BRAZIL MACRO

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SCENARIO REVIEW

SIGNS OF NORMALITY IN PUBLIC HEALTH, EVIDENCE OF RISKS IN FISCAL POLICY

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- On the fiscal side, we changed our primary fiscal balance estimates: we now see a lower deficit for 2021 (now 0.5% of GDP, previously 1.3%) on better revenues, and a higher gap for 2022 (now 1.3%, previously 1.0%) on court-ordered debt payments. We also estimate a clearer upward trajectory for government debt, after a brief interruption this year. Our gross debt estimate for YE2021 is now 80.7% of GDP (+1.0 p.p.), on higher debt costs (inflation, interest rate). We continue to forecast for a rising path of government debt for the medium term, with the road to long-term stabilization looking increasingly riskier. The fiscal debate remains in the spotlight, with discussions centered on the 2022 budget proposal and a particular focus on social programs.
- In our view, fiscal risks continue to cap BRL upside, with recent global jitters regarding the US monetary policy outlook and the slowing growth in China putting additional pressure on the USD/BRL. Amid a still heated political debate, we are revising higher our forecast for the USD/BRL for YE2021 to 5.35 (from 5.25). We still project the BRL will weaken to USD/BRL5.55 in YE2022.
- The mix of a weak currency, solid demand and favorable prices for commodities, as well as a gradual domestic demand recovery should continue to produce above-average current account results. We project nearly balanced current account results in 2021 and 2022 (-US$0.5 billion and -US$0.4 billion, respectively), as well as comfortable external financing with hefty direct investments (US$59.2 billion and US$67.5 billion, respectively).
- We are lowering our 2021 GDP estimate to 4.9% (from 5.1%) following weaker-than-expected 3Q21 activity data, mainly in the goods-related sectors. Our 2H21 outlook remains constructive, given an apparently safe economic reopening as the pandemic gradually fades with advances in the vaccine rollout. But a tighter monetary policy path and worse financial conditions prompted us to reduce our 2022 GDP estimate from 1.7% to 1.5%, partially offsetting the growth contributions from a mechanical recovery in services.
- Recent methodological changes in the PNAD household survey have anticipated part of the employment recovery, leading to a reduction in our 2021 unemployment rate forecast. We expect this effect to dissipate in 4Q21, so that we are keeping our estimates for 2022. We estimate average joblessness of 13.8% in 2021 (previously 14.1%) and 13.7% in 2022 (unchanged).
- We are raising our inflation forecasts once again—with IPCA 2021 upped to 9.0% (from 8.5%) and IPCA 2022 upped to 4.7% (from 4.3%). The level and composition of consumer inflation look increasingly unfavorable for 2022, and we project that inflation will not converge to the mid-target until 2023 (3.25%). In fact, we are starting to see upside risks for that horizon too.
- In response to a worsening inflation outlook and rising inflationary risks, the Brazilian Central Bank (BCB) continues to rapidly remove monetary stimulus and pledges a contractionary policy stance. We are further raising our forecasts for the terminal Selic rate in the cycle, to 9.00% from 8.50%, with risks still skewed to the upside. We continue to envision the start of a path towards the neutral level of 7.00% only in 2H23.

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Figure 1. Santander Macro Forecasts for Brazil – Summary

Macroeconomic variables		Previous		Current
GDP (%)	2021E	5.1	↓	4.9
	2022E	1.7	↓	1.5
	2023E	1.0	↓	0.8
IPCA (%)	2021E	8.5	↑	9.0
	2022E	4.3	↑	4.7
	2023E	3.3	→	3.3
Selic Rate (% end of period)	2021E	8.25	→	8.25
	2022E	8.50	↑	9.00
	2023E	7.00	→	7.00
FX Rate - USDBRL (end of period)	2021E	5.25	↑	5.35
	2022E	5.55	→	5.55
	2023E	5.20	→	5.20
Current Account Balance (% of GDP)	2021E	0.1	↓	0.0
	2022E	-0.6	↑	0.0
	2023E	-1.7	↑	-1.6
Primary Fiscal Balance (% of GDP)	2021E	-1.3	↑	-0.5
	2022E	-1.0	↓	-1.3
	2023E	-0.8	↓	-1.1
Gross Public Debt (% of GDP)	2021E	79.7	↑	80.7
	2022E	82.2	↑	83.8
	2023E	85.6	↑	87.8

Source: Santander estimates.

EXECUTIVE SUMMARY: Between the Vaccine's Benefits and Inflationary Stimuli Removal

After 18 months of the pandemic, we see the first signs of a return to full mobility and, therefore, economic normality.

The main factor responsible for this was the production of the vaccines in record time, which has proven efficacious. Though doubts remain about the robustness of immunity, the effectiveness of vaccines against more serious cases is evident. At the beginning of the pandemic, epidemiologists warned of a possible duration of 30 to 60 months, making the contribution of science and technology in shortening the process remarkable.

Thus, with three-quarters of the population inoculated with at least one dose in Brazil, the country is returning to normal mobility rates. The last quarter of the year should be the first time since the pandemic's outset that the economy could grow toward a post-pandemic normal. With no significant impact expected from possible coronavirus variants on the health system, the rates of new cases and daily deaths should quickly converge to minimum levels.

Though we continue to strongly advocate that vaccines are the safest and most effective strategy for achieving a rapid economic recovery both locally and globally, unequal access has widened the gap between advanced and developing economies.

We are hopeful that 2022, hence, will be the first year since the start of the pandemic without substantial health incidents, with millions of lives saved, students return to in-person learning, service consumption increasing (especially those provided to families) and goods consumption returning to normal. We expect the labor market to recover jobs — especially informal ones — that were the most affected by the pandemic. Since the pandemic began in early 2020, 12 million jobs have been lost, with just over half, or 7.4 million, having been recovered created since then. We expect the labor market gap to close by the end of next year, with the unemployment rate returning to 13.5% — a level that would still be extremely high by Brazilian standards.

It is these fundamentals that lead us to consider a 3.4% growth in wages next year, inflation discounted and already considering income transfers like *Auxílio Brasil*, a federal government program that replaces *Bolsa Família*. We project that services to families will grow above 20% in contrast to virtually stable goods consumption, with a drop in durable goods.

If the wage bill grows, credit and the use of circumstantial savings by the highest-income families will no longer drive consumption, as they did this year. On the other hand, a portion of the income growth will be directed to support the higher payment of financial services by families, whose indebtedness level recently reached 60% of income, according to BCB data. After the real increase in credit concessions contributed to 3.4% expansion in household consumption, we expect limited growth of 1.3% next year, due to the already high level of indebtedness. However, we do not expect a significant increase in delinquency.

Thus, the reopening of the economy and the jobs creation will be the main factor promoting GDP growth in 2022, which we estimate at 1.5%. The relatively strong deceleration in 2021 (4.9% forecast) should basically be spurred by a rise in inflation. We do not expect interruptions in the energy supply to production next year.

However, with the reopening of economies, a labor market recovery and the U.S. inflationary situation, the Federal Reserve has signaled the beginning of stimuli removal, which was heavily implemented during the pandemic. Thus, we consider the beginning of asset purchase reductions (tapering) between November and December of this year, ending in mid-2022. And also, but starting later (in 2023), the basic interest rate increase. Long-term fiscal stimuli, translated into investment programs in renewable energy, education, and technologies, both in the U.S. and in Europe, should remain, but with gradual evolution.

In particular, the Chinese economy has recently faced issues in real estate and financial market, energy shortages, and regulatory changes at major technology companies, raising doubts about China's potential

growth. Such uncertainties are of particular importance for Brazil, as this is our largest trading partner, responsible for two-thirds of our iron and soybean exports. These doubts, though, will be present for some time in the scenarios for the global economy.

In Brazil, uncertainties persist about the 2022 federal budget and fulfillment of fiscal rules. We expect the artificially opened space in the spending ceiling by the partial withdrawal of *precatório* payments to be occupied by more obligatory expenditures (higher inflation over-indexed expenditures) and by the government's new social program. We estimate the extra-ceiling payment of court orders at around BRL30 billion next year. Thus, the primary deficit in 2022 (1.3% of GDP) should be greater than this year's (0.5% of GDP), adding clarity to the deteriorating trajectory of public debt as a proportion of GDP, after a brief interruption this year.

Despite occasionally better primary results, helped by the faster-than-expected economic recovery, the inflationary environment, and the commodity shock, there is a clear increase in financial expenses, which will soon reach the volume of BRL300 billion per year, or about BRL200 billion more compared to pre-pandemic.

With the winds from abroad changing direction, idiosyncratic risks continue to weigh on domestic risk premiums and asset prices. In addition to an increase in global risk, uncertainties persist internally at the fiscal and political-institutional level, with the proximity of presidential elections. We estimate the exchange rate at 5.35 at the end of 2021 and at 5.55 at the end of 2022.

With the persistence and spread of inflation, with upside risks — we project IPCA at 9.0% this year and 4.7% next year — we see the Selic rate reaching 8.25% at the end of 2021 and 9.0% at next year's first Copom meeting. Inflationary inertia has returned, with price increases reaching the cores, especially administered prices and services. We expect the gradual easing of monetary policy to start only in mid-2023.

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 if new strains emerge, and vaccinations should accelerate in EMs. Supply chain and energy issues are slowing global growth and pushing inflation higher. Nevertheless, activity should remain robust and inflation expectations anchored. • The Fed will start tapering its asset purchases in November 2021 and should end these by June 2022. 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 expect all adults to be fully immunized (two shots) by the end of 2021. • Vaccines prove effective against new Covid-19 variants.
Fiscal Policy	• The price shock effect (via inflation and terms of trade) on revenue will be temporary. The government will curb pressure for new fiscal stimulus and manage risks regarding court-ordered debts (*Precatórios*). • 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". • 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 steady international trade flows to favor trade surpluses, thus counterbalancing larger primary income expenses. • Idiosyncratic (fiscal, political) risks should limit the room for a significant strengthening of the BRL, notwithstanding the help from a higher interest rate.
Economic Activity	• Maintenance ahead of the perennial mobility recovery, with no setbacks in the economic reopening process. • The continuity of the reopening will maintain the higher levels of labor demand, resulting in the normalization of the labor force participation and better employment conditions at the end of 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). • 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. • 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) and inertia will not remain stronger permanently.
Monetary Policy	• The BCB will continue to aim inflation at the mid-target for the relevant policy horizons. For calendar-year 2022, however, the intensity and nature of the shocks (highly supply and cost driven) will probably imply that Copom efforts will not be sufficient, despite a much more hawkish policy stance. • While achieving the mid-point inflation target for 2022 may prove an elusive task, we assume the BCB will retain its capacity to anchor inflation expectations for the medium and long term.

Source: Santander.

COMMODITIES: Global Energy Crisis Fuels Inflation Fears

A mixed outlook for commodities emerges as the energy crisis clouds the global economic recovery. Agri commodity prices had some relief owing to favorable weather, but the gas shortage in Europe means additional pressure for energy prices. While we see it as temporary, the risk is that it continues to trigger secondary effects in the economy, fueling concerns about global inflation. Still, we maintain our view that most commodity prices will continue to fall once the gas shortage is behind.

In agri commodities, the USDA forecasts a record soybean crop and the second-largest ever for corn in the U.S. As a result, ending stocks for 2021-22 have been revised higher. Meanwhile, the LatAm outlook for the 2021-22 marketing year is promising on the back of September rains and favorable October weather forecasts. Still, the La Niña remains a risk (albeit poised to be weaker than last year). China's demand for U.S. grains has been weak as of late, significantly below markets expectations.

In energy, prices for natural gas and coal from Europe to Asia soared in recent weeks on constrained supply, high demand and low inventories. At 77%, European gas storage is significantly less than in recent years (90% on average at this time in the last five years). While the shortfall should prove temporary — we believe that supply is likely to pick up and demand to normalize throughout the winter — it has been causing a massive switch to oil products, prompting unseasonably high demand for oil byproducts and deepening the supply deficit in crude markets. The risk is that this energy crisis continues to trigger secondary effects in the economy, restricting output from fertilizers to metals and fueling concerns about global inflation.

In metals, the broad surge in prices was driven by the energy shortage that forced production cuts from aluminum to zinc, either due to rising energy costs (Europe) or because of power restrictions (China). Industrial metals require large energy inputs to produce, which is why their prices usually track those of energy closely over time. With record-high raw material costs, manufacturing sectors around the world could be under threat. As for iron ore, the rally came to a halt as uncertainty on how China will implement steel curbs continues to cloud demand.

In our view, the food commodities market remains tight but larger-than-expected crop yields in key producers feed expectations for relief in food inflation ahead. In energy, we expect coal and natural gas prices to remain high in the coming months, whereas for oil, OPEC+'s production policy will be the main factor influencing prices. We still expect a slow production response from key exporting countries in spite of growing calls for higher output. The next OPEC+ meeting is set for November 4. Lastly, we expect metals to be pressured in the near term by the energy crisis but the outlook for China's demand remains weak, given the slowing housing activity despite discussions of renewed (targeted) stimulus.

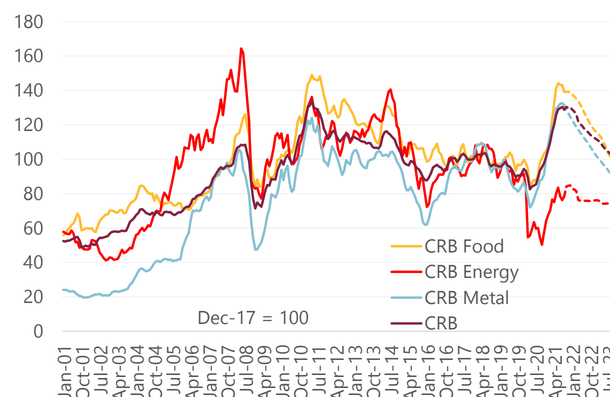
Figure 3. Our Forecasts for CRB Index – End of Period

End of Period	2019	2020	2021e	2022e	2023e
CRB Food	331	355	472	397	319
CRB Energy	1647	1161	1548	1392	1366
CRB Metal	749	887	1102	915	764
CRB	401	444	560 ↑	483 ↓	430 ↓

YoY	2019	2020	2021e	2022e	2023e
CRB Food	1%	7%	33%	-16%	-20%
CRB Energy	2%	-30%	33%	-10%	-2%
CRB Metal	-11%	18%	24%	-17%	-17%
CRB	-3%	11%	26%	-14%	-11%

Sources: Bloomberg, Santander.

Figure 4. Our Forecasts for CRB Index – Monthly Averages



Sources: Bloomberg, Santander.

COVID-19 in Brazil: Health Conditions Still Improving

The level of infections, hospitalizations and deaths continues to drop across the country. We expect an average vaccination rate of 1.5 million shots per day throughout the rest of the year, slowly declining but still enough to immunize the entire adult population. While the Delta variant remains the main risk, we believe that another round of social-distancing measures is very unlikely.

In mid-October, the 7-day average for infections was close to 10k/day — the lowest level since May 2020. The average for casualties stood at ~320/day — the lowest level since November 2020. Our proxy for a nationwide average ICU occupancy rate[1] continues to decline, reaching just below 40%, which compares to a previous peak of 92% in late March 2021.

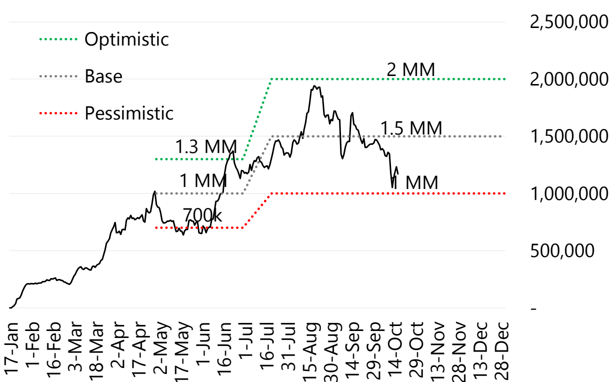
With nearly half of the population fully immunized, Brazil's vaccination campaign is moving ahead with booster shots for healthcare workers and the elderly, as well as first dose for teenagers. As such, it should lead to a rate of vaccinations consistent with our baseline scenario: we assume 1.5 million/day in 2H21. At this rate, we expect the entire adult population to be fully immunized (two shots) by the end of 2021. As of October 18, about 260 million doses (326 million available) had been administered in the country.

The Delta variant has been spreading in key regions, but it has not led to a significant surge in infections, hospitalizations or deaths. While there is still a fair amount of uncertainty around this variant, we consider another round of social-distancing measures as extremely unlikely.

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.

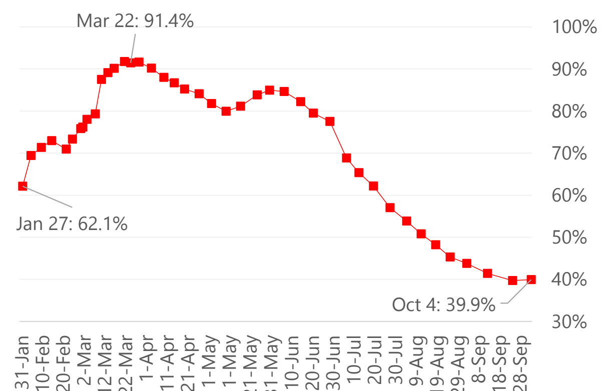
In our view, the better control of the pandemic (obtained with the advances in the vaccine rollout) keep the consistency of the gains in urban mobility seen in recent months. We believe this supports our assumption of a broader reopening of socially integrated services in the latter part of the year and "full normalization" until year-end.

Figure 5. Vaccination Pace (Daily Shots)



Sources: Brazilian Ministry of Health, Santander.

Figure 6. Our Proxy for a Nationwide ICU Occupancy Rate (%)



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: Pre-Pandemic Levels with a Bumpy Road Ahead

We continue to upgrade our fiscal estimates for 2021, considering higher revenue, boosted by the inflation-effect. For 2022, we forecast a higher deficit, with a rise in court-ordered debt and other expenses disbursements. For the gross debt, we continue to forecast an upward trajectory for the medium term, with the path to a long-term stabilization looking increasingly riskier. Additionally, the fiscal risks remain in the spotlight, with the discussion of the 2022 budget proposal and fiscal legislation debates.

Public finances continued to show better numbers for 2021, based on extraordinary revenue, the effects of higher inflation on tax collection, and the commodity price boom. In this scenario, we included a significant improvement in regional governments' primary results, reaching the all-time high. This occurs on the heels of an activity recovery, higher revenues related to the rise in energy prices, and also with one-off revenue from a public company's concession, which added BRL15 billion to the fiscal result. For the gross debt, we rose the estimates due to higher debt costs, affected by the increase in both Selic and IPCA. In this sense, our primary result and debt projections for 2021 are similar to our pre-pandemic forecast. However, we still anticipate a bumpy road ahead (and a higher debt trajectory compared to our pre-pandemic estimates), implying higher fiscal risks. For 2022, we have raised primary deficit and gross debt estimates. For the former, we assume full payment of the court-ordered debt budget (BRL89 billion), which will probably be split in categories after the approval of the constitutional amendment (PEC *Precatórios*), currently in debate in Congress. A total of BRL40 billion (out of BRL89 billion) should be normally paid under the constitutional spending cap rule. In addition, we assume an execution of BRL30 billion outside the spending cap, which will likely affect the primary result depending on the final legislation. The remainder BRL19 billion could be settled by an agreement with regional governments to offset assets and liabilities with one another. Our tally also assumes discounts granted by the creditors who will be seeing anticipated payments by the central government. Thus, with this "solution" for the judicial claims problem, the fiscal margin opened in the spending cap rule would be around BRL50 billion. From our point of view, half of that should be used to increase welfare transfers, with the other half possibly used to compensate for the impact of higher inflation this year on mandatory outlays in 2022. On the revenue side, we see a softening cyclical growth, a disinflation process and fewer one-off revenue. Our debt estimate reflects this deterioration in the primary deficit and an increase in debt costs, due to a higher Selic rate and inflation. Thus, we continue to envision an upward trajectory for debt, and major structural reforms are still needed. In addition, for the medium term, our forecasts indicate 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 the recent price shock. Thus, although we regard the fiscal rule as necessary, it is not a sufficient condition to ensure consistent fiscal consolidation.

Regarding the new forecasts, we project the public sector primary deficit for 2021 at BRL45 billion (0.5% of GDP), vs. BRL110 billion in September, considering a subnational primary surplus of BRL65 billion. For 2022, we expect a deficit widening to BRL 120 billion (1.3% of GDP) and a gradual decline afterwards (e.g., reaching 1.1% of GDP in 2023). We also forecast that the gross debt to reach 80.7% of GDP at the end of 2021 (2020: 88.8% of GDP). We estimate a peak in 2028 at ~94% of GDP (2.0pp higher than our previous scenario). After that, we expect a drop toward ~87% of GDP by 2040, assuming macro and fiscal reforms.

Figure 7. Fiscal Margin and Budget Simulations

2022 Budget: Spending Cap Margin - BRL bn

Year-end Inflation (INPC | Dec-21)	Court-ordered debts Budget (*"Precatórios"*)				
BRL bn	40	50	75	89	90
6.5%	54	44	19	5	4
7.0%	49	39	14	0	-1
7.5%	44	34	9	-5	-6
8.0%	40	30	5	-9	-10
9.5%	25	15	-10	-24	-25
10.0%	22	12	-14	-28	-29

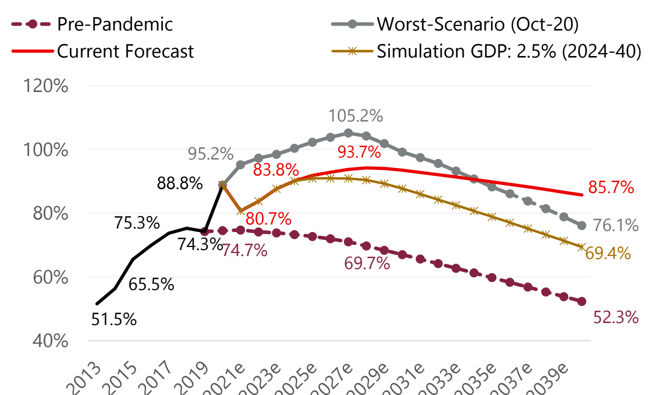
Additional Budget for Auxílio Brasil- BRL bn

Families (millions)	Monthly Average Benefit (BRL/month)				
	250	270	300	350	400
17	16	20	26	36	47
16	13	17	23	32	42

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

Sources: National Treasury, Santander.

Figure 8. Gross Government Debt - % GDP



Sources: Brazilian Central Bank, Santander.

BALANCE OF PAYMENTS: Weak Exchange Rate, Strong Balance of Payments

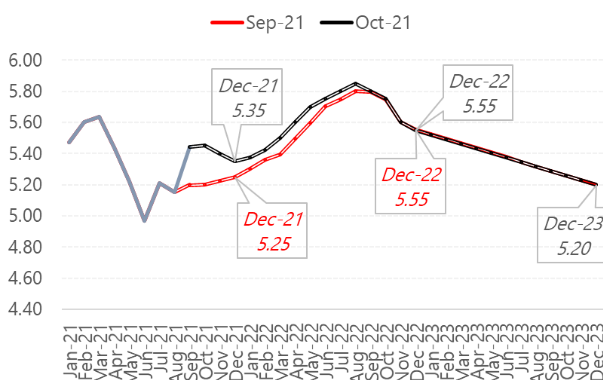
The balance of payments still is not on the list of market worries given the sizeable trade surpluses, compressed services outlays, low profit remittances and higher direct investments. However, the lack of progress on structural reforms, the heated political debate and worries about global growth, and financial conditions should cap BRL upside despite higher domestic interest rates.

At the risk of sounding repetitive, lingering uncertainties on the fiscal front, the lack of progress in the reformist agenda and some rising headwinds on the international front have weighed on the BRL recently, leading its risk premium to get larger than before. As a result, the USD/BRL cross has returned to the 5.50-5.60 level and led the BCB to tender FX swaps to correct perceived market dysfunctionalities. We think that some of these pressures on the BRL should ease ahead as the discussions on the 2022 budget indicate how the government will fund a new welfare program next year (more details in the Fiscal Policy section). However, we believe we are unlikely to witness much progress in the reformist agenda (both from a business/productivity or a budgetary standpoints). Thus, we project the USD/BRL pair to recede from the weak level it is at the moment, but the room for such a strengthening should prove to be limited once again. Accordingly, we are changing our forecast for the USD/BRL cross in YE2021 to 5.35 from 5.25 previously.

We still believe that elections next year could bring volatility, reflecting the uncertainties regarding the outlook for macro reforms, potential growth and, in particular, the trajectory of the government debt. Therefore, we continue to anticipate a new round of BRL weakening as the electoral process proceeds. It is true that the higher level of the interest rate may partially curb the move, but it should not suffice to prevent it from happening. Consequently, we continue to expect the BRL to weaken further into 2022 and maintain our forecast of the USD/BRL pair reaching 5.55 by YE2022.

In response to a weaker currency level, the shrinkage of the current account deficit should continue, and we forecast the current account to register near-zero deficits in 2021 (-US$0.5 billion) and 2022 (-US$0.4 billion). Previously, we expected the current account balance to register a US$0.8 billion surplus in 2021 and a US$9.7 billion deficit next year. Revisions in the historical data and some deceleration in exports responded for the bulk of the change in 2021 projections. For 2022, on top of weaker average level of the USD/BRL pair, we also had revisions in our growth expectations, which explain the change. Taking a look at its components, dynamics has remained unchanged, with trade balance still hinting at sizeable surpluses, the services account impacted by households' slow income growth and, last but not least, the primary income deficit running at low levels for historical standards. In a nutshell, the soundness of the Brazilian external position should continue to contrast with the poor performance of the BRL.

Figure 9. Nominal FX Rate (USD/BRL)



Sources: Bloomberg, Santander.

Figure 10. Current Account Forecasts

USD billion	2019	2020	2021e	2022e	2023e
Current account balance	-65.0	-25.9	-0.5	-0.4	-28.5
Trade balance	26.5	32.4	63.8	68.6	46.7
Exports	225.8	210.7	276.1	291.8	287.3
Imports	199.3	178.3	212.3	223.2	240.6
Services	-35.5	-20.9	-22.6	-28.0	-29.7
Tourism	-11.6	-2.3	-5.5	-8.7	-10.0
Eq. Rental	-14.6	-11.9	-11.0	-15.4	-15.8
Others	-9.3	-6.7	-6.0	-3.9	-3.9
Income	-57.3	-39.7	-44.7	-44.0	-48.5
Profits & Dividends	-31.9	-18.3	-19.7	-26.7	-31.4
Interest payments	-25.5	-21.5	-25.0	-17.3	-17.1
Transfers	1.2	2.3	3.0	3.0	3.0
Direct investment onshore	69.2	44.7	59.2	67.5	70.2
External funding (-ve=shortage / +ve=excess)	4.1	18.7	58.7	67.1	41.7

Sources: Brazilian Central Bank, Santander.

ECONOMIC ACTIVITY—CORE: Downgrading (Again) Our 2022 Estimate

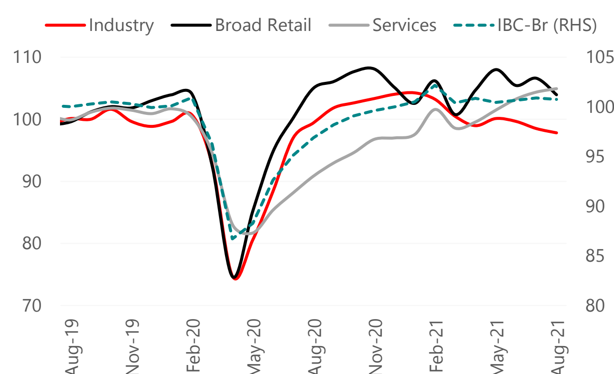
We are lowering our GDP growth forecasts for the horizon of 2021 to 2023. For this year, our estimate is 4.9% (previous 5.1%), as 3Q21 activity was not as strong as we had anticipated, mainly owing to the goods-related sectors. The positive pace of economic reopening and favorable commodity prices still support the outlook for growth this year and next. Yet a tighter monetary policy path prompted us to reduce our 2022 GDP estimate to 1.5% (from 1.7%) and our 2023 estimate to 0.8% (from 1.0%), partially mitigating the (nearly mechanical) contributions from the services sector.

The flattish GDP figure seen in 2Q21 highlighted heterogeneity in the composition of economic activity. The tertiary sector posted healthy figures, on the heels of urban mobility recovery and the new round of Emergency Aid stipends. Conversely, farm output gave back part of its positive 1Q21 GDP contribution, while industry weighed on activity, reflecting cost increases and the widespread shortage of inputs in manufacturing. We expect this heterogeneity to be repeated throughout 2H21, with farm output and industry dragging down activity less intensely (sequentially) and with the services sector standing as the main driver of GDP growth. Indeed, some important segments of the tertiary sector (accounting for nearly half of services GDP, the largest component from the supply standpoint) are still running at depressed levels, which leaves room for positive GDP contributions as the public health crisis is overcome and urban mobility returns to “normality”.

In the short term, August activity numbers reinforced our view of a 3Q21 not as strong as previously anticipate, mainly because of the goods-related sectors (i.e., manufacturing and some retail segments) amid a shift of spending out of goods and back into services, as the pandemic fades and economy reopens. Indeed, the IBC-Br (a monthly GDP proxy) retreated in August (-0.15%), leaving a +0.15% carryover for 3Q21 and highlights a softening of activity in this period. These numbers prompted us to reduce our 3Q21 GDP projection to +0.3% (from +0.7%) as well as our 2021 projection, to +4.9% (from +5.1%).

For 2022, we are reducing our GDP estimate to 1.5% (from 1.7%). We expect good growth contributions to come from the mechanical recovery of the services sector, mainly from those sectors that still show idleness regarding the pre-pandemic mark. We also expect a positive contribution from less cyclical commodity-related sectors, such as farm and mining. Moreover, the expected real wage bill expansion[2] (a byproduct of the labor market recovery) should also contribute to support activity in 2022. These factors are expected to be somehow shadowed by the delayed effects of a tighter monetary policy and worse financial conditions (owing to policy uncertainty).

Figure 11. Economic Activity (Jan/19=100, sa)



Sources: IBGE, Brazilian Central Bank, Santander.

Figure 12. GDP Breakdown (%)

GDP Projections					
	2018	2019	2020	2021e	2022e
Total GDP	1.8	1.4	-4.1	4.9	1.5
Agriculture & Livestock	1.3	0.6	2.0	2.3	2.0
Industry	0.7	0.4	-3.5	4.9	0.8
Services	2.1	1.7	-4.5	4.7	2.0
Household Consumption	2.4	2.2	-5.5	3.4	1.3
Government Consumption	0.8	-0.4	-4.7	1.4	2.1
Investments	5.2	3.4	-0.8	12.2	0.9
Exports	4.1	-2.4	-1.8	9.3	2.0
Imports	7.7	1.1	-10.0	9.8	4.7

Sources: IBGE, Santander.

[2] **Santander Brazil - *“Real Wage Bill – Outlook, Simulations”* –** October 18, 2021 – Available on: https://bit.ly/Std-special-101821

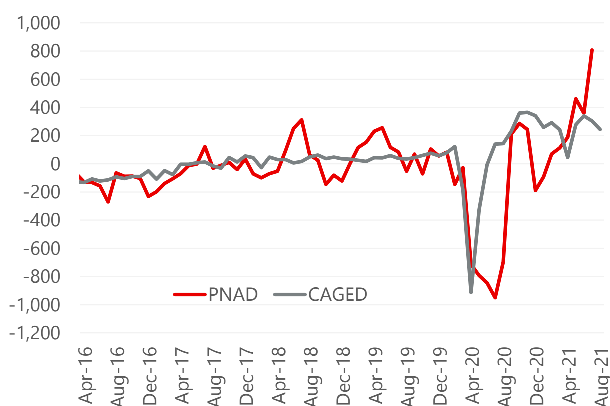
ECONOMIC ACTIVITY—EMPLOYMENT: Maintaining the Trend of a Gradual Recovery

We are revising our short-term joblessness trajectory, but maintaining the medium and long-term view of a gradual labor market recovery. The changes in the PNAD household survey to reduce the underestimation of formal employment have anticipated part of the expected recovery of the employed population, leading to a reduction in our unemployment projection for YE2021. We expect this effect to be dissipated afterward, so we kept our estimate for 2022. We estimate an average unemployment rate of 13.8% in 2021 (previously 14.1%) and 13.7% in 2022 (unchanged).

The latest batch of labor market data point to additional improvement in employment conditions[3]. Based on the IBGE's National Household Survey (PNAD), we calculate that the seasonally adjusted unemployment rate stood at 13.4% in July, a decrease compared to June (13.8%). This result stemmed from gains of 1.4% MoM-sa and 1.0% MoM-sa in the employed population and the labor force, respectively. The participation rate rose to ~59%, recovering more than half of the trough seen in the pandemic. While job market participation remains below the historical average (~62%), falling joblessness with higher participation means a good quality in the employment pickup. July data indicated another considerable improvement in informal employment (+1.3% MoM-sa) which, in our view, should lead the employment recovery as the economy reopens, especially in the services sector. What's more, the formal sector had an even more positive result in July (+1.6% MoM-sa), probably reflecting the methodological changes made by IBGE to reduce the underestimation for this class of workers. Based on the August CAGED (establishment) survey, we estimate that the seasonally adjusted net job creation eased to +243.3k, from +304.0k in July, but remained historically high. Despite some deceleration at the margin, the CAGED survey continued to show robust job creation due to a high urban mobility. Since April, a new round of the government's job-supporting program (BEm) has limited layoffs, in our view, and also helped boost net job creation. However, we believe that the end of the program on August 26 has already led to fewer salary reduction agreements, leading to layoffs.

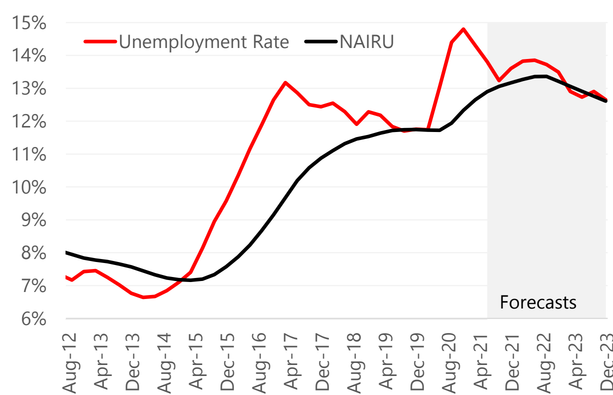
We have revised our unemployment rate projections for 2021, as the changes in the PNAD survey have implied a correction in the level of formal employment, leading to a sharper drop in the unemployment rate in 3Q21. We estimate the average unemployment rate at 13.8% in 2021 (previously 14.1%). As we expect this correction to be just an anticipation of our previously expected employment recovery, we foresee a return of the unemployment rate to our previously projected trajectory from 4Q21 onward. Therefore, we maintain our forecast for the average unemployment rate at 13.7% in 2022. We keep our view that the employed population will reach pre-pandemic levels only in mid-2022, and that the normalization in both employment and the labor force should be strictly linked to the urban mobility levels. Furthermore, we still believe that the current job market conditions remain fragile and with considerable slack, especially considering the pandemic's impact on informal workers. We continue to see the jobless rate reaching the NAIRU only at the end of next year.

Figure 13. Net Formal Job Creation (thousands, sa)



Sources: IBGE, Ministry of Labor, Santander.

Figure 14. Unemployment Rate and the NAIRU



Sources: IBGE, Santander.

[3] **Santander Brazil Labor Market - *"Keeping the Recovery Pace"* –** September 30, 2021 - Available on: https://bit.ly/Std-labor-093021

ECONOMIC ACTIVITY—CREDIT: Household Indebtedness Expected to Slow Lending in 2022

Due to the sharp increase in household indebtedness, as well as higher inflation and interest rate forecasts, we are revising our expectation for total nominal outstanding loans growth from 13.6% to 9.7% in 2021 and from 9.3% to 6.3% in 2022.

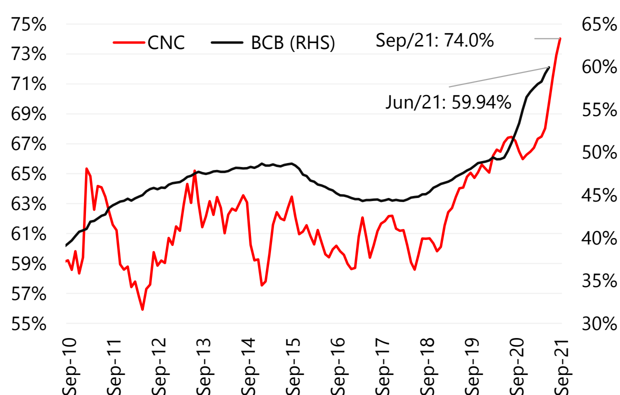
The Brazilian credit market registered anticyclical policies two years in a row to face the Covid-19 shocks over the economy. In August, total outstanding loans in the National Financial System (SFN, in Portuguese acronym) posted an inflation-adjusted growth of 5.6% YoY to BRL4.3 trillion (up 8.3% YoY for households and 2.3% YoY for firms). New loans adjusted for inflation and seasonality (using BCB methodology) decreased 3.0% MoM (-0.3% for households and -4.4% for firms). We believe it is hard to see bank lending remaining apace ahead, and the main reason is that household indebtedness already stands at record highs.

On the BCB's concept (outstanding consumer credit over annual disposable income), total indebtedness reached 59.9% as of June 2021. Excluding the real estate financing operations, the number is 37.1%. Both series stand at historical highs (the series started in 2005), reflecting a composition of a stagnant income and solid loan growth over the last couple of years.

Considering the indebtedness indicator built by the National Confederation of Commerce (CNC, in Portuguese acronym) – measured through a survey carried out in all Brazilian capitals with approximately 18 thousand consumers – the results paint the same picture. The numbers for September 2021 indicate that 74% of families reported having debts; the indicator is 75% for families with monthly income below 10 minimum wages. Those numbers usually herald the trends seen in the BCB series (official data).

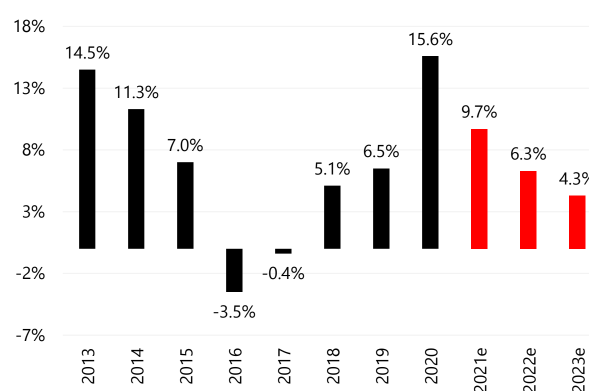
Nevertheless, both BCB's and CNC's data point to low levels of delinquency. An even if we consider the lag in the transmission of shocks from macroeconomic variables to credit (higher interest rates, in particular), we do not project a spike in NPLs. In our view, the adjustment in household balance sheets will be done via a recovery in household income and a softer pace of new lending in 2022.

Figure 15. Total Household Debt



Sources: Brazilian Central Bank, CNC, Santander

Figure 16. Growth in Outstanding Loans (%)



Sources: Brazilian Central Bank Santander

INFLATION: Peaking with Unfavorable Composition and Poised for Slow Decline

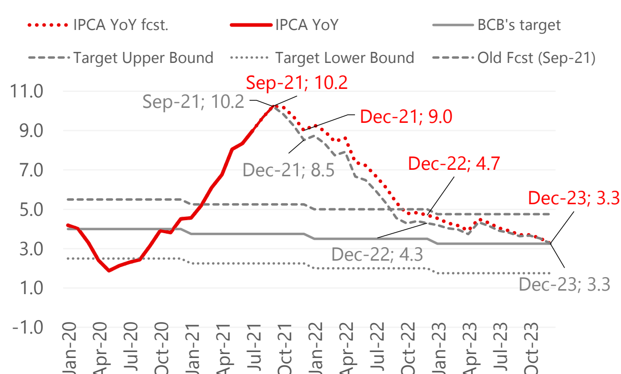
Once again, we are raising our inflation forecasts. We now project IPCA 2021 at 9.0% (previously 8.5%) and IPCA 2022 at 4.7% (previously 4.3%). The level and composition of inflation look increasingly unfavorable for 2022, and we project convergence to the mid-target only in 2023 (at 3.25%). Yet we also see upside risks for that horizon.

Since our last scenario revision, another round of shocks took place: the energy global shock this time around (impacting energy commodities as natural gas, coal and oil and also some metals like copper and zinc). On top of that, previous shocks persist—as the global supply chain disruption, for example—and continue spreading to general prices. As a result, we are revising IPCA 2021 to 9.0% from 8.5% (core inflation to 6.6% from 6.3%%) and IPCA 2022 to 4.7% from 4.3% (core inflation to 5.0% from 4.3%). For the short term (until year-end 2021), all groups were revised upwards. In regulated prices, the highlight was in fuels, with the global energy shortage impacting this item. Other volatile prices, such as food, also had upward adjustments still reflecting persistent shocks. More importantly, core inflation groups were also revised to the upside. Industrial goods rose to 9.9% from 9.2%, because of short-term surprises and the persistence of supply chain disruptions. Services went to 4.6% from 4.2%, mainly because of a stronger spread of primary shocks.

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. As a result, the spread of inflation continues gaining steam (and inertia seems to start to play a bigger role), particularly as the services sector starts to be more impacted, amid a reopening process. We estimate that inflation peaked in September 2021 at 10.25%, but the composition of the deceleration ahead is to be unfavorable (food, regulated prices and industrial goods decelerating, while services accelerating, resulting in core gauges resilient at high levels). Moreover, uncertainties brought by the COVID-19 pandemic continue to impart upside risks (i.e., inflation might prove stickier than we anticipate), with the recent global energy shortage being a representative example of those risks.

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 upper-bound (5.00%). The balance of risks, in our view, is still tilted to the upside. The backlog of price rises at the wholesale level that might still reach the 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. We also see some downside risks that could reduce the upward asymmetry for IPCA 2022 forecast: food inflation—as the favorable weather forecasts we were seeing are indeed realizing which can help the harvest, leading to lower food inflation than we anticipate. Despite the high level and unfavorable composition for inflation for IPCA 2021 and 2022, we highlight that we do not see a disruption scenario, as we believe the BCB's Selic rate hikes will likely to bring inflation to the mid-target of 3.25% in 2023 (see more in Monetary Policy section). Yet we recognize upside risks for 2023 as well.

Figure 17. IPCA Forecasts (% YoY)



Sources: IBGE, Brazilian Central Bank, Santander.

Figure 18. IPCA Details, Forecasts (% YoY)

	2021			2022		
	old	new	Δ bps	old	new	Δ bps
IPCA	8.5	9.0	49	4.3	4.7	46
Free prices	6.7	7.2	39	4.5	4.8	26
Food-at-home	8.4	9.0	9	3.5	3.5	0
Industrial goods	9.2	9.9	16	4.7	5.1	9
Tradables	9.2	9.9	14	4.7	5.1	8
Non-Tradables	9.2	9.9	2	4.7	5.1	1
Services	4.2	4.6	13	4.8	5.3	17
Food-service	8.0	8.0	0	7.2	7.3	1
Airline tickets	43.4	50.7	3	16.0	16.0	0
Economic activity	2.3	3.2	9	3.6	4.8	12
Education	3.0	3.0	0	5.5	5.5	0
Inertial	4.0	4.3	2	4.4	4.8	3
Salaries	2.7	2.8	1	3.7	3.9	1
Administered prices	13.7	14.0	9	3.7	4.5	20
Gasoline	35.6	38.0	15	4.5	6.7	13
Energy	19.1	18.5	-3	-7.9	-7.9	0
Health insurance	2.6	2.6	0	9.0	9.0	0
Bus fares	1.5	1.5	0	6.4	6.4	0
Cores	6.3	6.5	20	4.3	5.0	70

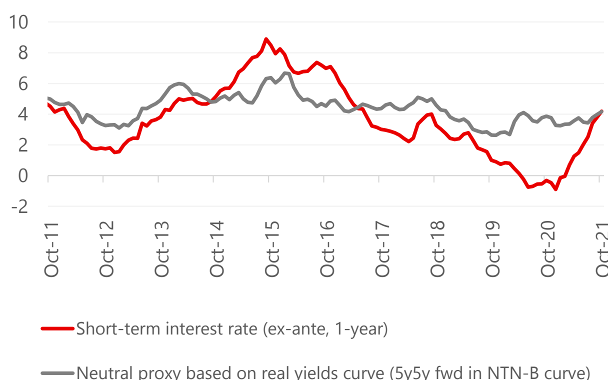
Sources: IBGE, Brazilian Central Bank, Santander.

MONETARY POLICY: In Search of a Significantly Tight Policy Stance

In response to rising inflationary risks and a worsening inflation outlook, the BCB continues to rapidly remove monetary stimulus. We calculate that the real ex-ante short-term interest rate[4] is averaging at 4.2% in October (up to the 15th), the highest reading since mid-2017. The series has now reached the same level as our asset-based proxy[5] for the structural interest rate, suggesting a neutral monetary policy stance as of now. Given the BCB's communications, we expect short-term interest rate to keep going higher, deeper into contractionary territory. Al least this is what the BCB has signaled in the last Copom statement[6], minutes[7] and inflation report[8]. In the September 21-22 policy meeting, the BCB continued to hike the Selic rate by 100 bps (reaching 6.25%) and signaled the same pace for the subsequent meeting. The authority believes that "at the present stage of the tightening cycle, this pace is the most appropriate to guarantee inflation convergence to the target at the relevant horizon and, simultaneously, allow the Committee to obtain more information regarding the state of the economy and the persistence of shocks." While in recent speeches (mid-October), BCB officials have clarified that there is no commitment to this pace, the message continues to indicate further moves of 100bps as part of the flight plan. In the inflation report, the BCB sees most of this year's inflation surprise largely associated with energy price shocks and believes an eventual persistence in inflation of industrial goods will hinge more on the future evolution of costs and shocks, rather than on the lagged CPI pass through of a repressed upstream inflation. The BCB also sees well-anchored inflation expectations for the long run and a small deviation for the shorter policy horizon.

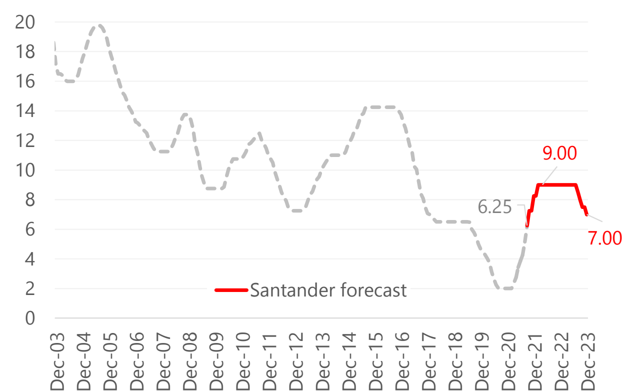
While the BCB's current message does not necessarily hint at a certain endpoint for the cycle, the flight plan has been revised higher from the previous meeting. According to the BCB's own inflation models, with the FX rate starting at 5.25 (and moving along with PPP afterward), a path of Selic rate hikes to 8.25% for YE2021 and 8.50% for YE2022 would produce IPCA disinflation from a beefy reading of 8.5% in 2021 (upper target: 5.25%) toward 3.7% for the main policy horizon now (2022). For 2023, the BCB sees inflation at the center target in the last simulation. Given the inflation simulations and the upwardly tilted balance of risks, we believe the current BCB flight plan includes a terminal Selic rate at no less than 9.00%. That said, we are revising our terminal rate forecast to 9.00% (previous: 8.50%), as we now look for a final 75bp move in February 2022. We see risks skewed to the upside about this call, with any number between 9.00-9.50% looking reasonable to us under current conditions. We cannot rule out even further moves, however, which might particularly hinge on inflation expectations for 2023, which will be the main policy horizon as of 1Q22. Signs of de-anchoring for that horizon could prompt a proportionally stronger response by the BCB, as the authority seeks to avoid inflation consolidating above the mid-target. We envision a path to the neutral level of 7.00% only in 2H23.

Figure 19. Implicit Monetary Stimulus (% p.a.)



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

Figure 20. Santander Selic Rate Forecast (% p.a.)



Sources: Brazilian Central Bank, Santander.

[4] This series is the 1-year nominal swap interest rate deflated by economists', median 12-month ahead IPCA forecasts.
[5] This proxy is based on the 5y5y forwards on the real yields curve (NTN-Bs) deducted by a constant historical term premium of 100bps.
[6] **Santander Brazil Monetary Policy - *"Scanning the Scene as It Moves at Cruise Speed"* –** September 23, 2021 - Available on: https://bit.ly/Std-COPOM-sep21
[7] **Santander Brazil Monetary Policy - *"Going Farther, Not Necessarily Faster"* –** September 28, 2021 – Available on: https://bit.ly/Std-Copom-min-set21
[8] **Santander Brazil Monetary Policy - *"Hindsight and Outlook"* –** September 30, 2021 - Available on: https://bit.ly/Std-InflaReport-3Q21

FORECASTS: Santander & Consensus

Figure 21. Evolution of Santander and Consensus Forecasts for 2021 Since Our Last Scenario Revision

	2021E					
	Consensus			Santander		
	10-Sep-21		15-Oct-21	16-Sep-21		21-Oct-21
IPCA Inflation (%)	8.0	↑	8.7	8.5	↑	9.0
GDP Growth (%)	5.0	↓	5.0	5.1	↓	4.9
Selic policy rate (%, year end)	8.00	↑	8.25	8.25	→	8.25
Exchange rate (USD/BRL, year end)	5.20	↑	5.25	5.25	↑	5.35
Current Account (USD billion)	-1.6	↓	-4.9	-0.3	↓	-0.5
Primary Budget Balance (% GDP)	-1.5	↑	-1.4	-1.3	↑	-0.5
Net Govt. Debt (% GDP)	82.1	↓	82.0	58.5	↓	58.0

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

Figure 22. Evolution of Santander and Consensus Forecasts for 2022 Since Our Last Scenario Revision

	2022E					
	Consensus			Santander		
	10-Sep-21		15-Oct-21	16-Sep-21		21-Oct-21
IPCA Inflation (%)	4.0	↑	4.2	4.3	↑	4.7
GDP Growth (%)	1.7	↓	1.5	1.7	↓	1.5
Selic policy rate (%, year end)	8.00	↑	8.75	8.50	↑	9.00
Exchange rate (USD/BRL, year end)	5.20	↑	5.25	5.55	→	5.55
Current Account (USD billion)	-18.1	↓	-20.8	-8.0	↑	-0.4
Primary Budget Balance (% GDP)	-1.1	↑	-1.0	-1.0	↓	-1.3
Net Govt. Debt (% GDP)	83.5	↓	83.1	59.8	↑	60.5

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

Figure 23. Evolution of Santander and Consensus Forecasts for 2023 Since Our Last Scenario Revision

	2023E					
	Consensus			Santander		
	10-Sep-21		15-Oct-21	16-Sep-21		21-Oct-21
IPCA Inflation (%)	3.3	⇨	3.3	3.3	⇨	3.3
GDP Growth (%)	2.3	⇩	2.1	1.0	⇩	0.8
Selic policy rate (%, year end)	6.50	⇨	6.50	7.00	⇨	7.00
Exchange rate (USD/BRL, year end)	5.07	⇧	5.10	5.20	⇨	5.20
Current Account (USD billion)	-25.4	⇩	-29.8	-30.4	⇧	-28.5
Primary Budget Balance (% GDP)	-0.7	⇧	-0.5	-0.8	⇩	-1.1
Net Govt. Debt (% GDP)	85.0	⇩	84.3	62.7	⇧	64.1

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

MAIN RISKS

Figure 24. 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. • Downside risks (activity): More intense and lasting inflationary pressures prompting the Fed to start withdrawing monetary stimulus earlier than expected, impacting the economy. • Possible outbreak of coronavirus strains that are more resistant to available vaccines, causing new setbacks in the reopening process in key regions. This could be highly inflationary.
Commodities	• Upside risks (prices): additional economic and fiscal stimulus (especially in China and the U.S.) could boost prices further in the short run. The global energy crisis persists, a risk for global inflation. • Downside risks (prices): New virus variants could trigger tightening in mobility conditions, weighing on consumption. A faster than expected reversal in Fed stimulus. Favorable weather conditions allow for record crops in key producing countries.
Covid-19	• Upside risks: Authorities shortening the dosing interval of AstraZeneca and Pfizer vaccines, pulling forward the expected vaccine schedule. • 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. Favourable institutional environment before the 2022 election. • Downside risks: Risks of fiscal slippage in the wake of temporary factors that prompt a misleading short-run improvement in primary balance. 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 not declining in 2022, thus opening room for a larger trade balance surplus and, consequently, for better current account balances. • 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. • 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 industrial (due to electricity generation) and agriculture output. A 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) and a permanent increase of inertia; (iii) a slower recovery of industry (and inventories) increasing supply-related costs; (iv) another round of FX depreciation (on fiscal risks); and (vi) global energy shortage pushing oil prices further up. • 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; (v) food inflation can be lower, if the weather helps.
Monetary Policy	• Upside risks: further price shocks or more prolonged global supply constraints could raise fears of inflation (and inertia), adding to second-round effects (mainly via expectations). Fiscal stimulus with a narrower output gap could add more fuel to inflation. Sluggish macro reforms could hurt the outlook for debt sustainability, affecting the anchoring power and the neutral rate. • Downside risks: credible signs of reforms aimed at curbing government spending could improve economic expectations and market conditions (read FX rate); a retracement of costs in BRL could reduce the backlog of PPI pressures, providing 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.

Source: Santander.

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