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SCENARIO REVIEW

# ADVANCES IN CONTROLLING THE PANDEMIC, SETBACKS IN QUELLING INFLATION

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- Like any other country, Brazil is not out of the woods yet in terms of the pandemic. However, the recent weeks have shown a notable improvement in health conditions, as the level of infections, hospitalizations and deaths have gradually eased across the country. And that apparently follows a more widespread vaccination process. We expect an average vaccination pace of 1.5 million shots per day through the rest of the year, leading to the full immunization of the adult population by December. This is to allow a broader and safer reopening of the Brazilian economy in 2H21. The main risk is a resurgence in infections due to the delta variant.
- We are upgrading our budget balance estimates due to better revenues following the upward price shock (inflation, terms of trade). For 2021, we now look for a public sector primary fiscal deficit of 1.6% of GDP (previous: 1.9% of GDP). Yet we believe the fiscal risks have resurfaced of late. While our gross debt estimate for 2021YE dropped to 81.6% of GDP (-0.6 p.p.), we continue to forecast an upward debt trajectory for the medium term, with the path to a long-term stabilization looking increasingly riskier and elusive.
- We continue to envision fairly constructive dynamics for the current account balance, with mild and easy-to-finance deficits expected for 2021 and 2022. However, recent developments also support our view that the lack of progress on structural (especially fiscal) reforms should put a lid on the BRL strength for the medium term, in spite of a higher interest rate. We continue to forecast USD/BRL at 5.05 and 5.55 for the end of 2021 and 2022, respectively.
- We keep our 2021 GDP estimate at 5.1% in light of the recent negative market surprises from broad activity indexes that were in line with our scenario of a modest GDP figure in 2Q21. The outlook for 2H21 remains bright, in our view, due to a probably faster (and safer) economic reopening and the support from higher commodity prices. For 2022, we maintained our forecast at 2.0%, with the lingering effects from the better terms of trade in conjunction with our expectation of a fully operational economy offsetting the removal of fiscal and (mainly) monetary stimulus.
- The increase in urban mobility has led to an acceleration in the labor force and employment recovery, in our view. These recent developments have been aligned with our labor market scenario. We have made mild revisions to our average unemployment rate forecasts to 14.1% in 2021 and 13.5% in 2022 (from previous estimates of 14.2% and 13.6%, respectively).
- Once again, we are raising our inflation forecasts. For 2021, we now project IPCA at 7.3% (previously 6.7%); for 2022, we now look for a 4.1% gain (previously 4.0%). The level and composition of inflation look increasingly unfavorable for 2022, and we project convergence to the mid-target only in 2023 (at 3.25%).
- As the BCB faces worsening inflation conditions and seeks to curb market expectations for the relevant policy horizons, we look for a faster and larger interest-rate adjustment in this cycle. We revised our Selic rate forecast for the end of 2021 to 7.50% (previously 7.00%) and continue to expect no changes across 2022. A possible decline to the neutral level (which we assume at 7.00%) is to take place only in 2023.

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**Figure 1. Santander Macro Forecasts for Brazil – Summary**

| Macroeconomic variables | | Previous | | Current |
|---|---|---|---|---|
| GDP (%) | 2021E | 5.1 | → | 5.1 |
| | 2022E | 2.0 | → | 2.0 |
| | 2023E | 1.5 | → | 1.5 |
| IPCA (%) | 2021E | 6.7 | ↑ | 7.3 |
| | 2022E | 4.0 | ↑ | 4.1 |
| | 2023E | 3.3 | → | 3.3 |
| Selic Rate (% end of period) | 2021E | 7.00 | ↑ | 7.50 |
| | 2022E | 7.00 | ↑ | 7.50 |
| | 2023E | 7.00 | → | 7.00 |
| FX Rate - USDBRL (end of period) | 2021E | 5.05 | → | 5.05 |
| | 2022E | 5.55 | → | 5.55 |
| | 2023E | 5.20 | → | 5.20 |
| Current Account Balance (% of GDP) | 2021E | -0.5 | ↑ | 0.0 |
| | 2022E | -0.8 | ↑ | -0.5 |
| | 2023E | -1.0 | ↓ | -1.7 |
| Primary Fiscal Balance (% of GDP) | 2021E | -1.9 | ↑ | -1.6 |
| | 2022E | -1.7 | ↑ | -1.2 |
| | 2023E | -1.3 | ↑ | -0.9 |
| Gross Public Debt (% of GDP) | 2021E | 82.2 | ↓ | 81.6 |
| | 2022E | 84.3 | ↓ | 83.5 |
| | 2023E | 87.2 | ↓ | 86.2 |

Source: Santander estimates.

# EXECUTIVE SUMMARY: Idiosyncrasies

Brazil has faced peculiar situations since the last scenario review released by Santander macroeconomics team on July 1, and these situations have led to an increase in the level of uncertainties, higher risk premiums in the domestic yield curve, and a weaker BRL. Since then, the 5-year and 10-year tenors of the future interest rates (DIs) have risen approximately 100bps; while the USD/BRL pair climbed to 5.23 on August 8 from 4.97 on June 30 according to official quotes (the so-called "Ptax"), which translates into a 5.7% weakening or a 26 cent increase.

It has been the second time since the beginning of the pandemic that market expectations of a BRL strengthening have been frustrated—the expected move would have brought the BRL to levels more compatible with its fundamentals, in our opinion. Incidentally, the coronavirus pandemic era has been the single period in which a rising cycle of commodity prices has not translated into a period of BRL strengthening since it became a free-floating currency in 1999.

According to our calculations, about 1/3 of the 26-cent increase (10 cents) in the exchange rate observed since June 30 can be explained by a deterioration in the BRL fundamentals (commodity prices, relative dollar performance, interest rate differentials, and country risk). However, the remaining 2/3 (16 cents) stemmed from idiosyncratic matters, not explained by fundamentals. Since then, understanding how Brazilian idiosyncrasies have affected asset prices and their impact on domestic inflation has become a challenge for analysts.

We believe that the first recent idiosyncratic factor comes from the worsening of the Brazilian hydrological situation and its potential impacts on energy prices and agricultural production. Although the scenario is extremely complex, several experts consider the risk of energy rationing to be very low, since the balance between energy supply and demand can be reached via prices. Since July 2021, we changed the energy tariff flag to "red 2" for the end of this year, which added 60 bps to the 2021 inflation expectations.

The second factor refers to the fiscal scenario, which has significantly worsened since the beginning of the pandemic. It is true that a roster of recent circumstantial factors offset the strong growth in the government debt in the short term (e.g., the approval of the constitutional fiscal amendment, "PEC fiscal") and the 2021 budget earlier this year, and these factors were: the milder-than-expected impact of the "second wave" of contagion on activity, which led to an upward revision of GDP growth expectations for the year; advances in the vaccination process; and the inflation spike combined with rising commodity prices that impacted positively public revenues and the nominal GDP. However, the ensuing rally on asset prices stemming from these factors was short-lived.

More recently, the BRL strengthening and the decline in risk premiums have lost momentum, especially after the tax reform proposal sent by the Executive branch to Congress and the announcement of a sharp rise in the judicial claims ("precatórios") account—whose clearances would be done in installments—so as to open room in the constitutional public spending cap for higher expenditure on social programs in the coming years.

Regardless of merit issues related to most recent themes, we judge there is an intention to reduce taxes and increase expenses (although they may be delayed) behind the discussions in Congress that are based on proposals presented by the federal government. Furthermore, we see risks for the future trajectory of the government fiscal balance and to the anchoring power of the spending cap rule given the ease and frequency with which constitutional changes in fiscal rules have been approved lately. We fear a more benign trajectory for the gross debt when compared to the path imagined at the peak of the pandemic.

Markedly, we see the payment of court orders in installments as a setback, as it generates incentives for less careful governance of the system—in addition to the fact that it does not deal with expenditures (it only postpones them)—without solving the problem of unpredictability. If court orders surpass the limit that would be established, they would lead to an increase in the volume of items to be paid, but not registered in the public debt statistics, thus contributing to the generation of new "fiscal skeletons").

Finally, the third idiosyncratic factor comes from the anticipation of the electoral calendar, with the intensification in political-party disputes, the loss of popular support of the incumbent administration and the increased friction between powers and the federal government and subnational entities.

The persistence of a weak BRL and recent inflationary shocks has changed our scenario for the 2021 IPCA to 7.3% from 6.7% and for 2022 to 4.1% from 3.9%. In addition to the water crisis, the normalization of production chains has been slow and may last until next year. Moreover, some consumption of resources saved during the pandemic and the double-digit growth of credit granted to families at still stimulating interest rates have contributed to sustain the consumption of goods in tandem with the recovery in the services sector.

As inflation expectations continue to deteriorate, we changed the forecast for the Selic rate to 7.5% from 7.0% at the end of 2021. We believe that the Brazilian Central Bank will raise the Selic beyond its neutral level in a front-loaded fashion. The risks for this scenario remain high, but it is important to note the possibility of some relief (e.g., rainy season, discussions of relevant proposals in Congress, political-electoral framework, etc.) or even the evolution of the international scenario. In 1Q22, the weight of projections for 2023 in the prospective scenario will increase, which may lead to more measured action by the monetary authority, in our opinion, despite the persistent inflationary risks.

We believe that an important event in the next 45 days, when we will have a new scenario review process taking place, will be the release of the 2Q21 GDP growth. There are chances of a revision in the outcomes of most recent quarters, due to changes in seasonal factors and the break in the off-season corn crop ("safrinha") recorded by the Systematic Survey of Agricultural Production (LSPA). These potential changes may affect the aggregate statistical carry-over forecast for the year–an inadequate reference for the annual growth, in our opinion. Considering that the other variables (external demand, industrial production, labor market, consumption of goods and services and investments) have performed in line with our estimates, we maintained our GDP growth projections unchanged at 5.1% for 2021 and 2% for 2022.

# 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 even with the surge of new strains, and vaccinations should accelerate in EMs. As a result, we expect the global economic recovery to continue in 2H21.<br>• 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.<br>• 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 all adults fully immunized (two shots) by the end of 2021.<br>• Vaccines prove effective against new COVID-19 variants. |
| **Fiscal Policy** | • The price shock effect (via inflation and terms of trade) on revenues will be temporary. The government will curb pressure for new fiscal stimulus and manage risks regarding court-ordered debts ("*Precatórios*").<br>• The fiscal framework conditioning the 2022 budget discussions in 2H21 will be maintained. Additional increases in mandatory outlays (e.g., revamped welfare program and increases in government wages) will be limited by the constitutional spending cap– with no "artificial factors".<br>• 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, thus counterbalancing larger primary income expenses.<br>• Idiosyncratic (fiscal, political) risks should limit the room for a significant strengthening of the BRL in the medium term, notwithstanding the help from a higher interest rate level in the short term. |
| **Economic Activity** | • Increased mobility along with progress in the vaccination campaign to prompt a safer resumption of economic growth in 2H21, with no major setbacks (e.g., new lockdowns).<br>• Economic reopening leading to an increase in labor demand, resulting in a normalization of the labor force and a partial recovery of labor demand in 2021.<br>• 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).<br>• No major shock in services prices in the early phase of the reopening. Electricity cost spike is temporary: tariff flag 'Red 2' for December 2021 and 'Yellow' for December 2022.<br>• Relative price level between the producer and the consumer levels did not change structurally and it will converge back to the norm.<br>• Inflation expectations will not de-anchor for the medium term (i.e., Selic hikes will be enough to keep inflation expectations within the target range) |
| **Monetary Policy** | • The BCB will continue to aim inflation at the mid-target for the relevant policy horizons. For calendar-year 2022; however, the authority may give in at some point (1Q22) and avoid a very tight stance in response to CPI pressures largely driven by supply shocks (cost-push inflation).<br>• No fiscal policy disruption despite the continued talk on the extension of budget stimulus and lingering risks for the government debt outlook.<br>• While achieving the mid-point inflation target for 2022 may prove an elusive task, we assume the will BCB retain its capacity to anchor inflation expectations for the medium and long term. |

Source: Santander.

## COMMODITIES: Commodities Lose Steam on Weather and Virus Concerns

**Despite aggregate indexes still running at historically high levels, we believe that the broad-based rally in commodity prices has likely run its course. Most prices should gradually start to ease from here on the back of both macroeconomic and idiosyncratic fundamentals. The spread of the COVID-19 delta variant is a risk and could mean a headwind for energy demand across the globe.**

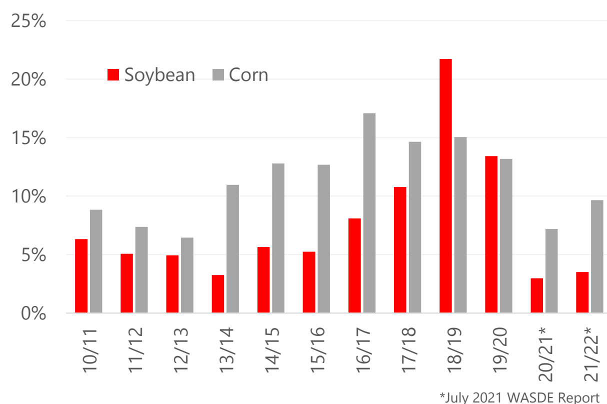
Agricultural commodities continue to move sideways. The U.S. crop is under close watch in August as weather in this critical stage of development should help determine final crop size. Chinese buying has recently showed improving signs of late, but still not enough to make big dent in the market.

In energy, OPEC+ agreed to a production deal that allows for monthly supply increases until all of its halted production has been brought back to the market. Extra supply coming from Iran is increasingly unlikely in the near-term as talks to restore the nuclear deal and lift U.S. sanctions have reached a deadlock. On the demand side, roads have remained busy in the U.S. but the virus has been eroding confidence in Asia as new restrictions on mobility are being imposed, particularly in China. More broadly, we continue to believe that some countries will not be able to boost production next year (due to a loss of productive capacity) which should support 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), despite near-term issues from labor shortages to bad weather. In China, authorities' efforts to curb demand for raw materials are apparently starting to take effect. The country has been imposing regulatory controls to cut steel output as well as raising export tariffs in an attempt to keep more steel at home.

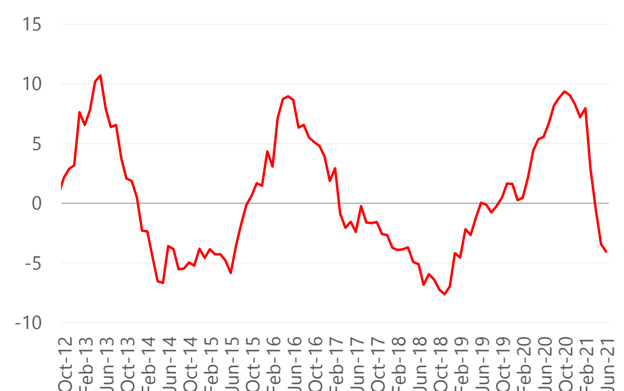
In our view, the food commodities market is likely to remain tight in the near term. Risks are tilted to the upside, depending particularly on the final outcome for the 2021-22 U.S. crop. As for energy, we see demand peaking in 3Q21 with mobility in other emerging economies increasing (as the pandemic 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 continue to fade towards the end of the year, weighing on construction activity and metals demand. With supply likely to ramp up in 2H21, we see risks tilted to the downside for metal costs 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: Vaccination Put to the Test as Delta Variant Spreads Globally

**As the level of infections, hospitalizations and deaths gradually ease across the country, Brazilian regional authorities have been lifting a number of business restrictions. We expect vaccine deliveries to support an average vaccination pace of 1.5 million shots per day throughout the rest of the year. The main risk here is a resurgence in infections due to the delta variant.**

In early August, the 7-day average of new cases was standing near 32k/day while average casualties were running at 902/day, the lowest level since February 2021. Our proxy for a nationwide average ICU occupancy rate[1] continues to decline, reaching close to 54%. That number compares to a previous peak of 92% (late March).

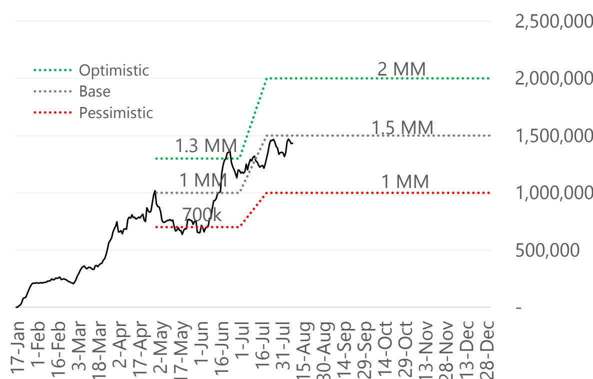
Brazil's vaccination rate continues to improve as deliveries are set to increase steadily in the coming months. The immunization process held close to 1.3 million shots per day in July. For August, the Brazilian Health Ministry expects to receive 60 million doses. As such, the rate of deliveries should allow a pace of vaccination consistent with our baseline scenario. As of August 8, about 152 million doses (of 194 million available) had been administered in the country.

In spite of this constructive backdrop, we understand that the delta variant spread is a relevant risk as a resurgence in infections have been spurring plans of (third) booster shots around the world. In response to that, the Brazilian Health Ministry may shorten the interval between doses (of Pfizer and AstraZeneca vaccines) after all the adult population is vaccinated with the first dose. Some Brazilian states are already following that trend. The schedule for a third-dose program is also on the plan for this year.

According to the National Immunization Plan, Brazil has already secured more than 645 million doses for 2021. The breakdown of the 645 million doses is: 222 million of Fiocruz/AstraZeneca; 200 million of Pfizer; 130 million of Butantan/CoronaVac; 42 million from COVAX; 38 million of Janssen; and 13 million of Moderna. Worth noticing, Sputnik and Covaxin contracts have been canceled by the Health Ministry. In our base scenario, we assume a vaccination rate of 1.5 million/day in 2H21. At that pace, we expect that the entire *adult* population will be fully immunized (two shots) by the end of 2021.

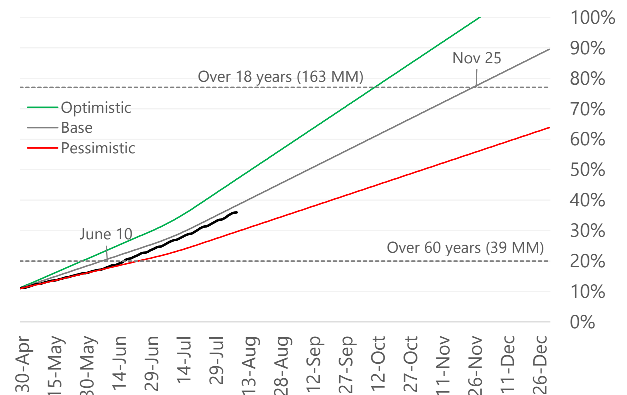
In our view, the numbers suggest the eventual immunization of a large majority of the population, allowing a continuing gradual easing of social distancing restrictions throughout the rest of the year. We believe this supports our assumption of a broader reopening of (socially integrated) services in 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.

[1] The nationwide average proxy is a weighted average (by state population) of state ICU occupancy rates. Hence, it is not the actual national occupancy rate = Total beds occupied in Brazil / Total beds available in Brazil.

## FISCAL POLICY: Short-Term Improvement Amid Higher Risks

**For the third time in 2021, we are upgrading our budget balance estimates on better revenues following the upward price shock (inflation, terms of trade). For 2021, the public sector primary deficit was revised to 1.6% of GDP (from 1.9% of GDP). Yet the fiscal risks have resurfaced of late. While our gross-debt estimate for 2021YE dropped to 81.6% of GDP (-0.6pp), we continue to forecast an upward debt trajectory for the medium term, with the path to a long-term stabilization looking increasingly riskier.**

We upgraded our forecasts, mainly due to an 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). In this scenario revision, a key factor was the new royalty revenue estimates, owing to the recent price surge, mainly from oil and iron ore production. We forecast this revenue now at BRL82 billion, from BRL69 billion in July, which represents an increase of 46.9% compared to 2020 and 25.8% compared to 2019. In this context, we improved our estimate of the structural long-term revenue gain based on favorable terms of trade, with a once-and-for-all increase of 0.25 pp of GDP per year (compared to 0.1 pp of GDP in July). As a result, we see the first year of primary surplus around 2025-26, one year earlier than in the previous scenario. Despite this improvement in the short-term figures, we believe the fiscal risks have increased since July. We see a higher inflationary pressure in the 2H21, which is causing a squeeze in the margin to execute the constitutional spending cap for 2022, as our estimate dropped to BRL22 billion (from BRL33 billion previously). This means less room to accommodate a new welfare program within the constitutional limits. Additionally, the 2022 estimate of court-ordered debt (so-called "*Precatórios*") soared to ~BRL90 billion for 2022, beating by and large the government's initial expectation (~BRL 55 billion). That can compress further the room for maneuvering the budget next year. For the medium-term fiscal outlook, we still envision significant risks for the fiscal consolidation process. On the revenue side, our numbers highly depend on the duration of the commodity boom, which we see as temporary. On the expenditure side, a good deal of mandatory outlays are indexes to inflation, and the spike is about to show in the subsequent year. Our calculations show 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. Thus, we see the fiscal rule as a necessary but not sufficient condition to assure consistent fiscal consolidation. This is especially true if economic tailwinds fade. In our view, any additional shock that raises the neutral interest rate or reduces potential GDP growth could derail the expected convergence of government debt. 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 BRL135 billion (1.6% of GDP), vs. BRL165 billion in June. Considering a regional government primary surplus of BRL30 billion. For 2022 onwards, we continue to expect primary deficits to gradually decline: -1.2% of GDP in 2022 and -0.9% of GDP in 2023. We forecast gross debt to reach 81.6% of GDP in 2021 (2020: 88.8% of GDP). We expect the indicator to peak in 2028 at ~91% of GDP (-3 pp from June), before falling toward ~77% of GDP by 2040.

**Figure 5.A. – Fiscal Margin and Budget Simulations**

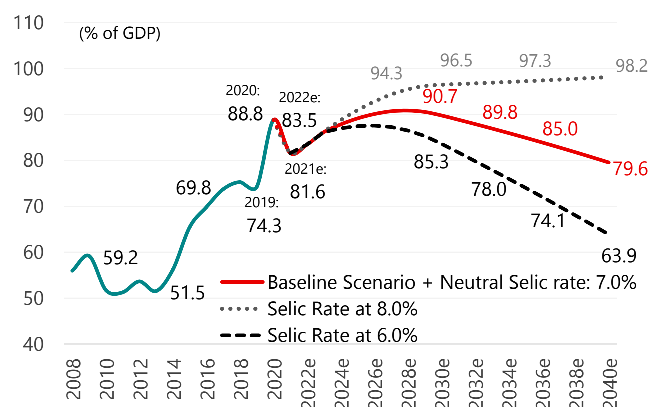
| 2022 Budget: Spending Cap Margin - BRL bn | | | | | | |
|---|---|---|---|---|---|---|
| | Court-oredered debts Budget (*"Precatórios"*) | | | | | |
| | BRL bn | 30 | 40 | 55 | 65 | 90 |
| Year-end Inflation (INPC \| Dec-21) | 6.5% | 60 | 50 | 35 | 25 | 0 |
| | 7.0% | 55 | 45 | 30 | 20 | -5 |
| | 7.8% | 47 | 37 | 22 | 12 | -13 |
| | 8.5% | 41 | 31 | 16 | 6 | -19 |
| | 9.0% | 37 | 27 | 12 | 2 | -23 |
| | 10.0% | 28 | 18 | 3 | -7 | -32 |

| New Welfare Program Budget - BRL bn | | | | | | |
|---|---|---|---|---|---|---|
| | Monthly Average Benefit (BRL/month) | | | | | |
| | | 250 | 270 | 300 | 350 | 400 |
| Families (millions) | 17 | 51 | 55 | 61 | 71 | 82 |
| | 16 | 48 | 52 | 58 | 67 | 77 |

*Bolsa Família*'s current budget (2021): BRL35 billion/year | Total: 14.6 million families

Sources: National Treasury, Santander.

**Figure 5.B. – Gross Government Debt Simulations**




Sources: Brazilian Central Bank, Santander.

## BALANCE OF PAYMENTS: Reality Check

**We continue to envision fairly constructive dynamics for the current account balance, with mild and easy-to-finance deficits expected for 2021 and 2022. However, recent developments also supported our view that the lack of progress on structural (especially fiscal) reforms should put a lid on the BRL strength for the medium term.**

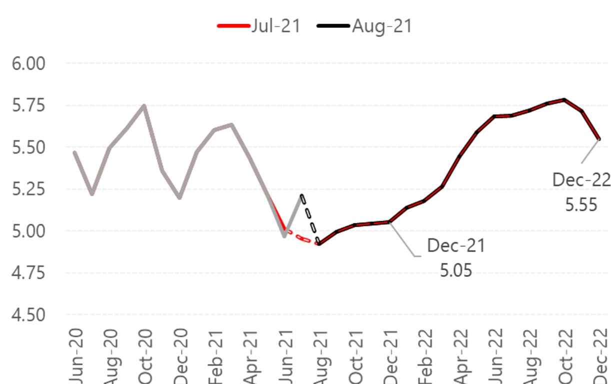
After having reached as low as USD/BRL4.90 in late June 2021 on intraday terms, the USD/BRL pair returned to the 5.20ish vicinity in early August 2021, chiefly in response to congressional debates of policies that can jeopardize the prospects for the fiscal consolidation process in the coming years (see details in the Fiscal Policy section). In our view, recent developments reinforced our perception that there are still high levels of uncertainties on the fiscal front, which can only be surmounted with structural reforms. However, a polarized political environment has turned the outlook for reforms a bit cloudier. This stalemate has kept markets skeptical about the trajectory of the government debt in the coming years and this lack of confidence has weighed on the BRL performance.

In other words, we believe that recent developments in Brazil have just reinforced our assessment that there is a limited room for the BRL to strengthen in the coming months. While the maintenance of favorable conditions on the international environment and a less expansionary monetary policy stance by the BCB may prop up the BRL in the short term, slow (if any) progress in structural reforms and electoral uncertainties could keep pressuring the BRL across 2022. That is why we continue to forecast the USD/BRL pair at 5.05 and 5.55 for YE2021 and YE2022, respectively.

We think it is important to bear in mind that this BRL weakness occurs in spite of favorable dynamics in the balance of payments. The Brazilian Central Bank revised the historical data for the balance of payments, which pointed to larger remittances of profits and dividends in 2020 and 2021, with the series revision enlarging the current account deficits. However, the flip side of these larger remittances of profits and dividends is a greater flow of direct investments in the country. In the end, the review did not alter the constructive perception about the Brazilian economy's external position.

Incidentally, this soundness of the Brazilian balance of payments continues to show up in our forecasts for the coming years. Even after the BCB's data revision, we are marking higher our current account estimates for the coming years. Part of this improvement refers to lower tourism outlays, which is related to the extension of mobility restrictions for Brazilian citizens on the heels of the pandemic. Another portion had to do with lower payments of equipment rental, which refers to oil platforms that have recently returned to the country (jn accounting terms). Last but not least, trade balance has also been revised upwards due to changes in the historical series that led to a higher basis of comparison. All of these changes led us to forecast current account deficits of US$0.3 billion and US$8.0 billion in 2021 and 2022 (from US$7.8 billion and US$12.4 billion deficits, respectively).

**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 | -25.9 | -0.3 | -8.0 |
| Trade balance | 26.5 | 32.4 | 64.9 | 64.3 |
| Exports | 225.8 | 210.7 | 276.5 | 290.9 |
| Imports | 199.3 | 178.3 | 211.6 | 226.7 |
| Services | -35.5 | -20.9 | -23.1 | -29.0 |
| Tourism | -11.6 | -2.3 | -6.0 | -9.4 |
| Eq. Rental | -14.6 | -11.9 | -11.0 | -15.7 |
| Others | -9.3 | -6.7 | -6.0 | -3.9 |
| Income | -57.3 | -39.7 | -45.1 | -46.2 |
| Profits & Dividends | -31.9 | -18.3 | -21.5 | -29.0 |
| Interest payments | -25.5 | -21.5 | -23.7 | -17.3 |
| Transfers | 1.2 | 2.3 | 3.0 | 3.0 |

Sources: Brazilian Central Bank, Santander.

## ECONOMIC ACTIVITY—CORE: Unchanged Outlook

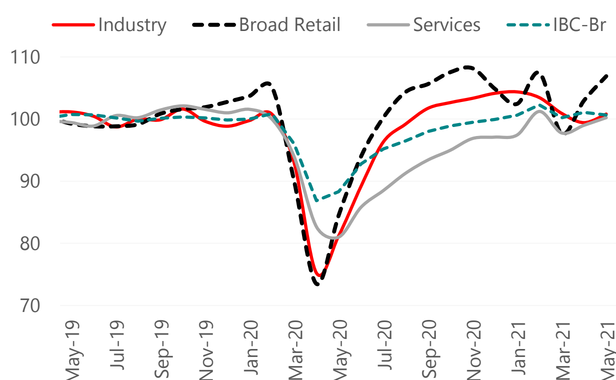
**We have maintained our 2021 GDP estimate at 5.1%. The negative market surprises seen in broad activity indexes up to now were in line with our scenario of a modest GDP figure in 2Q21, as we see farm and industrial output dragging activity in the short-term and offsetting the recovery in the tertiary sector. The expected economic reopening and favorable commodity prices support the outlook for this year. We are maintaining our 2022 GDP estimate at 2.0%, given the lingering effects from the better terms of trade in conjunction with expectations of a fully operational economy.**

The 1Q21 GDP positive figure stemmed from all the three sectors, yet less cyclical farm output provided the largest contribution (on the supply side). For 2Q21, we expect some heterogeneity in the composition of economic activity. The tertiary sector should contribute positively, on the heels of the faster-than-expected recovery of urban mobility and the new round of Emergency Aid. On the other hand, we expect farm output to partially give back its positive GDP contribution and 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 look for a faster recovery in 2H21, with a virtual return to "normal mobility" levels at the end of 3Q21 (from end of 4Q21 in our previous scenario). Regarding GDP, we maintained our expectations of 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 with the partial pay-back of agriculture's growth and weak industrial performance weighing on the overall performance. For 2H21, higher commodities prices, along with advances in the economy's reopening, should contribute to a better momentum. 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 are maintaining our forecast at 2.0%. We believe that good growth contributions are to come from the lingering positive effects from the commodity cycle and an economy in full-operation mode (over a basis of comparison still somehow affected by social distancing measures in 2021). Those factors are expected to be partially mitigated by the delayed effects of a less expansionary monetary policy and a little reduction of the fiscal impulses.

**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 | 2.1 | 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 | 4.7 | 2.0 |
| Government Consumption | 0.8 | -0.4 | -4.7 | 2.0 | 1.2 |
| Investments | 5.2 | 3.4 | -0.8 | 10.9 | 2.4 |
| Exports | 4.1 | -2.4 | -1.8 | 9.4 | 2.4 |
| Imports | 7.7 | 1.1 | -10.0 | 13.9 | 6.9 |

Sources: IBGE, Santander.

## ECONOMIC ACTIVITY—EMPLOYMENT: A More Consistent Recovery

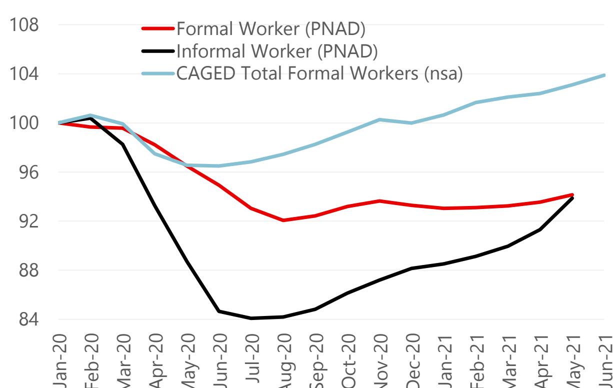
**The vaccine rollout and the increase in urban mobility led to a faster recovery in the labor force and employment, in our view. These recent developments are aligned with our scenario. We made slight upward revisions in our trajectories for employment and participation to incorporate higher mobility in 3Q21 and 4Q21. We now estimate an average unemployment rate of 14.1% in 2021 and 13.5% in 2022 (from previous estimates of 14.2% and 13.6%, respectively).**

The recent batch of labor market data showed some improvement in employment conditions[2]. According to the IBGE's National Household Survey (PNAD), the unemployment rate stood at 14.6% in the three months to May. We calculate that the seasonally adjusted jobless rate stood at 14.3%, a slight decrease compared to the April level (14.4%). This result stemmed from increases of 1.6% MoM sa and 1.4% MoM sa in the employed population and the labor force, respectively. According to the June 2021 CAGED survey, net (unadjusted) formal job creation stood at +309.1k, considerably above the month's historical average of +105.8k and matching the all-time record for the month (+309.4k in 2008). We estimate that the seasonally adjusted, net formal job creation increased to +321k in May, from +274k in April. The reports point to for a jobs recovery in sectors more dependent on social interaction (example: informal workers in PNAD, services sector in CAGED). We expect the vaccine rollout and urban mobility to play a crucial role for the labor force and employment recovery in coming months. We naturally see the segments more reliant on social interaction gaining traction.

We have made minor adjustments in our unemployment rate trajectory for 2021 and 2022, as our new hypothesis for urban mobility implies a slightly faster recovery for both the employed population and participation rate. We are marginally reducing our average unemployment rate forecasts for 2021 and 2022 to 14.1% and 13.5%, respectively (from previous estimates of 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.

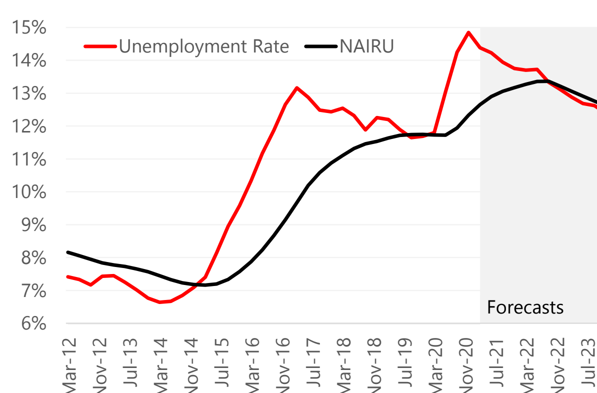
We evaluate that the job market remains fragile and with considerable slack, especially considering the pandemic's impact on informal workers, which CAGED fails to capture. We estimate[3] that the Non-Accelerating Inflation Rate of Unemployment (NAIRU) has increased significantly due to the pandemic but is still around 1.5 pp below the current unemployment rate (our estimates indicate a gap of 1.7 p.p. in 1Q21 and 1.4 p.p. in 2Q21). In our view, as the employed population and the labor force recover at similar rates, unemployment rate should slowly fall throughout 2021, 2022 and 2023. We expect the unemployment rate to reach the NAIRU level in mid-2022, with both series moving lower in tandem, subsequently.

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




Sources: IBGE, Ministry of Economy, Santander.

**Figure 8.B. – Unemployment Rate and the NAIRU (sa)**




Sources: IBGE, Santander.

[2] **Santander Brazil Labor Market - *"Higher Mobility Continues to Push Job Market Recovery"* –** July 30, 2021 – Available on: https://bit.ly/Std-labor-073021

[3] **Methodology based on Marta Areosa – "Combining Hodrick-Prescott Filtering with a Production Function Approach to Estimate Output Gap" –** August 2008 - Available on: https://www.bcb.gov.br/pec/wps/ingl/wps172.pdf

## ECONOMIC ACTIVITY—CREDIT: Solid New Landing and Higher Indebtedness

**We are revising our projections for real total outstanding loan growth to 4.8% in 2021 and 5.4% in 2022, from 3.2% and 3.9%, respectively, as recent data support our positive view on bank credit this year. However, a continued increase in household debt is a risk for loan growth in the medium term.**

Total outstanding loans in the National Financial System (SFN) posted inflation-adjusted growth of 7.3% YoY in June (to BRL4.2 trillion), up 8.4% YoY for households and 5.9% YoY for non-financial corporations. New loans adjusted for inflation and seasonality (using the BCB methodology) increased 1.1% MoM in June, after a slight drop in May (-0.1% MoM-sa).

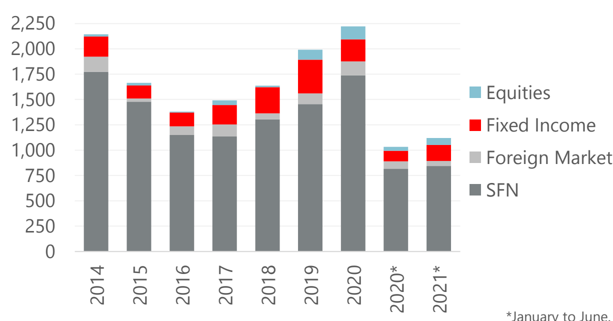
For households, the non-earmarked segment posted an increase of 3.4% MoM-sa, driven by credit card and vehicle purchases. In the earmarked segment, real estate financing keeps flying high (+60% YoY), reflecting the still favorable financial conditions. For companies, there was an increase of 3.8% MoM-sa in June in the non-earmarked segment, with discount of trade bills standing out (+35%). In the earmarked segment, there was a decrease of 2.5% MoM-sa. Importantly, out of the BRL25 billion in credit from Pronampe expected for 2021, BRL17 billion have already been used.

Considering total corporate financing[4] so far this year, through June vs. the year-ago period, issuances in the capital markets are 57% higher, while SFN concessions are now up 3%. As a result, total corporate financing is up 8% compared to the year-ago period.

The seasonally adjusted default rate (% of 90-day past-due loans) of non-earmarked loans came in at tame levels (4.1% and 1.6%, for households and corporations, respectively). Importantly, debt-to-income continues to rise, which we see as a risk for delinquency as the economy normalized (and the stimuli fade).

Risk factors for our baseline scenario: the reopening process and/or the delta variant spread 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. The growth mismatch between consumer new loans and household income is a risk for NPLs and the pace of origination for the medium term.

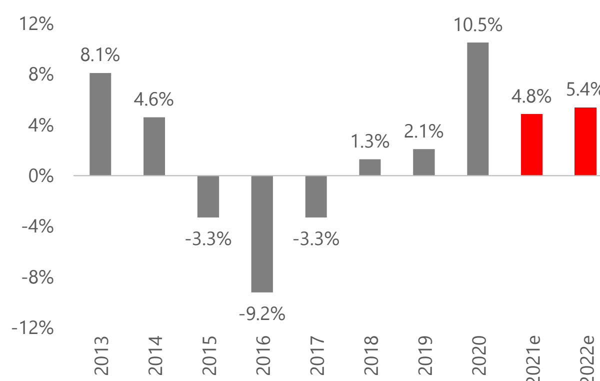
**Figure 9-A. Total Corporate Financing (BRL billion, Inflation Adjusted)**




SFN - exclude *conta garantida, cheque especial* (overdraft) and credit card.
Foreign Market - bonus, MTNs and securities.
Fixed Income - Debentures, commercial papers, LFs, CRAs, CRIs e FIDCs.
Equity - IPO and follow-on.

Sources: Brazilian Central Bank, Anbima, Santander.

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




Sources: Brazilian Central Bank, Santander.

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

## INFLATION: A Riskier Dynamics As Pressures Spread Out

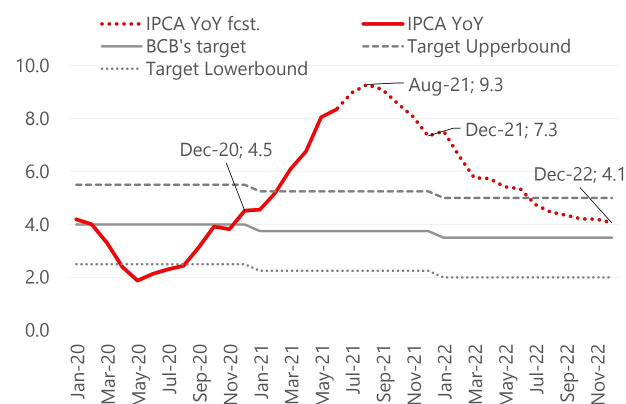
In our last scenario revision, the inflation section's title was "Upward Pressure Pile Up and Shocks Start to Spread", meaning we were already seeing new shocks (adding to the previous ones) and first signs of second-order effects coming from those primary shocks. Since then, we have seen more shocks (a new one hitting food prices) and further signs of further deterioration within the IPCA basket. These mounting second-order effects are making underlying inflation pick up steam. We are revising IPCA 2021 from 6.7% to 7.3% (core inflation from 4.9% to 5.4%) and IPCA 2022 from 4.0% to 4.1% (core inflation from 3.9% to 4.1%).

For the short term (until year-end 2021), a relevant part of the revision (see Figure below) was in food inflation, due to a weather shock (an inclement winter, prompting unusual frosts in agricultural areas) that impacted mostly fresh-food, but also some less volatile items, such as corn. In regulated prices, electricity inflation was also revised up, once again because of higher costs of the Red 2 tariff flag[5]. More important, core-related groups—services and industrial goods—also suffered upward revisions. On industrial goods, the impact on prices coming from the effects of the supply chain disruption and the commodities shock are proving stronger and longer than we anticipated. On services, the primary shocks on the food and industrial sectors are spreading to the services sector, while the reopening of the economy facilitates the pass-through, pushing services inflation up.

Looking ahead (2022), we continue to assume that the myriad of shocks that hit the economy remain temporary, but the size and persistency of those shocks continue to surprise. In particular, we now see stronger second-order effects reaching services inflation, while industrial goods inflation should continue under pressure, meaning an unfavorable composition for inflation, as those two groups are closely related to core measures, adding risks to underlying inflation. Indeed, our forecast for core inflation rose to 4.1% (from 3.9%). The high level of the diffusion index in historical terms is another sign of an unfavorable outlook for inflation.

Our IPCA 2021 forecast 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 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. The backlog of price rises at the wholesale level that are still to come to consumers is one risk and the possible stronger spread (second-order effects) of primary shocks to general prices is another risk, especially with the reopening of the economy facilitating the pass through. Despite the high level and unfavorable composition for inflation, we highlight that we do not see a disruption scenario, as we believe the BCB's Selic hikes (see more in Monetary Policy section) will bring inflation to the target (3.25%) in 2023.

**Figure 10.A. – IPCA 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 | 6.7 | 7.3 | 61 | 4.0 | 4.1 | 10 |
| Free prices | 5.1 | 5.9 | 53 | 4.1 | 4.2 | 10 |
| Food-at-home | 6.5 | 8.2 | 26 | 3.5 | 3.5 | 0 |
| Industrial goods | 6.7 | 7.4 | 16 | 4.7 | 4.7 | 0 |
| Tradables | 6.7 | 7.4 | 14 | 4.7 | 4.7 | 0 |
| Non-Tradables | 6.7 | 7.4 | 2 | 4.7 | 4.7 | 0 |
| Services | 3.5 | 3.9 | 12 | 3.9 | 4.2 | 10 |
| Food-service | 8.7 | 8.7 | 0 | 6.0 | 6.0 | 0 |
| Airline tickets | 10.3 | 35.0 | 8 | 16.0 | 16.0 | 0 |
| Economic activity | 1.9 | 1.9 | 0 | 2.7 | 2.8 | 1 |
| Education | 3.0 | 3.0 | 0 | 5.5 | 5.5 | 0 |
| Inertial | 2.9 | 3.3 | 3 | 3.3 | 4.1 | 6 |
| Salaries | 2.3 | 2.4 | 1 | 2.7 | 3.1 | 2 |
| Regulated | 11.1 | 11.4 | 8 | 3.8 | 3.8 | 0 |
| Gasoline | 29.7 | 29.7 | 0 | 4.5 | 4.5 | 0 |
| Energy | 10.7 | 14.5 | 17 | -3.0 | -3.0 | 0 |
| Health insurance | 3.9 | 2.6 | -5 | 9.0 | 9.0 | 0 |
| Bus fares | 1.5 | 1.5 | 0 | 6.0 | 6.0 | 0 |
| Cores | 4.9 | 5.4 | 50 | 3.9 | 4.1 | 20 |

Sources: IBGE, Brazilian Central Bank, Santander.

[5] We are assuming that Aneel will revise the cost of Red 2 flag to BRL 11.50 per 100 KWh, as per the public consultation they opened recently.

## MONETARY POLICY: Aiming for a Tight Stance

**As the BCB faces worsening inflation conditions and seek to curb expectations for the relevant policy horizons, we look for a faster and larger interest-rate adjustment in this cycle. We revised our Selic rate forecast for the end of 2021 to 7.50% (previously 7.00%) and continue to expect it to be on-hold in 2022. A possible decline to the neutral level (which we assume at 7.00%) is to take place only in 2023.**

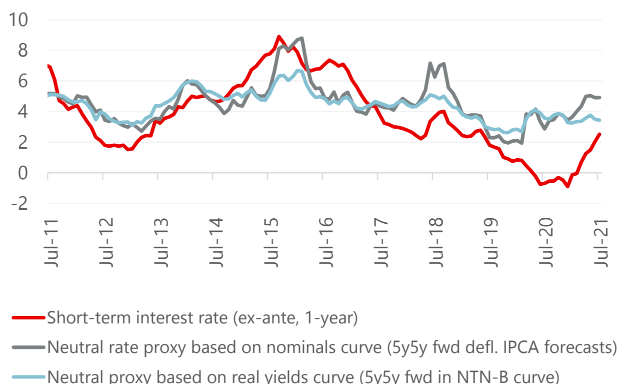
In the last formal communications (Copom statement[6] and policy minutes[7]), the BCB upped further the tone, responding to the deterioration in inflation conditions and outlook, with a view to rein in inflation expectations. In the August 3-4 policy meeting, the COPOM hiked the Selic policy rate by 100 bps to 5.25%, broadly in line with market expectations. According to the BCB, the decision "reflects the Committee's perception that the recent deterioration of inertial components of inflation, in a moment of reopening of the service sector, could result in an additional deterioration of inflation expectations." In the statement, the BCB has also signaled that it now deems appropriate a tightening cycle to take the Selic rate to a level above the neutral, meaning another adjustment to its flight plan (which previously pointed to a neutral Selic rate at the end of the cycle). For the short term, the committee hinted at another potential move of 100 bps (to 6.25%) in September.

The COPOM's decision to abandon the previous signal of a neutral Selic is in line with its IPCA inflation projections. According to the models, with the FX rate starting at 5.15 (and moving along with PPP afterwards), a path of Selic rate hikes to 7.00% for YE2021 and stable throughout 2022[8] would produce a disinflation of the IPCA exactly to the mid-target of 3.5% for the main policy horizon (2022). This forecast was stable from the last meeting, but now incorporates a tighter policy stance (to offset the worse outlook). For 2021, the BCB simulates a hefty IPCA inflation reading of 6.5% (previously: 5.8%), well above the upper target of 5.25%.

In the policy minutes, the COPOM highlights that "the fiscal risks continue to imply an upward bias in the projections. This asymmetry in the balance of risks affects the appropriate degree of monetary stimulus, thus justifying a path for monetary policy that is more restrictive than the one used in the baseline scenario." We believe these remarks make a 7% terminal Selic rate a lower bound for the expected adjustment.

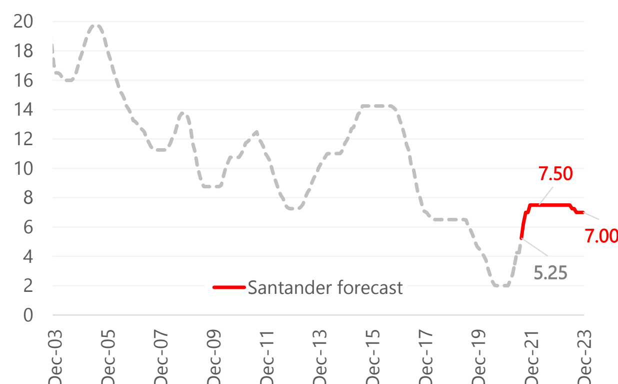
We continue to look for another hike of 100 bps (to 6.25%) in September and a subsequent move of 75 bps in October. We have recently incorporated to our baseline scenario a final move of 50 bps in December, with our terminal rate expectation upgraded to 7.50% (from 7.00% previously). We expect the Selic rate to remain at this level throughout 2022, with an expected reduction towards (our hypothesis of) the neutral level of 7.00% only in 2023. That's the horizon when we finally expect IPCA inflation to converge to the mid-target (3.25%), declining from a likely reading of just above 4% next year.

**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.

[6] **Santander Brazil Monetary Policy - *"Stepping Up the Pace and the Plan"* –** August 5, 2021 – Available on: https://bit.ly/Std-COPOM-aug21
[7] **Santander Brazil Monetary Policy - *"More Than the Simulations"* –** August 10, 2021 – Available on: https://bit.ly/Std-Copom-min-aug21
[8] According to the Focus survey, the trajectory of the Selic rate projected by analysts include another 100bps move in September.

## FORECASTS: Santander & Consensus

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

| | 2021E | | | | | |
|---|---|---|---|---|---|---|
| | Consensus | | | Santander | | |
| | 2-Jul-21 | | 6-Aug-21 | 1-Jul-21 | | 12-Aug-21 |
| IPCA Inflation (%) | 6.1 | ↑ | 6.9 | 6.7 | ↑ | 7.3 |
| GDP Growth (%) | 5.2 | ↑ | 5.3 | 5.1 | → | 5.1 |
| Selic policy rate (%, year end) | 6.50 | ↑ | 7.25 | 7.00 | ↑ | 7.50 |
| Exchange rate (USD/BRL, year end) | 5.04 | ↑ | 5.10 | 5.05 | → | 5.05 |
| Current Account (USD billion) | -0.4 | ↑ | 0.0 | -7.8 | ↑ | -0.3 |
| Primary Budget Balance (% GDP) | -2.4 | ↑ | -1.9 | -1.9 | ↑ | -1.6 |
| Net Govt. Debt (% GDP) | 61.6 | ↓ | 61.5 | 59.9 | ↓ | 59.2 |

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 | | |
| | 2-Jul-21 | | 6-Aug-21 | 1-Jul-21 | | 12-Aug-21 |
| IPCA Inflation (%) | 3.8 | ↑ | 3.8 | 4.0 | ↑ | 4.1 |
| GDP Growth (%) | 2.1 | ↓ | 2.1 | 2.0 | → | 2.0 |
| Selic policy rate (%, year end) | 6.75 | ↑ | 7.25 | 7.00 | ↑ | 7.50 |
| Exchange rate (USD/BRL, year end) | 5.20 | → | 5.20 | 5.55 | → | 5.55 |
| Current Account (USD billion) | -16.0 | ↑ | -14.0 | -12.4 | ↑ | -8.0 |
| Primary Budget Balance (% GDP) | -1.7 | ↑ | -1.4 | -1.7 | ↑ | -1.2 |
| Net Govt. Debt (% GDP) | 63.6 | ↓ | 63.2 | 61.4 | ↓ | 60.6 |

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 | | |
| | 2-Jul-21 | | 6-Aug-21 | 1-Jul-21 | | 12-Aug-21 |
| IPCA Inflation (%) | 3.3 | ⇨ | 3.3 | 3.3 | ⇨ | 3.3 |
| GDP Growth (%) | 2.5 | ⇨ | 2.5 | 1.5 | ⇨ | 1.5 |
| Selic policy rate (%, year end) | 6.50 | ⇨ | 6.50 | 7.00 | ⇨ | 7.00 |
| Exchange rate (USD/BRL, year end) | 5.05 | ⇩ | 5.00 | 5.20 | ⇨ | 5.20 |
| Current Account (USD billion) | -23.0 | ⇨ | -23.0 | -20.0 | ⇩ | -30.4 |
| Primary Budget Balance (% GDP) | -1.1 | ⇧ | -0.7 | -1.3 | ⇧ | -0.9 |
| Net Govt. Debt (% GDP) | 66.1 | ⇩ | 65.0 | 64.2 | ⇩ | 63.2 |

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 on global activity.<br>• 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 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.<br>• Downside risks (prices): New virus variants could trigger tightening in mobility conditions, weighing on consumption. A faster than expected reversal in Fed stimulus. |
| **Covid-19** | • Upside risks: Authorities shortening the dosing interval of AstraZeneca and Pfizer vaccines, pulling forward the expected vaccine schedule.<br>• Downside risks: 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 budgetary rigidity and idiosyncratic risk. More curbs on payroll spending. Lesser polarization for the 2022 election.<br>• Downside risks: Risks of fiscal slippage in the wake of temporary factors that prompt a misleading "fell-good" sensation. Approval of reforms without fiscal impact creating distortions in budget management across government branches. Loss of credibility in the fiscal consolidation process and transparency of the official numbers, causing financial conditions to deteriorate. Changes in the 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.<br>• 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 risk assets. |
| **Economic Activity** | • Upside risks: stronger than expected effect of economic reopening on services reliant on social interaction. Faster than expected solution to supply-chain disruptions in manufacturing.<br>• Downside risks: an additional increase of infections despite a more disseminated vaccine rollout and delays in the vaccination campaign would likely impair the economy's reopening process. A prolonged shortage of inputs in some production chains, along with likely implications of the drought for both electricity generation and agriculture output. An even stronger inflationary shock making the BCB's policy stance even tighter. |
| **Inflation** | • Upside risks: (i) a higher pass through 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) another round of FX depreciation (on fiscal risks); and (vi) the increase in electricity could be greater, depending on the weather.<br>• 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; and (iv) pass-through could be more limited than we estimate, given the still existing economic slack; |
| **Monetary Policy** | • Upside risks: further price shocks or more prolonged global supply constraints could raise fears of more secondary-round effects (services, expectations). Fiscal stimulus with a narrower output gap could add to inflation. Sluggish macro reforms could hurt the outlook for debt sustainability, affecting the anchoring power of monetary policy and the neutral rate.<br>• Downside risks: a retracement of costs in BRL could reduce the backlog of PPI pressures, providing some respite for industrial goods and inflation expectations. Better corporate margins could also mean lesser upstream price pressures. A faster increase in job market participation could soften the impact of the reopening in services inflation, alleviating a bit the BCB concerns. |

Source: Santander.

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