ECONOMICS **February 14, 2020**

Brazil – Macroeconomic Scenario

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Still on Track, but More Gradually

- **The public sector's primary result came in much better than the target in 2019. Furthermore, gross public debt as a percentage of GDP declined in 2019 as compared with 2018, owing to a sizeable contribution from non-recurring factors. In fact, mandatory spending remains on an unsustainable path, in our view, as further advances in the fiscal adjustment agenda are required.**
- **In this context, we do not expect disruptions in the reform agenda process, though few proposals are likely to be approved in 2020, given the batch of constitutional amendments being debated in tandem with a calendar shortened by municipal elections in October. Hence, for this year, we expect only the approval of a "fiscal emergency package" aimed at containing mandatory expenditures.**
- **Recently, deterioration in the current account balance has decelerated, but market participants remain uncomfortable with the theme–which was one of the drivers behind recent BRL weakening. As we expect the trade balance surplus to register a smaller shrinkage than in previous years, the current account deficit should continue to increase gradually—we project a US$56.9 billion shortage in 2020—and the discomfort with the matter should abate.**
- **Considering this factor, and assuming a partial reversal of the coronavirus impact during the year, the BRL pressure (that took the FX rate north of 4.35, weakest nominal level on record) should also subside. Additionally, as we anticipate progress on the reform agenda and better economic momentum—despite recent frustrations. As an upshot, we still anticipate a reversal of recent BRL weakening. However, worse terms of trade and the narrow interest rate differential should reduce the length of the retreat, in our view. Consequently, we are adjusting our YE2020 FX rate forecast to USD/BRL4.10 from USD/BRL4.00.**
- **The latest activity data for 2019 were disappointing, leading us to anticipate slower-than-expected economic growth—although still hinting at a recovery in place. Accordingly, we have adjusted our estimate to 1.1% from 1.2% for 2019, and to 2.0% from 2.3% for 2020. For 2021, we now forecast a 2.5% expansion instead of 3.0%. Notwithstanding the downward shifts, we continue to consider that the composition of growth is likely to be healthier—and consequently, more resilient—than before.**
- **Amid favorable inflation fundamentals (slacks, expectations), and helped by the reversal of the price shock in animal proteins observed at YE2019 and administered prices, we anticipate relatively tame inflation dynamics, leading to an annual IPCA much below the targeted level for 2020 (4.0%). Adding to the disinflationary pressures we expect to arise during the year, we have revised our 2020 forecast to 3.1% from 3.4% and for 2021 to 3.7% from 3.8%.**
- **Copom lowered the policy rate for the fifth straight meeting (-25 bps, to 4.25%, a new low), and at the same time announced the "interruption" of the easing cycle (which has totaled 225 bps since July 2019). The authority refers to "multiple uncertainties" regarding the transmission of the stimulus already provided, and wants to observe how the economy will react. We see the BCB on hold throughout 2020. Expecting acceleration in the economic recovery, we anticipate that the next Central Bank move will be a hike, as part of a normalization cycle that we see starting in 2Q21. For now, the slower activity has led us to revise down our call for the YE2021 Selic rate to 5.50% (from 6.00%).**

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Fiscal policy

Brazilian public debt as a percentage of GDP has fallen recently, largely due to non-recurring factors. As reported by the BCB, gross public debt ended 2019 at 75.8% of GDP, below the level observed at YE2018 (76.5% of GDP) and well below market expectations a few years ago. The main reasons behind the more favorable trajectory of public debt in the recent period were: **(i)** the sharp decline in the cost to roll over public debt in the wake of the perception of a lower fiscal risk in tandem with historically low levels of interest rates (by Brazilian standards); **(ii)** advance payments from BNDES (Brazilian Development Bank) to the National Treasury; and **(iii)** the BCB's sales of U.S. dollars (from FX reserves) on the spot market, leading to a reduction in the outstanding level of repo operations ("compromissadas"). We estimate that BNDES payments reduced the gross public-debt-to-GDP-ratio by 7.1 pp between 2015 and 2019, whereas the BCB's FX interventions contributed with a downward impact of 2.1 pp last year.

The 2019 public sector's primary result came in much better than the target, but excluding non-recurring revenue and expenditures—thus obtaining the so-called recurring result—we note that fiscal balance dynamics remain fragile. The consolidated public sector, which includes the federal government, regional governments and state-owned companies, registered a negative primary balance of R$61.9 billion last year (-0.85% of GDP), well below the targeted deficit of R$132 billion (-1.8% of GDP). However, atypical and temporary factors largely explained this difference, notably the extraordinary revenue from oil auctions (e.g., R$35.4 billion from the auction of Transfer of Oil Rights) and dividend payments from public banks. When we exclude all non-recurring contributions, the public sector's recurring primary result ended 2019 at -1.7% of GDP, according to our estimates, thus indicating that Brazilian fiscal adjustment is still far from completion.

For 2020, we expect a lower amount of extraordinary revenue, likely leading to an increased primary deficit, in our view. We anticipate a R$98.5 billion primary imbalance (-1.3% of GDP), implying a R$20 billion gap in comparison to the targeted level for 2020 (-R$118.9 billion, or -1.6% of GDP). Hence, as we expect non-recurring events to diminish in the coming years, additional progress on the reform agenda is crucial for holding up mandatory spending and complying with the main fiscal rules. After all, despite the approval of a robust pension reform in 2019, mandatory expenditures continue to grow at an unsustainable pace.

We find it unlikely that the federal administration's ambitious economic agenda proposal will be abandoned, though few initiatives are likely to be concluded in 2020. We expect discussions on fiscal, regulatory and efficiency measures to continue this year, but given that there are many of them—including several proposals of constitutional amendments (PECs, in Portuguese acronym)—and that the calendar of parliamentary activities will be shortened by October's municipal elections, it could be difficulty to conclude many of them. On the fiscal front, this year we expect the approval of an "emergency package" aiming at curbing mandatory expenditures, although the original proposals could be watered down (there are two PECs that could be combined: PEC186/19 in the Lower House and PEC438/18 in the Senate). In our opinion, lawmakers are interested in approving this emergency package, as it could provide the opportunity to use savings from mandatory expenditures on public investments, especially as lawmakers have more control of these investments from now on due to a change in the budget framework that allows them to impose on the government in what/where they want the money to be directed.

Broader reforms (e.g., tax, administrative and federative overhauls) could be concluded in 2021, in our view. More complex legislative proposals require more intense public debates and greater political organization. In this sense, we maintain a constructive view on the progress of reforms that deal with: (i) the simplification of the Brazilian tax system; (ii) restructuring the public servant sector; and (iii) the de-indexing and de-earmarking of the public budget framework. Nonetheless, we do not expect these changes to be concluded before next year.

Based upon these assumptions and the previously mentioned assessments, our base-case scenario considers that the federal government abides by the public spending cap rule until (at least) 2024, which combined with the cyclical economic recovery we expect to materialize in the coming years, is expected to allow for the gradual development of more favorable primary fiscal results, with the latter likely to return positive by 2023, in our view. Lastly, we expect public debt (as a percentage of GDP) to maintain a downward trajectory, reaching the 70% vicinity within the next three years.

Balance of payments

As we have discussed in previous reports (see our December 16 report, *A Better Outlook,* and our January 13 report, *Brazil Macro Propositions for 2020*), deterioration in the current account balance in 12-month terms decelerated in the last months of 2019, ending the year with a US50.8 billion deficit, compared with a US$41.7 billion shortage in December 2018. Hence, after the sharp increase observed between YE2017 and YE2018—when the current account deficit (CAD) jumped from 1.1% of GDP to 2.2% of GDP—the CAD closed 2019 at 2.8% of GDP. Despite a slower pace than seen before, the fact that the CAD has continued northbound has kept market participants wary of prospects for the Brazilian balance of payments.

Incidentally, market participants have ascribed to this concern some of the BRL weakening observed this year. Curiously, the issue did not prevent the BRL from strengthening in December 2019. In our view, the bulk of the disquiet stems from the Brazilian trade balance surplus contraction of recent years despite the lack of strong growth rates. However, we note that the decline had more to do with reduced export proceeds rather than expanded import outlays. As we expect the Brazilian economy to continue its gradual recovery, import outlays are not likely to boom, in our view, and data released for January 2020 underpinned this assessment. Consequently, we expect market participants to remain focused on the outlook for exports, whose volume index has pointed to some recovery recently, which offset some of the negative influence of prices. All in all, while still expected to decline, we continue to believe that the shrinkage of the trade surplus in 2020 is likely to happen in a milder fashion than in previous years, which could translate as well into the extension of the trend of a gradual deterioration in the CAD this year.

On the back of such trade balance developments and assuming that they will materialize, we would expect the BRL weakening pressure to cease as months go by, along with our expectation that the coronavirus epidemic will dwindle and the prospects for further progress in Brazil's structural reform agenda will lead to some BRL strengthening from current levels. However, we believe that some of the negative impacts on China's economy (and on commodity prices) owing to the coronavirus outbreak are not likely to completely reverse this year, implying that the USD/BRL cross could end 2020 at a higher level than we previously anticipated.

Based upon our calculations and the aforementioned assumptions, we now expect an FX rate retreat from the current USD/BRL4.35 level to USD/BRL4.10 by December 2020, versus our previous forecast of USD/BRL4.00. As we believe that this nominal change is not likely to mean a substantial change in the real effective exchange rate, we maintain our projections for the trade balance surplus and the CAD at US$38.3 billion and US$56.7 billion, respectively.

Economic activity

Following the release of strong economic activity data in October 2019, we expected Brazil's economy to remain strong in November and December, due to the temporary increase in income owing to withdrawals from FGTS (private workers' mandatory savings fund). However, activity indicators for those months were greatly disappointing for most economic sectors. In our view, this frustration could be partially attributable to the fact that FGTS fund withdrawals were lower than we had assumed. In addition, we believe some of the anticipated increase resulting from this temporary incentive was anticipated in 3Q19, especially in the industrial sector, which increased its production in the period, as it had expected a sharp increase in year-end sales.

Hence, we have lowered our 4Q19 GDP forecast to 0.4% q/q, in seasonally adjusted terms (sa), from 0.8% q/q sa, which subtracted 0.3 p.p. from the carry-over (i.e. inertial growth) previously expected for the GDP in 2020 (to 0.7% from 1.0%). However, we emphasize that, despite frustration, Brazil's economy in 4Q19 was positive, especially in the most income-sensitive segments. The Monthly Retail Sales Survey reported a 0.7% q/q sa increase in the period, while the Monthly Services Survey recorded a 1.4% q/q sa expansion.

Thus, we reiterate our proposition that, once the impacts of the temporary income stimulus have ended, we will see a GDP slowdown in 1Q20. Nevertheless, since 4Q19 growth was below our expectation, we believe that its reversal may also be less intense. On the other hand, we consider that the impacts of the one-off slowdown in Chinese growth—due to a halt in the supply chain due to the coronavirus outbreak in China—could hurt Brazil's economic activity. According to our estimates, the impact on Brazil's GDP is a tepid 0.1% in 2020. However, the negative outcome depends on the intensity and duration of the outbreak. As this remains uncertain, we believe this risk factor requires careful monitoring.

All in all, we have revised our 2019, 2020 and 2021 GDP real growth projections. For 2019, we expect GDP growth to decline to 1.1% from 1.2%; for 2020, to 2.0% from 2.3%; and, finally, for 2021, to 2.5% from 3.0%. We recognize that the balance of risks for this and the next year is adverse, implying that risks to our forecasts are skewed to the downside. Yet, we believe that the role of the private sector in the composition of growth will be essential for the process of the Brazilian economic recovery to be long and sustainable. In this context, we believe that, regardless of the pace of growth, the outlook is positive and that the continuity of the macro and microeconomic reform agenda is crucial for increasing productivity and, consequently, greater economic development.

Inflation

In late 2019, consumer inflation in Brazil (as measured by the IPCA) temporarily accelerated on the heels of protein costs, in the wake of the negative supply shock stemming from the African swine fever (ASF) outbreak that affected China's pig

herd. During this period, live cattle prices rose approximately 35%, from R$11.6/kg in October to R$15.7/kg in November. Currently, prices hover around R$12.9/kg, and we forecast a range of R$12.9/kg to R$14.3/kg in 2020. Thus, we have a downward bias for beef prices in 2020.

In addition to animal proteins, other items have potential to exert downward pressure on the IPCA annual change this year, such as gasoline prices, urban bus tariffs and electricity costs, among others. The first item has to do with the recent drop in international oil prices and our hypothesis is that they are likely to hover around US$60/barrel this year. The second item is related to the lower number of municipal adjustments in bus tariffs announced this year and, consequently, a lower average price for 2020 than in 2019. The downward inflation contribution from electricity follows favorable climatic conditions (affecting expectations for December) as well as muted annual tariff readjustments.

Additionally, we highlight that the IBGE started using a new weight structure this year, derived from the survey on household consumption basket—the so-called POF (Portuguese acronym)—which also brought a downward bias to inflation indices in comparison with the previous structure. Adding up all of these points previously described, we have adjusted our 2020 IPCA forecast to 3.10% from 3.40%, a level below the current median of market participants' inflation projections as reflected in the BCB's Focus weekly survey (3.25% as of February 7, 2019). First and foremost, this new forecast implies a 2.9% annual change for the so-called IPCA-EX3, a level far below the inflation goal set for 2020 (4.00%). The IPCA-EX3 is the most sensitive core inflation gauge to the economic cycle, and it was constructed by the BCB to support monetary policy handling, which reinforces our perception that interest rates should remain unchanged during this year.

Last but not least, we expect the IPCA in 2021 to climb to 3.7%, mainly due to larger adjustments of administered prices in the next year—important adjustments are likely to be postponed from 2020 to 2021, in our view—in tandem with higher energy costs derived from taxation on distribution companies that should be transferred to consumers. While close to the target set for 2021 (3.75%, which coincides with the median of projections seen in the BCB's Focus weekly report), the headline inflation implies a milder acceleration in the IPCA-EX3 annual change to 3.2%, thus underpinning our view that the Brazilian monetary authority could be able to carry out a gradual normalization process from 2Q21 onward.

Overall, we believe that the inflation outlook for the biennium 2020-2021 remains quite favorable, given below-potential activity and well-anchored inflation expectations.

Monetary policy

On February 5, Copom—Monetary Policy Committee of the Brazilian Central Bank (BCB)—lowered the policy rate for the fifth straight meeting. This time the cut was less sharp than in the four previous occasions—a 25-bp move as compared with the 50-bp drops previously chosen—taking the Selic rate to 4.25% p.a., which is a new record low since the implementation of the inflation-targeting regime (1999).

In the ensuing statement, Copom (pre-) announced the "interruption" of the easing cycle, which totaled 225 bps since July 2019. In the minutes of its last meeting (published nearly a week afterward), Copom pointed out that *"… given the multiple uncertainties regarding the current size of economic slack, the speed of economic recovery, and the increase in the power of monetary policy, which acts with lags in the economy, Copom considers that it is important to observe the effects of the monetary stimulus cycle (par. #18)."* The BCB also recognized that *"… a better understanding of these effects is essential to determine the next steps in monetary policy."* The authority also associated a more cautious approach with *"… uncertainties regarding the lag and the magnitude of the effects of the stimulus already granted."* The committee assessed that *"it is essential to observe the evolution of economic activity and inflation projections and expectations over the next months, with increasing weight for 2021 (par. #19)"*.

The gradual displacement of the focal policy horizon (out of 2020, toward 2021) is particularly relevant for the policy guidance. In fact, the simulations for IPCA annual inflation presented in both the communiqué and the minutes pointed to estimates in line with next year's central inflation target (3.75%). In a scenario assuming the Selic rate at 4.25% p.a. at the end of 2020 and 6.00% p.a. at the end of 2021, the Central Bank estimates annual inflation of 3.5% for 2020 (mid-target: 4.00%) and 3.7% for 2021 (mid-target: 3.75%). These scenarios assume a stable exchange rate (USD/BRL) at 4.25 for the entire horizon.

While some may say that the BCB communication leaves the range of monetary policy options wide open in the future, we prefer to view the current BCB wording as a natural absence of policy guidance (or pre-commitment to any given path) for the medium term, given a sea of uncertainties surrounding the economy. In our view, the primary factor expected to shape the interest-rate outlook will be the consistency and strength of the ongoing activity recovery.

In an environment as described in our baseline scenario, where Brazil keeps following the path of economic and fiscal reforms—contributing to the maintenance of broadly-anchored inflation and economic expectations—and assuming lack of greater or persistent shocks from abroad (e.g., coronavirus), the state of local demand will play a decisive role for inflation

projections for 2021. Thus, in practical terms, we continue to believe that Copom has ended the easing cycle (with Selic rates poised to remain on hold throughout 2020). A possible revision of strategy—and eventual implementation of additional stimuli—will fundamentally hinge on a sizable disappointment on economic activity, leading to inflation estimates well below the mid-target for 2021.

We expect GDP growth to head toward the ~2% level in the coming years from the ~1% levels seen in recent years. Thus, we continue to forecast that the BCB's next move could be a hike, as part of a normalization cycle that we expect to start in 2Q21. However, we recognize that downside risks are mounting, according to our GDP growth projections, implying an increasing likelihood that the BCB further extends the timeline for the normalization process, while reducing its speed and intensity. That said, we are now revising our YE2020 Selic rate forecast to 5.50% p.a. (from 6.00% p.a.). We basically believe that the likelihood of further downside revisions (in our Selic rate estimate for 2021) are directly proportional to the downside risks to our 2.0% GDP growth projection for 2020.

Macroeconomic forecasts

					SANTANDER FORECASTS		
	2015	2016	2017	2018	2019	2020	2021
GDP (%)							
GDP Growth	-3.5	-3.3	1.3	1.3	1.1	2.0	2.5
Inflation (%)							
IPCA-IBGE	10.7	6.3	2.9	3.7	4.31	3.1	3.7
IGP-M	10.5	7.2	-0.5	7.5	7.30	3.4	4.0
FX Rate							
BRL/USD - end of period	3.90	3.26	3.31	3.87	4.03	4.10	4.10
BRL/USD - average	3.33	3.49	3.19	3.65	3.94	4.20	4.10
Interest Rates (%)							
SELIC - end of period	14.25	13.75	7.00	6.50	4.50	4.25	5.50
Labor Market							
Unemployment rate (average)	8.5	11.5	12.8	12.3	11.90	11.0	9.4
Balance of Payments							
Exports (USD bi)	191.0	185.2	217.7	239.3	224.0	226.9	230.6
Imports (USD bi)	171.5	137.6	150.7	181.2	177.3	188.6	201.0
Trade Balance (USD bi)	19.5	47.6	67.0	58.0	46.7	38.3	29.6
Current Account (USD bi)	-54.5	-24.2	-21.8	-41.5	-50.8	-56.7	-66.4
Current Account (% of GDP)	-3.0	-1.3	-1.1	-2.2	-2.8	-3.0	-3.4
Fiscal Accounts							
Primary Balance (% of GDP)	-1.9	-2.5	-1.7	-1.6	-0.9	-1.3	-0.6
Net Public Sector Debt (% GDP)	35.6	46.1	51.4	53.6	55.7	56.3	55.8
Gross Public Sector Debt (% GDP)	65.5	69.8	73.7	76.5	75.8	74.9	72.7

Source: BCB and Santander estimates.

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