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Brazil Macro Compass

Eyeing Monetary Policy, Inflation and Balance of Payments

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- **Following FOMC signals that international liquidity conditions should remain copious for more than a while; the BRL is about to end the week stronger than a week ago.**

- **The nominal yield curve steepened once again this week, with the gap between Jan-22 and Jan-27 (in DI futures) reaching close to the recent highs, as of May. Movements in U.S. Treasuries seem to have influenced the trend, alongside the resurface of political noise locally. We still think there is too much "fat" (priced rate hikes or premium) in the front end, despite the relative favorable market conditions for EMs in recent days. We continue to see this as a reflexion of premia supported by fiscal concerns.**

- **As widely expected, the Brazilian Central Bank (BCB) kept the Selic policy rate at the historical low of 2.00%, marking the first stability outcome for the Copom in 10 meetings (i.e., since June 2019). In the statement, the BCB reaffirmed the forward guidance inaugurated in the previous meeting, as the BCB sticks to a flight plan with the interest rate steady at 2.00% or below for some time. Our baseline scenario sees the Copom on hold all the way until early 2022. However, the validity of the forward guidance hinges on maintenance of the fiscal regime. Concerns about the effectiveness of the constitutional spending cap are still the main threat to the inflation and monetary policy outlook, in our view.**

- **The BCB's monthly activity indicator ended the sequence of releases in the main activity indicators for the month of July. The IBC-Br posted a gain of 2.1% MoM s.a. (-4.9 YoY), below the market consensus of 3.4 % MoM s.a. (-5.3 % YoY). This result implies a recovery of 55% of the output drop seen in March and April, with the index still 6.5 % below the reading of February. A preliminary exercise based on July's carryover point to GDP 3Q20 at 8.3% QoQ s.a. (-3.8 % YoY), implying significant upside risk to our 2020 GDP forecast (-6.4%).**

- **According to FGV's industrial survey preview for September, headline industrial confidence rose 7.2 % MoM s.a. (reaching 105.8 points). For the first time since the pandemic's onset, the index has surpassed February's reading (4.3% above). On the other hand, the recovery in services and retail confidence seem to have softened. Next week (Wednesday, September 23), the FGV will release the consolidated figure for September's FGV Consumer Confidence.**

- **In our brief analysis published this past Wednesday (*The Real Wage Bill and the Impact of Emergency Aid*), we gauged the effects of government transfers to mitigate the impacts of COVID-19 on the "expanded" (i.e., including social benefits) real wage bill (total wages from work). Considering government stimulus to households, we forecast a 3.9% rise in the "expanded" wage bill, adjusted for inflation for full-year 2020 compared to 2019. 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 this year. On the flipside, the end of these temporary transfers means less impetus for consumer spending in 2021.**

- **On Tuesday (September 15), the executive branch made an announcement to halt budget simulations and discussions around the *'Renda Brasil'* (new welfare program). Amid the limited fiscal space in the budget (to comply with the constitutional cap) for the coming years, proposals to curb other mandatory expenses to finance the new program were discarded. Yet the local press refers to other initiatives in Congress to make a new social program viable after the pandemic.**

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- **On the fiscal side, the release of the report on the Federative Pact (constitutional reform) and the analysis of the presidential vetoes in the congress were postponed for the coming weeks. These are important fiscal topics to monitor. The first is intended to curb mandatory expenses, and the second to limit space to comply to the spending cap for 2021. Additionally, next week the Brazilian Internal Revenue Service will publish the federal tax collection information for August 2020. Our estimate is BRL112.3 billion, which would mean a contraction of ~9% compared to August 2019, in real terms.**

- **The IGP-10 inflation released on 16th Sep surprised, once again, to the upside. However, we start to see some signs of deceleration of Agro-IPA in our high-frequency price surveys. On consumers' inflation, IBGE will release IPCA-15 for September and we expect a change of +0.40% MoM (+2.60% YoY). Despite the upward pressure of food-at-home, we continue to see a muted pace for core prices. Our tracking for headline IPCA has been revised upward once again and is hovering at 2.3% for 2020. For 2021 we continue to forecast IPCA inflation at 2.7%.**

- **We expect the current account balance to have registered a USD1.7 billion surplus in August, and direct investments in the country to have reached USD1.5 billion in the same period. In our view, both results underpin the perception of sound prospects for the Brazilian balance of payments in the medium term.**

Local markets—FX: As of this writing (around noon, Brasilia time), the Brazilian currency was quoted at USDBRL5.30, thus indicating it is likely to end the week at a slightly stronger level than a week ago (USDBRL5.32), albeit far from the best intraday level seen in the last days (USDBRL5.21 on last Wednesday). The forward guidance provided by the FOMC members, which indicated that the Fed fund target rate should remain at the current level for a quite long period of time, reinforced general expectations for the maintenance of a bountiful environment as far as international liquidity conditions are concerned, thus weakening the USD against all currencies.

All in all, we believe the international environment continues to offer favorable circumstances for an appreciation of the BRL, which is likely to materialize as the reformist agenda moves forward. Nonetheless, we think this progress is unlikely to be smooth, but rather marked by a back-and-forth pattern, which we expect to continue to bring volatility to the FX market.

Local markets—rates: Based on prices from Friday around noon (time of writing), the nominal yield curve looks poised to steepen once again this week. In the front end, the Jan-22 DI future was on the verge of closing the week at 2.86% (+1 bp from last Friday, September 11). In the back end, the Jan-27 DI future was trading at 7.13% (+16 bps from last Friday, September 11), pushing the steepness in this segment (i.e., 2027s vs. 2022s) to nearly 427 bps, compared to 412 bps in the previous week and ~ 150 bps early this year. It is the highest gap for such maturities since mid-May.

Overall, this movement seems to have been influenced by the bear market in U.S. Treasuries. As opposed to last week, local bond auctions by the National Treasury came in line with market expectations. The stability observed in the front end seems to follow the maintenance of the forward guidance in the Copom's statement (see our comment below). Despite the relative favorable market conditions for EMs in recent days, political noise returned to the scene, amid difficult budget decisions for the executive and legislative branches to make ahead. We understand higher yields in both front and back end are still reflecting the perception of mounting fiscal policy risks.

Monetary policy: For the first time in 10 policy meetings (i.e., since June 2019), the Copom has decided to hold the Selic rate, which stands at its historical low of 2.00% in nominal terms. This outcome was widely expected by analysts and the markets. In the statement, the BCB reaffirmed the forward guidance inaugurated in the previous meeting, as the BCB sticks to a flight plan with the interest rate steady at 2.00% or below for some time.

Just as a reminder, in the first (short-term oriented) part of the forward guidance, the authority expresses the belief "that the current economic conditions continue to recommend an unusually strong monetary stimulus", but recognizes that the remaining space for additional stimulus which, "if it exists, should be small." The authority also claims that eventual future rate cuts would occur with "with additional gradualism," conditioned on the perception of the fiscal trajectory and the inflation outlook. In the second (medium-term oriented) part of the forward guidance, the BCB makes it clear that despite upwardly skewed risks for inflation "the Copom does not intend to reduce the monetary stimulus" for as long as inflation projections (both by consensus and BCB) remain fairly below the mid-target for the relevant horizon. That horizon encompasses not only calendar-year 2021, but also calendar-year 2022 (though to a lesser extent for the latter).

This part of the forward guidance is also conditioned “on the maintenance of the current fiscal regime and on the anchoring of long-term inflation expectations.”

The Copom took the opportunity now to justify the use of this communication as a policy tool. The idea is “to provide the monetary stimulus deemed adequate to meet the inflation target, but maintaining the necessary caution for prudential reasons.” In other words, the commitment to keep a same level of stimulus (under certain conditions) is seen as a complementary policy instrument, given restrictions imposed by the proximity of an effective interest-rate lower bound.

In the scenario assessment, the BCB highlights and upgrades its views on the global and local economy. The Copom sees the recovery in major economies and the lower volatility in asset prices prompting a relatively more favorable backdrop for emerging economies. Yet the authority shows some concern about an uneven recovery pattern (across sectors) and the uncertainty related to the pandemic and the effects of a removal of government stimuli. The recovery in the Brazilian economy is seen as “partial” and similar with the developments in other nations.

On inflation no alarm rang for now, in our view. The Copom mentioned that it already expects higher inflation for the short term, led by temporary pressure on food costs and a normalization process for some prices in the services sector, as the economy reopens. But core inflation is still seen running below the mid-target for the relevant policy horizon. Official inflation projections continue to point to headline CPI figures below or in line with the target for key horizons (mostly 2021, but increasingly 2022). We believe this means there is one more reason for the BCB not to worry too much about localized price pressures.

Our baseline scenario contemplates a stable Selic rate at 2.00% all the way until early 2022, when we envision the start of a gradual removal of stimuli and normalization of the policy stance. Importantly, our scenario still has as key assumption of expected compliance with the constitutional spending cap, which plays a decisive role in keeping inflation expectations anchored. In the event that important changes in the fiscal regime take place, putting at risk the (credibility of the) fiscal consolidation process after the pandemic, we believe the conditions for the forward guidance would be breached. This would impart considerable upside risks for inflation and interest rates for the medium term. We see the fiscal risks as a much more significant threat than the current pressures on volatile items.

Economic activity: The BCB's monthly activity indicator ended the sequence of releases of the main activity indicators for the month of July. The IBC-Br posted a gain of 2.1% MoM s.a. (-4.9 YoY), below market consensus of 3.4 % MoM (-5.3 % YoY), implying that 55.5% of the drop seen between March and April has already been recovered. The index is still 6.5 % below February’s reading (pre-crisis). This result is consistent with a sequential resumption seen for other key sector-based indicators in July (e.g., industrial production, retail sales and the services sector). A preliminary exercise, based on July's carryover, points to 3Q20 GDP at 8.3% QoQ s.a. (-3.8 % YoY).

According to FGV's industrial survey preview for September, headline industrial confidence rose 7.2 % MoM s.a. (reaching 105.8 points). For the first time since the pandemic onset, the index has surpassed February’s reading (4.3% above). On the other hand, the recovery in services and retail confidence is apparently softening. Headline service confidence posted a gain of 0.4% MoM s.a. (reaching 85.3 points), while headline retail posted a drop of 1.2% MoM s.a. (reaching 95.4). Compared to pre-crisis level, these confidence indicators stand -9.6% and -4.4% below the February reading, respectively. Building and consumer both followed the sequential gain, rising 3% MoM s.a. and 2.6% MoM s.a.; these indicators are only a respective 2.6% and 6.3% below February’s reading.

In our Wednesday report, *The Real Wage Bill and the Impact of Emergency Aid,* we attempted to gauge the impact of government transfers to mitigate the impacts of the COVID-19 on the “expanded” (i.e., including social benefits) real wage bill (total wages from work).

In order to mitigate the effect of the pandemic on household income, many countries have adopted direct cash transfer policies for unemployed workers. In Brazil, most of the budgetary stimulus came from emergency aid to households, a temporary welfare program that we expect will amount to BRL320 billion (4.4% of GDP) in transfers by year end.

Considering government stimulus to households, we estimate that the “expanded” wage bill will rise by 3.9%, adjusted for inflation, for full-year 2020 compared to 2019. In a counterfactual simulation, 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, although the creation of a new income program has been ruled out, in a hypothetical scenario with a new permanent welfare program worth BRL35 billion, the real wage bill would register a decrease of 6.9%. We estimate a decline of 7.8% for the “expanded” wage bill without such a program.

In addition to the social distancing measures, government transfers seem to indicate a clear pattern for household spending in recent months. In retail, sales in the income-driven segments (such as food and medicine) fell significantly less than sales in the credit-driven segments (such as automobiles and appliances). In comparison to February (pre-crisis), the index in April (worst month of the crisis) for sales associated with credit concessions was 51.4% lower, vs. 5.4% lower for income-related sales.

Fiscal policy: On Tuesday (September 15), the executive made an announcement to halt the discussions on the '*Renda Brasil'* (new welfare program). Amid the limited fiscal space in the budget for the coming years, proposals to curb mandatory expenses to finance the new program were discarded. The measures not endorsed were to de-index welfare and pension benefits' raises from inflation or to alter other existing social benefits to create a new social program to replace Bolsa Familia. Despite this, in the discussion of the 2021 budget in the coming weeks, the creation of a new welfare program is apparently returning in the Congress, debating a way to finance it and complying to the fiscal rules.

On the fiscal side, the release of the report on the Federative Pact (constitutional reform) and the vote on presidential vetoes were postponed again. The rapporteur of the Federative promised to announce his draft of the proposal in the coming weeks. This reform contains several mechanisms to contain mandatory spending and can open space to other discretionary expenditures. Additionally, the congress postponed the vote on the overturn of several presidential vetoes to a new date (September 30). The focus will be on the one extending the payroll tax exemption to 2021, which could mean less revenue and slightly reduce the margin for complying the spending cap for 2021.

Inflation: September IGP-10 inflation released on Wednesday (September 16) surprised to the upside, once again led by building pressures at wholesale level (4.34% MoM against 4.18% of median market expectation). Both the Industrial-PPI and the Agro-PPI (in which pass-through to IPCA is stronger and more direct) accelerated compared to August IGP-M. Looking ahead, we start to see some signs that the Agro-PPI might start to decelerate and, as an upshot, food-at-home inflation on IPCA could also start to lose steam at some point in the future (although not necessarily in the very next few months, as there is a lag between wholesale and consumer prices, and the effects on consumers has just started to kick-in).

On this coming Wednesday (September 23), the IBGE is set to release the IPCA-15 inflation for September. We expect a reading of +0.40% MoM (+2.60% YoY). While administered prices continue to decelerate, free prices accelerate. We forecast administered prices inflation at 0.46% MoM and free prices at 0.37% MoM, the main driver will be food-at-home, which has been surprising in the last few weeks—and we see many reasons for that: increased external and domestic demand owing to a change in the consumer basket, along with income support and a depreciated BRL. We forecast the group to reach 1.71% MoM, while industrial goods and services should post much milder changes, at 0.14% and 0.02% MoM, respectively.

Despite the upward pressure of food-at-home, we continue to see a muted pace for core prices, as economic slacks are expected to remain high for a considerable period. Well-anchored inflation expectations also to play a big role. The food pressure, however, has been pushing our high-frequency tracking for 2020's IPCA inflation and it now stands at 2.3%. For 2021 we continue to forecast 2.7% of IPCA inflation.

Balance of payments: On Wednesday (September 23), the IBGE is set to release the IPCA-15 inflation for September. We expect a reading of +0.40% MoM (+2.60% YoY).) we will become acquainted with the data for the Brazilian balance of payments referring to August 2020. We expect them to continue hinting at a pretty sound dynamics on the heels of the fifth monthly surplus in a row in the current account balance (USD1.7 billion) and the net inflow of direct investments in the country (USD1.5 billion), a combination that underpins the comfortable situation regarding the Brazilian external financing needs. While the pandemic has hit imports, services outlays and the remittance of profits and dividends in a strong fashion, the strong demand for grains, animal proteins and iron ore in tandem with the weak currency level has managed to keep export proceeds relatively stable, thus contributing for a swift and significant adjustment in the current account deficit registered last year.

On the other hand, albeit smaller than the volume observed in 2019, direct investments in the country have continued to be a reliable funding source to the country, thus helping to partially offset the outflows seen in portfolio investments. All in all, we believe that the constructive conditions and outlook for the Brazilian balance of payments should remain out of the list of macro (and FX) concerns in Brazil, which we see helping the BRL to register some strengthening ahead in coming months, provided that the fiscal regime remains intact.

Next week: This coming Wednesday (September 23), the FGV will release the consolidated figure for September's Consumer Confidence. On the fiscal side, the Brazilian internal revenue service will publish the federal tax collection information for August 2020. Our estimate is BRL112.3 billion, which would mean a contraction of ~9% compared to August 2019, in real terms. The performance of tax collection has been recovering gradually driven by the better performance of economic activity. Even so, the result is still affected by temporary tax relief measures and deferral of tax collection announced by the federal government to mitigate the economic blow of the COVID-19 crisis.

In the realm of monetary policy, the BCB publishes on Tuesday, September 22, the minutes from last week's Copom meeting, which could shed more light on the BCB's scenario assessment and forward guidance. This will be followed by (on Thursday, September 24), the release of the quarterly inflation report, with details on the inflation simulations and policy-related studies.

MACRO AGENDA

Indicator	Date	Estimate	Prior
Federal tax collection Aug/20 (BRL billion)	18/24-Sep	112.2	116.0
Copom Minutes	Tue, 22-Sep		
Consumer Confidence Index FGV Sep/20 (points)	Wed, 23-Sep	-	80.2
IPCA-15 Sep/20 (% MoM)	Wed, 23-Sep	0.40	0.23
IPCA-15 Sep/20 (% YoY)	Wed, 23-Sep	2.60	2.28
Retail Confidence Index FGV Sep/20 (points)	Thu, 24-Sep	-	96.6
Central Bank Q3 Inflation Report	Thu,24-Sep		
Construction Confidence Index FGV Sep/20 (points)	Fri, 25-Sep	-	87.8
Current Account Balance Aug/20 (USD billion)	Fri, 25-Sep	1.7	1.6
Foreign Direct Investment Aug/20 (USD billion)	Fri, 25-Sep	1.5	2.7

Sources: Bloomberg and Santander.

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