composition of Q2 GDP points to a sharp quarterly drop in non-farm sectors (supply): industry posted a fall of -12.3 % (all-time low) while services registered a decline of -9.7 % (all-time low). Regarding industry components, the main contribution to the fall came from the 'Manufacturing' and 'Building' sectors, which together represent 70% of the rubric, with quarterly losses of 17.5% and 5.7%, respectively. Regarding services, the effects of the social distancing measures implemented to avoid the spread of COVID-19 affected especially 'Other Services' and 'Public Administrative Sectors,' which together represent 48% of the rubric, with quarterly losses of 19.8% and 7.6%, respectively. 'Other Services' includes 12 activities such as mercantile health and education, hotel accommodation and administrative services, which highlights the huge impact suffered by families-related services.

Regarding aggregate demand, the negative surprise was government consumption. As a reaction to the pandemic, we would expect an increase in public spending, but this did not happen (there was a quarterly decline of 8.8%). The remaining rubric performed as expected: the sharpest drop registered was in investments (-15.4 %), followed by consumption (-12.5 %); in the external sector, exports and imports registered quarterly changes of +1.8% and -13.2 %, respectively. Domestic absorption and external sector contributed (respectively) with -11.9 p.p. and +2.5 p.p., for the quarterly headline change, and inventories posted a quarterly contribution of -0.2%.

In terms of perspectives, the carryover for the remainder of 2020 is -9.1%. That figure is just a (rather counterfactual) lower-bound for growth this year, since the reopening of the economy and early indicators point to a strong recovery in the third quarter, eating into this carry-over effect.

The first hard data relative to the third quarter (July) has also been released. Industrial Production has confirmed the expectations of a third gain in a row after April's sharp drop. The headline index pointed to growth of 8.0 % MoM (s.a.) in July, a better result than our forecast (5.5%) and market consensus (5.8%). The carryover for the next quarter is 17.8%. In relation to July 2019, there was a decline of 3.1%, while our projection and consensus were pointing to -6.3% and -6.0%, respectively. Mining and manufacturing industries posted monthly gains of 6.7% and 8.6%. In terms of trends, the three-month average (headline) points to a relevant increase (8.8 %) for the first time since February. This positive result for July means that 77.7% of the points lost between March and April have already been recovered, and the level is 6.0 % below the reading observed in February (pre-crisis level).

Among the categories, the positive highlights were Durable Goods and Capital Goods, registering monthly gains of 42.0% and 15.0 %, respectively. Durable goods pointed to growth after two sharp rises (112.6% and 81.5%). Construction supplies (related to investment as Capital Goods) posted a gain of 9.7%. The behavior of these rubrics points to a possible rise in investments in the third quarter, especially in an environment with looser financial conditions. Nevertheless, it is necessary to keep in mind that fiscal-condition deterioration may be a headwind for investment in the coming quarters, due to the drop in confidence and tightening of financial conditions. Regarding the accumulated drop, Construction supplies and Intermediate Goods have already recovered 99.3% and 93.8% of the points lost between March and April, while Durable goods recovered 82.0%. In comparison with the reading observed in February, Intermediate Goods, Non-Durable Goods and Construction supplies are only 1.1%, 4.8% and 0.2 % below the pre-crisis mark.

Regarding details, some of the positive highlights this month were 'Vehicles' (42.2%), 'Electronics' (15.6%) and 'Metallurgy' (15.4%). Some rubrics like 'Textiles' (29.3%), 'Clothing' (40.1%) and 'Furniture' (18.3%) may have been pushed by emergency aid. In general terms, the Diffusion Index (percentage of industrial categories with monthly growth)

reached 94.3%, virtually the same result than the June reading. The great question that was raised is the concern regarding the sustainability of this recovery amid an environment of a gradual withdrawal of emergency aid.

In term of outlook, making use of this figure for Industrial Production, we have updated our July IBC-Br (BCB's monthly activity index) projection, to +3.2% MoM s.a. (from +2.6% previously). In a tracking exercise for 3Q20 GDP based on this number, we now have a preliminary surrounding the neighborhood of +8.0% QoQ s.a.

Inflation: On Tuesday (September 8), IBGE releases the IPCA inflation for August. We expect a reading of +0.28% MoM (+2.48% YoY).

This reading will be pressured, again, by administered prices, although less than in previous readings. This group should go up +0.76% MoM, per our calculations, driven by the recovery of gasoline and also still some electrical energy tariff adjustments. This time, market-free prices should be slightly positive, +0.12%, in our opinion. We expect the rise to be driven by food-at-home inflation 1.04% and industrial goods 0.47%. Food-at-home has been pressured by external demand of proteins, a change in consumer's basket and the income support given by government's emergency aid. While on industrial goods there has been some exchange rate pass-through on specific items where demand did not fall much, sanctioning the raise of prices. Finally, we project that services will remain considerably negative, -0.45%, as the reopening of the economy has been gradual.

We continue to see a muted pace for core prices, as we expect economic slacks to remain high for a considerable period, despite the cushioning of demand generated by government stimulus and the reopening of a number of regional economies. Well-anchored inflation expectations also to play a key role.

Trade Balance: Although the USD6.6 billion surplus registered by the Brazilian trade balance in August 2020 was slightly higher than our estimate (USD6.4 billion), there were some discrepancies between the actual results for its components and what we had forecast for export proceeds (USD17.7 billion vs. USD18.2 billion, respectively), as well as for import outlays (USD11.1 billion vs. USD11.8 billion, respectively). On the heels of this result, the trade balance surplus increased to USD52.5 billion in 12-month-to-date terms, from USD49.9 billion in July reading and USD48.0 billion in December 2019.

The outcome reinforced our perception that the pandemic has weighed less heavily on exports than it has on imports. According to our calculations, when we factor out deals related to oil platforms – which are not considered either exports or imports, but rather accounting operations derived from tax issues – and adjust for the number of working days in the month, the exports daily average expanded 1.1% MoM in seasonally adjusted (sa) terms (or -5.5% YoY) in August. As for the imports daily average, after a six-month streak of contraction, it registered an expansion of 6.2% MoM sa in the period. Despite this positive signal, it is important to note that the imports daily average was 32.9% lower than a year ago, which indicates to us the protracted recovery the Brazilian economy is likely to experience in the coming months.

Finally, by annualizing the exports and imports daily averages of the last three months, we come to an indication of a USD84.2 billion annual trade surplus, which is far higher than our forecast for 2020 (USD60.5 billion). However, it is important to bear in mind that we assume that the Brazilian economy will continue to gradually recover in the coming months, which should foster some revival in imports during that period. Hence, as the months go by, we believe this metric should converge toward our projection.

Next week: On the macro agenda, retail sales and services volume are slated to be released next week (September 10 and 11, respectively); these are important figures for tracking activity conditions in the beginning of the third quarter. Due to the gradual reopening of the economy and the emergency aid extension until year end, we expect the path of recovery seen up to now to continue. For core and broad retail sales, we project +4.4% MoM (s.a.) (+3.7% YoY) and +7.9% MoM (s.a.) (+3.4% YoY), respectively, and for services volume, our projection is -10.3% YoY.

MACRO AGENDA

Indicator	Date	Estimate	Prior
IGP-DI Aug/20 (% MoM)	Tue, 08-Sep	3.03	2.34
IGP-DI Aug/20 (%YoY)	Tue, 08-Sep	14.30	10.37
IPCA Aug/20 (% MoM)	Wed, 09-Sep	0.28	0.36
IPCA Aug/20 (%YoY)	Wed, 09-Sep	2.48	2.31
IGP-M 1st Preview Sep/20 (% MoM)	Thu, 10-Sep	-	1.46
Retail Sales Broad Jul/20 (% MoM)	Thu, 10-Sep	7.9	12.60
Retail Sales Broad Jul/20 (%YoY)	Thu, 10-Sep	3.4	-0.90
Retail Sales Jul/20 (% MoM)	Thu, 10-Sep	4.4	8.00
Retail Sales Jul/20 (%YoY)	Thu, 10-Sep	3.7	0.50
IBGE Services Sector Volume Jul/20 (%YoY)	Fri, 11-Sep	-10.3	-12.10

Sources: Bloomberg and Santander.

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