Santander Corporate & Investment Banking

ECONOMICS

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Brazil Macro Compass

Rising Fiscal Deficit, Dwindling External Gap

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- **On the heels of external developments and the resumption of Congressional discussions on economic reforms in Brazil, the BRL strengthened substantially this week, ranking among the top-five performers of major currencies.**

- **The nominal yield curve traded with a steepening pattern this week, amid muted core inflation readings and mixed global sentiment toward risky assets. Term structure steepness remains relatively higher compared to early this year, reflecting the risk premium generated by fiscal uncertainties. The short-end of the curve now prices in the greater likelihood of a 25-bp cut at the next Copom meeting (August 4-5). We continue to expect the Brazil Central Bank (BCB) to remain on hold (at 2.25%) until 1Q22 but recognize that the next policy decision could be a close call.**

- **July's IPCA-15 registered a 0.30 % MoM change (2.13% YoY), considerably below our estimate of 0.48% MoM and the market's median expectation of 0.52% MoM. This major downside surprise reaffirms our view of a benign inflation scenario. In particular, we continue to anticipate a muted dynamic for core prices, now hovering around 0.4% on an annualized trend basis.**

- **Regarding economic activity, the FGV's monthly consumer survey started a batch of soft data releases for July. Following last week's extraordinary preview release, the headline consumer index rose 10.8 % MoM (s.a), reaching 78.8 points (75.9 points in the preview), suggesting, in our view, that the upward trend that began in May will continue. Nonetheless, consumer confidence stands 10.3% below February's level. All in all, the numbers suggest a gradual "normalization" of economic activity. June's job market numbers expected for next week will be key to gauging the downside risks ahead.**

- **On the policy front, the executive branch submitted this week its tax reform proposal to Congress that calls for the creation of a federal VAT. We believe that this contribution should be put in the context of the broader discussion already in taking place in both houses of Congress (and expected to resume in coming weeks).**

- **According to our projections, June's fiscal accounts (due on Thursday and Friday) will reveal a substantial impact from the pandemic, in line with April and May's readings. In addition to weak federal tax collection, we highlight the massive expansion of government spending related to the COVID-19 crisis.**

- **We expect June's current account balance to have registered the fourth consecutive monthly surplus (USD3.7 billion) stemming from a substantially positive trade balance, reduced remittances from profits and dividends, as well as tourism outlays, reinforcing our expectation of an annual current account surplus in 2020 (the first positive reading since 2007).**

Local markets—FX: The EU authorities' agreement on a spending plan to fight the economic impact of COVID-19 underpinned market participants' confidence of a possible global recovery in the near term, thus increasing risk appetite and favoring the performance of emerging market financial assets. We believe this is one reason behind the BRL's substantial strengthening this week, possibly in tandem with the resumption of the tax reform debate on the domestic front. However, rising diplomatic tension between China and the U.S. diminished some of the enthusiasm that this news brought, thus preventing the BRL from ending the week at its strongest level in the period (BRL5.08/USD on Wednesday). However, despite our acknowledgment that new geopolitical issues could arise, we do not believe they would likely escalate irreversibly, implying that progress on the domestic reformist agenda and evidence of a global economic recovery should lead to further BRL strengthening (although remaining subject to a volatile trajectory).

Local markets—rates: Based on prices from early Friday (the time of this writing), the nominal yield curve traded with a steepening pattern this week. In the front end, the Jan-22 DI future was on the verge of closing the week at 2.89% (-6 bps from last Friday), possibly influenced by muted core inflation readings in the July IPCA-15 preview (see details below). In the back end, the Jan-27 DI future was trading at 6.39% (+10 bps from last Friday), amid mixed global sentiment for risky assets. As an upshot, the Jan-27 vs. Jan-22 steepness in DI futures was poised to end the week at 350 bps (last week: 334 bps) — not only the highest level in nearly two weeks but also way above the ~150-bp levels seen early this year.

The market is pricing in a probability of nearly a 70% probability for (a final, "residual") cut of 25 bps for the next Copom meeting (August 4-5). That is also the consensus among analysts. Our baseline scenario still looks for a terminal Selic rate of 2.25% in this cycle (i.e., no more cuts in coming months). But we believe this is a close call, given a still favorable inflation outlook on one hand and the likely proximity of an effective lower bound on the other. The BCB dilemma is still whether to accommodate/accept (part of) a highly disinflationary COVID-19 shock or run the risk of a potentially counterproductive easing (from the standpoint of policy transmission via market conditions, financial stability, and anchoring of expectations).

Economic activity: This week, the FGV's survey of consumer confidence started a batch of releases of economic surveys for July. And the results confirm last week's preview that already indicated positive numbers.

For households, the consumer confidence index rose 10.8 % MoM (s.a), to 78.8 points, slightly better/worse than the preview's 75.9 points and marking the third consecutive gain after April's sharp drop. The headline number has fallen 10.3% since February's pre-crisis level, meaning that 70% of the points lost between March and April have already been recovered. July's result was mainly driven by the expectation component, up 16.9 %, while the current component pointed to slight growth of 0.6 %. In term of trends, the three-month average (of headline) posted a gain of 10.8 %, the first positive result since February, after April's all-time low. In the details, the survey shows that the intention to purchase durable goods points to growth of 48.9 %, the third positive result after April's sharp tumble. The labor differential (i.e., percentage of respondents having a hard time finding a job, minus those easily finding jobs) was slightly down, to 93.9 (from 94), though still high; this number highlights some existing headwinds in the job market.

In manufacturing, FGV's industrial survey preview for July showed that headline business confidence rose 16% MoM (s.a.). This result follows an increase both in the current situation component (12.9%) and in the expectations index (19.2%). Regarding the accumulated drop in recent months, 74% of the points lost between March and April have already been recovered, but despite the positive result, the headline index is still 11.1% below February's reading. The details show capacity utilization rose to 72.6%, the third consecutive gain after April's all-time low of 57.3% but still below the historical average of 80% and February's 76.2%. We expect low capacity utilization to remain a significant headwind to investment spending this year. The final results and details of this report are slated for next Wednesday, July 29.

Inflation: July's IPCA-15 registered a 0.30 % MoM change (2.13% YoY), considerably below our estimate of 0.48% MoM and the market's median expectation of 0.52% MoM.

Downside surprises were concentrated in free prices (a -14-bp difference to the headline forecast). The food-at-home group fell 0.20% MoM (+8.8% YoY), while we had expected it to stay stable. The divergence contributed -3 bps to the actual headline result compared with our estimate. Industrial goods rose 0.11% MoM (0.3% YoY), also surprising to the downside and contributing -5 bps to our forecast error. However, the main downside surprise came in services (-7 bps of error in the headline), which fell 0.06% MoM (+1.64%), while we expected +0.12% MoM (apparently, even with the gradual reopen of the economy, demand is pretty low, making it difficult for establishments to raise prices). Finally, administered prices were almost in line, +1.28% MoM, against our forecast of +1.42% (-3 bps to the headline forecast).

The new average of core measures (EX0, E3, DP, MS, and P55) registered a 0.11% MoM change, with the annualized (and seasonally adjusted) three-month moving average reaching a muted 0.4%, while the target for 2020 is 4.0%. In particular, the trend for the IPCA EX3 core gauge (a measure highly correlated with the output gap) hovers around -0.5% MM3saar. Additionally, the diffusion index stood at 53.4% on a seasonally adjusted basis, still close to the lowest historical levels.

The major downside surprise reaffirms our view of a benign scenario for inflation. In particular, we continue to see a muted dynamic for core prices, as economic slack should remain high for a considerable period of time despite the cushioning of demand generated by government stimulus and the reopening of a number of regional economies. We believe the well-anchored inflation expectations should also play an important role in price dynamics in Brazil. We forecast IPCA inflation to decelerate to around zero in August, ending 2020 at 1.5% (the upside risks we had been seeing are now much lower after that downward surprise). Finally, for 2021 we estimate IPCA inflation at 2.7%; the usual inflation determinants (economic activity, imported inflation, inflation expectations and inertia) suggest downside risks, but we are monitoring a major tail-risk to the upside: a possible tax hike for “essential living” goods.

Fiscal policy: According to data released Thursday, July 23 by the Brazilian Internal Revenue Service, federal tax collection amounted to BRL86.3 billion in June, slightly worse than our expectation (BRL90.5 billion) and market consensus (BRL87.3 billion). Adjusted for inflation, this was a significant contraction of 29.6% YoY (May: -32.9% YoY). Once again, weak federal tax revenue can be explained by a combination of deteriorating economic activity and government measures allowing for tax exemptions and the deferral of tax payments (total amount of BRL22.8 billion in June) in order to mitigate the social and economic effects of the pandemic.

For full-year 2020, we expect total federal tax collection to tumble 11.5% YoY (in real terms), which corresponds to tax losses of ~BRL180 billion, compared to 2019. Incidentally, we emphasize that the federal government plans to allow tax debts to be paid in installments over the next few years.

The Ministry of Economy published this week the third bi-monthly revision of budget 2020, which incorporated more stimulus measures on the expenditure side (e.g., emergency aid for households, transfers to regional governments) to fight the economic effects of COVID-19. In total, the report announces an upward revision in federal expenses around BRL245 billion for this year. The revision also incorporated a stronger cyclical impact on tax collection (particularly income tax), resulting in a net downward revision of nearly BRL18 billion in total net proceeds for the federal government. As an upshot, the government revised upwardly (once again) its projections for this year’s central government primary budget deficit, to BRL787.5 billion (from the BRL540.5 billion previously projected). In 2019, the federal deficit was BRL95.1 billion.

Regarding the legislative agenda, last Tuesday, July 21, the Lower House approved a proposed constitutional amendment proposal (PEC 15/2015) to expand the Fundeb fund for basic education in two rounds of remote voting. According to the current version of Fundeb, which expires on 31 December, the federal government must match 10% of state and municipal education spending, while the PEC 15/2015 increases the federal match from 10% to 23% by 2026, at a gradual pace. We calculate that the federal government will transfer BRL18.5 billion to regional governments for spending in education next year (~BRL3 billion increase to this year’s transfers). For 2026, the total increase (i.e., additional spending) is estimated to reach ~BRL19 billion, in our calculations.

Last Saturday, the federal government’s economic team presented a counterproposal to redirect part of the additional Fundeb resources to finance a new social welfare program, *Renda Brasil*. We note that Fundeb outlays are exempted from the constitutional spending cap rule. In our view, the government’s initiative to allocate some spending outside the constitutional cap restrictions to make room for the new direct transfer program (and the negative reaction from the majority of Congressional representatives) signals the challenging fiscal debate expected to take place in coming months, especially concerning the announcement of a broader social welfare program that complies with the expenditure ceiling rule, the latter being the most important fiscal anchor in the Brazilian economy, in our view.

Lastly, this week the Ministry of Economy presented the executive branch’s contribution for the debate on the tax reform. With a view to simplify the Brazilian tax code (seen in business surveys as one of the most complex in the world), and help improve productivity and investment, the government proposes the creation of a federal VAT (or CBS in Portuguese) in the form of a levy on goods and services. The CBS would merge PIS and Cofins taxes into fewer special regimes, and, according to government calculations, have a neutral effect on tax collection. According to the government, those two taxes (PIS and Cofins) account for a quarter of the tax disputes involving unions and is among the most difficult tax rules to comply with. We believe the government proposal will be part of a broader Congressional discussion on the tax reform, as the joint (Senate-House) commission is expected to restart discussions of proposals from both houses already in place (such as the PEC 45/2019 and PEC 110/2019) in the coming weeks.

Although the initial intention to raise taxes on the Brazilian consumer staples basket (the so-called *cesta básica*) has apparently been put on hold, the shift of taxation out of the industry and toward services (which account for a greater part of the economy and the CPI basket) can generate some temporary inflationary effects. Based on our preliminary numbers and as long as inflation expectations remain well anchored, we do not expect the tax reform to significantly affect monetary policy going forward.

Next week: The BCB is due to release June's balance of payment next Tuesday, and we expect data to reinforce the trend of a significant adjustment in the current account balance this year. According to our calculations, the current account balance should have registered the fourth monthly surplus in a row (USD3.7 billion) in the wake of a positive result in the trade balance and low expenditures related to tourism and remittance of profits. The economic deceleration stemming from the pandemic has weighed more heavily on imports than on exports, as the latter has been underpinned by increased demand for (less cyclical) agricultural products, while the former are more linked to intermediate goods (more cyclical). Additionally, the pandemic has also diminished corporate profits, thus reducing the total of proceeds that multinational companies send to headquarters. Last but not least, lockdown measures implemented to curb COVID-19 have also reduced tourism outlays substantially, thus completing the list of factors that have led the current account balance to register surpluses lately. As a result, only six months after having registered a USD49.5 billion deficit in 12-month-to-date terms (December 2019), we calculate the gap should have receded to USD36.1 billion in June 2020. Moreover, as we do not expect this dynamics to change anytime soon, we project the current account balance to end 2020 with a USD1.4 billion annual surplus (the first positive result since 2007).

Following this week's release of tax revenue data (see comment above), we estimate that the central government's primary deficit will have totaled BRL149.5 billion in June 2020 (this data is due out next Thursday, July 30). In addition to shrinking tax collection, we highlight the impact from the substantial expansion in primary spending to combat the COVID-19 crisis, which added to BRL97.2 billion in June. In turn, next Friday (July 31) the BCB will publish the consolidated public sector's fiscal balance for June 2020, which encompasses the federal government, regional governments and state-owned companies. We anticipate a monthly primary deficit of BRL152.8 billion, with the following breakdown: -BRL148.8 billion for the federal government; -BRL3.6 billion for states and municipalities; and -BRL0.4 billion for state-owned companies.

On economic activity, the macro agenda includes two key indicators of labor market conditions for June. On Tuesday, Labor Ministry will release its report on formal job creation (Caged); on Wednesday, IBGE's National Household Survey (PNAD) will also be published. These figures are essential for tracking the deterioration in the labor market conditions on the sequence of the COVID-19 crisis and therefore gauging the downside risks ahead.

MACRO AGENDA

Indicator	Date	Estimate	Prior
Central Govt's Primary Fiscal Balance June/20 (BRL billion)	Thu, 30-Jul	-149.5	-126.6
Public Sector's Primary Budget Balance June/20 (BRL billion)	Fri, 31-Jul	-152.8	-131.4
Formal Job Creation – Caged June/20	Tue, 28-Jul	-	-332K
Unemployment - IBGE's National Household Survey June/20	Wed, 29-Jul	-	12.9
IGP-M inflation (% MoM)	Thu, 30-Jul	2.10	1.56
IGP-M inflation (% YoY)	Thu, 30-Jul	9.13	7.31

Sources: The National Treasury Secretariat, Brazilian Central Bank, IBGE and Santander.

Recent Publications (Available on Our Website)

- *Updating our Inflation, FX and Interest Rate Forecasts* (June 25, 2020)
- *FX Compass – BRL – A roller-coaster ride* (June 25, 2020)
- *Inflation: How Low and How Long?* (June 17, 2020)
- *FX Compass - BRL – Despite a little help from our friends* (May 21, 2020)

- *The Shock Is Even Worse and Stimuli Much Bigger* (May 18, 2020)

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