Santander Corporate & Investment Banking

Waiting for the Fiscal Decisions

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- **Fiscal jitters have intensified, and we believe that the policy trajectory will become clearer only after the municipal elections in late November. For our baseline scenario, the fundamental hypothesis continues to be compliance with the spending cap. Regarding our fiscal policy forecasts, we did not make significant changes, only marginal adjustments due to the rise in inflation, generating obstacles to the execution of the spending cap in 2021 but easing somewhat the conditions for 2022.**

- **Although we believe compliance with the spending cap rule should help the BRL to strengthen over the medium term, the political debate about the issue should remain heated in the short term, thus adding some premium to (what we consider) fair levels. As a result, we are revising our forecast for the USDBRL pair to 5.30 from 4.90 for December 2020, but keeping it at 4.60 and 4.15 for year-end 2021 and 2022, respectively.**

- **The weaker-than-expected level that we now anticipate for the BRL in the coming months led us to revise our projections downward for the current account deficits in 2020, 2021 and 2022 (to USD2.5 billion, USD3.5 billion and USD29.6 billion, respectively, from USD9.3 billion, USD8.7 billion and USD31.0 billion, previously), thus reinforcing the buffer generated by the balance of payments.**

- **The recent releases of economic activity indicators highlighted a gradual and heterogeneous pattern of recovery by the Brazilian economy. The latter was largely supported by temporary fiscal stimulus. Our forecasts assume a gradual but continued reopening of the economy ahead, but with a full "normalization" only around mid-2021, with a "mechanical" effect of the reopening offsetting the expected drop in aggregate wages (with the end of temporary household stimulus). We are maintaining our projections for real GDP growth at -4.8%, 3.4% and 2.6% for 2020, 2021 and 2022, respectively.**

- **Recent BCB data for September reveals credit to households has been recovering, with non-earmarked new loans practically back to pre-crisis levels. As for corporate, new loans (especially for working capital) are still rising, offsetting the decline in capital market transactions. We revised our projections for total outstanding growth (inf. adj.) to 7.5%, 5.3% and 6.8% for 2020, 2021 and 2022, respectively, from 6.1%, 5.5% and 5.8% previously.**

- **On inflation, the main surprises have been food-at-home and industrial goods, which led us to raise our 2020 headline IPCA forecast to 3.3% (from 2.3%) and 2021 to 2.9% (from 2.7%), while 2022 was kept at 3.2%. Despite the upward revision, with low core measures, inflation expectations well anchored and the output gap still wide open, we maintain a benign view on inflation.**

- **Despite the mounting fiscal risks and possible implications for the interest-rate outlook, our baseline scenario still sees the Copom on hold (at 2.00%, Selic's historical low) until 1Q22, when we envision the start of a gradual removal of stimulus. While anchored inflation expectations and below-potential activity imply limited worries about demand-led inflation in the medium run (baseline scenario), a fiscal slippage scenario could lead to stagflation (alternative scenario), in our view.**

Executive Summary

In this review of the macroeconomic scenario, we reinforce our perception introduced since May that the fiscal framework should define the recovery of the post-Covid economy. On the one hand, we maintain as a baseline scenario the approval of reforms capable of sustaining the current fiscal regime, with the compliance of the spending cap rule until, at least, 2023. On the other hand, we observe an increasing risk of moving to an alternative scenario, where Brazil would return to fiscal dominance condition.

In this context, the asset prices have deteriorated since the government presented its 2021 budget proposal to the National Congress (late August), which made clear the lack of fiscal space for complying to the spending cap beyond 2022 and for the creation of a new welfare program (increasing mandatory expenses, without curbing others). An eventual decision to "do nothing", therefore, does not consist in a definitive solution.

Since then, the evolution of asset prices has implied an increasing risk of changes in the fiscal framework. This could happen, for example, through the approval of a breach to the spending cap to accommodate the creation of the new welfare program, more expensive and with more beneficiaries than the current *Bolsa Família* program (BRL34.9 bn in the 2021 budget).

Undoubtedly, the end of emergency aid in December, in addition to the withdrawal of fiscal stimulus adopted temporarily during the pandemic, will bring additional challenges to the labor market and to the situation of the most vulnerable people. We estimate a decrease in the real wage bill of almost 7% YoY in 2021[1].

The increase in the risk perception occurs as a response to the higher gross public debt/GDP level, almost 20 p.p. above the pre-crisis estimative and, consequently, to the greater borrowing requirements for debt rollovers and primary deficits until at least 2027. We maintained our primary deficit forecast of BRL880 billion in 2020, with gross debt reaching 94.9% in 2020 and 105.8% at its peak (2027). In practice, such a long period with primary deficits is not usually immune to possible shocks of confidence or external shocks.

With the end of the municipal elections, clear communication is awaited on what the government's strategy will be for resuming fiscal consolidation and for building a credible strategy for intertemporal sustainability of public debt. Containment of mandatory public spending demands urgent action, a broad consensus, and a lot of political coordination, capable of altering a persistent trajectory observed in the last 30 years. The pension reform was a very important step, but it was not enough to solve the problem. The growth in mandatory expenditures has remained above the growth in GDP (on average 3.9% real) since then, excluding temporary expenses to face the impacts of the pandemic.

We still maintained our baseline scenario, where a few steps could be taken in coming months – such as the approval of fiscal emergency measures, with de-indexation of the wages and benefits; a broad re-arrangement of social benefits, in case of creation of a new welfare program; changes in forms of hiring public servants, remunerating and structuring public service careers, the approval of a tax reform, and microeconomic reforms in general. In this scenario, we maintained the projection of a GDP decline of -4.8% in 2020, with growth of 3.4% in 2021.

We believe that the 'lower-than-expected' impact of the health crisis on the economy, the decrease in the contagion curves and, more importantly, the reduction to less than half the daily average of deaths and lower levels of UCI utilization, all support a safe reopening process.

With the maintenance of confidence in the sustainability of public debt, the "rather mechanical" effect of the reopening of the service sector would more than compensate for the withdrawal of cash transfers to the most vulnerable in late December, when the public calamity period and the temporary "War Budget" ends.

In this scenario, household consumption would return to a composition more focused on services than on goods. Stimulating monetary policy, since the approval of the new "Termination Law"[2] in late 2018, has been consolidating an expansion cycle in home building. In addition, the recent approval of updated regulatory frameworks for infrastructure (energy, telecommunications, sanitation) is beginning to reactivate long-term business. We believe these sectors would be the key-drivers of a gradual and sustained recovery in the coming years, as they are important for the recovery of the labor market.

[1] **Santander Macro Brazil Activity and Fiscal Policy - *The Real Wage Bill and the Impact of Emergency Aid* –** September 16, 2020. Available on: *https://cms.santander.com.br/sites/WPS/documentos/arq-the-real-wage-bill-and-the-impact-of-emergency-aid/20-10-09_142043_special_real_wage_bill.pdf*

[2] Federal Law No. 13,786/18, known as "Termination Law", allows home buyers and sellers (i.e., real estate developer) to abort the transaction of a future unit.

In addition, the earlier-than-expected recovery of the global economy, in response to the massive fiscal and monetary stimulus from advanced economies, tends to reduce the risk associated with the pandemic and contribute to the recovery of commodity prices. The fundamentals of the exchange rate - relative price of advanced economies' currencies, global risk, interest rate differential, and commodity prices - remain in the direction of a BRLUSD appreciation, to 5.30 at the end of 2020 and 4.60 at the end of 2021 (please see our report[3]).

Thus, despite the recent shock on food prices and the pressure from imported industrial component prices, the inflation scenario tends to normalize due to the predominance of low services' inflation level and anchored expectations, converging to the center of the target in 2022. This makes it possible to maintain the SELIC rate at 2% pa until the beginning of 2022, when we believe that the output gap will be about to close.

However, the recent increase in the risk of changing the fiscal framework has been manifesting both in the exchange rate (standing around 5.60 to the USD, compared to ~ 4.00 late in 2019) and in its volatility. The yield curve also supports a steepness (400 bps for the Jan-27 vs. Jan-22 tenors, compared to ~150 bps before the pandemic). Both inflation and interest premiums have risen, pointing to level above the historical average and the levels prior to the pandemic (see our recent publication[4]). Exchange rate depreciation begins to affect the price of tradable goods with a higher external demand, leaving the forecasts of the general wholesale price indices measured by the IGP-DI from 15% to 20% and contributing to raise our IPCA projection to 3.3% for 2020 (a full percentage point higher than in our previous scenario review).

We believe, therefore, that the recent trend that would be followed in a scenario of fiscal dominance - with the rapid deterioration of the inflationary scenario, asset prices, confidence indicators, and difficulties in financing the public debt - tends to strengthen the commitment of the politicians with fiscal responsibility. Yet, the time is short to stop and reverse such deterioration, in our view.

[3] **Santander FX Compass** – October 22, 2020**.** Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-fx-compass-october/20-10-26_165942_2010+-+fx+compass.pdf

[4] **Santander Macro Brazil Monetary Policy - Mind the (Fiscal Risk) Premium** – October 6, 2020. Available on: *https://cms.santander.com.br/sites/WPS/documentos/arq-mind-the-fiscal-risk-premium/20-10-09_140012_special+-+mind+the+%28fiscal+risk%29+premium.pdf*

Key Hypotheses In Our Baseline Scenario

The main set of assumptions conditioning our forecasts for Brazil have barely changed since our last scenario review. Thus, we keep the following set of hypotheses:

- In the global scenario, we assume that the sanitary and economic effects of the pandemic will fade in 2021 (following a possible vaccination to start in 1H21). Despite a recent resurgence of COVID-19 cases in the Northern Hemisphere, especially U.S. and Europe, we assume that the main economies will see scattered episodes of isolation but not go back to as tight lockdowns as in the early days of the pandemic. Our scenario takes for granted no escalation of geopolitical tensions between the largest economies, especially the “trade war” between the USA and China, as well as the adoption of another round of fiscal stimulus in the U.S. We also assume a global backdrop of low interest rates for long, prompting relatively favorable financial conditions for emerging economies

- Our numbers consider that the social distancing measures would continue to observe a gradual easing at the local level in coming weeks and months. We assume that the reopening process would be such that mobility reaches something close to a “normal” level in 2H21, as a large scale vaccination takes place.

- In what we see as the most important assumption of all, our baseline scenario for Brazil assumes a decision (by both Executive and Legislative branches) to approve correctional measures in order to open new fiscal space to sustain a minimum of BRL100 billion discretionary expenses. This should allow keeping intact the basis of the current fiscal regime, with no policy changes damaging the credibility of the constitutional spending cap, meaning that our budget estimates federal expenses running around or slightly below the spending cap until 2022 (with a small margin for 2021 and a tiny leeway for 2022).

- We continue to assume that the pandemic will generate neither widespread bankruptcies nor a labor market collapse, keeping the economy relatively well positioned for a continued economic recovery amid a socially stable environment.

- Our inflation forecasts assume additionally that the exogenous (international) component of the upward price shock in food costs will lose steam in 2021, following a gradual recovery in the Chinese swine herd and a high agricultural productivity (i.e., output per acre) in Brazil, on the heels of plentiful agricultural revenues and large investment. Recently, the emergence of weather-related risks (La Niña) brought a bit of challenge to this assumption.

- Our scenario also contemplates a normalization of contracts of services that have been re-discussed during the pandemic (e.g., education, health care), as well as the postponement of tariff adjustments in regulated sectors. In most cases, we assume as full compensation already in 2021, unless in cases where pending adjustments have been differed for a longer period of time (e.g., electricity). It also contemplates the normalization of deferred taxes or the rescheduling of loans.

Fiscal Policy

Government measures to mitigate the effects of the pandemic continue to prompt a deterioration in the fiscal accounts in Brazil. On the revenue side, in the last few months, the federal tax collection performance has been improving with the gradual recovery in domestic activity, but is partially offset by the major use of tax credits. Thus, we continue to estimate primary revenue losses of BRL210 billion in 2020, compared to the pre-pandemic scenario. On the expenditure side, the total related to the Pandemic adds up to BRL457 billion by October, and is expected to reach around BRL590 billion by the end of the year.

In general, our scenario has no major changes from the September report. There were marginal adjustments due to the revision of the inflation projection, impacting nominal GDP (denominator). Our projection of the public sector primary deficit for 2020 remains at BRL880 billion (12.4% of GDP). For 2021 and 2022, we continue to expect primary deficits to gradually reduce (Figure 1-A).

In turn, gross debt is expected to reach 94.8% of GDP in 2020, an increase of 19pp compared to 2019. For 2021, we consider the possibility of BNDES to repay up to BRL100 billion in loans owed to the federal government, which would maintain the debt virtually stable at 95.2% of GDP (see Figure 1-B). More importantly, we expect the indicator to peak only in 2027[5] at ~106%, ~30 p.p. higher compared to the pre-pandemic estimate. Subsequently, our scenario estimates convergence towards ~93% of GDP by 2035.

The crucial hypothesis of the scenario is that the fiscal stimuli will be (almost entirely) limited to 2020. The main risk for our scenario is the possibility of creating a new permanent expense, causing a “breach” of the spending ceiling - the main anchor of the country's fiscal system. In addition, we recently explored additional risks in deviating from fiscal adjustment in our reports, such as the substantial need for financing in 2021[6] (Figure 2-A) and the reduction in the margin of the spending cap[7] (Figure 2-B) due to the mismatch in inflation rates. Our baseline scenario anticipates a sustainable public debt trajectory, reflecting our fundamental view that the country will remain committed to the fiscal consolidation agenda, especially with the maintenance of the effectiveness of the spending cap.

Figure 1-A. Consolidated Primary Fiscal Balance (% GDP)

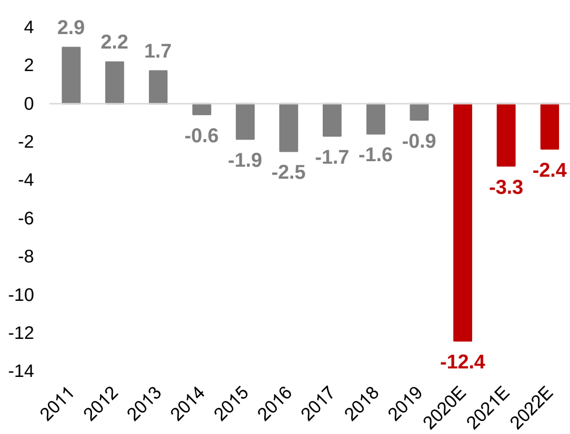
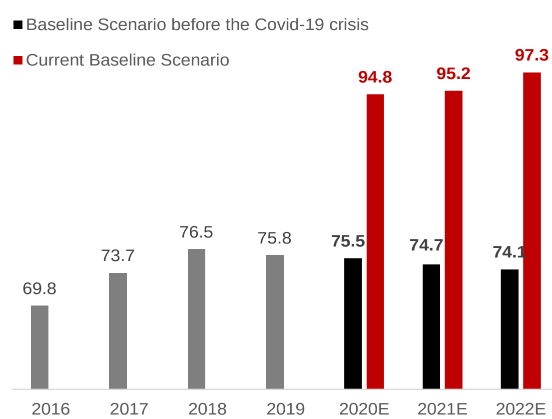


Figure 1-B. Gross General Govt. Debt (% GDP)



Sources for both charts: Brazilian Central Bank, Santander.

[5] According to our simulations, the stabilization of the gross public debt-to-GDP ratio at ~107% would require a primary fiscal surplus of (at least) 1% of GDP.

[6] For more details see: **Santander Macro Brazil Fiscal Policy - *Borrowing Requirements and Debt Management: The Importance of the Fiscal Adjustment*** – October 7, 2020- Available on:https://cms.santander.com.br/sites/WPS/documentos/arq-borrowing-requirements-and-debt-management/20-10-09_140544_special+-+borrowing+requirements+and+debt.pdf

[7] For more details see: **Santander Macro Brazil Fiscal Policy - *Spending Cap Rule: Narrowing the Margin for 2021*** – October 20, 2020. Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-special-spending-cap-rule/20-10-21_204025_bzmacrospcap102120.pdf

Figure 2-A. Gov. Financial Needs (BRL billion)

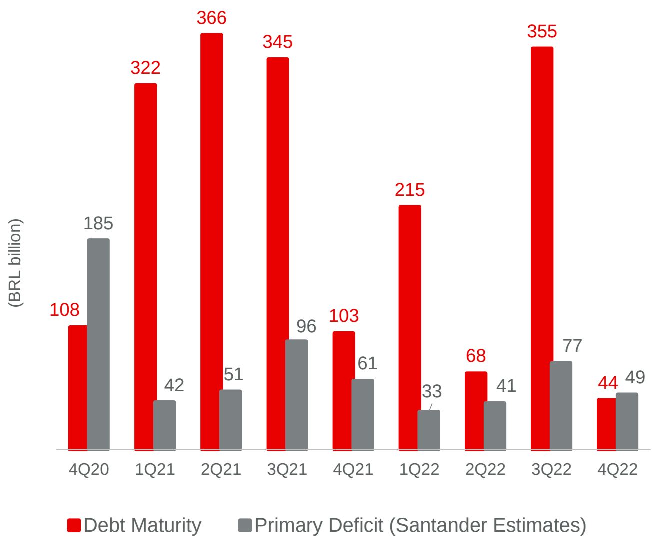
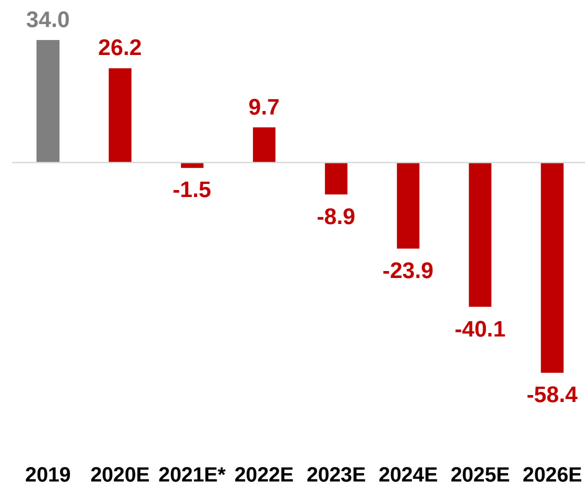


Figure 2-B. Margin to comply with the spending cap (BRL billion)



Sources for both charts: Brazilian Central Bank, Santander.

External Sector and Exchange Rate

As we stated previously (refer to our report[8]), despite constructive international circumstances, the perception of fiscal risks in Brazil has weighed on the BRL lately. Hence, we considered that only a credible indication of a return to a more frugal stance in the fiscal front would be able to trigger some correction in the Brazilian FX market. However, any decision about the budget framework that should prevail from 2021 onwards is going to be known only when the municipal elections cycle is over (end of November).

That is, for the coming weeks we think the uncertainty regarding the implementation—or not—of a new welfare program in 2021 and whether such program will abide—or not—by the spending cap rule should remain up in the air, which should make it difficult for the BRL to strengthen in the period, in our view. Given the risks for the fiscal regime seen by market participants, we continue to believe that the final outcome should be the maintenance of the current fiscal framework, which would lead to BRL strength in the medium term. However, we reckon that the limited number of days to political negotiations until the end of the year—congressional activities will be adjourned on December 23—should limit the chances of breakthrough in the negotiations and thus the magnitude of any strengthening in the short term. As a result, we are revising our forecast for the USDBRL pair to 5.30 from 4.90 for December 2020, but maintaining it at 4.60 and 4.15 for year-end 2021 and 2022, respectively.

On top of our key assumption that the current fiscal framework will remain intact in the coming years—which is far from being a given, and will require serious debate about mandatory public expenditures—we also think that structural changes in the Brazilian current account balance should help to stabilize the BRL. Since the inception of the floating FX rate regime in January 1999, the Brazilian current account deficit has registered three episodes of substantial correction in current account deficits: one between 2001 and 2004, another one between 2014 and 2017 and the current one, which we expect to last until mid-2021. In the first two episodes, the trade balance accounted for the bulk of the adjustment, while services and income accounts represented a smaller portion of the move.

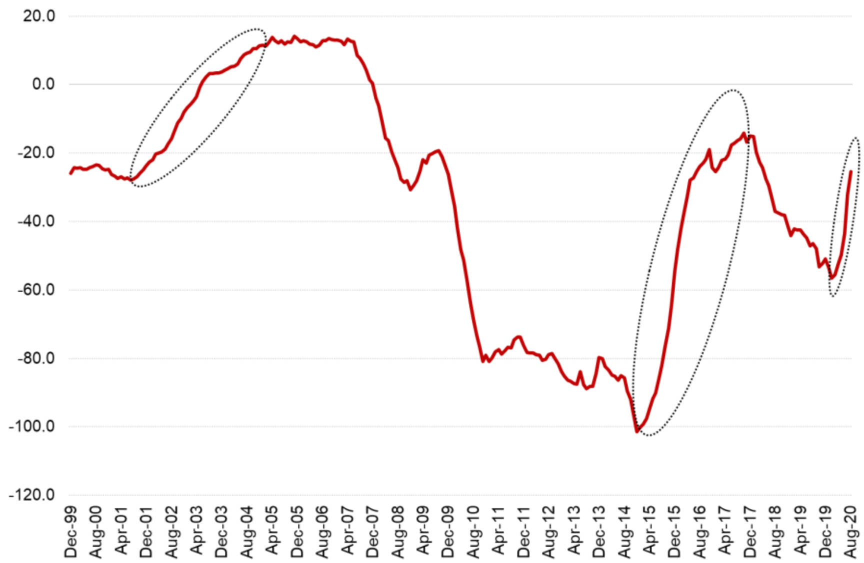
Presently, the contraction seen in the remittance of profits and dividends has led the process, with the services account coming right after that. In our view, this breakdown signals a stronger integration between the Brazilian economy and international markets. This integration is mirrored by a better composition in the net external liabilities, with direct investment replacing external debt over the last decades, as foreigner investors became more partners than creditors to the Brazilian economy.

Thus, in periods of crisis, the current account balance should adjust faster than before, given the larger number of channels through which FX devaluation will be able to influence it. As a result, we expect the USD50.9 billion deficit registered in 2019 to shrink substantially this year to USD2.5 billion and to present a similar figure (USD3.5 billion) in 2021 as the economic recovery tends to be gradual. For 2022, on the back of the BRL strengthening and the consolidation of the

[8] **Santander FX Compass** – October 22, 2020. Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-fx-compass-october/20-10-26_165942_2010+-+fx+compass.pdf

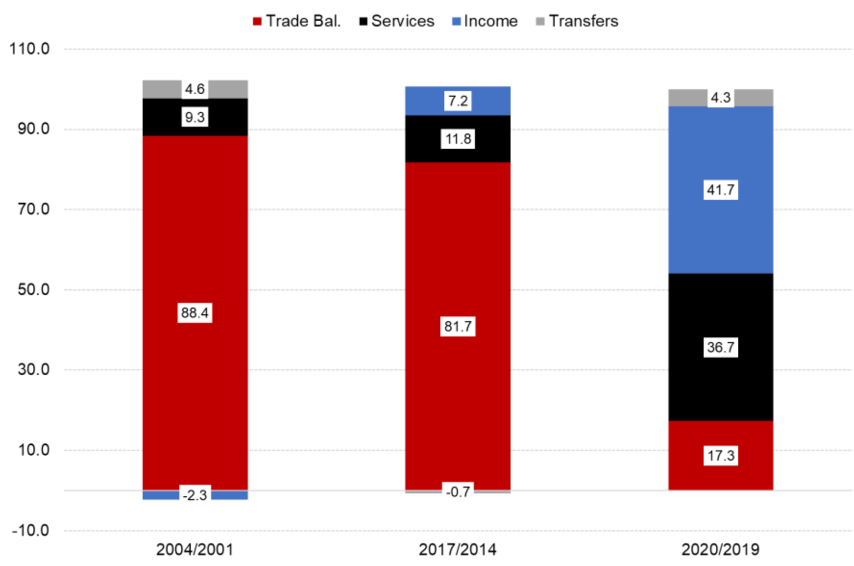
economic recovery, the current account deficit should nearly reach ~ USD30 billion as the remittance of profits and dividends, tourism outlays and imports are likely to grow at a faster pace. However, that would still represent c. 1.6% of GDP, a quite financeable level for the Brazilian economy.

Figure 3-A. Current account balance (USD billion, 12m)



Sources: Brazilian Central Bank, Santander.

Figure 3-B. Adjustments in the Current Account Balance – Contribution to total (%)



Sources: Brazilian Central Bank, Santander.

Economic Activity

The releases of economic activity indicators for the last four months highlighted the gradual and heterogeneous pattern of recovery presented by the Brazilian economy (see Figure 4-A). Reflecting the effects of the emergency aid, retail sales led this process, more than offsetting April's tumble and reaching multi-year highs; Industry has also presented a strong resumption, almost fully recovering from the drop. On the other hand, the Services Sector has been the laggard, still well below February's reading (pre-crisis mark).

In our baseline scenario, we expect that the social distancing-measures-easing process will last until around the middle of 2021, with the economy in the "full-operation" mode in 3Q21. We also expect that the emergency aid will be ended in the next year and employment will be back to pre-crisis levels at the end of 2022. In terms of risks, a deterioration in the fiscal outlook is the main downside risk, as it may trigger a deterioration in financial conditions and a drop in confidence, with recessive spillovers in economic activity.

We assume that the pandemic will generate neither generalized bankruptcies nor a labor market collapse, with no severe and lasting supply constraints and keeping the economy relatively positioned for a continued recovery amid a socially stable environment. According to the recent data on bankruptcies, this hypothesis still seems to be a reasonable one (Figure 4-D). As a result, we are maintaining our projections for real GDP growth at -4.8%, 3.4% and 2.6% for 2020, 2021 and 2022, respectively.

Figure 4-A. Economic Activity 2011=100, SA

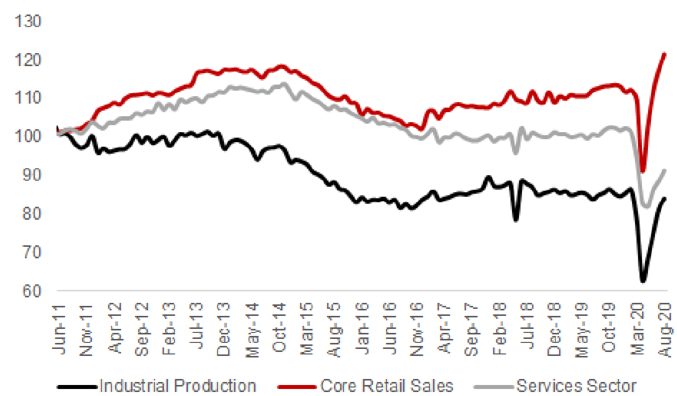
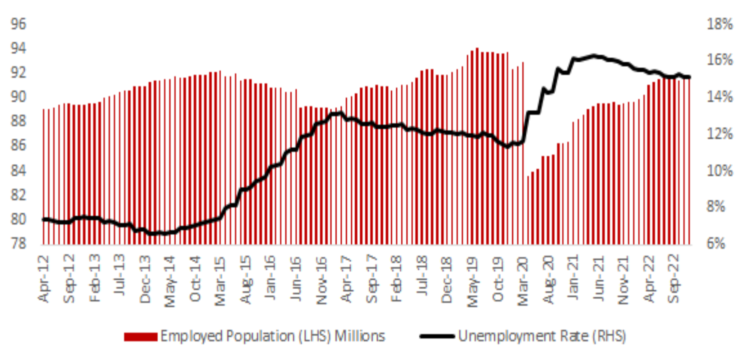


Figure 4-B. Labor Market Conditions and Forecasts (SA)



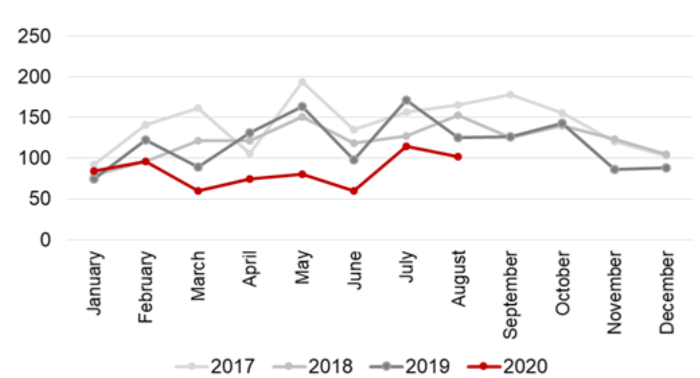
Sources for both charts: IBGE, Santander.

Figure 4-C. GDP Breakdown

	GDP Projections Baseline Scenario 2018	2019	2020e	2021e	2022e
Total GDP	1.3	1.1	-4.8	3.4	2.6
Agriculture & Livestock	1.4	1.3	1.5	3.2	2.4
Industry	0.5	0.5	-4.6	6.0	1.8
Services	0.5	1.3	-6.1	2.6	2.6
Household Consumption	2.1	1.8	-4.5	1.9	3.6
Government Consumption	0.4	-0.4	-5.6	3.8	1.0
Investments	3.9	2.2	-8.1	12.0	8.0
Exports	4.0	-2.5	1.5	9.7	0.3
Imports	8.3	1.1	-10.4	18.2	14.9
Memo (contribution)					
Domestic Absorption	2.0	1.5	-5.4	4.0	3.8
External Sector	-0.6	-0.6	1.7	-1.1	-2.4
Inventories	-0.1	0.2	-1.1	0.5	1.2

Sources: IBGE, Santander.

Figure 4-D. Liquidation Bankruptcy requests



Sources: Serasa Experience, Santander.

Regarding labor market conditions, on the heels of the social-distancing-measures easing, we expect the labor force to reach pre-crisis levels in 2Q21. In this context, a sharp increase in the unemployment rate is unavoidable in our view (see Figure 4-B): we expect it to reach an annual average of 13.4 % in 2020 and 16.1% in 2021, with a slow decrease to 15.3% in 2022. Regarding the unemployed population, after reaching 12.0 million in the end of 2019, we expect it to reach more than 17.3 million (2Q21), with a slow decrease to 16.3 million in 2022. The conclusion is that labor market idleness is expected to remain high in the coming years, despite some uncertainty about possible increases in the economy's natural rate of unemployment after the pandemic.

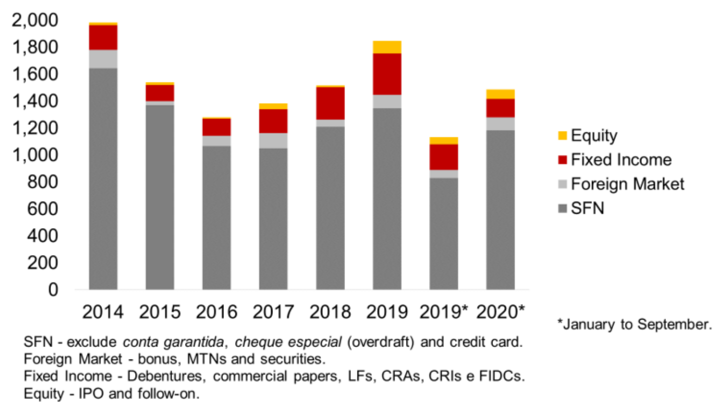
In an analysis of the impacts of emergency aid on the real wage bill, considering government stimulus to households during the pandemic, we forecast a 3.9% rise in the “expanded” (i.e., including social benefits) wage bill, adjusted for inflation for full-year 2020. In a counterfactual simulation without 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. For 2021, the effect of the so-called fiscal cliff in expanded wages, we estimate will lead to a drop of 6-8%, depending on the adoption or not of a new welfare program. The impact of the latter on the economy should be offset by the reopening process, prompting sort of a “mechanical” rebound, especially in the services sector.

In terms of risks for the economic activity scenario, the deterioration of the fiscal framework is the main downside risk, as it can trigger a deterioration in financial conditions and a drop in confidence, with deleterious repercussions on the economy.

Recent data (BCB) for September reveals household lending has been recovering, maybe helping support economic activity (and a consumer spending spree) in recent months. For this category, non-earmarked new loans are already at 98% of February’s volume, meaning nearly a full recovery from the pandemic. As for the corporate segment, new loans are still moving higher, reflecting expansion both in non-earmarked credit for working capital and earmarked through government fiscal measures. Importantly, while the increase in bank lending for non-financial firms is offsetting the retracement in capital market transactions (see Figure 5-A), it is possible that Brazilian companies might be more willing to hoard cash (to protect against hypothetical liquidity constraints) than to boost investment. Last, and reflecting the expansionary monetary policy stance and limited delinquency, the Credit Cost Indicator (ICC), interest rates and default rates for both households and non-financial corporations all continue the trend downwards.

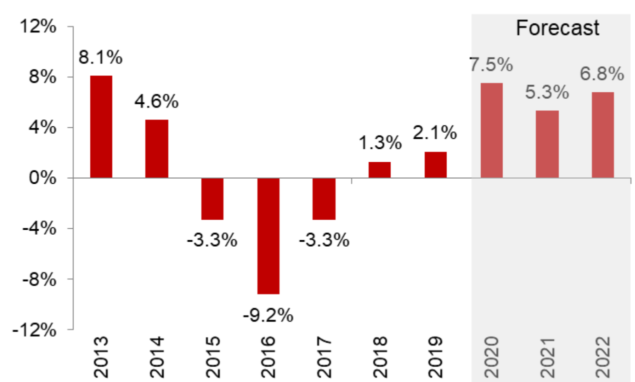
We revised our projections for total outstanding growth (inf. adj.) to 7.5% in 2020, 5.3% in 2021 and 6.8% in 2022 (see Figure 5-B), from 6.1%, 5.5% and 5.8%, respectively. Risk factors for our baseline scenario: setbacks in the reopening could delay a recovery in income and consumption, leading to an increase in defaults and indebtedness of households. The impact of the end of temporary stimuli for households (e.g., corona vouchers) on NPLs is also worth monitoring. For non-financial corporations, the same setbacks could prolong liquidity problems, increasing their indebtedness.

Figure 5-A. Total corporate financing (BRL billion, Inflation Adjusted)



Sources: Central Bank of Brazil, Anbima, Santander.

Figure 5-B. Credit Market Forecast – Total Outstanding Loans (%, Inflation Adjusted)



Sources: Central Bank of Brazil, Santander.

Inflation

Food-at-home was, again, a major reason for us to revise our IPCA forecasts further upwards – the drivers remain the same: external and domestic increase in demand increase (change in consumer's basket, because of the pandemic), a devalued BRL and income support (government emergency aid). Industrials are also being impacted by those pressures and, on top of that, the sector is suffering a temporary mismatch between supply and demand, so we raised our forecast for the group too. On services, inflation continues with a very benign dynamic and we have done only a small adjustment, focused on volatile items (mainly airline tickets). Administered prices were the only ones revised downwards, but with no major highlights.

Looking ahead, we continue to believe that most upward pressures will cool down. Consumer's basket should normalize with the economy reopening and income emergency aid should end, adjusting demand. Also, the BRL should appreciate once the fiscal risk reduces (baseline scenario). We have only made an upward adjustment for food in 2021, because we believe the La Niña phenomenon should delay the deceleration for the group. Moreover, we see the supply and demand mismatch being adjusted once Pandemic-related effects fade out. On services, we continue to believe that the high unemployment rate during 2021 (peaking 16%) will keep inflation very well behaved. Finally, on administered prices, we continue to anticipate a pressured inflation, as the postponements of 2020 adjustments on tariff should be compensated in 2021.

To sum up, we revised our IPCA 2020 forecast from 2.30% to 3.30%, IPCA 2021 from 2.70% to 2.90% and kept 2022 at 3.20% -- all still well below the BCB's targets of 4.00%, 3.75% and 3.50%, respectively. It is worth to notice that we continue to see a benign dynamic and good composition (low core measures) for inflation.

On the balance of risks, it is tilted to the upside for 2020, because of all of the pressures cited previously. For 2021, there are risks on both sides: on the upside, La Niña could be even worse and cause losses to the grain harvest – another shock on food would be dangerous, as it would increase the possibility of transmission to other prices; on the downside, weak demand continues as a risk, particularly for services.

Monetary Policy

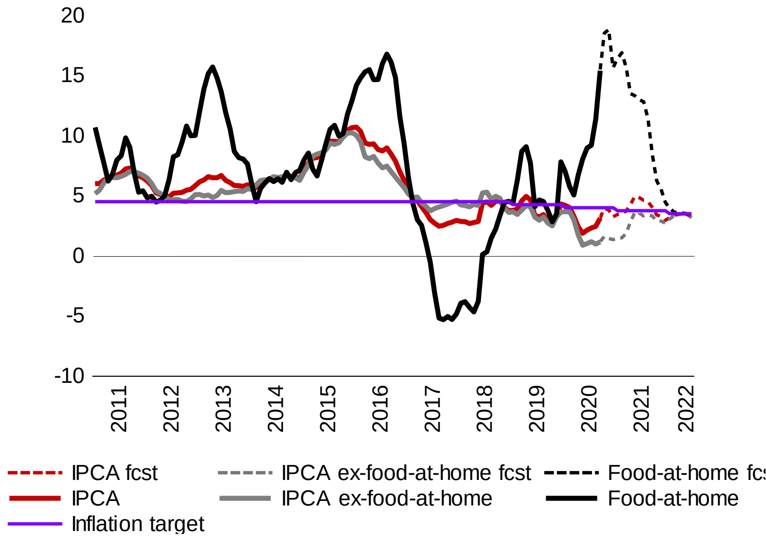
The general perceptions of greater execution risks for the fiscal consolidation process after the Pandemic have definitely influenced recent discussions about monetary policy. In the latest communications, the Brazilian Central Bank (BCB) has become more vocal on the fiscal risks, putting greater emphasis on the (already mentioned) conditionality to keep its forward guidance of no hikes for the foreseeable future. According to the BCB, the latter holds as long as the fiscal regime remains in place, with inflation expectations remain below the target for the relevant policy horizon (medium term) and well-anchored for the long term. Various members of the board have lately indicated that if the fiscal regime is changed, then the forward guidance will be suspended.

While the authority clarifies that the dropping of the forward guidance does not necessarily mean mechanic or immediate rate hikes (that would probably take some time, conditional on the speed of de-anchoring of inflation expectations), the discussion is a reminder of the adverse monetary policy spill overs from a process of fiscal deterioration. In fact, we continue to see an eventual fiscal slippage as the main risk for the monetary policy outlook, leading to stagflation scenario for the medium run.

For the time being, however, fiscal dominance is just an alternative (risk) scenario. In our baseline scenario, we continue to envision a lack of demand-led price pressures for the relevant policy horizon (medium term). Despite an ongoing pickup in headline inflation – mostly on the heels of volatile items (notably food) – the key fundamentals for monetary policy remain well behaved, with inflation expectations below the mid target for the medium run and with the economy expected to keep running below its potential for considerable time. If these conditions do materialize, we cannot help projecting a stable Selic rate (at such an expansionary level of 2.00%) all across 2021.

Thus, our baseline scenario of fiscal convergence (i.e., constitutional spending cap still credible for the coming years, probably backed by reforms) contemplates the start of a gradual removal of monetary stimuli only in 1Q22. Under these circumstances, the BCB would not be behind the curve at that time, and then would have time to adjust the policy rates very gradually, with hikes of 25bps per meeting, until the policy stance is back to neutral (real rate of 3.00%) in 2023. We look for a Selic policy rate of 4.00% at the end of 2022 and 6.00% at the end of 2023.

Figure 6-A. IPCA Inflation and forecast - % YoY



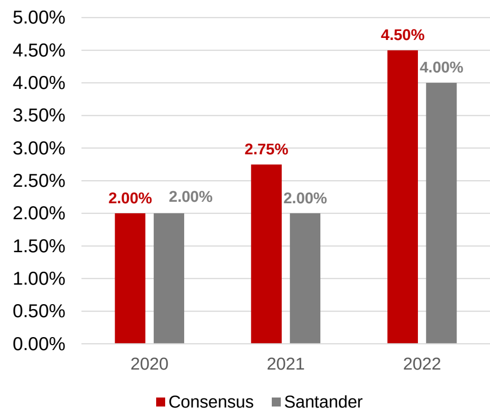
Sources: IBGE, Brazilian Central Bank, Santander.

Figure 6-B. IPCA details - % YoY

	2017	2018	2019	2020e	2021e	2022e
IPCA	**3.0**	**3.8**	**4.3**	**3.3**	**2.9**	**3.2**
Free prices	**1.3**	**2.9**	**3.9**	**4.3**	**2.4**	**2.8**
Food-at-home	-4.9	4.5	7.8	15.6	4.5	2.0
Industrial goods	1.1	1.1	1.7	2.5	1.5	2.7
Tradables	1.0	1.0	1.7	2.5	1.5	2.7
Non-Tradables	1.5	1.9	1.8	2.0	1.4	2.6
Services	4.5	3.4	3.5	1.6	2.1	3.3
Food-service	3.8	3.2	3.8	4.9	3.0	4.0
Airline tickets	3.1	16.9	2.3	-20.8	15.0	12.0
Economic activity	4.2	1.7	2.9	0.3	0.7	2.5
Education	7.6	5.5	5.0	1.2	5.0	6.0
Inertial	2.6	2.8	3.4	2.7	2.0	2.0
Salaries	6.3	3.7	3.2	2.0	1.8	2.5
Administered prices	**8.0**	**6.2**	**5.5**	**0.2**	**4.8**	**4.0**
Gasoline	10.3	7.3	4.0	-3.9	5.0	4.0
Energy	10.4	8.7	5.0	0.2	5.0	4.0
Health insurance	13.5	11.2	8.2	2.5	9.5	4.0
Bus fares	4.0	6.3	6.6	1.8	6.0	4.0
Cores	3.6	3.3	3.5	2.8	2.9	3.2

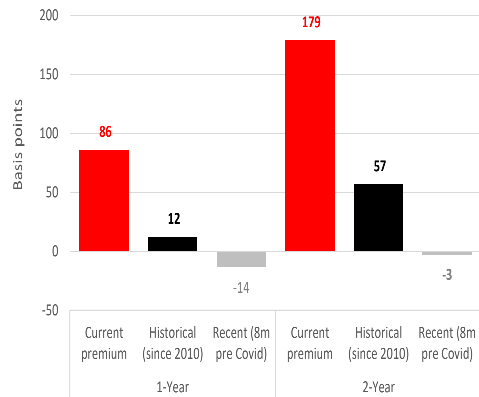
Sources: IBGE, Brazilian Central Bank, Santander.

Figure 7-A: Selic rate expectations (year-end)



Sources: Brazilian Central Bank, Santander.

Figure 7-B: Premium in the front end of the local yield curve



Sources: Brazilian Central Bank, Bloomberg, Anbima, Santander.

Figure 8. Santander's Projections for the Brazilian Economy

Macroeconomic variables		Previous	Current
GDP (%)	2020	-4.8	-4.8
	2021	3.4	3.4
	2022	2.6	2.6
IPCA (%)	2020	2.3	3.3
	2021	2.7	2.9
	2022	3.2	3.2
Selic Rate (% end of period)	2020	2.00	2.00
	2021	2.00	2.00
	2022	4.00	4.00
FX Rate - USDBRL (end of period)	2020	4.90	5.30
	2021	4.60	4.60
	2022	4.15	4.15
Current Account Balance (% of GDP)	2020	-0.6	-0.2
	2021	-0.5	-0.2
	2022	-1.6	-1.4
Primary Fiscal Balance (% of GDP)	2020	-12.6	-12.4
	2021	-3.5	-3.3
	2022	-2.6	-2.4
Gross Public Debt (% of GDP)	2020	95.8	94.9
	2021	96.2	95.3
	2022	98.3	97.4

Source: Santander.

Figure 9. Brazil Forecasts - Santander vs. Consensus Estimates

	2020E						2021E					
	Consensus			Santander			Consensus			Santander		
	A month ago		Last	A month ago		Last	A month ago		Last	A month ago		Last
IPCA Inflation (%)	2.1	↑	3.0	2.3	↑	3.3	3.0	↑	3.1	2.7	↑	2.9
GDP Growth (%)	-5.0	↑	-4.8	-4.8	→	-4.8	3.5	↓	3.4	3.4	→	3.4
Selic policy rate (%, year end)	2.00	→	2.00	2.00	→	2.00	2.50	↑	2.75	2.00	→	2.00
Exchange rate (USD/BRL, year end)	5.25	↑	5.40	4.90	↑	5.30	5.00	↑	5.20	4.60	→	4.60
Current Account (USD billion)	-6	↑	-5	-9	↑	-3	-19	↑	-16	-9	↑	-4
Primary Budget Balance (% GDP)	-12.0	→	-12.0	-12.6	↑	-12.4	-2.8	↓	-3.1	-3.5	↑	-3.3
Net Govt. Debt (% GDP)	67.0	↑	67.7	67.9	↓	67.1	70.0	↑	70.0	72.4	↓	71.6

Note: Based on the BCB's Focus report as of October 23, 2020.

Sources: Brazilian Central Bank, Santander Estimates.

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