ECONOMICS

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Brazil Macro Compass

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Another milestone in fiscal consolidation

- **This week, Brazil's Senate approved a bill that defines the rules for sharing the transfer of oil rights (ToR) proceeds with states and municipalities. This approval opens the door for the Senate to vote on pension reform next week (October 22) and advance on other key reforms as well.**
- **The government's tax reform proposal is to be submitted to Congress "in installments". The first stage may include the creation of a value added tax (VAT) that would replace a number of federal taxes. Subsequently, topics such as changes in income tax and payroll tax relief should be addressed.**
- **Another key topic on the economic reform agenda is the search for structural cuts in mandatory spending. The Ministry of Economy currently is in negotiation with Congressional leaders to set initiatives (e.g., administrative reform) aimed at cutting mandatory expenses and ensuring compliance with the constitutional spending cap.**
- **We forecast Tuesday's October IPCA-15 at +0.04% m/m and 2.67% y/y, well below the mid-target (4.50%) and the lower bound (2.75%). We raised our inflation forecast for 2019 to 3.5% y/y from 3.4% y/y on the heels of a one-off lottery price readjustment. Our inflation expectations fall both for 2019 and 2020.**
- **In August 2019 the IBC-BR—the index established by the Brazilian Central Bank (BCB) to mimic the GDP behavior on a monthly basis—registered a tiny expansion (0.1% MoM sa) on the back of widespread weak readings of activity indicators in the period. That reinforces our view of a gradual recovery of the Brazilian economy.**

Politics: On October, the Senate approved a bill that defines the rules for sharing the transfer of oil rights (ToR) proceeds with states and municipalities. The auction (scheduled for November 6) will generate proceeds totaling BRL106.6 billion, to be distributed as follows: BRL33.6 billion to the state oil company; 15% to municipalities (BRL10.9 billion) and the same amount to states. With respect to the latter, two-thirds will be distributed according to the distribution criteria of the State Participation Fund (FPE, acronym in Portuguese), thereby benefiting North and Northeastern states, and one-third will be distributed according to the criteria of the Kandir Law (this law exempted agribussines exports from paying sales taxes), thereby benefiting exporting states (especially those located in the South, Southeast and Midwest). The state of Rio de Janeiro, in turn, should receive further BRL2.2 billion, given that the oil fields to be auctioned are in its territory. The main destination of funds should be the payment of social security expenditures (governed by strict rule for states and suggested measures for municipalities). After these payments, funds may be allocated to public investments. Finally, we note that approval of this bill opens the door for a Senate vote (second round) on pension reform.

Accordingly, the approval of the PEC 006/19 (constitutional amendment) in the Senate is expected to take place next week (October 22). The government projects cost savings of around BRL800 billion over 10 years. Furthermore, according to the final draft of the Senate rapporteur for social security reform, the so-called "side amendment" (a separate draft that included the extension of changes in retirement rules to state and municipal civil servants) will be submitted to the Senate the day after the approval of the PEC 006/19.

Regarding the tax reform, the government's economic team is mulling the partitioning of the proposals in order to speed up transit through Congress. This would entail, for instance, including in the bill a new VAT resulting from the replacement of some federal taxes this year. Subsequently, government's focus would be on changes in income tax, a payroll tax break and the inclusion of other taxes in the new VAT. We highlight that two other tax reform proposals are already being debated in Congress: PEC 110/2019 in the Senate and PEC 45/2019 in the Lower House.

Another key topic on the economic reform agenda is the search for structural cuts in mandatory spending. To that end, the Ministry of Economy is negotiating with Congressional leaders on a set of initiatives (such as administrative reform, budget flexibility, among others) that aim to undo the straightjacket of mandatory expenses and ensure compliance with the constitutional spending cap in coming years. According to the O Estado de São Paulo newspaper on Friday, the government is mulling prioritizing this agenda, even in anticipation of the (already ongoing) tax reform discussions, with a view toward freeing up around BRL30 billion (0.4% of GDP) in non-discretionary expenses.

Inflation: We are increasing our inflation expectation for 2019 to 3.5% y/y from 3.4% y/y, owing to a one-off hike in lottery prices. In contrast, the BCB´s Focus survey from earlier in the week showed a downward revision in median inflation expectations for 2019 and 2020, to 3.28% (from 3.42%) and to 3.73% (from 3.78%), respectively. While we do not expect further downward revisions for 2019 inflation forecasts, we do see room for analysts to keep marking down their 2020 IPCA forecasts, following the recent revisions to the CPI basket from the 2017-2018 household consumption basket—the so-called POF (Portuguese acronym). We estimate a deflationary impact of 0.2 percentage points for next year's result after this methodological change.

On Tuesday, October IPCA-15 (preview of Brazil´s official inflation index) will come out: we forecast a gain of 0.04% m/m, with the year-over-year change declining further to 2.67%–that is well below the mid-target (4.50%) and the lower bound (2.75%).

From the inflation standpoint, two factors help pave the way for further Selic rate cuts of 50-bp ahead: (i) downward movements in inflation expectations for 2020—a key policy horizon for the BCB as of now; and (ii) stubbornly low current inflation figures, creating a favorable inertial effect for next year. We see the BCB bringing the Selic rate to 4.50% by YE2019 and keeping it at that level throughout 2020.

Economic activity: Two important indicators were released this past week: retail sales and services revenue for August 2019. Core sales managed to record a 1.3% YoY change, which translated into paltry MoM expansion of 0.1% in seasonally adjusted terms; the supermarkets segment—which accounts for 45% of the index—was the main driver. However, sales of durable and semi-durable goods grew less than we expected, thus confirming that the nature of the economic recovery remains gradual. The broad retail sales index—which includes building materials stores and autos and autopart dealers—was disappointing, remaining unchanged in seasonally adjusted terms, versus our projection of 1.0% MoM expansion, s.a. Whereas autos and autopart dealers saw their sales receding 1.7% MoM s.a. (+2.9% YoY), building materials stores registered a decline of 0.8% MoM s.a. (-1.6% YoY). Likewise, the survey on services—the so-called PMS—was up 0.2% MoM s.a.—with three of the five categories showing contractions in the same terms. The lowlight was services for households, which dropped 1.7% MoM s.a. Accordingly, the IBC-BR grew 0.1% MoM s.a. in August. We expect 3Q19 GDP to see a 0.3% QoQ s.a. expansion, in line with our full-year 2019 forecast of 0.8%.

Additionally, according to data from the Ministry of Labor published this week, the net creation of formal jobs (Caged) in September reinforced a scenario of a gradual recovery in Brazil's labor market. There was a net generation of 60,000 jobs in seasonally adjusted terms, which was slightly above our expectations of 53,000 formal jobs. Between January and September, 302,000 new jobs were created, representing an improvement (albeit modest) compared to the net creation of 244,000 vacancies YoY. In addition, the quarterly moving average accelerated to some 53,000 per month, up from 44,000 in August. Other factors that we highlighted are the intermittent and partial work posts resulting from the new labor legislation. These categories have gained relevance in total job creation, having accounted for 20.5% of the posts in the last 12 months. Despite the positive note, the total creation of formal posts accumulated in the last 12 months (470,000) remains small compared with the job losses wrought by the last recession. That is, labor market conditions have improved, but gradually.

Number of the Week

60K

Our estimate for the seasonally adjusted net creation of formal jobs in September 2019, hinting at improved labor market conditions.

Quote of the Week

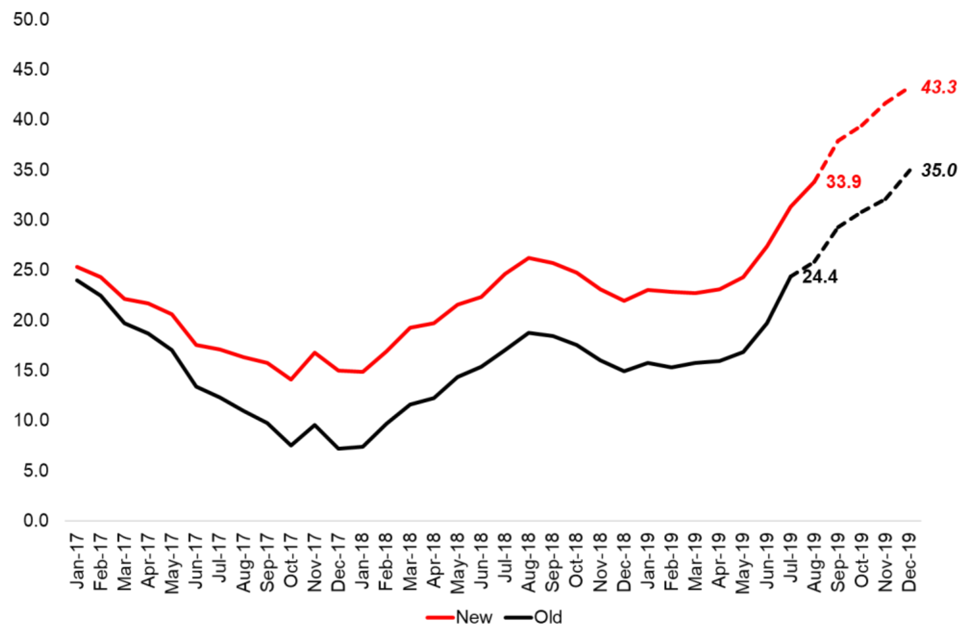
Presidential election in 2022 is a marathon. If someone starts running now they will be dead by then.

— **Rodrigo Maia**, Speaker of the Brazilian Lower House, about the next presidential elections.

Chart of the Week: Level shift

Our "Chart of the Week" illustrates the expected trajectory of the current account deficit before and last month's revision by the BCB, which led to a level shift as compared to previous figures. According to the monetary authority, there was previously an overestimation of commercial claims, reducing the size of the deficit. Following the correction of this problem and the BCB's data revision, we currently estimate a current account deficit of USD43.3 billion by YE2019, versus our proviso estimate of USD35.0 billion. Although higher than before, we expect the deficit to continue being easily financed by foreign direct investments, which have been hovering around USD70 billion of late. Next Thursday, the BCB will release external sector data for September 2019, when we expect the current account deficit to show a USD4.4 billion reading.

Brazilan current account deficit – US$ billion, 12M-to-date



Sources: Banco Central do Brasil, IBGE, Santander.

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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