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BRAZIL MACRO

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SCENARIO REVIEW

IMPROVEMENT IN THE SHORT TERM, CAUTION FOR THE MEDIUM TERM

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- Amid persistently high Covid-19 infections, hospitalizations, and casualties, on a positive note the immunization process is picking up in Brazil. Assuming a rate of 1.5 million vaccinations per day in the coming months, the entire adult population would be fully immunized by year-end. That assumption is key to our scenario of a broader reopening of the economy in 2H21 and a “normalization” by the end of the year.
- We are “upgrading” our fiscal numbers, owing to a higher inflation and better terms of trade than we expected. We are revising our primary deficit estimate to 1.9% of GDP in 2021 (from -3.0% of GDP), based on a more robust revenue recovery and extra-cap expenses at 1.6% of GDP. We are also lowering our gross debt-to-GDP estimate to ~82% (-2.8 p.p.). For the long-term debt outlook, we continue to expect a risky path to consolidation.
- We are revising our year-end 2021 FX forecast to USD/BRL5.05 from USD/BRL5.25, based on market perceptions of lower fiscal risks in the short term and a faster monetary policy normalization. However, we are keeping our year-end 2022 FX forecast at USD/BRL5.55, given our assumption of slow progress in macro reforms and a stronger USD against global currencies.
- The trade balance and current account continue to be supported by a weak BRL, robust external demand, and high commodity prices. However, we believe the improved outlook for Brazilian GDP should lead to larger remittances of profits and dividends, along with outlays for services. Hence, we now expect the current account balance to register deficits of US$7.8 billion and US$12.4 billion in 2021 and 2022 vs. our previous estimates calling for surpluses of US$4.9 billion and US$2.5 billion.
- We are raising our 2021 GDP estimate to 5.1% from 3.6% following solid 1Q21 GDP growth and a more rapid recovery in mobility. In our view, the outlook for 2H21 has improved due to heightened expectations regarding the pace of economic reopening and support from higher commodity prices. The lingering positive effects from strong raw materials prices in conjunction with the outlook for a fully operational economy also motivated our upward revision for 2022 GDP to 2.0% from 1.5%.
- We still expect the vaccine rollout and urban mobility to be crucial for a recovery in the labor force and employment in the coming months, with sectors more reliant on social interaction gaining traction. Our average unemployment rate estimates are unchanged at 14.2% for 2021 and 13.6% for 2022.
- Once again, we are raising our inflation forecasts. For 2021, we now project IPCA at 6.7% (previously 5.9%); for 2022, we project 4.0% (previously 3.9%). Our revisions follow higher electricity costs, stronger effects of industrial shocks, and a spread of primary shocks to services.
- We now expect an even more front-loaded monetary policy adjustment, with our year-end 2021 Selic rate forecast revised to 7.00% (previously 6.50%). We see that as the neutral level, also prevailing for 2022 and 2023. The path to neutrality still seems a bit uncertain, but our inflation forecast looks consistent with a 100-bp Selic hike at the August 3-4 Copom meeting.

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Figure 1. Santander Macro Forecasts for Brazil – Summary

Macroeconomic variables		Previous		Current
GDP (%)	2021E	3.6	↑	5.1
	2022E	1.5	↑	2.0
	2023E	1.8	↓	1.5
IPCA (%)	2021E	5.9	↑	6.7
	2022E	3.9	↑	4.0
	2023E	3.3	→	3.3
Selic Rate (% end of period)	2021E	6.50	↑	7.00
	2022E	7.00	→	7.00
	2023E	7.00	→	7.00
FX Rate - USDBRL (end of period)	2021E	5.25	↓	5.05
	2022E	5.55	→	5.55
	2023E	5.20	→	5.20
Current Account Balance (% of GDP)	2021E	0.3	↓	-0.5
	2022E	0.2	↓	-0.8
	2023E	-0.5	↓	-1.0
Primary Fiscal Balance (% of GDP)	2021E	-3.0	↑	-1.9
	2022E	-2.1	↑	-1.7
	2023E	-1.6	↑	-1.3
Gross Public Debt (% of GDP)	2021E	85.0	↓	82.2
	2022E	87.6	↓	84.3
	2023E	90.0	↓	87.2

Source: Santander estimates.

EXECUTIVE SUMMARY: The Commodity Cycle

The recent improvement in Brazilian markets is a consequence of the faster-than-expected worldwide recovery from the COVID-19 pandemic, the resultant global economic recovery, and the significant rise in commodity prices. As a commodity-exporting country, Brazil has benefited from gains in terms of trade, which quickly softened several negative effects of COVID-19 from a macroeconomic perspective.

Importantly, we have seen substantial progress in the global vaccination process. Consequently, the main economies are reopening and thus have a better outlook for a faster and more solid cyclical economic recovery. The World Bank forecasts global GDP to expand roughly 10% in the years 2021-22, thus reaching a level only 2% below the one prior to the onset of the pandemic.

This is an economic recovery based on synchronized massive stimuli (both fiscal and monetary) in most countries, which are estimated to have exceeded US$10 trillion, nearly four times the incentives provided during the global financial crisis of 2008-09. Moreover, it is worth mentioning that new stimuli measures introduced in 2020-21 were provided in a context where the 2008-09 stimuli had not been fully withdrawn from most economies.

In addition, the recovery has been quite heterogeneous across economic segments, with similarities in the initial shocks on both the demand and supply sides. High-income families are gradually resuming consumption of services, using part of the savings accrued during the periods of social distancing. Lower-income families, whose members were affected the most by social distancing measures, continue to allocate governmental income transfers to essential goods consumption. Companies, for their part, are reducing some of the liquidity used during the crisis, protecting their cash flow in times of great uncertainty, amid logistical restrictions and a shortage of the raw materials needed to resume production.

Given the disruption and disorganization in the global chain of production and consumption, in a context of elevated global liquidity levels, commodity prices rapidly increased, resulting in more intense inflationary pressure in foodstuffs and industrial goods. In addition, we believe advanced economies probably will maintain high levels of stimuli for some time until labor markets "normalize". That is, we think they will tend to accept higher inflation rates, seen as temporary, to allow faster job creation.

The main emerging economies, including Brazil, have already started to withdraw stimuli, owing to macroeconomic weakness and greater fiscal constraints. Nevertheless, the accelerated recovery scenario and the recent gains in terms of trade have made markets more optimistic. Undoubtedly, this is good news, especially for the 8.5 million people who have lost their jobs or who have not yet been able to return to the work force.

The **first good news** came from the 1.2% growth during 1Q21, which was above market expectations. GDP was positively affected by commodities production, with record crops (soybeans and corn, in particular), along with strong demand for animal proteins (especially due to Chinese demand, following the impact of African swine fever in that country) and for iron ore. However, given the distortions in the seasonal adjustment processes brought on by the COVID-19 pandemic, with growth concentrated in some sectors, we believe it is not correct to simply extrapolate the positive result observed in 1Q21 to the rest of the year.

As mentioned, we are revising our GDP forecasts to 5.1% for 2021 and 2.0% for 2022, from 4.8% and 1.5%, respectively. In addition, we estimate that the output gap will be fully narrowed in 4Q23. In order for our 2021 forecast to materialize, it will require a sound performance of household consumption in the period (we estimate an increase of 4.5%). This implies that the drop in the "extended" real wage bill (including government transfers) of 5.7% will need to be offset by the "use" of savings accumulated during 2020 and double-digit growth of credit to households. Nonetheless, with the increase in household indebtedness and higher interest rates, we expect slower consumption next year (up by 2%).

The **second good news** came from a decrease in the markets' fiscal risk perception, with lower estimates for debt-to-GDP in 2021 due to the price-shock effect. We are revising our 2021 estimate for the debt-to-GDP ratio to 82.2% from 85%, with the gauge peaking at 93.7% in 2027, instead of at the level of ~105% projected last year in the worst period for the fiscal account forecasts. Although the margin is significantly above the pre-pandemic indicators, there was a clear improvement, prompted by more inflation (we estimate the GDP deflator at 10% this year, converging to 3%, below the IPCA, in 2023) and by the outlook for a faster cyclical recovery, supported by commodity-producing sectors. On the one hand, Brazil escaped from the latent risk of an explosive debt trajectory; however, on the other, the country has not yet ensured secure fiscal consolidation, although it has gained more time to achieve that, in our opinion.

The **third good news** is that the accelerating vaccination process in Brazil makes it feasible to forecast that 90% of the population should be vaccinated by the end of this year. In our view, this will enable the gradual return of the services sector and reduce the risks of a new overload on the health system, even with the eventual spread of new and even more resistant variants of the coronavirus. Thus, we estimate the seasonally adjusted unemployment rate to reach 14.3% of the work force in 2Q21 and 14.0% at the end of 2021, a historically high level but lower than initially expected.

However, there are important points of attention (and caution) in this cyclical recovery.

First, climate issues will affect GDP in 2H21, because of both the downward revision for the *"SAFRINHA"* (largest corn crop in the country) and the drought affecting electricity prices and water availability in some regions, with possible impacts on the harvesting of next year's crop. As mentioned, we are revising our agricultural GDP forecast to 3.4% from 2.2% for 2021 and to 2% from 1.8% for 2022, but we do recognize the downside risks.

Second, the inflation scenario has deteriorated; we are raising our forecasts to 6.7% for 2021 and 4.0% for 2022, converging toward the center of the target only in 2023 (at 3.25%). The inflationary shock, largely resulting from pressure on commodity prices, the depreciation of the BRL through 1Q21, and the breakdown of global supply chains, pushed wholesale price increases in June 2021 to 45.4% YoY in the industrial segment, 53.3% YoY in the agricultural segment, and 16.9% YoY in the civil construction business. In our view, this inflationary pressure at the wholesale level should feed through to sectors that faced problems in their production chains and whose demand allows them to adjust their prices. As a result, these inflationary pressures indirectly (via secondary effects) may contaminate prices in the services sector when activity in the sector resumes more widely.

Third, inflationary pressures have had a significant positive impact on public tax collection, which benefited from higher government revenue, recovery of margins in the export sectors, and the advance of digital commerce (less subject to tax dodging). The nominal growth of 28.5% in federal tax collection through May in YDT terms and the 21.6% increase in the states' tax revenue should lead to a smaller primary deficit of 1.9% of GDP in 2021, per our forecasts. Part of this increase in tax collection comes from real gains related to better terms of trade (resulting in a permanent increase in revenue estimated at 0.1 p.p. of GDP per year), yet most of the effect is due to inflation's temporary but substantial impact. See details in the link[1].

Fourth, the reduction in the idiosyncratic risk associated with the serious fiscal situation allowed the BRL to appreciate, with the exchange rate moving from USD/BRL5.82 at the year's peak (early in March) to ~4.90 at the end of June. We are revising our exchange rate forecast to a lower level for year-end 2021 (to USD/BRL5.05 from USD/BRL5.25) and maintaining our projection at USD/BRL5.55 for 2022, largely due to uncertainties associated with the electoral cycle, but also owing to the relative strengthening of the USD with the beginning of the withdrawal of stimuli in advanced economies. We see the commodity cycle starting to decelerate, returning in 2023 to the long-term trend seen before the pandemic crisis.

[1] **Santander Brazil Fiscal Policy - *"Fiscal Accounts: Pandemic Impact, Price Shock Contribution, and Outlook"* –** June 15, 2021 - Available on: http://bit.ly/Std-special-fiscal-061521

Thus, we foresee softening of tax revenue in the coming months. In our view, the BRL's appreciation at the margin and the beginning of the weakening of commodity prices will tend to subtract part of the higher profits of sectors benefiting from the current export cycle. In addition, we expect costs to increase considering the high level and pressure of wholesale price increases, which has not been fully incorporated in companies' results. Furthermore, companies' profit margins could be affected by rising financial costs, in our view, considering the recent rise in the Selic rate. As subnational entities' expenditures are still strongly linked to revenue, and the constitutional spending cap is indexed to past inflation, we expect this to lead to an increase in mandatory expenditures ahead, especially if we consider electoral pressures. These facts reinforce the effects of inflationary inertia on public accounts, and make more evident the growing pressure for tax breaks and the fragility of positive fiscal results.

Therefore, in order to achieve the objective of bringing inflation to the center target, the Central Bank has indicated the possibility of accelerating the pace of Selic increases over the next several meetings. In a context of the risk of inflation spreading by the secondary effects of supply shocks (commodities, energy) and a faster cyclical recovery, the BCB has signaled the possibility of accelerating the pace of Selic hikes. We estimate an increase of 100 bps at the next Copom meeting, due to the end of the monetary tightening cycle in 2021, with a terminal 7.0% Selic rate, which would thus contain the deterioration of inflationary expectations simultaneously with the reactivation/reopening of the services sector.

We understand that financial conditions create greater volatility for the fiscal scenario, including because of mark-to-market conditions and their impact both on international reserves and from the perspective of debt securities held by the public. This makes it crucial to analyze the fiscal outlook considering the assumptions for macroeconomic long-term variables, such as recurrent and structural public sector results. We also understand that differences in estimates of unobservable variables—neutral interest rate, changes in relative prices embedded in the GDP deflator, potential GDP—tend to lead to different long-term scenarios for Brazilian fiscal consolidation.

Therefore, more than relying on short-term gains, it is important to understand that the pandemic created shocks to the economic environment that will tend to fade, in our view, especially those resulting from the temporary shock on commodities, the rupture in production chains, changes in consumption patterns, and the consequent inflationary shocks.

Once the pandemic is over, its temporary effects will fade and its permanent impacts will unveil their nature. We expect to see the coexistence of high levels of indebtedness (both public and private) and higher neutral interest rates.

KEY HYPOTHESES IN OUR BASELINE SCENARIO

Figure 2. Summary of Key Hypotheses Behind Our Macroeconomic Forecasts for Brazil

THEME	KEY HYPOTHESES
International	• The pandemic should remain under control in advanced economies and vaccinations should accelerate in EMs. As a result, we expect the global economic recovery to continue in 2H21. • The Fed will maintain an accommodative stance by seeing inflationary pressures as temporary. The gradual reduction in asset purchases will occur only from 2022 (guidance should come in September) and interest rate increases are only expected in 2023.
Commodities	• An economic recovery led by China should boost demand for commodities in 2021, favoring terms of trade for producing countries (Brazil included). However, we see a softening pace in 2H21. • Vaccination programs around the globe allow greater mobility, a tailwind for demand (particularly for the energy segment), especially in 2H21.
Covid-19	• Improved execution of the government's immunization program, leading to faster vaccine rollout in 2H21. We envision 90% of the population being vaccinated (at least one shot) and all adults fully immunized (two shots) by the end of 2021. • Vaccines prove effective against new COVID-19 variants.
Fiscal Policy	• The price shock effect (higher inflation and terms of trade) on revenues will be temporary. The government will curb pressure for new fiscal stimulus and manage risks of partial shutdowns of some services. Extra-cap expenses forecast at around BRL 135 bn (1.6% of GDP) in 2021. Transparency maintained regarding the official estimates in order to comply with the fiscal rules. • Maintenance of the current fiscal framework, especially during the 2022 budget discussion, which is expected in 2H21. In this debate, additional increases in mandatory outlays (e.g., revamped welfare program and increase in government wages) will be limited by the constitutional spending cap rule. • Medium term: economic policy still seeks debt sustainability, with the approval of reforms to accelerate potential GDP and keep the neutral interest rate at or below 4% per year.
Balance of Payments	• Still favorable commodity prices in tandem with increasing international trade flows to favor trade surpluses. However, faster-than-expected domestic economic growth should weigh on the primary income account and keep the current account balance negative. • Idiosyncratic (fiscal, political) risks should limit the room for a significant strengthening of the BRL in the medium term, notwithstanding its more constructive prospects in the short term.
Economic Activity	• Increased mobility along with progress in the vaccination campaign to prompt resumption of economic growth in 2H21. • Economic reopening leading to an increase in labor demand, resulting in a normalization of the labor force, a partial recovery of employment, and a stable unemployment rate at high levels in 2021. • Limited episodes of corporate bankruptcy, meaning no major and persistent impact on the country's productive capacity.
Inflation	• Pandemic-related shocks are temporary (supply chain disruption, commodity price shock, change in consumers' basket, and demand shocks led by fiscal impulses), although stronger and more persistent in the manufacturing sector. No services shock in the reopening. • Second-order effects are happening (spreading of recent shocks to general prices), but interest rate hikes (and the recent relief in commodity prices in BRL) should curb a complete de-anchoring of inflation expectations for the medium and long term
Monetary Policy	• The BCB will continue to pursue inflation at the mid-target for the relevant policy horizons. At some point in 2021, however, the authority may refrain from taking a very tight policy stance, amid inflation pressures that are largely driven by supply shocks (i.e., cost-push inflation). • No fiscal policy disruption despite the continued looming risks for the government debt outlook. • BCB retains its capacity to anchor inflation expectations for the short, medium, and long term.

Source: Santander.

COMMODITIES: Fundamentals Remain Solid as Commodities Cool Down

Aggregate indexes are still running at historically high levels, despite a recent drop in most commodities, driven by more hawkish than expected signals from the Fed. We are still of the view that fundamentals point to prices ending the year lower, with a USD rally likely to weigh on commodity prices.

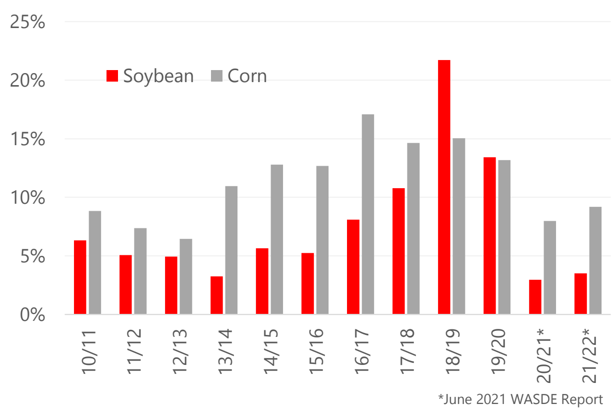
Agricultural commodities have been moving sideways, as an uneven weather forecast in the U.S. adds uncertainty to already tight supply. Meanwhile, Chinese buying continues (albeit at a slower pace), and discussions in the U.S. over renewable fuels blending exemptions could weigh on grains demand. The market is waiting for the USDA plantings report on June 30 (before the time of writing), which is expected to show record combined soybean and corn acreage for the coming season.

In energy, OPEC+ is expected to boost production in August, as global oil demand continues to recover at a rapid pace, especially in developed economies, where the vaccine rollout has been faster. Demand from emerging economies will likely follow suit in 3Q21, putting additional upward pressure on oil prices. Extra supply coming from Iran is a wild card, as talks to end U.S. sanctions continue. More broadly, we continue to believe that the capacity of producing countries to boost supply will be a limiting factor for oil (and derivatives) prices in the post-pandemic period.

In metals, iron ore supply has room to improve in key exporting countries (Australia and Brazil) in 2H21. China's central government stepped up its campaign to control commodity prices, as state stockpiles of metals are being sold to manufacturers in an attempt to ease rising raw materials costs.

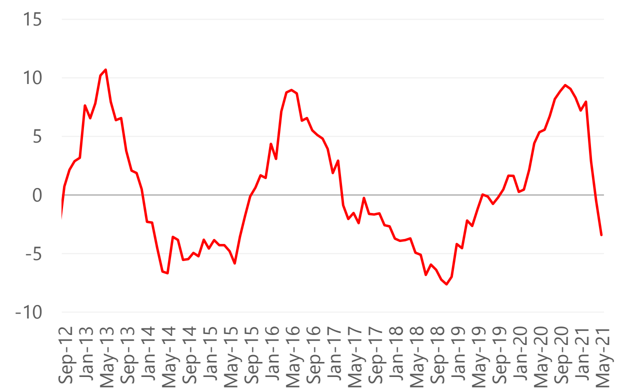
In our view, the food commodities market is likely to remain tight in the near term. Risks are tilted to the upside, depending particularly on the 2021-22 U.S. crop. As for energy, we see demand peaking in 3Q21, as mobility in other developed and emerging economies increases (as the pandemic gradually subsides). We expect oil to be supported in the very near term by a slow production response in key exporting countries, given OPEC agreed-upon constraints. Lastly, we think the demand impulse generated by China's credit stimulus will lose momentum in 2H21, weighing on construction activity and metals demand. With supply also likely to ramp up throughout the year, we believe risks are tilted to the downside for metals in general.

Figure 3.A. – U.S. Stock-to-Use Ratio (%)



Sources: USDA, Santander.

Figure 3.B. – China Credit Impulse (%, YoY)



Sources: Bloomberg, Santander.

COVID-19 in Brazil: Brighter Outlook as Vaccinations Advance

The country faces a grim milestone of 500k casualties and a persistent level of infections and hospitalizations. Yet the immunization process has gained considerable speed of late, and we expect deliveries to support an average vaccination pace of 1.5 million shots per day in 2H21.

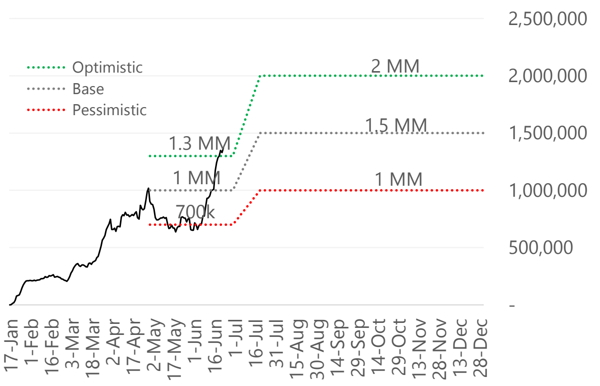
By the end of June, the daily average of new cases was standing near 77k/day, breaking the record set in late March. The daily average casualties count is running at 2k/day, a still high level compared to developments in 2020. The ICU occupancy rate is above 90% in at least seven states (compared to a peak of 18 states in late March) as key regions of the country continue to gradually lift social-distancing measures.

Since our last scenario review, Brazil's vaccine rollout has accelerated considerably. While both Butantan and Fiocruz, the producers of the Coronavac and AstraZeneca vaccine, respectively, have been receiving shipments of API (active pharmaceutical ingredients) that are below expectations, Pfizer's deliveries have been offsetting these near-term setbacks, effectively supporting the National Immunization Plan (PNI). In the coming months, we expect deliveries to increase steadily. Thus, the rate of deliveries should allow a pace of vaccination consistent with our baseline scenario. As of June 23, about 92 million doses (of 132 million available) had been administered in the country, with the rate of vaccination running at 1.3 million a day (seven-day average).

According to the National Immunization Plan, Brazil has already secured more than 677 million doses for 2021, with local governments closing parallel vaccine deals. In our base scenario, we assume a vaccination rate of 1 million/day throughout 2Q21, rising to 1.5 million/day in 2H21. The 677 million doses breakdown is: 224 million of Fiocruz/AstraZeneca; 200 million of Pfizer; 130 million of Butantan/CoronaVac; 42 million from COVAX; 10 million of Sputnik; 20 million of Covaxin; 38 million of Janssen; and 13 million of Moderna. By the end of the year, we expect nearly 90% of the population to have been vaccinated (at least one shot). We also project that the entire *adult* population will be fully immunized (two shots) by the end of 2021.

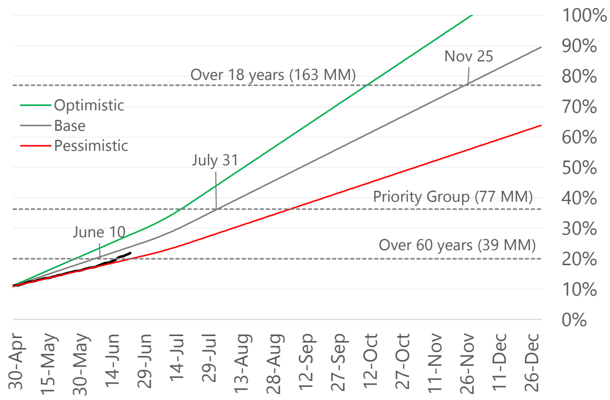
In our view, the numbers suggest the eventual immunization of a large majority of the population, allowing a continuing gradual easing of social distancing restrictions throughout the rest of the year, especially in 2H21. We believe this supports our assumption of a broader reopening of (socially integrated) services in the latter part of the year and "full normalization" by the end of December.

Figure 4.A. - Vaccination Pace (Daily Shots)



Sources: Brazilian Ministry of Health, Santander.

Figure 4.B. - Vaccinated People (At Least 1 Shot - %)



Sources: Brazilian Ministry of Health, Santander.

FISCAL POLICY: A Better Short Term, Caution on the Outlook

Once again, we are raising our fiscal estimates due to a more persistent price shock (inflation and terms of trade). The primary deficit was revised to 1.9% of GDP in 2021 (from 3.0% of GDP) owing to "price help" on the revenue side. We are lowering our gross debt forecast for this year to ~82% of GDP. Yet we continue to forecast an upward debt trajectory for the medium term, with long-term stabilization looking increasingly risky. See details in the link[2].

Our forecasts have improved, mainly due to a substantial increase in tax revenue in both regional and federal terms, on the heels of a more persistent and intense price shock (higher inflation and more favorable terms of trade). This took place in the context of a positive surprise in activity and higher GDP forecasts. Considering that revenue suffered a sharp drop last year due to the pandemic, it is "normal" for the revenue-GDP elasticity estimate (using IPCA as a deflator) with this price effect to be higher than 1.0: we now estimate it at ~1.7 this year. However, we expect it to return to somewhere between 1.0-1.1 in the medium term. We still view the medium-term fiscal outlook with some caution and with significant risks for the fiscal consolidation process. Our fiscal numbers show significant sensitivity with respect to the duration of the commodity boom. In our scenario, the first key issue is that we believe that this recent price shock will be temporary, with the positive effect on revenue (and GDP deflator) fading in the coming period. Additionally, an important effect of inflation on the primary result comes from the time mismatch (usually at least one year) between a positive effect on revenue and a subsequent impact on expenditures (given that a large share of mandatory expenses are linked to inflation). That is, we believe that mandatory spending will increase in federal and regional terms during the rest of the year. Another important inflationary effect is that the constitutional spending cap has lost its capacity to add to the fiscal consolidation process, as compliance with the fiscal rule up to 2026 is now easier than before this recent price shock. We see the fiscal rule as a necessary but not sufficient condition to assure consistent fiscal consolidation. This is especially true if favorable macroeconomic conditions are no longer maintained. In our view, any additional shock that raises the neutral interest rate or reduces potential GDP growth could derail the expected debt convergence, given the limited room for a primary surplus much higher than 2% of GDP in the long term. Additionally, approving tougher fiscal measures seems increasingly challenging, in our view.

Regarding the new forecasts, we project the public sector primary deficit for 2021 at BRL165 billion (1.9% of GDP), vs. BRL250 billion in our last scenario. We are also revising the regional government primary balance to BRL28 billion from BRL15 billion. For 2022 onward, we continue to expect primary deficits to gradually decline: -1.7% of GDP in 2022 and -1.3% of GDP in 2023. We forecast gross debt to reach 82.2% of GDP in 2021 (2020: 88.8% of GDP). We expect the indicator to peak in 2030 at ~94% of GDP, before falling toward ~85% of GDP by 2040.

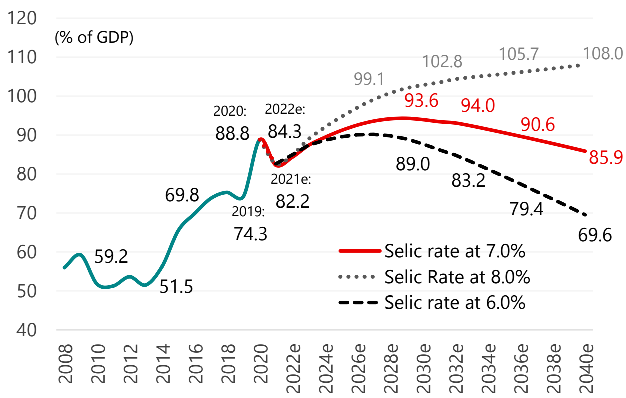
Figure 5.A. – Primary Surplus Simulation: When?

Elasticity: GDP-Revenues	GDP Growth 1.0%	1.5%	2.5%	3.0%
0.9	2038	2032	2029	2027
1	2031	2028	2027	2026
1.1	2028	2027	2026	2025
1.2	2027	2026	2025	2024
1.3	2026	2025	2024	2024

Assumptions: GDP deflator: 4.0% after 2023; Net revenue from the 2nd bimonthly government report; Santander expenses scenario.

Sources: National Treasury, Santander.

Figure 5.B. – Gross Government Debt Simulations



Sources: Brazilian Central Bank, Santander.

[2] **Santander Brazil Fiscal Policy - *"Fiscal Accounts: Pandemic Impact, Price Shock Contribution, and Outlook"* –** June 15, 2021 - Available on: http://bit.ly/Std-special-fiscal-061521

BALANCE OF PAYMENTS: Short-Term Respite, Medium-Term Headwinds

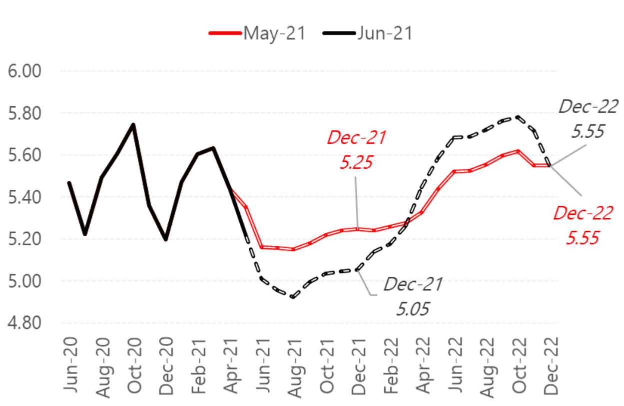
In 2021, we expect the BRL to benefit from market perceptions of lower fiscal risks and the faster normalization of monetary policy. However, we continue to anticipate a cloudy medium-term fiscal outlook, leading to concerns before the 2022 presidential elections. We expect the latter to weigh on the BRL next year.

The USD/BRL pair has recently breached the threshold of 5.00 for the first time since June 2021 due to a short-term improvement in market perceptions about the Brazilian fiscal outlook stemming from non-structural issues, whose influence should not last in the medium term, in our opinion (for more details, see the “Fiscal Policy” section). Since we believe that fiscal risk accounted for a good chunk of the premium or misalignment between the trajectory of the BRL and the path indicated by the behavior of (mostly financial) variables that usually influence the FX rate—terms of trade and DXY index, among others—the strengthening of the currency does not come “out of the blue”. Another factor that seems to have helped, in our view, was the BCB’s indication of a faster normalization of monetary policy (for more details, see the “Monetary Policy” section). We do not expect these influences to change dramatically in the coming months, which should keep the USD/BRL pair hovering around the 5.00 level until the end of 2021, when we expect it to be at USD/BRL5.05 (revised from USD/BRL5.25 previously).

Nonetheless, in our opinion, we are likely to see this short-term respite on the fiscal front being reversed further down the road, when discussions about budget 2022 and the proximity of the presidential race move to the forefront for market participants. In addition, we think the FOMC is likely to start its tapering in 2022 (and begin signaling it more credibly from September 2021 onward). Therefore, on top of domestic issues, global themes are also likely to make the outlook for the Brazilian currency a bit less sanguine, in our view. As a result, after having strengthened in 2021 compared with 2020, we continue to project the USD/BRL pair to end 2022 at 5.55 – unchanged from our previous report.

The stronger currency in the short term and the better-than-expected GDP outlook for 2021 led us to change our forecasts for the current account balance, even though the numbers continue to hint at a fairly comfortable external situation. We continue to project an improvement in the current account deficit compared to 2020, but it should not turn into surpluses as previously thought. Now, we expect the combination of a faster economic pace in 2021 and a stronger BRL to boost imports, which has meant a decline in our projections for the trade balance. Additionally, our forecasts for services outlays have been revised upward, and we are raising our projections for remittance of profits and dividends as well. These changes translated into forecasts of deficits in the current account balance of US$7.8 billion and US$12.4 billion in 2021 and 2022, respectively—or -0.5% and -0.8% of GDP, levels still easily financed by the Brazilian economy, especially via direct investment, a less volatile source of funding.

Figure 6.A. – Brazilian Nominal FX Rate (US$/BRL)



Sources: Bloomberg, Santander.

Figure 6.B. – Brazilian Current Account Balance

USD billion	2019	2020	2021e	2022e
Current account balance	-65.0	-24.1	-7.8	-12.4
Trade balance	26.5	32.4	61.1	60.0
Exports	225.8	210.7	272.7	284.8
Imports	199.3	178.3	211.6	224.8
Services	-35.5	-20.6	-25.6	-28.8
Tourism	-11.6	-2.3	-7.8	-9.3
Eq. Rental	-14.6	-11.7	-13.0	-15.7
Others	-9.3	-6.6	-4.9	-3.8
Income	-57.3	-38.2	-45.2	-45.7
Profits & Dividends	-31.9	-17.2	-24.3	-28.9
Interest payments	-25.5	-21.1	-20.9	-16.8
Transfers	1.2	2.4	2.0	2.0

Sources: Brazilian Central Bank, Santander.

ECONOMIC ACTIVITY—CORE: Better Outlook Due to Mobility and Commodities

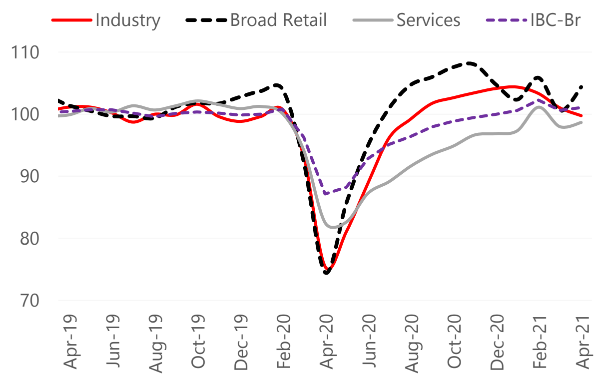
We are raising our 2021 GDP estimate to 5.1% from 3.6%. Activity surprised to the upside in 1Q21, and urban mobility is recovering faster than expected. The expected pace for the economy's reopening, along with support from commodity prices, has improved the outlook for this year. Lingering effects from the better terms of trade in conjunction with expectations of a fully operational economy next year have prompted us to raise our 2022 GDP estimate to 2.0% (from 1.5%).

Activity surprised to the upside in 1Q21, despite the reduction in fiscal support and the resurgence of the pandemic. The 1Q21 GDP result summarizes this surprise, with three sectors contributing positively to place the headline index back at the pre-pandemic level (4Q19). Yet less cyclical farm output provided the largest contribution (on the supply side). For 2Q21, we expect the faster-than-expected recovery of urban mobility, along with the new round of Emergency Aid, to improve the recovery in the tertiary sector, as suggested by the timely indexes and our proprietary indicator (IGet)[3] [4]. On the other hand, we expect farm output to partially give back its positive GDP contribution throughout the rest of the year; we also expect industry to be a short-term drag on the recovery, likely reflecting cost increases and the widespread shortage of inputs seen in manufacturing and construction.

Regarding our scenario, urban mobility has recovered faster than expected since April, exceeding our expectations for 2Q21 and leading to a better outlook for 2H21. Assuming continued progress in the vaccination rollout, we expect better mobility conditions for 2Q21, and we look for a faster recovery in 2H21, with a virtual return to "normality" in 4Q21. Regarding GDP, we expect stability in 2Q21 (0% QoQ-sa), with the tertiary sector propping up activity—stemming from the recovery in mobility and payment of the Emergency Aid—but dragged down by the partial give-back of agriculture's growth and weak industrial performance. For 2H21, higher commodities prices, along with advances in the economy's reopening, should contribute to a better outlook for activity. Indeed, some important segments of the tertiary sector (accounting for nearly half of services GDP) are still running at depressed levels, which leaves room for growth as the public health crisis is gradually overcome.

For 2022, we believe that the lingering positive effects from the commodities cycles, in conjunction with an economy in full-operation mode (over a basis of comparison affected by social distancing measures), should contribute to more robust growth, despite the delayed effects of a less expansionary monetary policy. For these reasons, we are upgrading our forecast for 2022 to 2.0% from 1.5%.

Figure 7.A. – Economic Activity (Jan/19=100, sa)



Sources: IBGE, Brazilian Central Bank, Santander.

Figure 7.B. – GDP Breakdown (%)

GDP Projections					
	2018	2019	2020	2021e	2022e
Total GDP	1.8	1.4	-4.1	5.1	2.0
Agriculture & Livestock	1.3	0.6	2.0	3.4	2.0
Industry	0.7	0.4	-3.5	5.3	1.9
Services	2.1	1.7	-4.5	4.4	2.2
Household Consumption	2.4	2.2	-5.5	4.5	2.0
Government Consumption	0.8	-0.4	-4.7	2.0	1.2
Investments	5.2	3.4	-0.8	12.9	2.4
Exports	4.1	-2.4	-1.8	14.3	2.1
Imports	7.7	1.1	-10.0	15.8	6.5

Sources: IBGE, Santander.

[3] **Santander Brazil Economic Activity - *"Varejo Desacelera no Final do Trimestre"* –** June 21, 2021 – Available (in Portuguese) on: https://bit.ly/Std-IGET-p-jun21
[4] **Santander Brazil Economic Activity - *"Serviços Seguem Mostrando Crescimento"* –** June 17, 2021 – Available (in Portuguese) on: https://bit.ly/Std-IGETser-previa-jun-21

ECONOMIC ACTIVITY—EMPLOYMENT: A Slowly Improving Job Market

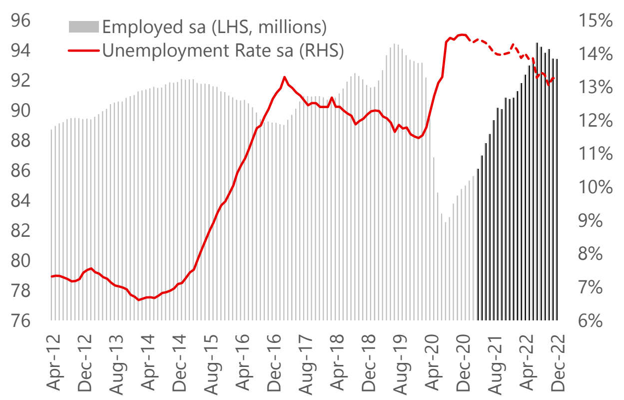
We have made minor revisions to our unemployment rate trajectory for 2021. We continue to expect the vaccine rollout and urban mobility to be crucial for the labor force and employment recovery in the coming months, with sectors more reliant on social interaction gaining traction. We estimate an average unemployment rate of 14.2% in 2021 and 13.6% in 2022 (unchanged from our last review).

The recent batch of labor market data came out relatively in line with our scenario. According to IBGE's PNAD household survey, both the labor force and participation rate remained at depressed levels, following the deceleration trend seen since January. The employed population has also shown modest growth, which kept the unemployment rate relatively stable at levels close to its all-time high. After showing strong results in 1Q21, CAGED net formal job creation data has also decelerated, reflecting March's mobility restrictions and the headwinds still faced by some sectors. Formal and informal employment show distinct behaviors. The CAGED (establishment survey) results indicate full recovery of the formal jobs lost during the pandemic, whereas the PNAD (household survey) still points to a slow recovery for formal employment. Considering the recent issues presented by both surveys[5], the actual formal labor market situation should be somewhere close to pre-pandemic levels, in our view, as in the past few months CAGED has apparently better reflected the upside surprises in economic activity. As for the informal sector, recent PNAD results point to employment levels marginally above the lower figures observed in 2020, still far from pre-pandemic levels.

We maintain our view that the unemployment rate will remain high throughout 2021. In our previous scenario, we revised our unemployment rate trajectory to a more stable path, as we started to project similar recovery rates for both the labor force and the employed population. We still maintain this view, but we are also introducing some new elements to our balance of risks. On the upside, the positive surprises (seen so far) from economic activity indicators may lead to a faster than expected recovery in employment, in our view. Furthermore, mobility levels have also been surprising on the upside, despite some social distancing measures still in place, which can favor informal jobs. On the downside, the further extension of the Emergency Aid may keep part of the population away from the labor market for longer, implying additional delays in the recovery of the informal sector.

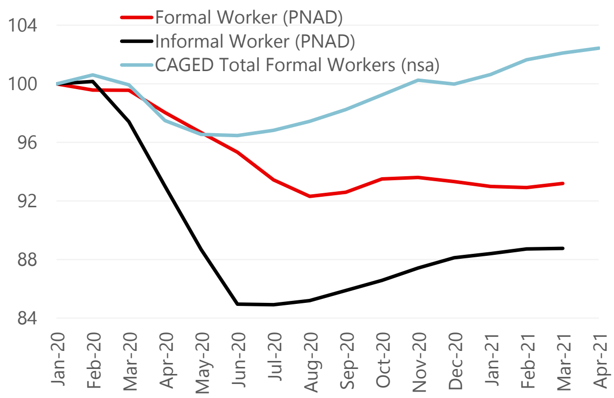
All in all, we have made minor adjustments in our unemployment rate trajectory for 2021, as we believe these risks are balanced. We are keeping our average unemployment rate forecasts for 2021 and 2022 unchanged at 14.2% and 13.6%, respectively. We maintain our view that the employed population should gain momentum as the pandemic gets under control but will reach pre-pandemic levels only in 2022. We believe the normalization in both employment and the labor force should be strictly linked to the vaccination process rollout and the recovery in informal jobs. We still see this labor market as having considerable slack, especially for informal workers.

Figure 8.A. – Unemployment Rate Scenario



Sources: IBGE, Santander.

Figure 8.B. – Employed Population (sa, Jan-20=100)



Sources: IBGE, CAGED, Santander.

[5] **Santander Brazil Labor Market - *"CAGED vs. PNAD: Which Labor Survey is Right?"* –** April 12, 2021 - Available on: http://bit.ly/STD-pnad-caged-apr21

ECONOMIC ACTIVITY—CREDIT: Credit Growth Continuing

We are revising our projections for real total outstanding loan growth to 3.2% in 2021 and 3.9% in 2022, from 1.4% and 4.9%, respectively. Moreover, recent data support our positive view on credit this year, meaning an upward revision for balances growth in 2021.

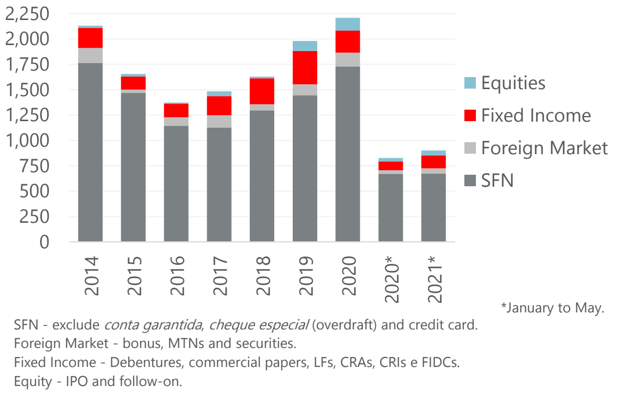
Total outstanding loans in the National Financial System (SFN, in the Portuguese acronym) posted inflation-adjusted growth of 7.5% YoY in May (to BRL4.2 trillion), up 7.8% YoY for households and 7.1% YoY for non-financial corporations. Total new loans adjusted for inflation and seasonality (using Central Bank of Brazil methodology) decreased 2.8% in May, after a significant rise in April (+4.5% MoM-sa).

For households, the non-earmarked segment posted a decline of 2.7% MoM-sa, also an adjustment after a strong figure in April. In the earmarked segment, real estate financing remains high (+100% YoY), reflecting favorable financial conditions. For companies, there was a decline of 4.7% MoM-sa in May in the non-earmarked segment. In March, companies relied heavily on short-term credit for support amid activity restrictions imposed by local governments, so an adjustment for firms was also expected. In the earmarked segment, there was an increase of 6.8% MoM-sa, and we expect a new round of BRL5 billion in *Pronampe* (now a permanent program) to support firms in the coming months.

Considering total corporate financing[6] so far this year, through May vs. the year-ago period, issuances in the capital markets are 48% higher, while SFN concessions are now up 1%. As a result, total corporate financing is up 9% compared to the year-ago period.

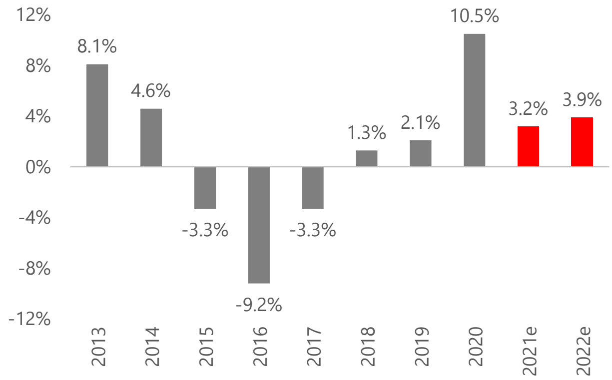
Risk factors for our baseline scenario: the reopening process could eventually trigger a resurgence in infections, and the ensuing restrictions could delay a recovery in personal income, while an increase in defaults and household indebtedness could induce a curbing of credit supply. However, we see these risks as diminishing due to advances in the vaccine rollout.

Figure 9-A. Total Corporate Financing (BRL billion, Inflation Adjusted)



Sources: Brazilian Central Bank, Anbima, Santander.

Figure 9-B. Forecast – Growth in Outstanding Loans (%, Inflation Adjusted)



Sources: Brazilian Central Bank, Santander.

[6] This calculation includes new loans in the SFN, debt and equity issues in the capital markets.

INFLATION: Persistent Inflation Shocks Start to Spread

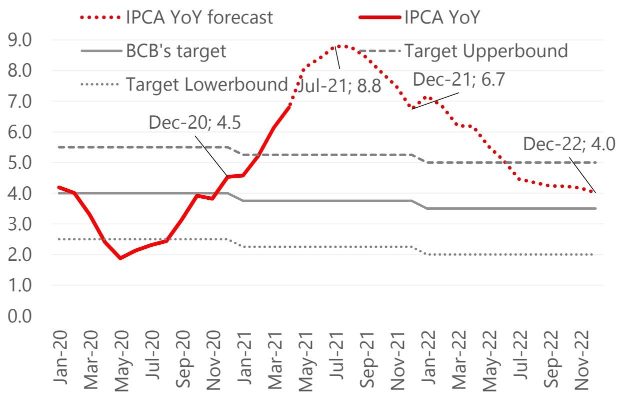
Since our last scenario revision, we have made further upward adjustments to our inflation forecasts. We are revising our IPCA 2021 forecast to 6.7% (from 5.9%) and IPCA 2022 to 4.0% (from 3.9%), mainly as a result of higher electricity costs and stronger effects from the shocks in industrial goods. Higher services inflation is also playing a role, owing to larger second-order effects from the primary shocks and a stronger economic activity recovery.

For the short term (i.e., until year-end 2021), many of our revisions were in regulated prices, due mostly to a change in the hypothesis of the electrical energy tariff flag for December 2021, given a difficult and risky hydrology scenario this year (see Figure 10.B. below). We are now assuming a Red 2 flag (previously Yellow)—with the new values published by Aneel on June 29, 2021—which raises costs for consumers. In free market prices, the most important development was in industrial goods, as we are assuming, once again, a stronger impact from the shocks in commodity costs and supply-chain disruptions. In services, the headline did not show a notable increase, although there was a qualitatively important revision in food-service, due to second-order effects from the food inflation shock. The latter is facilitated by stronger economic activity. Finally, food-at-home offset part of the upward revisions, as we are reducing our forecast for the group because high-frequency price surveys are showing stronger-than-expected relief ahead.

Looking further ahead (i.e., 2022), although the main hypotheses remain the same, particularly the one that assumes that the recent shocks are temporary, we now consider larger second-order effects from the primary shocks (commodities, FX rate, and supply chains). In short, we continue to believe that the main pandemic-related noises will fade, with the supply chain back on track, commodity prices cooling down, a normalization of consumers' basket, and the end of most of the fiscal impulses (for domestic demand). However, we are raising our services inflation estimate, as we already see evidence of second-order effects from the primary shocks, particularly on food services, but also in other subgroups in services. We are also raising our inflation estimate for industrial goods, due to the stronger effect of the shocks in 2021, generating higher inflation inertia for 2022. Finally, we are making a downward revision in electricity prices, as we expect the effect of the higher tariff flag for December 2021 to fade in 2022; however, this effect has been partly offset by higher tariff adjustments by electricity firms expected for next year. Moreover, given the higher IPCA 2021 headline, we are also raising our forecasts for regulated prices in general, as those tend to be more inertial.

Our IPCA 2021 forecast of 6.7% is way above not only the BCB's mid-point IPCA inflation target (3.75%) but also above the upper-bound of the tolerance interval (5.25%). For 2022, our forecast of 4.0% is above the mid-point target (3.50%), but still within the interval (5.00%). The balance of risks is now more symmetrical but, in our view, still tilted to the upside, given the backlog of price rises at the wholesale level that are still to pass through to consumers and because of the risk of a more widespread impact (i.e., second-order effects) of primary shocks on general prices.

Figure 10.A. – IPCA Headline, Cores, Forecasts (% YoY)



Sources: IBGE, Brazilian Central Bank, Santander.

Figure 10.B. – IPCA Details, Forecasts (% YoY)

	2021			2022		
	old	new	Δ bps	old	new	Δ bps
IPCA headline	5.9	6.7	85	3.9	4.0	5
Free prices	5.0	5.1	10	3.6	4.1	38
Food-at-home	8.5	6.5	-31	3.5	3.5	0
Industrial goods	5.1	6.7	37	3.8	4.7	22
Services	3.4	3.6	4	3.5	3.9	17
Regulated	8.3	11.1	75	5.0	3.7	-33
Cores	4.2	4.9	70	3.7	3.9	20

Sources: IBGE, Brazilian Central Bank, Santander.

MONETARY POLICY: Hitting the Gas Pedal

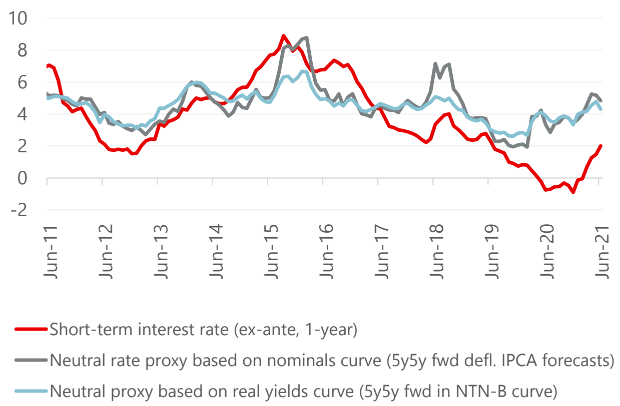
We now expect an even more front-loaded monetary policy adjustment, with our YE2021 Selic rate forecast revised to 7.00% (previously 6.50%). We see that as the neutral level, also prevailing for 2022 and 2023. The path to neutrality still seems a bit uncertain, but our inflation forecast looks consistent with a 100-bp Selic hike at the August 3-4 Copom meeting.

In the last formal communications (Copom statement[7], policy minutes[8] and inflation report[9]), the BCB clearly upped the tone, mirroring the mounting evidence of resiliency in economic activity and the spread of inflation pressures. In our view, both entail the need to reduce monetary stimulus even more rapidly. At its June 15-16 meeting, the Copom raised the Selic policy rate by 75 bps to 4.25% and indicated a neutral Selic rate at the end of the cycle (i.e., abandoning a previous signal of "partial normalization"), as BCB inflation projections now show the interest rate at (the BCB's neutral estimate of) 6.50% early next year as necessary to bring IPCA inflation back to the mid-target (of 3.50%) for the relevant policy horizon of 2022. The Copom's justification for the more hawkish tone was the need to curb "the dissemination of the temporary shocks to inflation."

The Copom still believes the high fiscal risks generate "an upward asymmetry in the balance of risks, i.e., in the direction of higher-than-expected paths for inflation over the relevant horizon for monetary policy." In the minutes, the BCB mentions that "this asymmetry in the balance of risks affects the appropriate degree of monetary stimulus, thus justifying a path for monetary policy that is less stimulative than the path used in the baseline scenario." The committee also says that it has "evaluated a quicker reduction of monetary stimulus" for the June meeting—signaling an inclination to step up the pace (i.e., maybe to 100 bps), conditional on services trends and inflation expectations. In our view, the BCB showed greater flexibility and willingness to do whatever it takes to curb the second-round effects of ongoing inflation shocks and reinforced its commitment to bringing inflation back to the mid-target next year. We believe these signals overshadow the fact that the BCB's GDP forecasts for 2021 stand below the market's (4.6% vs 5.1%).

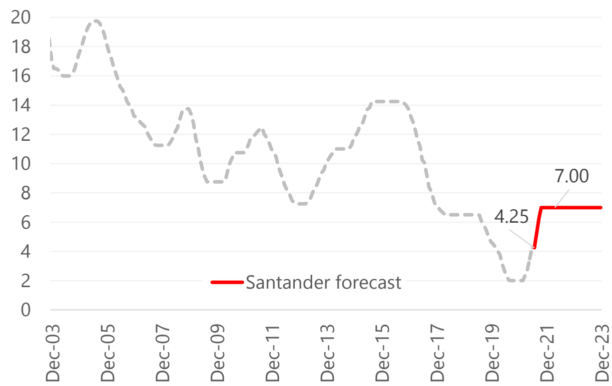
In our baseline scenario, we project a deterioration in inflation conditions (and outlook), with our revised IPCA forecast standing way above the upper target for 2021 (6.70% vs. 5.25%) and above the center target for 2022 (4.00% vs. 3.50%). Although we estimate the economic slack to last until 2023 (whereas the BCB estimates GDP convergence to potential output in 2022), we believe the signs for the materialization of an inflation scenario such as ours (e.g., via continued pressure in underlying inflation in coming months) will probably tip the BCB into again altering its flight plan and adopting a slightly tighter monetary policy stance. Thus, we are pulling forward our expectation for the path of rate hikes, with the Selic likely reaching our (estimate for the neutral or) terminal level of 7% sometime in 4Q21. That estimate is consistent with various trajectories for the BCB policy steps in the coming months, but our baseline scenario is for a 100-bp hike at the August 3-4 Copom meeting.

Figure 11.A. – Implicit Monetary Stimulus (% p.a.)



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

Figure 11.B. – Our Selic Rate Forecast (% p.a.)



Sources: Brazilian Central Bank, Santander.

[7] **Santander Brazil Monetary Policy - *"A New Route for The Flight Plan"* –** June 16, 2021 – Available on: https://bit.ly/Std-COPOM-jun21
[8] **Santander Brazil Monetary Policy - *"Whatever It Takes"* –** June 22, 2021 – Available on: https://bit.ly/Std-Copom-min-jun21
[9] **Santander Brazil Monetary Policy - *"BCB still poised to speed up hikes"* –** June 24, 2021 – Available on: https://bit.ly/Std-Inflation-Rep-2q21

FORECASTS: Santander & Consensus

Figure 12-A. Evolution of Santander and Consensus Forecasts for 2021 Since Our Last Scenario Revision

	2021E			
	Consensus		Santander	
	21-May-21	25-Jun-21	20-May-21	30-Jun-21
IPCA Inflation (%)	5.2	6.0	5.9	6.7
GDP Growth (%)	3.5	5.1	3.6	5.1
Selic policy rate (%, year end)	5.50	6.50	6.50	7.00
Exchange rate (USD/BRL, year end)	5.30	5.10	5.25	5.05
Current Account (USD billion)	-0.5	-0.3	4.9	-7.8
Primary Budget Balance (% GDP)	-3.0	-2.5	-3.0	-1.9
Net Govt. Debt (% GDP)	63.5	61.6	62.4	59.9

Note: Based on the BCB's Focus reports.
Sources: Brazilian Central Bank, Santander estimates.

Figure 12-B. Evolution of Santander and Consensus Forecasts for 2022 Since Our Last Scenario Revision

	2022E			
	Consensus		Santander	
	21-May-21	25-Jun-21	20-May-21	30-Jun-21
IPCA Inflation (%)	3.7	3.8	3.9	4.0
GDP Growth (%)	2.3	2.1	1.5	2.0
Selic policy rate (%, year end)	6.50	6.50	7.00	7.00
Exchange rate (USD/BRL, year end)	5.30	5.20	5.55	5.55
Current Account (USD billion)	-15.0	-18.5	2.5	-12.4
Primary Budget Balance (% GDP)	-2.0	-1.7	-2.1	-1.7
Net Govt. Debt (% GDP)	66.0	63.4	64.7	61.4

Note: Based on the BCB's Focus reports.
Sources: Brazilian Central Bank, Santander estimates.

Figure 12-C. Evolution of Santander and Consensus Forecasts for 2023 Since Our Last Scenario Revision

	2023E			
	Consensus		Santander	
	21-May-21	25-Jun-21	20-May-21	30-Jun-21
IPCA Inflation (%)	3.3	3.3	3.3	3.3
GDP Growth (%)	2.5	2.5	1.8	1.5
Selic policy rate (%, year end)	6.50	6.50	7.00	7.00
Exchange rate (USD/BRL, year end)	5.20	5.05	5.20	5.20
Current Account (USD billion)	-29.5	-22.5	-8.3	-20.0
Primary Budget Balance (% GDP)	-1.2	-1.1	-1.6	-1.3
Net Govt. Debt (% GDP)	69.0	65.9	67.5	64.2

Note: Based on the BCB's Focus reports.
Sources: Brazilian Central Bank, Santander estimates.

MAIN RISKS

Figure 13. Summary of Main Risks to Our Macroeconomic Scenario for Brazil

THEME	MAIN RISKS
International	• Upside risks (activity): more prolonged effects from fiscal stimulus, – especially in the U.S. – on global activity. • Downside risks (activity): More intense and lasting inflationary pressures prompting the Fed to start withdrawing monetary stimulus earlier than expected. Possible outbreak of coronavirus strains that are more contagious or highly resistant to available vaccines, causing new setbacks in the reopening process in key regions.
Commodities	• Upside risks (prices): additional economic and fiscal stimulus (especially in China and the U.S.) could boost prices further in the short run. Weather conditions could stress U.S. 2021-22 crops. • Downside risks (prices): delays in vaccination or new virus variants could trigger tightening in mobility conditions, weighing on consumption. A faster than expected reversal in Fed stimulus.
Covid-19	• Upside risks: more vaccine deals could soon be approved, increasing the number of available shots and pulling forward our vaccine forecasts. • Downside risks: global shortage of ready-made vaccines and APIs (ingredients) could delay the vaccination process. Current vaccines could be less effective against new coronavirus strains.
Fiscal Policy	• Upside risks: more intense and persistent effect of the commodity boom on revenue. Approval of reforms with a significant budget effect, reducing idiosyncratic risk. Maintaining curbs on payroll spending. Reducing budgetary rigidity. A less polarized than expected 2022 election. • Downside risks: decisions to increase mandatory outlays amid a short-run rise in revenue. Approval of reforms without fiscal impact creating distortions in budget management across government branches. Loss of credibility in the fiscal consolidation process (and constitutional spending cap) and in transparency of the official numbers, causing financial conditions to deteriorate. Changes in the current fiscal framework without addressing structural problems.
Balance of Payments	• Upside risks: commodity prices through the roof in 2022, thus opening room for an even larger trade balance surplus and, consequently, an even smaller current account deficit. • Downside risks: frustration with the institutional environment leading to outflows from portfolio accounts and reduction of direct investments in the country. An eventual anticipation of Fed tightening to 2022, thus reducing global appetite for risky assets.
Economic Activity	• Upside risks: Massive vaccination campaign unrolls faster than expected, increasing mobility and positioning the services sector to recover earlier than expected. Resilience of industry amid a rebuilding of inventories. • Downside risks: An additional increase of infections before a more disseminated vaccine rollout and delays in the vaccination campaign would likely set back the economy's reopening process. A continued widespread shortage of inputs and high costs in some production chains, along with likely implications of the drought for both electricity generation and some important crops, are additional factors that could slow the pace of activity resumption. An even stronger (and inflationary) supply shock causing even further tightening in the BCB's policy stance.
Inflation	• Upside risks: (i) a higher transmission of the cost-related shocks to general prices (services, for example); (ii) de-anchoring of inflation expectations (related to fiscal risks); (iii) a slower recovery of industry (and inventories) increasing supply-related costs; (iv) a more intense and persistent FX pass-through on industrial goods, especially with the stronger activity at the margin; (v) another round of FX depreciation (on fiscal risks); (vi) the increase in electrical energy costs could be greater, depending on the weather. • Downside risks: (i) BRL could appreciate more than we estimate, as BCB hikes the interest rate, raising the carry attractiveness; (ii) commodity prices could cool down faster and more intensely than we estimate; (iii) cost/supply-related shocks could normalize faster than we expect; (iv) pass-through could be more limited than we estimate, given the still existing economic slack; (vi) interest rate hikes could curb expectations further, leading realized inflation to be lower.
Monetary Policy	• Upside risks: further price shocks could raise fears of secondary-round effects (dissemination, expectations). Fiscal stimulus with a narrower output gap could add to inflation. Sluggish reforms could hurt the outlook for debt sustainability, affecting anchoring power and neutral rate. • Downside risks: vaccination delays and mobility restrictions could hurt the activity recovery and delay the BCB's normalization. A retracement in costs in BRL could reduce a backlog of PPI pressures, providing some respite for industrial goods and inflation expectations.

Source: Santander.

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