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ECONOMICS

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Brazil – 2016 Macro Forecasts

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The Four Awakens

- **We expect the BRL/USD to surpass 4.00/USD in the upcoming months and remain above this level in the near term.**
- **A longer than previously expected gloomy political environment and insufficient fiscal adjustment will likely sustain high risk premiums and poor confidence for longer, in our view.**
- **According to our forecasts, GDP will contract 2% next year, bringing unemployment close to 10%.**
- **However, we do not see room for further considerable deterioration in the scenario as long as policymakers struggle to signal commitment with a minimal degree of fiscal consolidation**.
- **We still see room for lower inflation and Selic rate next year.**

Macro Scenario: Muddling Through

The Brazilian macroeconomic outlook remains difficult, at best. Among a wide range of factors, fiscal uncertainties remain as the primary source of concern from the point of view of financial markets. **We do not believe that the current economic and political conditions are consistent with a substantial reassessment of policymakers' willingness or ability to stabilize public sector debt.** For this reason, we do not expect any serious improvement in risk premiums and asset prices from current (in our view) distressed levels.

Due to persistent uncertainties, we believe the BRL will soon surpass 4.00/USD and persistent anemic confidence will maintain the variation of the GDP in meaningful negative territory next year (see table below).

However, we do not see room for considerable additional deterioration as long as policymakers struggle to signal commitment with a minimal degree of fiscal consolidation, despite acknowledging that initiatives, to date, have and will probably, in our view, remain insufficient.

In our view, Brazilian assets seem to have already incorporated a non-negligible worsening of the primary surplus, a substantial increase in gross debt to GDP (above 70% in two years) and additional sovereign debt downgrades. Moreover, although we expect political and policy-related news to remain negative in the near term, we anticipate that the performance of certain macro variables will be more benign in the meantime. We forecast that inflation will probably start to fall from 1Q16 onward and note that external accounts are quickly improving fast and that the impact of the BRL adjustment on economic activity will likely intensify in the upcoming months. Finally, we highlight that the magnitude of international reserves held by the BCB remains an important source of fiscal strength, particularly considering the intense currency correction. For these reasons, we still see room for lower inflation and Selic next year (see table).

Forecasts

	2015	2016	2017
Exchange Rate (BRL / USD)	~~3.90~~ 4.00	~~3.60~~ 4.10	~~3.80~~ 4.20
Risk Premium (5 yr CDS eop)	~~300~~ 450	~~270~~ 350	~~250~~ 300
GDP (%)	~~-2.8~~ -3.2%	~~-1.0%~~ -2.0%	~~2.5%~~ 2.0%
Inflation (IPCA %)	~~9.5%~~ 10.0%	~~6.5%~~ 7.0%	~~5.0%~~ 6.0%
Selic (% p.a.)	14.25%	~~11.5%~~ 13.0%	~~9.0%~~ 11.5%

Source: IBGE, Brazilian Central Bank and Santander estimates.

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Diagnosis: Fiscal Accounts Cancer

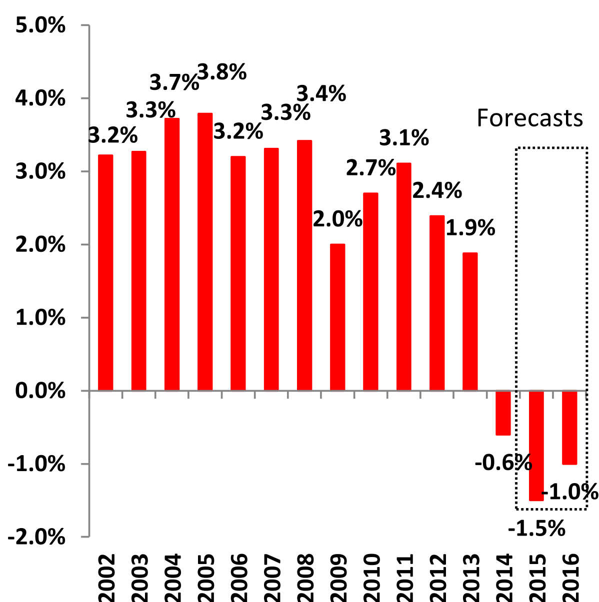
Brazilian risk premiums have recently skyrocketed, chiefly as a consequence of fiscal uncertainties. Public sector gross debt to GDP has been on the rise, escalating concerns that an unsustainable dynamic may be underway.

Although debt dynamics crucially depend upon the performance of economic activity, the behavior of the BRL, financial costs and primary surplus, this latter variable is the most straightforward policy instrument. In Brazil it is widely accepted that the threshold consistent with debt stability has been around 2% of GDP. To illustrate this point, the following figures show how the collapse of the primary surplus has been associated with a sharp rise in public sector debt and risk premiums.

We thus believe that after such sharp deterioration (lower potential GDP growth, higher debt and financial costs), the new primary surplus, consistent with stable debt, will be in the vicinity of 3% of GDP.

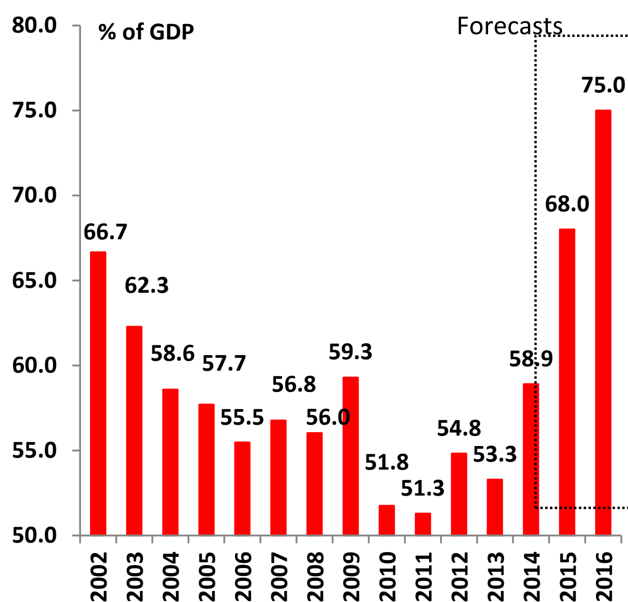
For further details, please see our respective June 8 and August 13 reports, *Fiscal Maze (I): Origins*, and *Fiscal Maze (II): Divergent.* We also will soon publish our follow-up to these reports, *Fiscal Maze (III): Insurgent*.

Public Sector Primary Surplus (% of GDP)



Source: Brazilian Central Bank.

Public Sector Debt (% of GDP)



Sources: Brazilian Central Bank, The Ministry of Finance, Santander estimates.

What has gone wrong: As we have consistently discussed in our aforementioned research, **the recent deterioration has been mostly a result of:** (1) rigidities associated with mandatory spending growth; (2) excessive fiscal laxity in recent years (aggressive spending, tax exemptions, subsidies and credit), aimed at preventing a more substantial slowdown in economic growth; and (3) GDP contraction, stemming from a more adverse global economic environment, as well as distortions generated by recent excessive government intervention in the economy.

What has been done so far: At this point, it is important to emphasize that there has been substantial changes in terms of macro policy since the beginning of the year, reinforcing our view that the current government approach represents a clear inflection from earlier populist policies. The idea of a **much more austere bias can be illustrated by initiatives adopted since the end of 2014**: (1) an aggressive reduction in subsidized credit supply from public-owned banks; (2) considerable monetary tightening despite weak domestic demand; (3) a substantial correction in electricity and gasoline prices in order to eliminate subsidies; and (4) audacious actions to contain spending and increase tax collection (we estimate that government measures on the fiscal front have amounted to approximately 2% of GDP, implying that this year's primary surplus would probably be much lower in the absence of such a push).

In an overall assessment, however, it is evident that fiscal fundamentals have continued to worsen this year, suggesting, in our view, that these initiatives have been insufficient. We believe that these shortcomings can be explained, in part, by the political

obstacles faced in obtaining Congressional support for unpopular measures; we believe that these measures, if approved, could not only prevent a more drastic deterioration in the primary surplus in the short term, but also reduce the pace of spending growth from a medium to long term perspective. Moreover, the magnitude of the recession has been much more intense than initially expected, leading to a collapse in revenue.

What has to be done: Our straightforward conclusion is that any improvement in Brazilian asset prices and risk assessment requires a much less adverse outlook for public sector debt. For this outlook to brighten, we believe that the government would have to be able and willing to bring and sustain the primary surplus to approximately 3% of GDP in the near term. For this to be accomplished, we believe the government should address not only next year's budget but also long-term spending trends. **Therefore, as necessary conditions for better fiscal prospects than those already incorporated into market prices, we highlight the need of:** (1) social security reform; (2) a revision in the correction mechanisms of the minimum wage; (3) action on existing distortions in social programs; the latter has led to fraud in some cases; and (4) an emergency tax increase of at least 2% of GDP within the next two years.

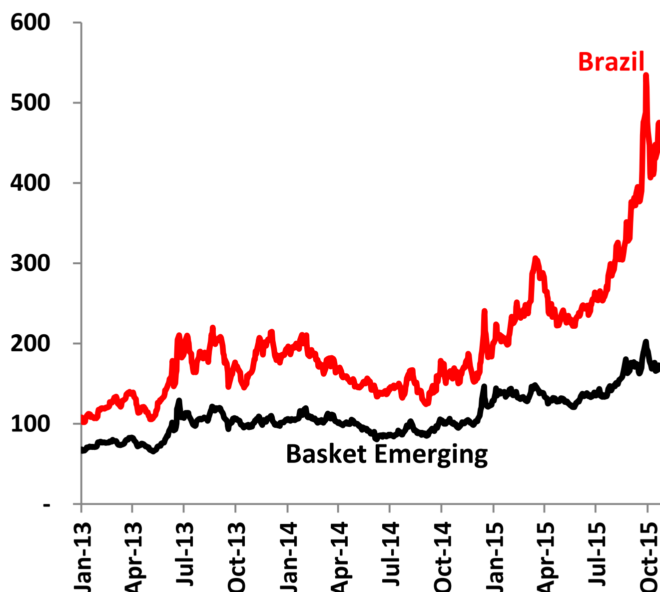
Unfortunately, we believe current political scenario is not consistent with such initiatives.

Exchange Rate: I Am Number Four

Based on our aforementioned arguments, **we do not expect meaningful improvement in risk premiums and asset prices in the short term**. Actually, we expect the news flow to essentially remain negative in the upcoming months. In our view, the current and substantial political uncertainties will not abate in the next six months, leading primary surplus targets for 2015 and 2016 to be further revised for the worst. We also expect economic activity to continue to disappoint, as well as increasing social tensions, with the global environment unlikely to provide any source of joy.

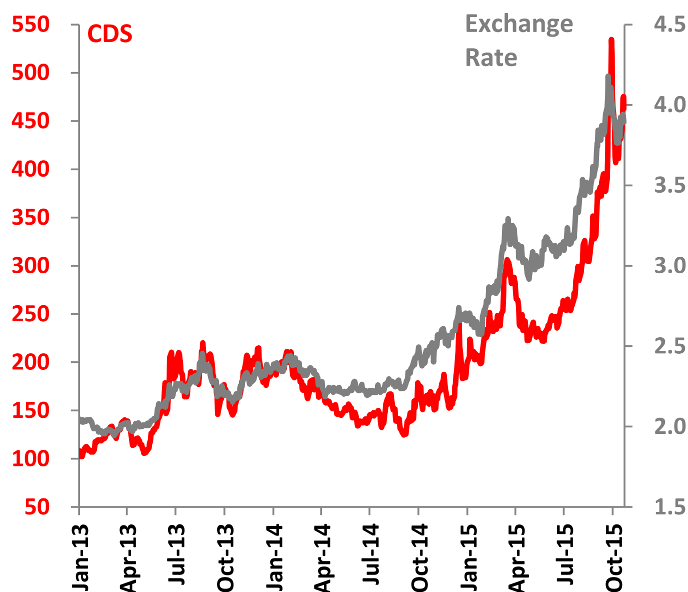
We are changing our forecast for the five-year sovereign CDS from 300 to 400 in 2015, from 270 to 350 in 2015 and from 250 to 300 in 2017. Consequently, we expect country risk to remain the most important driver for the currency for at least the next two years. We are revising our BRL/USD forecast accordingly: from 3.90/USD to 4.00/USD for year-end 2015, from 3.60/USD to 4.10/USD for 2016 and from 3.80/USD to 4.20/USD in 2017.

Five-Year CDS Brazil and EM



Source: Bloomberg.

Brazilian CDS and BRL



Sources: Bloomberg.

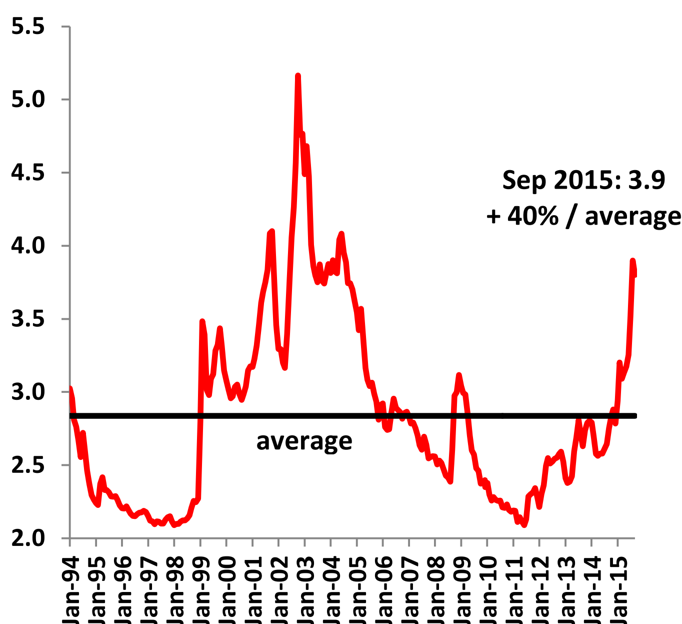
Although, we remain skeptical regarding the short-term prospects for overall macro outlook, we do not see much room for substantial additional deterioration in the medium term. Actually, we expect improvement from mid-2016 onward: (1) Despite remaining skeptical regarding policymakers' willingness and ability to engender a benign fiscal agenda, we believe

the scenario of minimal (although insufficient) fiscal consolidation is already priced in by markets (in 2016, public sector debt will likely surpass 70% of GDP, according to our projections). (2) We forecast that inflation will fall from 1Q16 onward. (3) External accounts are improving fast. (4) Economic activity, in our view, will probably bottom out by mid-2016. (5) International reserves will continue to be seen as an important source of strength, in our view. (6) Brazilian asset prices appear to be considerably cheap at current levels.

As for this last topic, we highlight some indications that the Brazilian *real* may currently be weaker than its long term equilibrium. The following chart on the right shows the real exchange rate 40% above the average of last 20 years. In fact, this depreciated level was more the exception rather than the rule in the period. Only 6% of the analyzed period contained weaker real exchange rates than current.

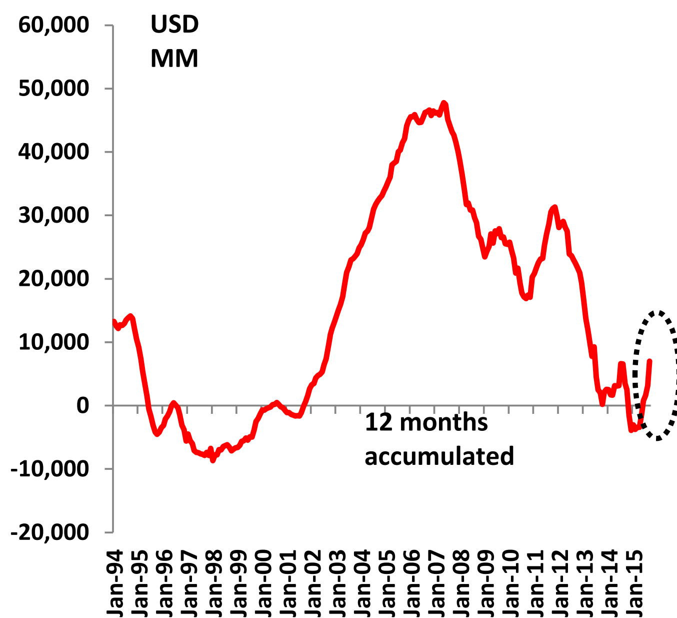
Another indication that the currency may have surpassed its long-term equilibrium is the performance of external accounts, particularly the trade balance. Although economic activity has, up until now, been an important driver of better readings of the trade balance, we find it highly likely that the current account deficit will approach 2% of GDP (its historical average) by 2017.

Real Exchange Rate (At Sep 2015 prices)



Source: BCB.

Trade Balance (USD MM in 12 months)



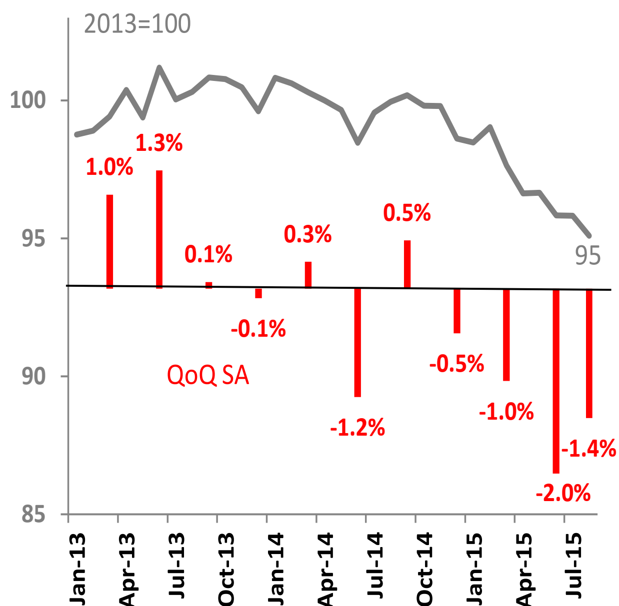
Sources: Funcex.

GDP and Inflation: It Can Always Be Worse….

A worse than expected performance of the economy in 3Q15 and the persistence of a negative news flow toward the beginning of 2016 implies, in our view, that a meaningful GDP contraction will not be restricted to 2015. The most important coincident economic activity indicators have not yet shown any sign that the current free fall is close to an end.

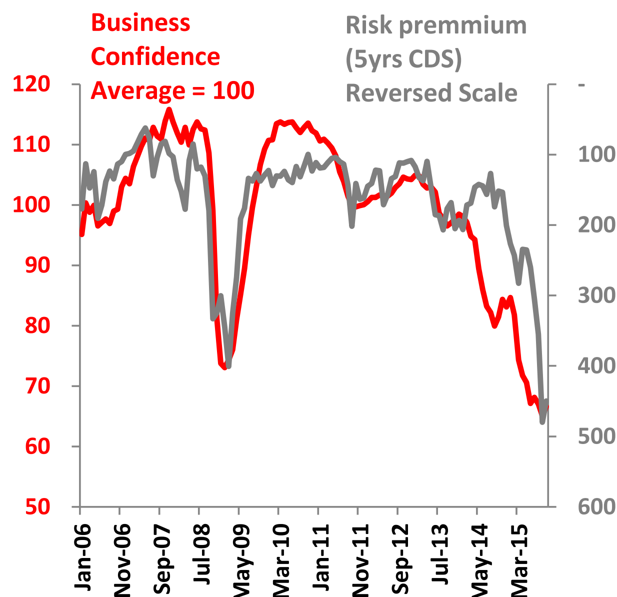
We expect GDP to contract 1.1% and 0.7%, QoQ SA in 3Q15 and 4Q15, respectively, which brings the 2015 forecast to -3.2% instead of previous -2.8%. For 2016, we are changing our projection from -1% to -2%, as leading indicators (notably confidence and CDS) have not yet show any sign of recovery from the recent collapse.

IBC-Br (BCB Monthly Proxy of the GDP)



Source: BCB.

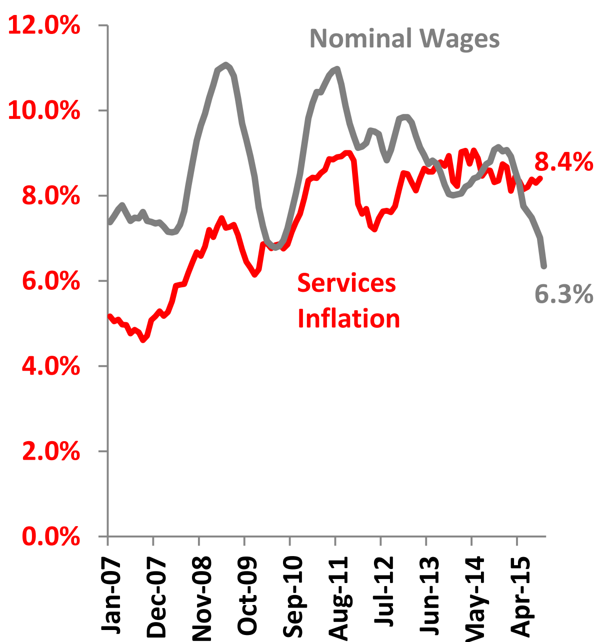
Business Confidence and CDS



Sources: FGV and Bloomberg.

However, while recurrent disappointments with economic growth do not help to build a more benign political environment, it can contribute, at least, to anchor inflation and expectations under an intense currency correction and higher inertia. Although we believe that our own 2016 inflation forecasts, as well as that of consensus, will be under pressure for upward revision, we still believe inflation will fall by at least 3 p.p. in 2016 compared to 2015, mostly due to: (1) lower administered price inflation, particularly due to a much slower pace of gasoline price increases; and (2) lower services inflation, following the intense process of real salary contraction (see following charts).

Services Inflation and Nominal Wages (% YoY)



Source: IBGE.

Inflation Forecast for 2016

	2015 (f)	2016 (f)
IPCA	10.0%	7.0%
Controlled	15.9%	6.5%
Free Prices	8.3%	7.1%
Food	10.1%	9.0%
Services	8.4%	6.0%
Industrials	6.8%	7.5%

	2015 (f)	2016 (f)
Regulated	15.9	7.3
Water and Sewage	15.0	6.0
Electric energy	59.8	6.5
Urban transportation	15.0	3.0
Gasoline	15.0	10.0
Diesel	15.0	10.0
Medicines	6.0	10.0
Healthcare plan	6.0	10.0
Fixed telephone	6.0	0.0

Sources: Funcex.

We are increasing our inflation forecasts by 0.5 p.p. for current and next year, toward 10% in 2015 and 7% in 2016.

Monetary Policy: Fiscal Dominance as a Scapegoat

In our view, monetary policy discussions have been clouded by the debate on whether Brazil faces, or not, a situation of fiscal dominance. Advocates of Fiscal Dominance argue that any additional Selic increase would not be of any help in containing both inflation and expectations, as its dynamics have been fully associated with poor fiscal performance. Actually, new interest rate hikes could make the situation even worse, in our view, as it would add pressures on debt through service costs, further increasing increase risk premiums and weakening the exchange rate.

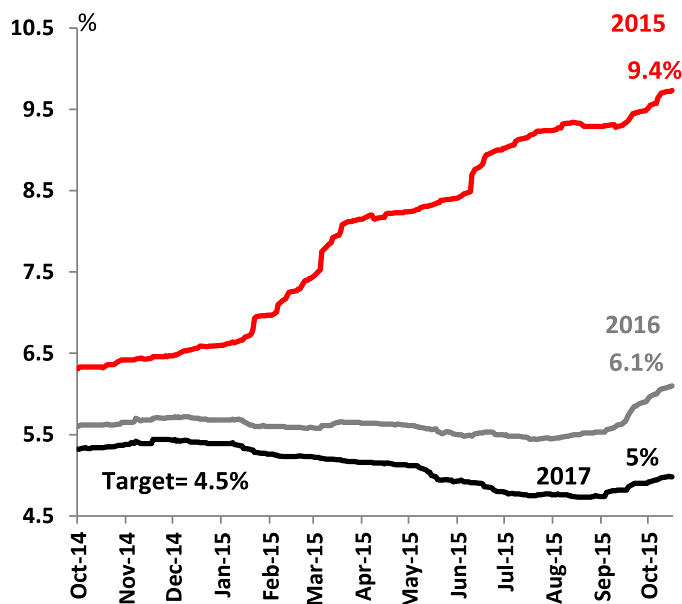
The opposite view is that, in spite of an existing economic imbalance being in a great extent sustained by poor fiscal position, monetary policy should still be guided by the prescriptions of the inflation targeting regime, which means interest rates should be managed to anchor expectations. In this case, the easier the fiscal stance, the tighter monetary policy would have to be.

Although from a theoretical perspective we tend to lean toward the second view, our macro scenario incorporates the assumption that policymakers will act according to the first. In fact, the Monetary Policy Committee has maintained the basic interest rate unchanged in spite of inflation expectations for 2016 increasing from 5.5% to 6.1% in two months. Arguably, we believe that it makes sense that, as year-end approaches the monetary policy's relevant horizon migrates from 2016 to 2017. This measure, however, has also increased in the same period, having reached 5%, which although low when compared to current levels, and not very far away from the objective, would not be consistent with stable interest rates in a pure inflation forecast target regime.

In our view, in spite of adopting "non-fiscal dominance" official rhetoric, we expect the BCB will assign considerable weight to the current deep recession and catastrophic fiscal situation in its monetary policy decisions. For this reason we still expect interest rates to fall next year, particularly when the monetary policy's relevant horizon moves to 2018, between 3Q and 4Q16.

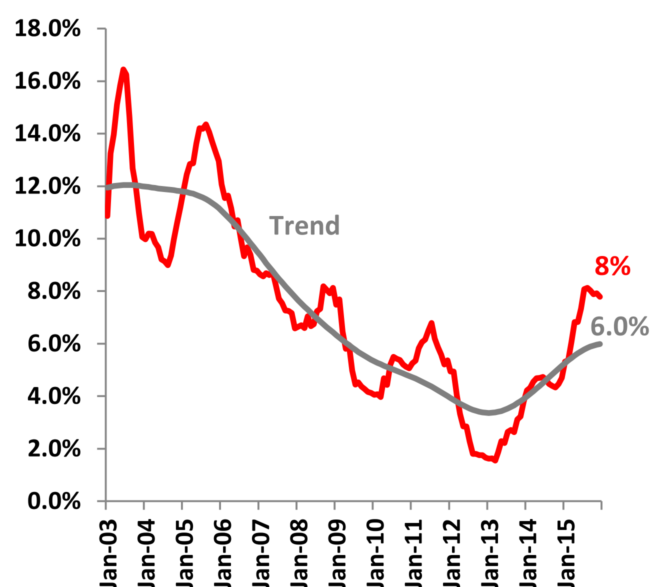
We have increased our year-end Selic forecast from 11.5% to 13% in 2016 and from 9% to 11.5% in 2017.

Inflation Expectations (Focus)



Source: BCB.

Real Interest Rate (Selic (-) 12 months ahead inflation expectations)



Sources: Funcex.

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