Santander

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Brazil— Economic Scenario

Stayin' Alive

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- **Political turbulence might keep asset prices under pressure in the short term, but so far there is no material factor altering the medium-term economic outlook for Brazil. In fact, our scenario incorporated the potential for some political stress as one of its drivers.**
- **We believe the substantial improvement in fundamentals in the recent year — with consistent economic policymaking, contained inflation, robust external accounts, high international reserves and a still tight monetary policy stance — have rendered the Brazilian economy significantly more resilient, with capacity to weather the short-term storm without drifting from the current economic path.**
- **The main uncertainty lies on the reform front — lack of progress could impact long-term interest rates but is unlikely to prevent interest rate cuts in the short term.**
- **We maintain our forecasts of BRL 3.50/USD and Selic at 8.5% at end-2017, with inflation at 4.2% this year. We also maintain our forecast for 0.7% GDP growth in 2017, but downside risks have risen mainly due a potential adverse shock in confidence, which tends to be more relevant the longer the political scenario takes to normalize.**

Fundamentals and uncertainties

The heightened political uncertainty, which raised the stakes for the advance of the reform agenda in Brazil, resulted in a weaker BRL, a higher risk premium and a steepening yield curve. With so many uncertainties in the scenario, it seems likely that resolving the crisis may take at least a couple of months, leading some in the market to worry that Brazil might undergo a wave of volatility and stress reminiscent of that faced in 2015, during the political crisis that led to President Dilma Rousseff's impeachment.

Although this scenario is possible, we do not see it as likely. In this piece, we argue that while we wait for normalization in the political arena, in the meantime improved fundamentals warrant a more benign trend for asset prices than that seen in 2015. **Recall that our scenario – more negative than the then-prevailing consensus for currency, inflation and interest rates – already incorporated the potential for some political stress as one of its drivers. Nevertheless, our forecasts always assumed a more benign scenario than in recent years**, and these are the main reasons why:

- **Economic policy is on a consistent and sustainable path, with no reason to expect a reversal in the short term:** Since early 2015 and especially since May 2016, important adjustments were made to economic policy, leading to significant reduction in macroeconomic imbalances: currently, there is no misalignment in regulated prices, the exchange rate is perceived as adequately floating, and a credible monetary policy has space to act in whatever direction necessary. The one fundamental that still inspires concern is, in our view, Brazil's still vulnerable fiscal stance: while the spending cap approved last year did much in terms of securing long-term sustainability for Brazil's fiscal accounts, its implementation may become unfeasible in the absence of social security reform.
- **External vulnerability is very low:** When assessing the outlook for the currency under the current scenario, Brazil's robust position with respect to external accounts is relevant. The 12-month current account deficit remains low at around 1.5% of GDP, and foreign direct investment has brought net inflows that are four times as high as the change in the current account deficit over the same period. Perhaps even more importantly, Brazil boasts over USD 370 billion in international reserves which, once deducted from all public sector liabilities indexed to foreign currency (including external debt and swaps), leaves the public sector in a very comfortable net creditor position in foreign currency of USD 213 billion (as of end-March). This is around USD 100 billion higher than the net creditor position held by the public sector at the end of 2014 and throughout most of 2015, when it already had a key role in mitigating depreciation pressures on the BRL. Also, Brazil's robust position with respect to external accounts leaves ample room for the BCB to intervene in the FX market with all of its available instruments, without jeopardizing either external sector solvency or public debt dynamics, and in that sense this may, once again, act toward limiting the downside potential for the BRL at this time.

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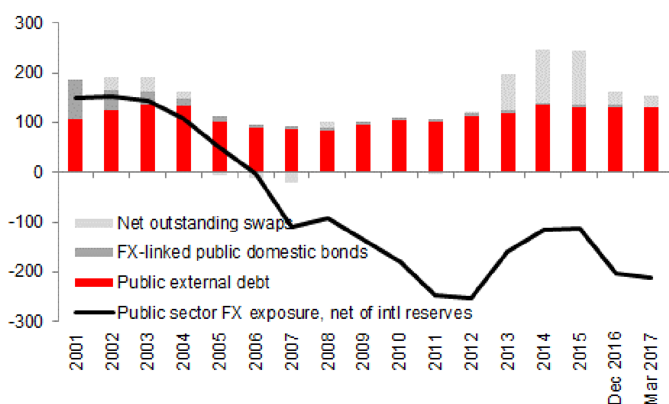
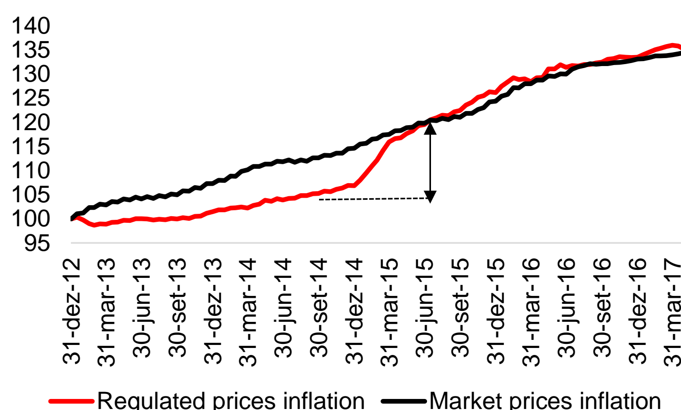
- **Currency pressures may not translate into an inflation spike:** The exchange rate pass-through to inflation should be modest given the strengthening of BRL in the first 5 months of the year. The average BRL YTD is 3.15 per dollar, 9.7% stronger than the average BRL in 2016 of 3.49. Bear in mind that the pass-through of currency to inflation is not dictated only by the exchange rate level at the margin; rather, it is conditional on the output gap (a negative gap limits the room for pass-through) of the average level of the currency during the period of acquisition of inventories (even with a weaker BRL at the margin, the strong appreciation in recent months – 3.15/USD year to date, versus 3.49 in the same period of 2016 – mitigates the pressure for an immediate pass-through).
- **Monetary policy has ample room to inject stimulus into the economy:** Monetary stance is still tight and economic activity is still weak. Regardless of how you look at it, real interest rates (ex-ante or ex-post) remain high, the monetary condition indicator still points to a tightened stance, and outstanding bank credit continues to contract.

Public sector: net FCY exposure (USD billion)

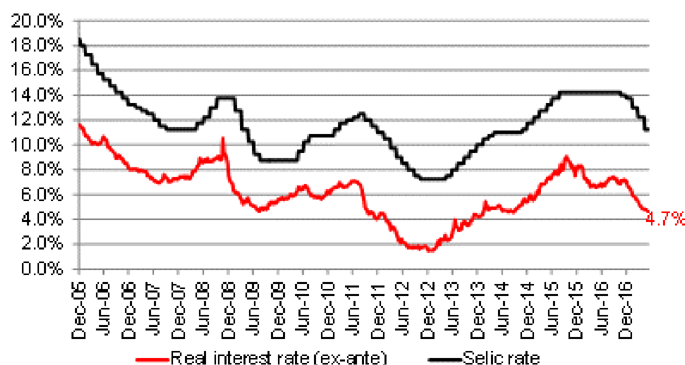


Regulated prices vs Market prices inflation

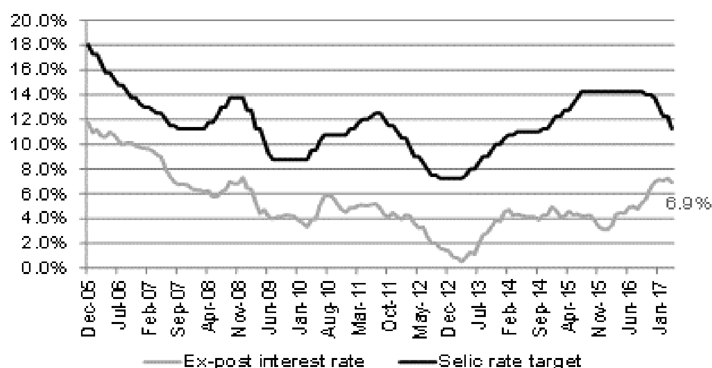


Sources: BCB, IBGE and Santander estimate.

Real interest rate ex-ante (DI 1-y minus inflation expectation)



Real interest rate ex-post (Selic rate minus inflation)



Sources: BCB and Santander estimate.

We argue that it is too soon to be bold in revising macro forecasts, given all the uncertainty of the political scenario. In any case, it is important to bear in mind that, **while political turbulence can translate into volatility in the short-term, fundamentals tend to prevail over the medium- to long-term.** Fundamentals are in the right place, with the notable exception of fiscal accounts – and the gradual nature of the proposed reform means that an eventual postponement in the approval of the key social security reform weighs on the medium- to long-term fiscal outlook rather than on short-term performance. There are two relevant questions to understand how this could change (or not): the first one is whether the current theme of economic policymaking will be maintained – which seems very likely in most potential scenarios for the resolution of the ongoing turmoil. The second question is whether reforms will advance: we do not expect reforms to advance an inch before the normalization of the political scenario, perhaps not even before the 2018 election.

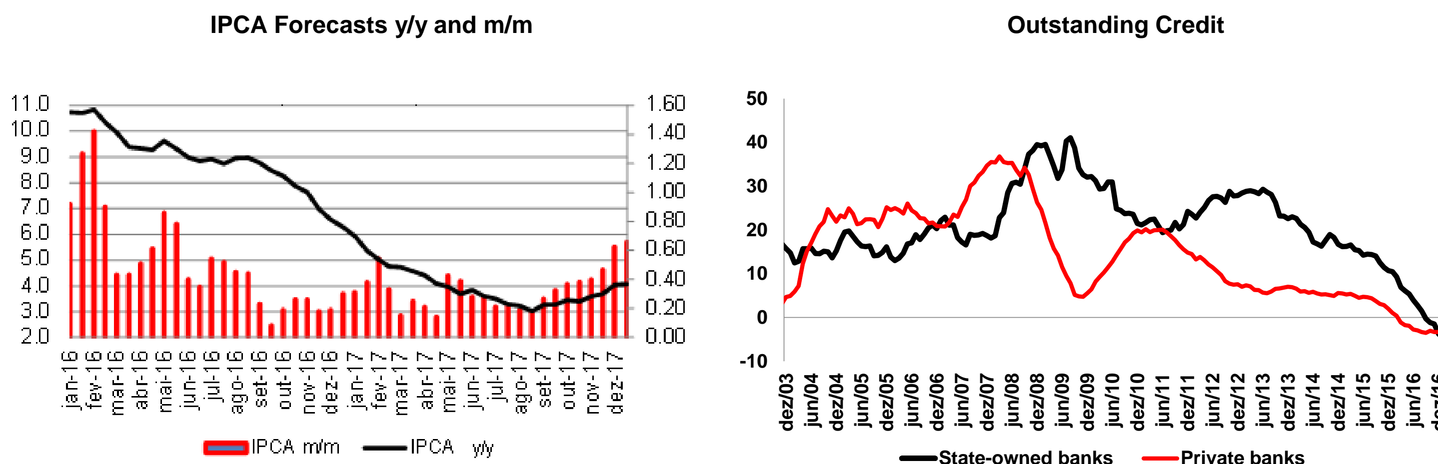
That said, under regular policymaking and with mitigated inflation risks, for now we see no reasons for the BCB to stop cutting the Selic rate in the upcoming Copom meetings. Rather, we are maintaining our call for the Selic rate at 8.5% p.a. at the end of 2017. We are also maintaining our call for 2017 IPCA at 4.2%, mainly because our BRL forecast for the end of 2017 – which we maintain at 3.50/USD -- already reflected a potential worsening balance of risks.

Similarly, we are maintaining our projection that Brazil's GDP will grow 0.7% this year, but in this case we see significant downside risks. Depending on the extent and intensity of the political turmoil, the upward trend in business and consumer confidence could be dramatically reversed, which would prevent a resumption of investments and household consumption in the Brazilian economy this year. As we have emphasized, the recovery in domestic activity is still anemic and should gain steam only in 2H17 onward, given the lagged reaction of the credit market and labor market conditions to the improvement in macroeconomic fundamentals. (For more information, please see our report "*Maintaining the Route but Adjusting the Speed: A Gradual Economic Recovery*" dated February 2, 2016). Therefore, a long period of political uncertainty could severely damage economic sentiment and postpone the economic recovery, keeping GDP at very depressed levels. Although we do not believe that an economic double dip is the most likely scenario, we cannot completely rule out the possibility of another year of contraction in Brazilian GDP, albeit at a much lower magnitude than in the last two years.

Monetary Policy: May Copom could confirm policy normality

We are maintaining our call for the Selic rate at 8.5% p.a. at the end of 2017, with the next COPOM decision keeping the pace of cuts at 100bps. The previous Copom statement unveiled that a monetary easing cycle would depend on the combination of two factors in the short run: (i) "*Disinflation in food prices constitutes a favorable supply shock, which might produce second-round effects, and, thus, contribute to additional reductions of inflation expectations and inflation in other sectors of the economy*" (paragraph 11 in the BCB's April Copom minutes); and (ii) "*Economic activity points to stabilization in the short run"* (paragraph 12 in the same document).

Regarding these two points, the balance of risks will continue to favor monetary easing. Indeed, the favorable supply shock in foodstuff prices due to a very positive harvest is still influencing other prices in the economy, such as fuel prices, which have important second-round effects on price index levels. We see consumer price inflation (IPCA) declining on a year-on-year basis until August and September – the rise expected for May represents a blip caused by a one-off adjustment in electricity prices[1]. A relatively contained BRL weakness (due to the low external vulnerability) added to the aforementioned factors mitigating the potential pass-through means that, even with the political uncertainties, inflation will close the year below the center of the target.



Sources: IBGE and Santander estimate.

[1] In April, there was a deflation of electricity tariffs of -6.4% m/m due to the improper charge of costs from the Angra III nuclear power plant, which was not delivered on time. After returning the amount of money that was paid by mistake for the nuclear energy, the electricity tariffs will return to just under the previous level in May.

Additionally, recent economic indicators, especially related to the service sector (which represents around 60% of GDP), disappointed on the downside, increasing the odds of a frustration of the BCB's and the market's call for economic normalization. Regarding the credit market, total outstanding credit is still decreasing (even in nominal terms) and the final lending rates are still at a high level compared to recent years. In this sense, a longer easing cycle would be important not only to turn on the credit channel to the recovery process, but to improve the financial situation of companies and households through a lower cost of debt servicing. In our view, the ongoing monetary easing is a *sine qua non* condition to reduce the final lending rates and the income burden with debt service, allowing credit demand to resume growth and facilitate the recovering process.

Another important message in the latest minutes was in paragraph 10: "*reforms and other necessary adjustments in the Brazilian economy are important for the sustainability of disinflation and for the reduction of its structural interest rate",* which, in our opinion, made clear that the BCB believes that the end of the monetary cycle depends on the neutral rate level, which depends on reforms and other economic adjustments.

In other words, the evolution of reforms is relevant for monetary policy in the long run. The monetary easing cycle in the short run, on the other hand, is more linked to inflation and activity scenarios. Because of this, we still envisage room for the easing cycle to continue, despite the frozen reform agenda. The well-behaved inflation and downside risks of economic recovery coupled with real rates at above-neutral levels and contracting outstanding credit pave the way for further cuts in the target overnight rate.

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