Santander Corporate & Investment Banking

ECONOMICS

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Brazil Macro Compass

When Things Change, We Change

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- **Although 2Q19 GDP data were a bit better than we expected, the data reinforced our view that the economic recovery will be gradual, which led us recently to revise our forecast for 2020 to 1.6% from 2.0% previously.**
- **We also revised our projections 2019 and 2020 FX projections to reflect recent developments on both the domestic and international fronts. We now expect the FX rate to end 2019 and 2020 at USD/BRL4.00 vs. USD/BRL3.70 and USD/BRL3.80 previously.**
- **Public spending has continued on what we see as an unsustainable path, with compulsory expenditures jeopardizing government services in the short term.**
- **After a tumultuous week, next week is scheduled to see a calmer calendar of events (in theory), with industrial production data for July 2019 and IPCA figures for August 2019 unlikely to rattle market participants, in our view.**

Economc activity: The slightly positive surprise brought by the release of 2Q19 GDP data has substantially reduced fears about a recession in the country. While the median of market participants' estimates pointed to a 0.3% QoQ seasonally adjusted expansion, the Brazilian economy managed to deliver a 0.4% increase in the same terms due to a better than expected performance of the industrial sector—an element that underpins expectations for a continued recovery ahead. However, the reading has not been enough to lead to an optimistic wave of revisions in market participants' expectations for either 2019 or 2020. Why? Likely because Brazilian economic growth has been frustrating expectations for a long time. Factors such as the sharp deterioration of the fiscal environment, fluctuations in business and consumer confidence, weakening international demand, and a pronounced loss of productivity seem, in our view, to explain much of the deviation between expectations and reality. This situation will not change quickly, in our opinion; hence, we expect the Brazilian economy to continue to run at a moderate pace in the short term. We project expansion of 0.8% and 1.6% for Brazilian GDP in 2019 and 2020, respectively. Given that backdrop, we believe that idleness in the economy will not be eliminated until 2022 (the current output gap is a negative 2.9%, according to our estimates).

For the long term, potential domestic growth is also at depressed levels (we estimate 0.7% p.a. under current conditions). We believe that for potential growth to exceed 2% per year, the investment rate of the Brazilian economy would need to reach at least 19% of GDP, while the annual gain in total factor productivity would have to reach at least its (low) historical average of 0.4% p.a. Although not a trivial improvement, we consider this evolution feasible. We believe Brazil has the necessary conditions to advance the growth agenda, including a more accurate diagnosis of the causes and consequences of the current situation, more reformist guidelines, and the policies proposed by the government's economic team and the National Congress, as well as growing support from Brazilians regarding the need for adjustments and reforms.

Advances in institutional frameworks, measures to stimulate competition, trade openness and integration, greater transparency and legal certainty, initiatives aimed at boosting infrastructure investments, and the government's commitment to fiscal consolidation are some of the elements that need to move forward in order to promote stronger and sustained growth in the long run, in our view. Therefore, unlike in other not-so-distant periods, when demographic factors, positive shocks in international commodity prices, and/or fiscal stimuli boosted Brazilian economic growth, we

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believe that, from now on, progress on the productivity agenda and measures to stimulate investment (mostly private, with domestic and foreign capital) will become increasingly prominent.

FX dynamics: About a month ago we thought we were enjoying a period of "perfect calm", as events on the domestic and international fronts seemed to point toward a relatively tranquil environment for the BRL to strengthen against the USD. Although we believe domestic developments continue to imply some progress on the agenda of structural reforms, events on the international front have strongly departed from the previously projected path: (i) trade war tensions have worsened; (ii) an increasing number of advanced economies have begun to consider additional incentives to prevent a major slowdown; and (iii) the results of the Argentine presidential primary elections suggest the likely victory of the opposition bid in the official race due to be held on October 27. Thus, just one month after what appeared to be "perfect calm", it seems to us that though the sun is now shining on the domestic front, an international cumulonimbus cloud looms on the horizon.

Following this sudden shift in the international environment, the hit the Brazilian currency has taken of late should not come as a surprise, in our view—since the end of last month, the FX rate has moved to near USD/BRL4.15 from USD/BRL3.81 (nearly 10%). Likewise, the Brazilian Central Bank's decision to intervene in the FX market in order to prevent malfunctioning of the FX market did not completely surprise us. However, the BCB's choice of intervening more actively in the spot FX market—although coupled with the issuance of reverse swaps (equivalent to buying back USD in the futures market)—has raised some questions. According to the BCB, the change in its way of intervening in the market—previously, the *modus operandi* was to offer FX derivatives instead of greenbacks—was a response to signs that market participants had shifted their demand to greenbacks from FX derivatives. With domestic interest rates running at historical lows and a fizzy local capital market, Brazilian companies started choosing not to roll over bonds previously issued abroad. As we do not anticipate a hike in the base interest rate anytime soon, we think the demand for greenbacks to pay back external bonds is due to continue, and, hence, the BCB is likely to continue to provide greenbacks and reduce its FX derivatives exposure, as has already been announced.

However, the BCB's move on August 27—selling greenbacks in the spot market without issuing reverse swaps—has raised a new question: Was the monetary authority attempting to signal a cap for the FX rate? We do not believe that is the case, because we do not expect the international cumulonimbus to dissipate soon. Thus, an attempt to establish a cap for the FX rate appears to us a stillborn strategy. Rather, we believe the BCB's interventions are still likely to aim at ensuring the normal functioning of the floating FX regime.

Last but not least, despite remaining relatively confident in the progress of the reforms agenda, we believe the international environment should remain challenging, which led us to revise our forecasts for the USD/BRL cross to weaker levels than previously. We now expect the FX rate to end both 2019 and 2020 at USD/BRL4.00, vs. our previous estimates of USD/BRL3.70 and USD/BRL3.80, respectively.

Fiscal balance: The central government's primary fiscal balance registered a R$6.0B deficit in July 2019, which was a little worse than our estimate (-R$4.5B), leading to a R$116.4B imbalance over the last 12 months (-1.7% of GDP). As we have emphasized in our reports, the steady growth of compulsory expenditures—especially those related to the pension system—has significantly held back discretionary spending, which should end 2019 at around R$100B, by our estimates; indeed, if confirmed, 2019 spending will mark a 10-year low since 2009. Thus, the risk of a partial paralysis of government activities is increasing, in our view. It is also important to highlight the quite depressed level of the federal government's investments, whose volume amounted to R$21.6B YTD through July—a third of the amount registered between January 2014 and July 2014 (adjusted for inflation), which was the peak of the historical series.

We think it is also worth mentioning that there was a reduction in so-called "resources hoarding"—that is, the difference between authorized payments and settled payments—to R$12.1B in July 2019 from R$15.0B in June. Despite the drop, the existence of "resources hoarding" reflects the significant rigidity of the Brazilian budgetary framework: while some public services face a shortage of resources, there are others with a (partial) excess of cash that cannot be redirected to the former. All in all, we believe the government will meet the primary fiscal balance target set for the year—a R$139.0B deficit—but we reiterate our concern regarding the possibility of a shutdown of some public services within the next few months.

The week ahead: In our view, next week theoretically should be calmer on the domestic front, with the release of only two key indicators—industrial production for July 2019 and the IPCA for August 2019. Regarding activity data, we expect Brazilian factories to have increased production by 0.8% MoM in seasonally adjusted terms, which would point to a carry-over forecast of 0.4% QoQ expansion in 3Q19—also seasonally adjusted—if our calculations prove right. In the last three quarters, the industrial sector has contracted, so we believe the reading should support the view that the economy is on the mend—albeit gradually, as the carry-over forecast for 2019 as a whole still suggests a 1.4% full-year contraction. Therefore, while constructive, the industrial production figure should not mean a substantial change in economic activity dynamics, in our view. That is largely the same conclusion we are likely to reach when assessing

the August 2019 IPCA, which we expect to have risen 0.13% MoM (or 3.5% YoY). As both headline and core inflation gauges continue to run far below the targeted level for 2020 (4.0%), we believe price dynamics should not prevent the BCB from cutting the base interest rate at the Copom meeting scheduled for September 17-18.

Number of the Week

R$990B

Projection of fiscal gains from the pension reform bill after the changes proposed by the rapporteur Sen. Tasso Jereissati in the Senate.

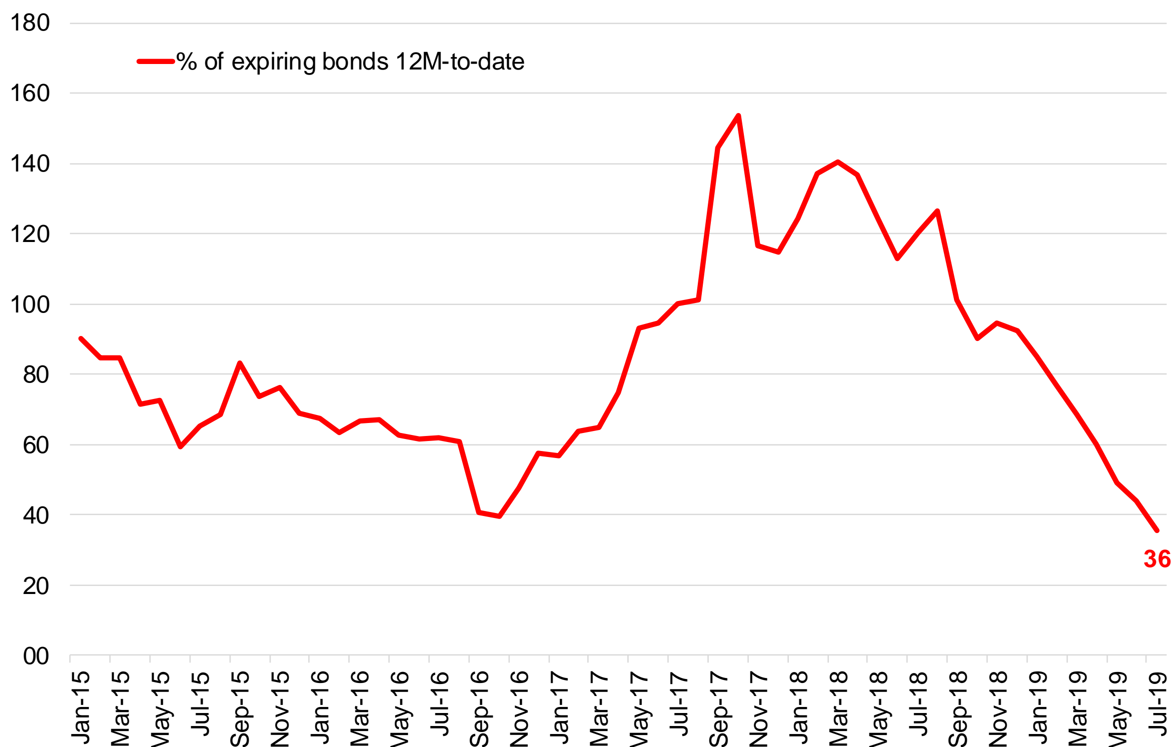
Quote of the Week

"*In the last days, the BRL has weakened more than its peers, but there is no atypical move.*"

— **Roberto Campos Neto**, BCB governor, during a hearing session in the Congress. A few minutes later, the BCB intervened in the spot FX market.

Chart of the Week: Let Them Expire

Our "Chart of the Week" shows the evolution of the rollover of Brazilian long-term external bonds—stripping out sovereign bonds—over the last few years as evidence of the change in the demand profile in the FX market, which has led the Brazilian Central Bank to resume interventions in the spot market instead of resorting to derivatives.



Source: Banco Central do Brasil.

Recent Publications (Available on Our Website)

- *In Search of Growth* (August 29, 2019)
- *Fiscal Policy: Climbing the Cliffs in Bad Weather* (June 18, 2019)
- *Economic Activity and Credit: Highway to Heaven?* (June 7, 2019)
- *Is It Time to Upgrade Core Inflation Measures?* (May 21, 2019)
- *Inflation—Year of the Pig: Good Fortune?* (April 30, 2019)

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