Santander
Corporate & Investment Banking

# BRAZIL ECONOMICS

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## Macroeconomic Scenario

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# Scenario Revision: Reaffirming the Recovery but Recognizing the Risks

- **In the Fiscal accounts, the primary deficit and debt continue to increase, owing to the extension of the emergency measures to mitigate COVID-19 effects. We believe that the massive fiscal stimulus will be temporary, but the risk of creating new mandatory spending has increased significantly, which could undermine the fiscal consolidation framework. Hence, progress on fiscal reforms is essential.**
- **As the compliance with the spending cap rule by the federal administration becomes clearer for market participants, we believe the BRL should benefit from constructive conditions currently prevailing abroad, thus leading the FX rate to appreciate from current levels (we estimate USDBRL will reach 4.90, 4.60 and 4.15 by the end of 2020, 2021 and 2022, respectively).**
- **The strong contraction of the Brazilian economy and the gradual process of recovery that we expect in coming years should keep the current account balance running at low levels, on the heels of constrained import and services outlays in tandem with smaller remittances of profits and dividends than in recent years.**
- **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. We are revising our projections for real GDP growth to -4.8%, 3.4% and 2.6% for 2020, 2021 and 2022, respectively (from -6.4%, 4.2% and 3.1% previously).**
- **On inflation, the main surprise has been food-at-home, which led us to raise our 2020 headline IPCA forecast (that now stands at 2.3%). On core-related prices, however, we were surprised to the downside—especially on services. With inflation expectations well anchored and the output gap still wide open, we maintain a benign view on inflation. We keep our 2021 forecast of 2.7% unchanged, and are reducing our 2022 forecast to 3.2% (from 3.50% previously).**
- **Our baseline scenario 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. The BCB's forward guidance hinges on the maintenance of the fiscal regime, so that budget concerns pose the main threat for the monetary policy outlook, in our view.**

## Executive summary

Six months after the announcement by the World Health Organization (WHO) of the coronavirus pandemic, the Santander Macro research department publishes its fourth review of macroeconomic scenarios. On this occasion, we highlight the heterogeneous impact of the crisis on activity, as the consequences are more profound for services and, therefore, the labor market. The global economy will emerge from the crisis with economic, political and social side-effects which will only gradually be fully understood; and thus, we believe that the risks related to our base scenario are increasing, both on the external front (with the possibility of electoral tensions in the USA, hard Brexit, intensification of the trade war between the US and China), and the domestic front (with the possibility of changes in the fiscal regime and postponement of reforms).

The stimuli implemented by several countries were able to mitigate the effects of social distancing and the suspension of productive activities, both on national economies and international trade. With an early contagion cycle, China, Europe and the US have shown a more marked economic recovery than initially forecasted. Brazil is heading in the same direction. The Brazilian economy shrank at a sequential pace of 11.9% in the first half, in line with the least-impacted countries. But we think the worst is over.

The first factor of surprise was in the external sector. Exports were propped up by a record crop harvest, and with firm demand and high prices for agricultural products. International oil prices, initially hit by the price war between Russia and Saudi Arabia, have recovered again. The CRB index for agricultural, mining and metal commodities also performed better than expected between August and September, having already returned to the pre-COVID-19 level on the heels of the global recovery.

The floating exchange rate regime and international travel constraints resulted in an adjustment of the Brazilian external current accounts totaling ~2% of GDP, mitigating the macroeconomic effects of the recession. We observed a sharp drop in imports of goods and services, also reflecting the weakening of the national currency. Due to a less pronounced contraction in domestic demand this year (-5.4%, compared to -7.6% previously) we are revising our forecast of current account balance from +0.1% of GDP to -0.6% of GDP in 2020. Despite the downward revision, the number is still close to equilibrium. We project a converging gradual rise to -1.6% of GDP in 2022, a relatively lower deficit compared with the pre-crisis period.

We are revising our GDP growth forecast for 2020 from -6.4% to -4.8%. We see the external sector contributing positively (1.7 p.p.) to the annual reading. Yet the major factor supporting the Brazilian Economy this year is the fiscal stimulus program, which pumped the equivalent of ~9% of GDP into the economy. The main measure in the stimulus package was income transfers to families. The Emergency Aid reached 67 million people, or 64% of the economically active population, with an average value of BRL845 per beneficiary between April and August. With the surprising reaction of the goods-related sectors, and with the extension of the emergency aid (at half of its previous value per head) until December, we project a more gradual recovery as of 2021, with activity returning to pre-COVID-19 levels no earlier than the 2Q22.

Consumption has been driving the recovery, with a pickup in on-line sales channels and following the increase in income transfers for groups with greater propensity to consume essential goods. Broad retail sales have returned very close to pre-crisis levels. The recovery of the service sector tends to occur more gradually, in the wake of the reopening of the economy and the reopening of services for households, especially education, healthcare, tourism, and leisure, among others. This heterogeneous impact of this crisis should also have consequences for the pace of recovery in 4Q20, as the labor market tracks more closely any developments in the (slow-recovering) service sector.

We assume that the withdrawal of the fiscal stimuli will occur in 2021. Both Emergency Aid and the other programs (such as formal employment support ("*BEm"*), and some credit measures ("*Pronampe"* and "*Pese*") will be discontinued at the end of the year, with the end of the public calamity period and suspension of fiscal rules ("*War budget*") constrained to 2020.

The total transfers planned for 2020 should generate a gain for the "expanded" total income (i.e., including social benefits) by 3.9%, compared to a (counterfactual) 6.0% decrease in the absence of these. Even so, unfortunately about 17 million workers will be jobless at the expected peak of unemployment in May 2021, in our view, with this number gradually falling to 16 million by the end of 2022. The unemployment rate will be sustained above 15% in the period, due to the gradual return of people looking for work after the pandemic.

In our view, monetary stimulus should remain in place for a long time, in line with the high economic slacks and well-anchored inflation expectations. We project the IPCA at 2.3% in 2020, 2.7% in 2021 and 3.2% in 2022, below the inflation target set by the National Monetary Council until 2022, which is set to decline from 4.0% to 3.5% in that period. According to the recent Central Bank communications from the August and September meetings, the flight plan is that the Selic rate will not be raised in the foreseeable horizon if the fiscal regime (spending cap) is maintained, medium-term projections are below the target-level and long-term expectations remain well anchored (around targets). Thus, we see Selic maintained at 2% until the first Copom meeting of 2022.

We expect the withdrawal of fiscal and credit stimulus in 2021 to be compensated by the gradual reopening of services to a sort of “normality” by mid-2021, which in our view removes the risk of a double-dip recession in Brazil. The jump in government spending during the pandemic, which we estimate will reach BRL605 billion, in addition to the drop in revenues, which we calculate at BRL225 billion, should result in a consolidated primary deficit of BRL880 billion, or 12.6% of GDP in 2020. The path of government debt should jump to 95.8% of GDP by end of the year, reaching a peak of 106.8% of GDP in 2027. If our forecasts materialize, government debt will have doubled as percentage of GDP over a 15-year period (2012-2027), an unparalleled movement among emerging countries with high debt levels.

With the gradual normalization of the economy, it will be essential to signal support to contain the trajectory of public debt for the long run. For this end, a necessary (but not sufficient) condition is the viability of the spending ceiling until 2026, at least. The resumption of structural reforms, including tax and administrative reforms, among others, is essential to increase the GDP performance, that is, to the potential growth of the economy. Both an increase in the fiscal effort (to an annual primary surplus not below 1% of GDP) and an acceleration of potential GDP (to somewhere below 2% per year) are essential elements to stabilizing the debt-to-GDP ratio in the long run, in our view.

Our baseline scenario sees the maintenance of the spending cap until 2026, at least. The budget bill for 2021 demonstrated that the fiscal space (assuming a minimum threshold for discretionary expenses) is practically non-existent. Thus, for us to keep compliance with the spending cap as an assumption for the next scenario revisions, we would need to see either the approval of concrete measures to curb mandatory expenses, especially personnel and social security, or additional cuts in the growth of social security outlays in the cumulative amount of BRL130 billion until 2026.

The eventual introduction of a new welfare program would only be compatible with the maintenance of an effective spending cap through the approval of even more comprehensive measures than those already proposed by the government via some draft constitutional amendments (PECs 438, 2018 or PECs 186 and 188, 2019).

In case the policy choice is for easing the spending cap rule to accommodate new expenses—be it for welfare, healthcare or investment—our baseline scenario would no longer hold. Thus, we have updated our alternative scenario, initially simulated in May. The focal point of this simulation now is the fiscal framework. Without an effective spending cap, the convergence of government debt would no longer be assured, anticipating the risk of insolvency in asset prices (yields, FX and real assets) and undermining inflation expectations. In this scenario of macroeconomic disruption, inflation and interest rates start to rise with considerable inertia, bringing the economy to a scenario of low growth, higher inequality and poverty.

It is important to note that the market is beginning to suffer from the lack of visibility in the realm of macro reforms. Despite the substantial (but still partial) improvement in global conditions, domestic financial conditions have been hit by this local (budgetary) uncertainty.

In recent months, the USDBRL exchange rate has shown very strong volatility, and 10-year rates have been above pre-crisis levels despite a reduction of 250 bps in the Selic rate since the arrival of the pandemic in Brazil. Thus, the yield curve remains quite steep (close to 600 bps for some key tenors). The National Treasury will have to roll shorter debt maturities topping BRL1 trillion a year (15% of GDP) in coming years. It will also have to finance primary deficits for at least another seven years, even under constructive assumptions. Thus, the pricing of Brazilian assets is increasingly dependent on external conditions, amid uncertainty related to the long-term solvency of government debt.

The social implications of a hypothetical insolvency scenario are so obscure that we maintain confidence in building consensus compatible with our base scenario, where the country is capable of ensuring the maintenance of the fiscal regime (i.e. the efficiency of the constitutional spending cap) and the return of discussions on structural reforms in Brazil.

However, we highlight the rising risks for the materialization of the alternative scenario, owing to the boldness of the measures that would necessarily need to be approved by the National Congress to ensure the maintenance of the fiscal regime (such as replacement of social programs, freezing wage gains and reducing working hours and wages of public servants, or temporary freezing or untying social assistance benefits from the minimum wage). In addition, the need to expand the reach of social assistance programs in light of increasing poverty and inequality in the post-crisis represents, at This moment, an even greater intensification of such controversies.

## Key Hypotheses in our Baseline Scenario

- 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 possible resurgence of COVID-19 cases during winter in the Northern Hemisphere, we assume that the main economies will maintain a gradual reopening of businesses, overall (this assumption remains consistent with scattered episodes of selective isolation). Our scenario takes for granted no escalation of geopolitical tensions between the largest economies, especially the "trade war" between USA and China. 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 (our previous scenario assumed "normality" for 4Q20), as a large scale vaccination takes place worldwide;

- 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 RBL100 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 consider federal expenses running 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 generalized 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.

- 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

The massive government measures to mitigate the (economic and sanitary impact of the) outbreak of COVID-19 continue to deteriorate Brazilian fiscal accounts. On the revenue side, the favorable effects from a "better" GDP outlook for 2020 (see Economic Activity section) is partially offset by the major use of tax credits and longer-lasting tax exemptions. Thus, we continue to estimate primary revenue losses of BRL210 billion for this year, compared to the pre-pandemic outlook. On the expenditures side, we now incorporate the emergency aid extension for informal workers and low-income households at BRL300 stipend per month for the last four months of the year, which would imply in almost BRL100 billion additional cost for the public coffers.

Our base scenario assumes that the wide set of primary fiscal spending measures to fight the pandemic will add up to BRL605 billion (8.7% of GDP), higher than EM average (5.2%). Accordingly, we now foresee the 2020 public sector primary fiscal deficit at BRL880 billion (12.6% of GDP)—worse than our previous scenario (BRL845 billion, or 12.2% of GDP). For 2021 and 2022, we continue to expect primary fiscal deficits to reduce gradually (see Figure 1-A).

Gross debt is expected to reach 95.8% of GDP in 2020, by our calculations, up ~20 p.p. from 2019. For 2021, we now consider the possibility of BNDES[1] to repay up to BRL100 billion in loans owed to the federal government, which would maintains the debt virtually stable at 96.2% of GDP (see Figure 1-B). More importantly, we expect the indicator to peak only

[1] Brazil's federal development bank

in 2028[2] at ~107%, ~30 p.p. higher compared to the pre-pandemic estimate. Subsequently, our scenario estimates convergence towards ~95% of GDP by 2035.

This scenario takes as a crucial assumption that the fiscal expansion this year will be (almost entirely) limited to 2020.The main risk to our scenario is the possibility of creating a new permanent expense, causing a breach in the spending cap (the main fiscal anchor, in our opinion). Lastly, it is important to reiterate that our base scenario does not anticipate an unsustainable trajectory in public sector debt, reflecting of our fundamental hypothesis that the country will remain credibly committed to the fiscal consolidation agenda, especially the spending cap framework. With reforms, low levels of interest rates and better potential GDP growth would also favor the debt dynamics.

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

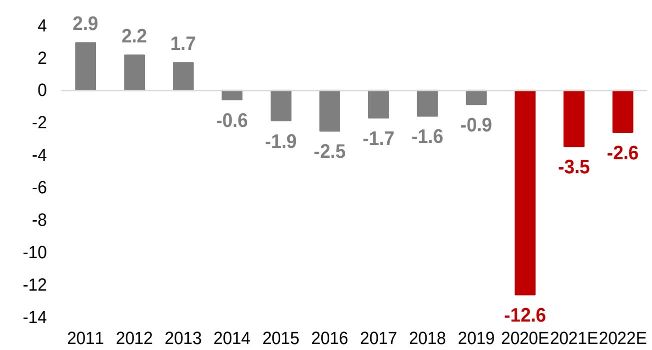
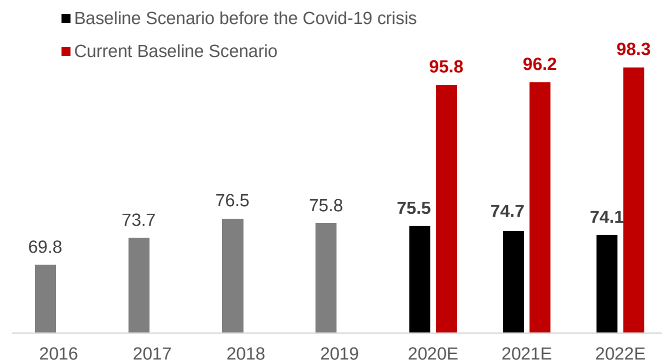



**Figure 1-B. Gross General Govt. Debt (% GDP)**




Sources for both charts: Brazilian Central Bank, Santander.

## External Sector and Exchange Rate

When we assess some variables that usually influence the behavior of the Brazilian FX rate, it is easy to perceive that the current level is much weaker than it should be in scenarios of economic normality (or stability). According to our econometric simulations, the current quotes of commodity prices, CDS spreads, interest-rate differential and risk aversion, among others, indicate the FX rate should be trading below USDBRL5.00. In our opinion, the bulk of the divergence to the actual level of the currency has to do with the uncertainty regarding the fiscal balance for the coming years, which introduces a premium to the “fair” level.

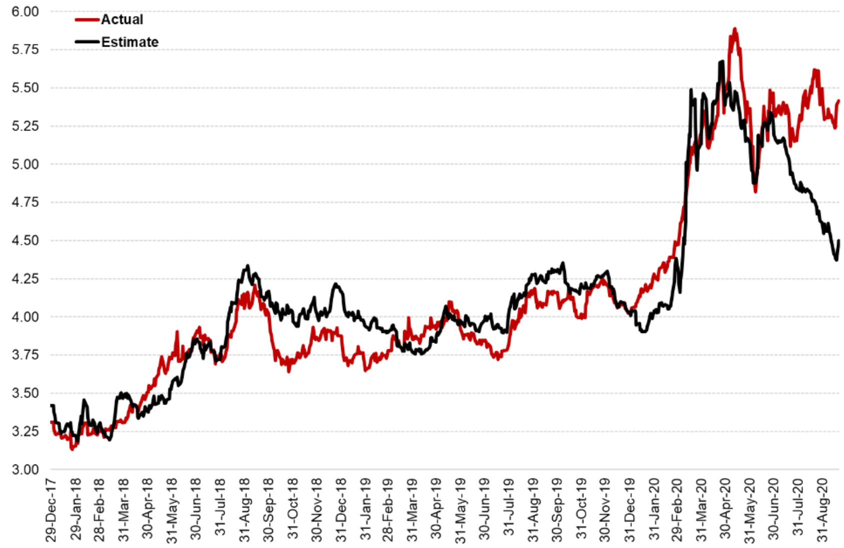
However, as we assume that the federal administration should abide by the spending cap rule in the coming years—thus reinforcing its commitment to fiscal discipline after the necessary increase in public spending registered this year to fight the economic fallout of the pandemic—we think this difference should narrow. Hence, under this key assumption, we project the BRL to strengthen against other currencies in the coming quarters, with USDBRL ending at 4.90, 4.60 and 4.15 in 2020, 2021 and 2022, respectively.

Beside the reduction in the concern regarding the conduct of fiscal policy, we think the expected maintenance of a sound situation in the Brazilian balance of payments should also help to improve the perception regarding the currency. On the heels of the economic contraction that the economy has lived and the gradual recovery we foresee for the coming years, imports and services outlays and remittances of profits and dividends are likely to run at much lower levels than in recent years, in our view.

At the same time, the strong demand for edible items—especially grains and animal proteins, among other products—have led exports proceeds to register a favorable performance, and prices in futures markets indicate this situation is unlikely to change soon. Consequently, the significant reduction in the current account balance (in 12-month-to-date terms) the country has seen of late should persist for this year and next. In 2022, as we expect the economy to get back to a situation closer to its old normal, we think services outlays and the remittances of profits and dividends should increase, thus causing the current account deficit to enlarge, but at a level still below the net inflow of direct investments in the country—i.e., without turning into a source of concern as far as external financing needs are concerned.

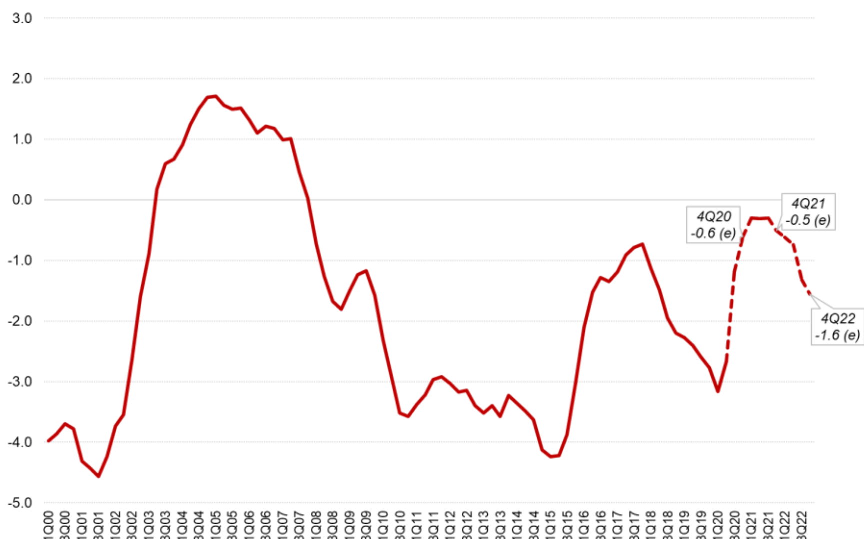
[2] According to our simulations, the stabilization of the gross public debt-to-GDP ratio at ~107% would require a primary fiscal surplus of (at least) 1% of GDP.

**Figure 2. USD/BRL – Actual FX Level vs. Estimated FX Level (Based on Global Conditions)**




Sources: Bloomberg, Santander.

**Figure 3. Current Account Balance (12m, % of GDP)**




Sources: Brazilian Central Bank, Santander.

## Economic Activity

The releases of economic activity indicators for the last three 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; 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, keeping the economy relatively positioned for a continued recovery amid a socially stable environment. As a result, we are revising our projections for real GDP growth to -4.8%, 3.4% and 2.6% for 2020, 2021 and 2022, respectively (from -6.4%, 4.2% and 3.1% previously).

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

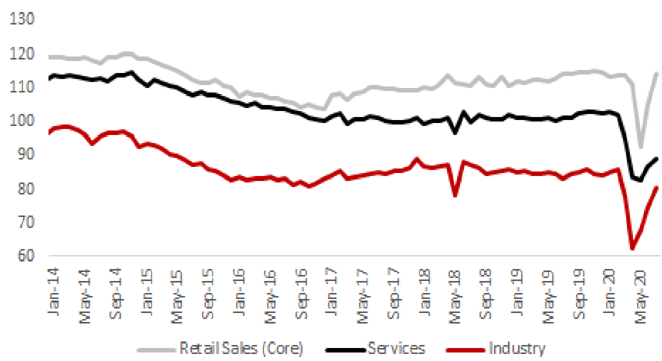
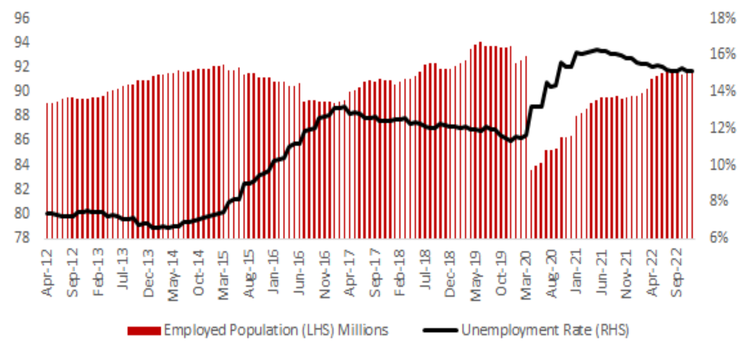



**Figure 4-B. Labor Market Conditions and Forecasts (SA)**




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.

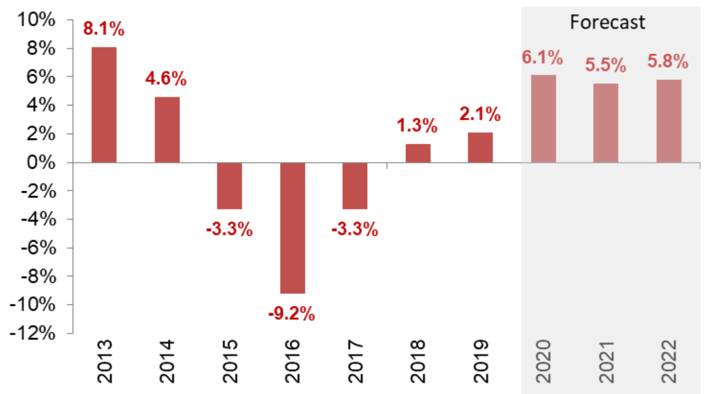
Regarding labor market conditions, on the heels of the social-distancing-measures easing, we expect the labor force to reach pre-crisis levels in the second quarter of 2021. In this context, a sharp increase in the unemployment rate is unavoidable in our view (see Figure 4-B): we expect it to reach an annual average of 13.4 % in 2020 and 16.1% in 2021, with a slow decrease to 15.3% in 2022.

In an analysis of the impacts of emergency aid on the real wage bill, considering government stimulus to households, 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.

Recent data from the Central Bank of Brazil indicate that the household lending rebound might be losing momentum. Recovery from now on should follow the trend of economic activity. Credit to non-financial corporations continues to increase, reflecting expansion both in non-earmarked credit for working capital and in earmarked through government fiscal measures. Interest rates for households and non-financial corporations continue to fall. For default rates, emergency aid and renegotiations with creditors seem to keep it under control.

We estimate the total portfolio balance to grow 6.1% in 2020, 5.5% in 2021 and 5.8% in 2022. Risk factors for our base scenario: setbacks in the reopening could delay recovery in income and consumption, leading to an increase in defaults and indebtedness of households. For non-financial corporations, the same setbacks could prolong liquidity problems, increasing their indebtedness.

**Figure 5. Credit Market Forecast – Total Loan Balances (%, Inflation Adjusted)**




Sources: Brazilian Central Bank, Santander.

## Inflation

Since our last scenario revision in June, the most important quantitative surprise was in food-at-home inflation, which has been pressured by 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). Another upward surprise was on industrial goods. Our hypothesis of a fall in prices because of the weak demand worked well on the first months of the pandemic, but then the income support and change in consumer's basket allowed for a small acceleration (backed by a small pass-through). On the other side, services surprised to the downside, as the economy is opening more gradually than we anticipated. Also, administered prices were more or less in line with what we were expecting.

Looking ahead, food-at-home inflation should decelerate considerably. Industrial goods should continue recovering, but just to the levels they were hovering at before the pandemic. The appreciation of the BRL that we anticipate should apply downward pressure to those two groups. More important, services should start to recover once the economy becomes more open, but at a very gradual pace, as it is highly dependent on the job market which in our view should be weaker than it was pre-pandemic. Finally, administered prices should be a source of upward pressure as some of these prices were repressed this year and thus should be compensated in the next tariff revision cycles. This composition of quick food-at-home deceleration with very gradual recovery of services should keep core prices with a very benign dynamic.

We increased our 2020's IPCA forecast from 1.5% in June to 2.3%. For 2021 we keep our forecast of 2.7% IPCA inflation, but we now reduce our 2022 forecast to 3.2%—below the 3.5% target, as the output gap should continue negative until then. On the balance of risks, we see it tilted to the upside for 2020, because of food inflation and a possible stronger rebound of services/industrial goods once economy reopens more. For 2021 and 2022 we continue to see the risks tilted to the downside, mainly because of the weak demand (negative output gap closing very gradually).

## Monetary Policy

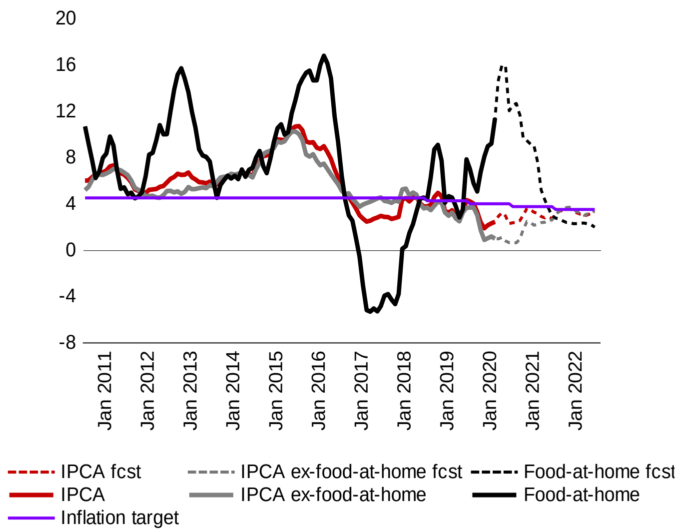
For the first time since June 2019, the Copom held the Selic rate (at its historical low of 2.00%) in the September meeting. In the statement, the BCB reaffirmed its forward guidance, sticking to a flight plan with rate steady at 2.00% or below for the foreseeable horizon. The committee took the opportunity to justify the use of this communication as a complementary policy tool "to provide the monetary stimulus deemed adequate to meet the inflation target, but maintaining the necessary caution for prudential reasons," given restrictions imposed by the effective interest-rate lower bound.

In the scenario assessment, the BCB sees a recovery in major economies and lower volatility in asset prices prompting a favorable backdrop for emerging economies. The Brazilian recovery is seen as "partial" and similar to other nations. The BCB still refers to an asymmetry with the depression in sectors "directly affected by social distancing measures" (services) and continues to mention doubts about the recovery as stimulus fades later this year. The Copom expects higher inflation in the short term on temporary pressures in food and services. But core inflation is still seen below the mid-target for the relevant policy horizon. Official inflation projections continue to point to CPI below or in line with the target for key horizons (mostly 2021, but increasingly 2022).

Given the below-target inflation and below-potential activity, our baseline scenario contemplates a stable Selic rate at 2.00% until 1Q22, when we see the start of a gradual removal of stimuli. Importantly, the key assumption here is an expected compliance with the constitutional spending cap, which plays a decisive role in keeping inflation expectations well anchored.

If important changes in the fiscal regime take place, putting at risk the credibility of the post-pandemic fiscal consolidation process, then the conditions for the forward guidance would be breached, imparting considerable upside risks for inflation and interest rates in the medium term. We see fiscal risks as the key threat for the interest rate outlook.

**Figure 6-A. IPCA Inflation and Forecast - % YoY**



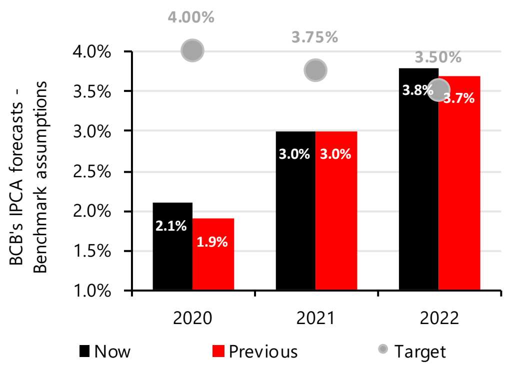

Sources: IBGE, Brazilian Central Bank, Santander.

**Figure 6-B. IPCA Inflation and Forecast - % YoY**

| | 2018 | 2019 | 2020E | 2021E | 2022E |
|---|---|---|---|---|---|
| IPCA | **3.8** | **4.3** | **2.3** | **2.7** | **3.2** |
| Administered | 6.2 | 5.5 | 0.7 | 4.8 | 4.0 |
| Free | 2.9 | 3.9 | 2.9 | 2.1 | 3.0 |
| *Services* | 3.4 | 3.5 | 1.1 | 2.2 | 3.8 |
| *Industrial goods* | 1.1 | 1.7 | 0.4 | 1.5 | 2.2 |
| *Food-at-home* | 4.5 | 7.8 | 12.0 | 3.8 | 2.0 |
| EX3 core | 2.2 | 2.9 | 1.2 | 2.5 | 3.3 |

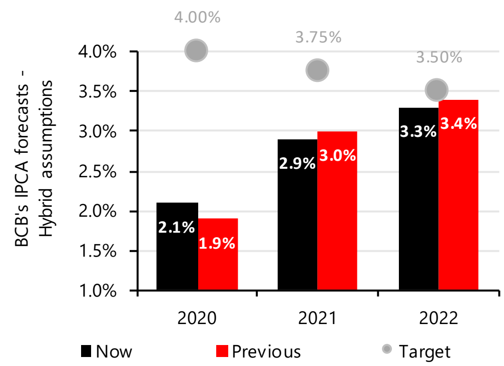
Sources: IBGE, Brazilian Central Bank, Santander.

**Figure 7-A: BCB Inflation simulations – Benchmark Scenario**




Sources: Brazilian Central Bank, Santander.

**Figure 7-B: BCB inflation simulations – Hybrid Scenario**




Sources: Brazilian Central Bank, Santander.

## Figure 8. Santander's Projections for the Brazilian Economy

| Macroeconomic variables | | Previous | Current |
|---|---|---|---|
| GDP (%) | 2020 | -6.4 | -4.8 |
| | 2021 | 4.2 | 3.4 |
| | 2022 | 3.1 | 2.6 |
| IPCA (%) | 2020 | 1.5 | 2.3 |
| | 2021 | 2.7 | 2.7 |
| | 2022 | 3.5 | 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 | 4.95 | 4.90 |
| | 2021 | 4.50 | 4.60 |
| | 2022 | 4.15 | 4.15 |
| Current Account Balance (% of GDP) | 2020 | 0.1 | -0.6 |
| | 2021 | -0.3 | -0.5 |
| | 2022 | -0.4 | -1.6 |
| Primary Fiscal Balance (% of GDP) | 2020 | -12.2 | -12.6 |
| | 2021 | -3.4 | -3.5 |
| | 2022 | -2.5 | -2.6 |
| Gross Public Debt (% of GDP) | 2020 | 94.8 | 95.8 |
| | 2021 | 96.0 | 96.2 |
| | 2022 | 96.9 | 98.3 |

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 (%) | 1.7 | ↑ | **2.0** | 1.5 | ↑ | **2.3** | 3.0 | ↑ | **3.0** | 2.7 | → | **2.7** |
| GDP Growth (%) | -5.5 | ↑ | **-5.1** | -6.4 | ↑ | **-4.8** | 3.5 | → | **3.5** | 4.2 | ↓ | **3.4** |
| Selic policy rate (%, year end) | 2.00 | → | **2.00** | 2.00 | → | **2.00** | 3.00 | ↓ | **2.50** | 2.00 | → | **2.00** |
| Exchange rate (USD/BRL, year end) | 5.20 | ↑ | **5.25** | 4.95 | ↓ | **4.90** | 5.00 | → | **5.00** | 4.50 | ↑ | **4.60** |
| Current Account (USD billion) | -6 | ↓ | **-6** | 1 | ↓ | **-9** | -16 | ↓ | **-18** | -4 | ↓ | **-9** |
| Primary Budget Balance (% GDP) | -11.6 | ↓ | **-12.0** | -12.2 | ↓ | **-12.6** | -2.7 | ↓ | **-2.8** | -3.4 | ↓ | **-3.5** |
| Net Govt. Debt (% GDP) | 67.0 | ↑ | **67.3** | 67.5 | ↑ | **67.9** | 69.7 | ↑ | **69.9** | 71.8 | ↑ | **72.4** |

Sources: Brazilian Central Bank, Santander Estimates.

## Appendix: Hypothetical Scenario – A Breach in the Constitutional Spending Cap

Uncertainty remains high, reflecting the economic damage from the pandemic and the policy reaction afterwards. We recognize that the worst of the crisis may be behind us, and there is a more positive outlook for recovery in global and domestic activity. Yet this recovery has taken place in a very heterogeneous way between sectors and should have consequences for the future scenario, especially in the job market. A significant part of this recovery is due to fiscal stimulus measures, mainly income transfers. In a brief analysis that we sent recently ("The Real Wage Bill and the Impact of Emergency Aid" – dated September 16) we could observe that the government transfers more than offset the fall in income this year.

Thus, due to the positive effect of fiscal stimulus on activity, there is likely to be pressure for the extension of or an increase in the welfare transfer programs. In other words, there could be pressure to create new mandatory expenses, which is the biggest risk for our base scenario if it is not accommodated in the fiscal framework (especially under the spending cap limit—the main fiscal anchor). Our base scenario considers an increase in fiscal transfers, but the main hypothesis is that it would be financed by reducing other expenses in order to create a more robust program. In our baseline scenario, the spending cap remains intact (in terms of effectiveness) at least until 2022.

Considering the risk of having a breach in spending cap, we consider below a hypothetical scenario in which the new income program is removed by the spending cap limit, thus adding BRL70 billion in new permanent expenses, basically doubling the budget of the current program ("*Bolsa Família*"). The increase in expenses would be partially financed by a tax increase in the amount of BRL30 billion (taxing dividends or changing personal income tax), in this hypothetical scenario. This scenario adds on average 1.0 percentage point (of GDP) in terms of primary deficit per year over time.

Since the spending cap is just a tool to credibly signal to the markets a will of the Brazilian government to comply with the budgetary restriction and stabilize debt over time, a breach of this long-term commitment could add risk to the way financial markets see the debt outlook going forward. The latter could help make the conditions for debt dynamics even more difficult, given a possible building of premium in financing rates as well as a considerable downward effect on potential GDP growth.

Considering this hypothetical stressed scenario, Brazilian public debt would rise continuously over time (i.e., public debt insolvency); for example, we estimate the gross public debt-to-GDP ratio would jump to around 160% of GDP by 2035 in this case. The worsening would be partially offset by the tax increase, but it affects other macro variables influencing debt dynamics (i.e. higher interest rates, slower GDP growth); and consequently, the trajectory might become explosive.

In this alternative scenario, the deterioration in the fiscal (and particularly the debt) outlook would lead to considerable revisions of broader macroeconomic forecasts by analysts, as well as a massive formation of risk premium in Brazilian asset prices.

In this difficult environment, especially from a funding standpoint, the market could anticipate the emergence of a new regime, where the inflation tax starts to help bridging the fiscal gap—leading to higher inflation expectations. For a low-savings, low-growth emerging economy such as Brazil's, the fiscal risks could limit the capacity to tap foreign savings (to fund a current account deficit). Thus, amid a potential drought in foreign funding and considering the redemptions of foreign debt in time, the (nominal) FX rate would have to see a sell-off to a level weak enough to generate a very high current account surplus (with no productivity gains to help boost export volumes) in order to compensate for the scarce currency inflows.

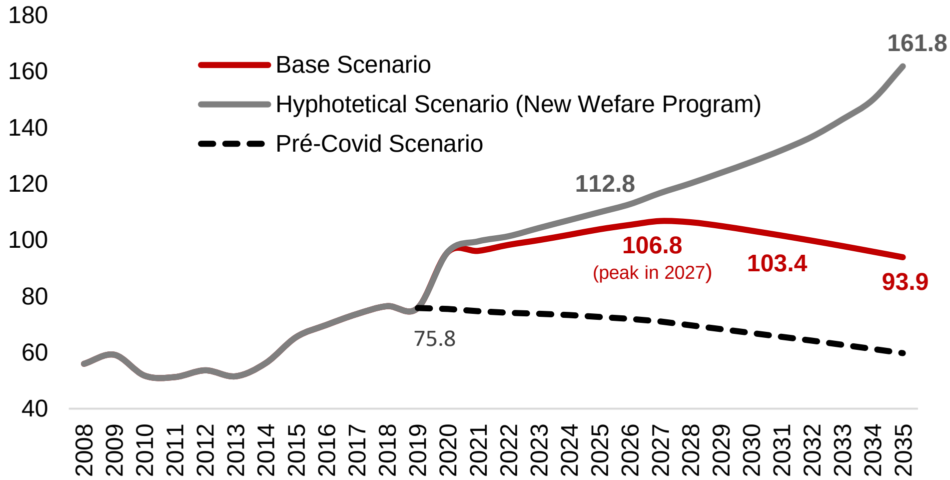
Higher nominal yields and a weaker FX rate would then prompt considerable deterioration in financial conditions, weighing on domestic demand. Along with a lack of structural reforms to improve the business environment for Brazilian firms, this type of scenario might cause the post-pandemic recovery and the structural growth of the economy to stall.

Despite the existing slacks in the economy, inflation pressures could intensify in time, as unanchored expectations make the price trends more susceptible to temporary shocks in relative prices, be if from the FX rate or other volatile items (such as food). In other words, the loss of anchoring owing to the fiscal deterioration would make the impact of temporary inflation shocks permanent. In this context, the central bank is naturally seen pushing interest rate higher, but the lack of fiscal controls would limit its capacity to fight the accelerating inflationary pressures. Thus, a stagflation period could well be in the making under such a scenario.

Hard to determine the speed of this process, as it could also depend on the global context—e.g., global risk-on scenarios (maybe accompanied with rising commodity prices) could lead to some degree of complacency in the markets for some time. Yet the directions are clear. At the same time, the process could be magnified and sped-up if it occurs simultaneously with a worsening global backdrop for EMs.

All in all, this merely hypothetical exercise is a way to justify why we see compliance with the budgetary constraint as a key element in guaranteeing macro stability in the years to come.

**Figure 10. Gross Government Debt Projections in Baseline and Alternative Scenarios (% GDP)**



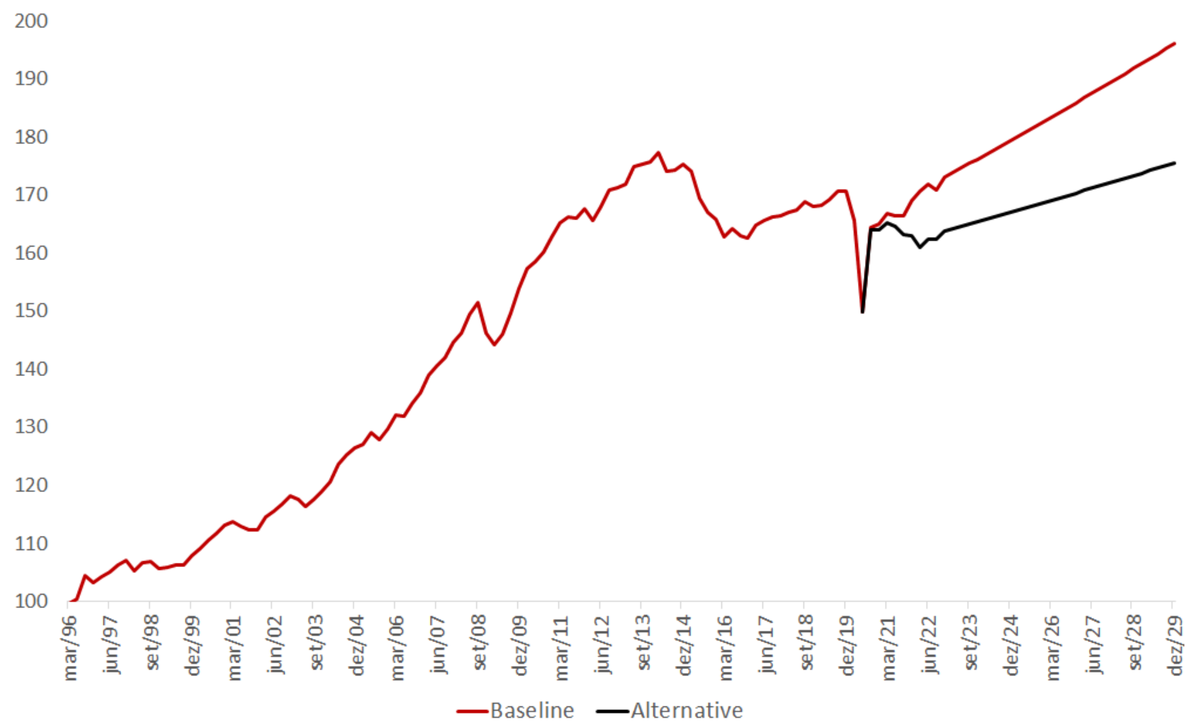

Sources: National Treasury Secretariat, Brazilian Central Bank, Santander.

**Figure 11. Brazilian Economy in an Alternative Scenario - Santander's Projections**

| Macroeconomic variables | | Alternative |
|---|---|---|
| GDP (%) | 2020 | -4.8 |
| | 2021 | 1.4 |
| | 2022 | 1.1 |
| IPCA (%) | 2020 | 2.3 |
| | 2021 | 4.5 |
| | 2022 | 6.5 |
| Selic Rate (% end of period) | 2020 | 2.00 |
| | 2021 | 6.00 |
| | 2022 | 9.00 |
| FX Rate - USDBRL (end of period) | 2020 | 5.10 |
| | 2021 | 6.70 |
| | 2022 | 6.70 |
| Current Account Balance (% of GDP) | 2020 | -0.7 |
| | 2021 | 1.3 |
| | 2022 | 4.3 |
| Primary Fiscal Balance (% of GDP) | 2020 | -12.6 |
| | 2021 | -4.7 |
| | 2022 | -3.9 |
| Gross Public Debt (% of GDP) | 2020 | 95.8 |
| | 2021 | 98.5 |
| | 2022 | 102.4 |

Source: Santander.

**Figure 12. Brazil’s Real GDP Overtime – Baseline Vs Alternative Scenarios – Santander’s Projections**




Source: Santander.

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