ECONOMICS

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Brazil: Economic Activity

No News Is Bad News

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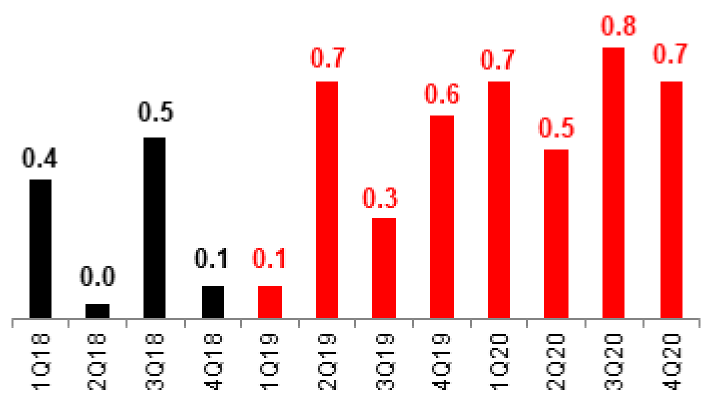
- **We have been arguing (see *Low for (Much) Longer*, March 29, 2019) that, in the absence of an expansionary fiscal policy, strengthened demand for Brazilian exports, or an additional monetary impulse, growth will be fully dependent on an improvement of expectations, which would drive consumers to reduce savings and businesses to pursue investment.**
- **The absence of a solution for high unemployment has contributed not only to reduce GDP growth expectations in the first three months of the year, but also to signal a yellow light in terms of the potential evolution of confidence in the coming quarters.**
- **This context has led us to further reduce our GDP growth estimates, to 1.3% (from 2.3%) for 2019 and 2.5% (from 3%) for 2020.**
- **The protracted soft economic environment suggests that a new cycle of Selic reductions is not out of the cards. However, we still believe the Brazilian Central Bank will not engage in such an approach before gaining clarity on whether the outcome of the social security reform is favorable.**
- **In our view, an eventual worsening of prospects associated with the evolution of the economic agenda could increase financial uncertainties and market volatility to a point at which an additional cycle of monetary easing would be unadvisable.**
- **On the other hand, we believe a more timely favorable evolution of reforms would be enough to further improve financial conditions, making additional monetary impulse unnecessary.**

Figure 1. GDP Components Forecasts

GDP Forecasts		
Components	**2019**	**2020**
Total GDP	**1.3**	**2.5**
Agriculture and Livestock	3.0	2.5
Industry	0.9	2.1
Services	1.4	2.6
Household Consumption	1.5	2.8
Government Consumption	-0.2	0.4
Gross Fixed Capital Formation	3.5	5.9
Exports	2.3	2.9
Imports (-)	3.1	4.1

Sources: Santander estimates.

Figure 2. Real GDP Growth (% QoQ)



Sources: IBGE and Santander estimates.

Confidence → Savings Rate → Consumption

A frequent concern of the business community, particularly among those closer to services and retail-related activities, is about the development of demand in an environment of weak labor market conditions. **We argue that labor tends to lag the economic cycle, rarely leading it.**

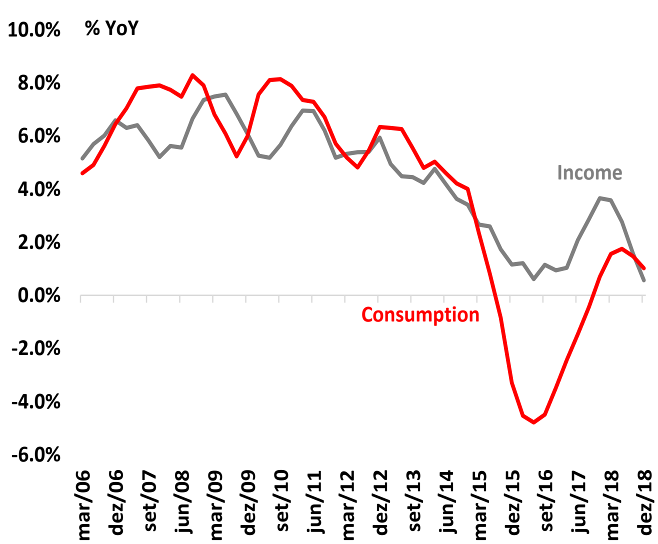
Without an impulse from government spending or the external sector (through increased demand for exports), the evolution of employment and wages is fully dependent on business investment decisions, which ultimately depend on the outlook for household consumption.

In order for consumption to outpace income, consumers would be required to reduce their savings rate, a decision that depends upon the degree of optimism regarding the growth of the economy (particularly, expectations related to future income).

The following charts illustrate this argument. Figure 3 reflects a meaningful contraction of consumption in 2015 and 2016, well beyond the decline of income. This indicates that households substantially increased their savings rate, which is fully compatible with the unusually low levels of confidence in the period (Figure 4).

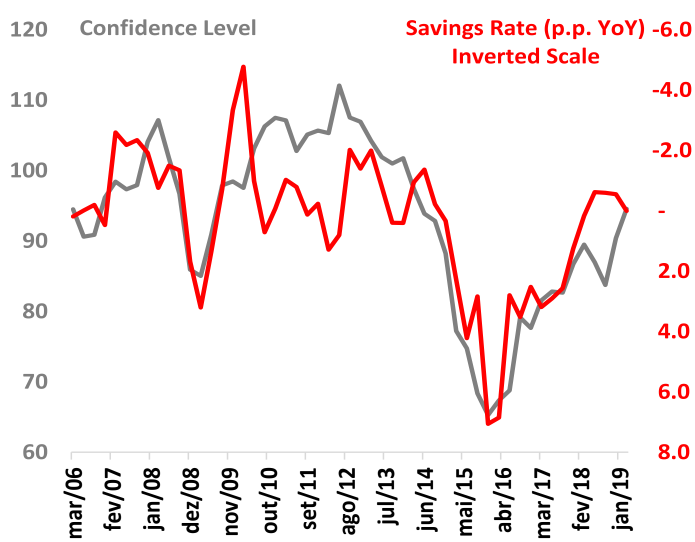
The good news is that expectations seems to have already reached a point at which the savings rate should oscillate around stability, meaning there is no reason to believe that consumption growth should turn negative. **The bad news is that recent dynamics have not been as nearly as favorable as we were expecting** (see *Is Monetary Policy Stimulative for Consumption?*, March 6, 2019). After peaking in January, consumer confidence contracted in February and March, challenging the hypothesis we had for the year that drove our GDP growth forecast of 2.3% for 2019.

Figure 3. Consumption and Income*



Source: IBGE for consumption and BCB for Income (*BCB's estimate of total disposable income).

Figure 4. Household Estimated Savings Rate Variation and Consumer Confidence (average in the quarter)



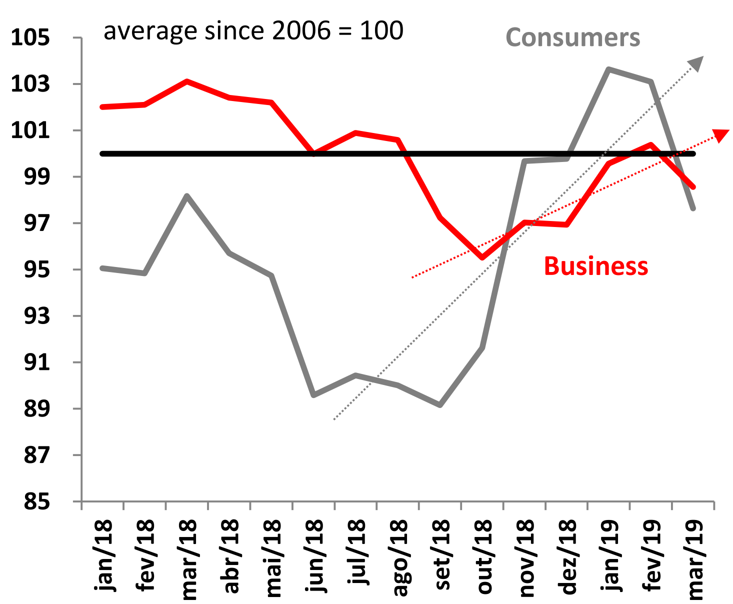
Source: FGV for Consumer Confidence, Santander estimates for savings rate (based on variations of consumption and income (Figure 3).

News Flow → Confidence

The economic sentiment that has prevailed in 1Q19 is, in our view, still not sufficient to provide a meaningful impulse to economic activity.

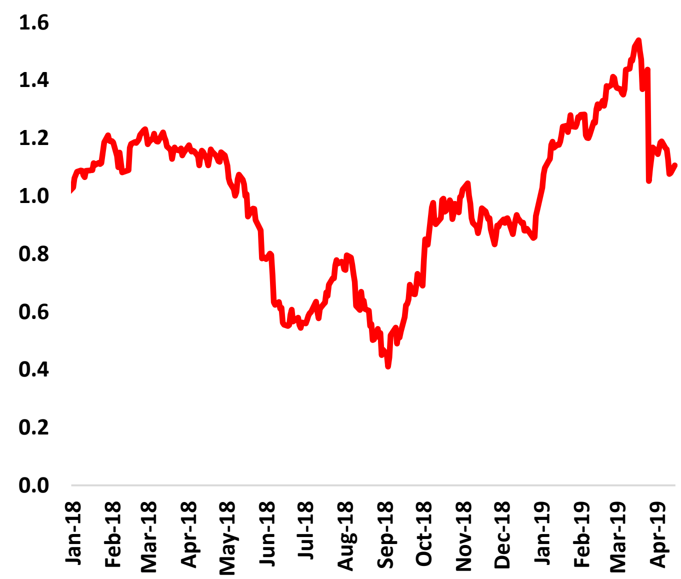
Figure 5 illustrates recent dynamic of business / consumer confidence, while the one on the right shows our preferred measure of financial conditions (which reflects the mood of financial markets). Apart from intermittent noise relate to politics, uncertainties associated to the evolution of the economic agenda in Congress have anchored household and consumer confidence, as well as prevented financial conditions from improving further. Figure 5 illustrates how a much worse dynamic of confidence has, not only contributed to damage the performance of the economy in 1Q19, but also challenges our benign assumption for the reminder of the year. The longer the unfavorable news flow dominates, the latter confidence will reach a level compatible with falling savings rate and accelerating consumption. The revision of the hypothesis associated to the evolution of confidence is behind the downgrade of our GDP growth forecast from 2.3% to 1.3% in 2019 and from 3% to 2.5% in 2020.

Figure 5. Business and Consumer Confidence



Source: FGV.

Figure 6. Financial Conditions Index - Santander[1]



Sources: Santander estimates.

Positive Agenda and Social Security Reform

Our macro scenario implies that policymakers and monetary authorities will be able to improve the current sentiment by carrying out a more constructive agenda in the coming months. This agenda could include discussions about Central Bank autonomy, tax reform, further initiatives on privatizations and concessions, and measures aimed at stimulating economic activity (lowering reserve requirements, for example).

Figures 7 and 8 illustrate two issues of particular importance related to confidence: government approval ratings and Social Security Reform.

A positive agenda will be critical to sustain government approval ratings, which is a necessary condition for confidence and savings rates to be sustained at levels consistent with stronger consumption (see Figure 7). After all, we would not expect households to be optimistic regarding the evolution their financial health if they not have a favorable view of the government.

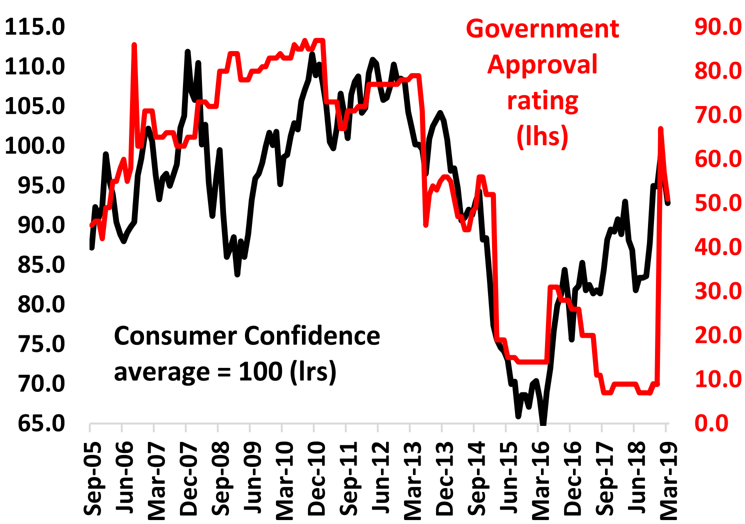
As for the Social Security reform, its importance goes far beyond the fiscal impact. It is true that a meaningful adjustment of current rules is urgently needed for improving the public sector's perceived solvency conditions, and thereby preventing excessive market volatility, negative adjustment of asset prices, and another decline of economic activity.

[1] *The SAN-ICF is the "common factor" captured by the Principal Component of the following variables: (i) ex-ante real interest rates (1-year forward rates minus 12-month forward inflation expectations, as captured by the BCB's weekly survey of market expectations); (ii) the spread between overnight rates and 3-month forward rates (capturing the slope of the short end of the yield curve, which tends to react more readily to changes in expectations in monetary policy, usually driven by shocks); (iii) the 5-year CDS of Brazilian sovereign external debt (a measure of country risk); (iv) the Ibovespa – the stock exchange index (correlated with firms' cost of equity and, to a lesser extent, with the "wealth effect" that an increase in stock prices could have on families); and (v) the real effective exchange rate, calculated by the BCB on a currency basket, representing the change in the nominal exchange rate of the BRL versus such currencies minus the inflation differential between Brazil and the corresponding countries (a proxy of the firms' capacity to meet external debt obligations from cash flows in BRL).*

The progress of the Social Security Reform will also be an important indicator of the capability of the government to address other reforms and measures that remain of crucial importance to the Brazilian economy (some of them previously mentioned). For this reason, we could argue that, at least in part, decreased consensus expectations for GDP growth in 2019 could be associated with expectations that the original proposal will be watered down by at least 40% (see forecasts conducted by the Senate's Independent Fiscal Institution or our report, *The Moment of Truth: From Intentions to Bargaining*, March 28, 2019).

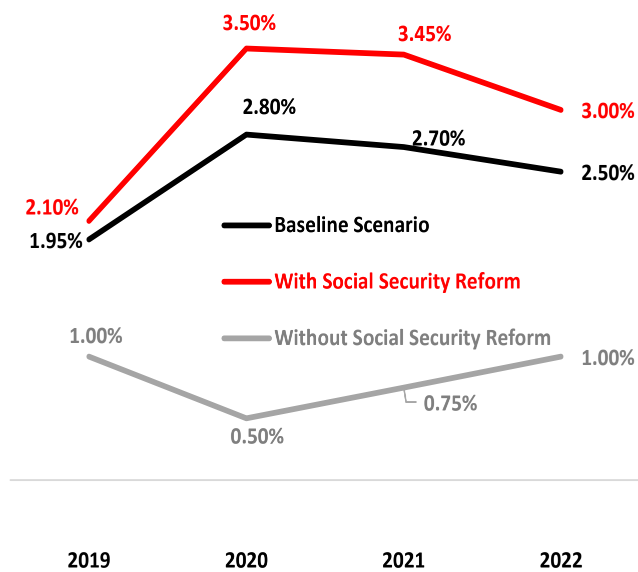
The importance of the evolution of the Social Security bill to the macroeconomic outlook can also be illustrated by Figure 8, which shows market consensus forecasts for GDP growth based on various scenarios for the reform.

Figure 7. Consumer Confidence vs. Government Approval Rating



Sources: FGV and IBOPE.

Figure 8. GDP Growth Consensus Forecasts Dependent on Social Security Reform



Sources: Ministry of Finance (Prisma Fiscal).

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