BRAZIL ECONOMICS

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Macroeconomic Scenario

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The Shock Is Even Worse and Stimuli Much Bigger (Revising GDP, Inflation, Interest Rate and FX Forecasts)

- **The impact of the pandemic and the duration of the social distancing measures seem to have turned out much greater than we previously anticipated. Therefore, we are revising our 2020 and 2021 GDP growth forecast from -2.2% and +1.7% to -6.4% and +4.4% respectively. The numbers point to a much greater loss of output, in addition to more prolonged economic slacks.**
- **We expect the public sector's primary deficit to be much larger than we previously anticipated for 2020 (~BRL800 billion vs. ~BRL600 billion), owing to the extension of the emergency measures to fight the COVID-19 crisis and the greater-than-expected damage from the pandemic on tax revenues. Hence, we now project that the gross public debt-to-GDP ratio will climb to ~94% this year, peak in 2028 at ~103%, and finally converge to ~96% in 2035. Despite the clear rise in budgetary risks, we still believe that this massive fiscal expansion will be temporary, thereby preserving the fiscal consolidation framework and addressing necessary macro reforms in the post-crisis.**
- **Our forecast for inflation has also been revised lower, mainly on the back of downward GDP revisions (implying larger and more prolonged economic slacks). We now forecast 2020 inflation at 1.4% (from 2.2% previously), 2.9% in 2021 (from 3.1%) and 3.5% in 2022. Our forecasts indicate two years with CPI running below the central target path set by the CMN (Monetary Council).**
- **Following the Brazil Central Bank's (BCB) surprising announcement of additional stimuli, we now project a terminal Selic rate of 2.25% for the cycle. We also expect a very gradual normalization of the policy stance to start only in 3Q21, assuming still-anchored inflation expectations as well as a wide-open and slow-closing output gap.**
- **A greater hit on real activity and fiscal outlook could weaken the BRL more than we previously thought: we now forecast the YE2020 and YE2021 FX rate to reach USD/BRL5.80 and USD/BRL5.50, respectively, from USD/BRL4.90 and USD/BRL4.05 previously.**
- **Given the more pronounced contraction in domestic demand and the weaker currency level, the current account should register a smaller imbalance in 2020-2021, in our view. We project deficits of 1.6% and 1.4% of GDP in 2020 and 2021, respectively, from 3.5% and 3.0% previously. We see foreign direct investment in Brazil covering the gap for the period.**
- **For bank credit, our growth forecast for balances has decreased from 9.4% to 7.1% YoY, on the heels of the pandemic's adverse impact on the unemployment rate and the risk of solvency of firms. With a backdrop of weak consumption and investment, the appetite for credit (for both individuals and companies) should also decrease, in our opinion.**

Introduction

In the two months since the World Health Organization (WHO) declared COVID-19 a pandemic on March 11, we have seen governments implement clear strategies to combat the outbreak and its initial economic impact. As such, we re-emphasize a single macroeconomic scenario (i.e. with fewer alternative hypotheses), despite a more negative bias toward this new baseline.

First, we highlight the defined strategy to combat the pandemic, most notably the transmission rate (R_0), which authorities would like to see at values of less than 1 (or put another way, ensuring that each infected person does not transmit the virus to more than one other). The objective is to slow down the contagion until there is either (i) an effective vaccine/treatment; or (ii) herd immunity.

To that end, at a minimum, large-scale testing, expansion of hospital capacity and social distancing measures must be implemented. Countries and regions have varied in implementing these measures.

Second, we already have a set of macroeconomic data that illustrate the impact of the crisis on the economy, suggesting a sudden halt of activity. Just as an example, March IBC-Br (a monthly GDP proxy calculated by the central bank) posted a drop of 5.9% m/m, the worst reading for the series (started in 2003).

In response to the scope of this global crisis, which is only comparable to secular events like world wars and other major pandemics, in our view, several countries have meted unprecedented doses of fiscal and monetary stimulus. In other words, considering that the economic impact is inevitable, we believe that it is also inevitable that the public sector must temporarily assume current private expenses in order to keep the economy functioning until its natural recovery. This saves lives and mitigates job losses and bankruptcy, preparing the economy for recovery after the pandemic.

Looking at the first activity indicators since the beginning of the first social isolation measures in Brazil and globally, we forecast a GDP drop of 6.4% in 2020, with a subsequent recovery in the third quarter of this year. Although we expect production to react immediately once the measures are relaxed, we also believe that demand will be greatly affected by increased unemployment, which we estimate will unfortunately reach over ~8 million Brazilians. We further anticipate increased uncertainty and profound behavioral changes in households and firms that dictate consumption and investment decisions. In other words, we see a gradual U-shaped economic recovery and no return to the pre-crisis level of production before 2022.

Like the vast majority of countries affected by the pandemic, Brazil has also adopted temporary measures along four general lines: (i) income transfers to the most vulnerable Brazilians (Emergency Aid); (ii) support for small- and medium-sized businesses with the following programs: FOPA (credit lines for payroll financing), BEM (Emergency Employment and Income Preservation Benefit), and PRONAMPE (National Support Program for Micro and Small Enterprises); (iii) liquidity injections to provide resources to firms that need to reinforce their cash flows (including reduced reserve requirements and FGC guarantees for the purchase of debentures, among others); and (iv) fiscal support to states and municipalities (e.g., direct transfers, debt suspension). With the sudden paralysis of capital markets, we expect Brazil's solid banking system to play a fundamental role in the economic recovery. Considering the fiscal impulse and the monetary and credit stimulus, Brazil has already committed more resources than the world average and much more than the average for emerging countries.

Although necessary and in line with policies adopted in other countries, the fiscal impulse and the economic downturn will produce a primary deficit of 11.7% of GDP or BRL810 billion in 2020, per our projections, following both a temporary primary expenditure of BRL470 billion and a revenue fall of BRL210 billion. This implies a further jump in government debt, from ~76% in 2019 to ~103% of GDP in 2028. At the end of 2013, the level was close to 52% of GDP. So, in 15 years Brazilian gross public debt will have doubled in size.

This new level of debt implies that if we were to assume potential GDP growth of 1% after the pandemic, with an unchanged structural interest rate close to 3%, we estimate a primary surplus of 2% of GDP would be necessary to stabilize government debt. Given the challenging starting point for this fiscal consolidation (due to higher deficits expected for 2020-2021), we estimate the need for a total fiscal adjustment of at least 5% of GDP in the coming years, so as to ensure fiscal solvency for the long run. If the goal is to reduce debt of the Brazilian government, which was already higher than its EM peers before the crisis, then the budgetary effort should be even greater.

In this difficult passage through the crisis, the reforms undertaken since 2016 have played a fundamental role, as they have granted Brazil greater resilience, in particular by setting real structural interest rates at historical lows. With still idle capacity in the economy, due to the gradual recovery from the previous crisis (2015-16), nominal interest rates in Brazil have been at an expansionary level (i.e., below the structural level). Before the start of the pandemic, the Selic rate stood at 4.25% and the expected inflation for 12 months ahead was anchored at 3.5%.

The Copom's subsequent Selic rate reductions to 3.00%(-50 bps in April and -75 bps in May) may have contributed to an adverse movement in asset prices (in terms of broad financial conditions). Yields for up to 5- and 10-year rose by 100-150 bps, meaning that the term premium has gone up. In addition, the depreciation of the BRL has been more pronounced than its peers: since the beginning of the year, the BRL has depreciated 45% vs. the USD, even approaching the milestone level of BRL6.00/USD.

Nonetheless, we expect the IPCA to end the year at 1.4% and converge to 2.9% in 2021, below the inflation target (3.75%). Applying the monetary policy rule, the monetary authority would, in theory, have a little more space in its “budget” for Selic rate cuts. Although we see risks of a counterproductive effect from additional rate cuts, we project another 75-bp move at the Committee's June meeting, largely due to the communication components seen in the Copom statement and minutes. As a result, the cycle of monetary easing would end in June with the policy rate at 2.25%. We project interest rate will remain at that level until the 3Q21.

Projecting the exchange rate trajectory is a much more difficult task. In addition to the external components (country risk, interest differentials and commodity prices) that usually explain an important part of their variation, we added the evolution of the exchange rate in emerging countries (excluding Brazil) to better filter the idiosyncratic components of Brazilian exchange rate moves. We thus reached a value of BRL5.80/USD at the end of the year, converging to BRL5.50/USD by the end of 2021 and BRL5.30 by the end of 2022. One hypothesis is that the end of the crisis should reduce to some extent the degree of global risk aversion, which would contribute to some appreciation of emerging market currencies. The implementation of reforms in Brazil in the future should also help to improve sentiment toward national assets, improving the flow of external funding for an emerging economy with low levels of domestic savings.

We understand that in view of the marked fiscal fragility with which Brazil will emerge from the crisis, it will be necessary, as soon as possible, to have a clear signal of a set of measures that could ensure the restart of a fiscal consolidation process as well as a broader set of macroeconomic reforms. The first step, in our view, would be to affirm the maintenance of the constitutional “Spending Cap” rule, whose compliance, until 2022, would be ensured by taking four measures: (i) the maintenance of the real value of the minimum wage; (ii) the maintenance of the nominal value of the payroll of federal employees; (iii) a hiring freeze in federal public services; and (iv) a moratorium on new primary expenses. In addition to the maintenance of the constitutional spending cap, we believe it will be important to return to the debate in Congress for a modernizing agenda of priorities for the Brazilian economy. The (rather long) list also includes administrative and tax reform; measures to improve the business environment; modernization of regulatory frameworks in infrastructure; privatizations and asset sales; and trade openness. We see these as fundamental initiatives to signal an acceleration in potential GDP and the feasibility of maintaining monetary and macroeconomic stability in Brazil.

To illustrate the importance of choosing to return to the trajectory of structural reforms, even though this may seem arduous in light of the current contingencies, we have constructed an alternative hypothetical scenario in order to estimate the value of this strategy.

The alternative scenario will be presented in the appendix, showing what the trajectory of expected growth, inflation, exchange rates and interest rates would be in a condition of "fiscal dominance", meaning an upward trajectory for debt, without stabilization. Under such an environment, it is possible to envisage a return to inflation, amid strong macroeconomic deterioration, in addition to a more pronounced GDP decline and job losses. We include this exercise to illustrate our conviction regarding the best way for the country to achieve the recovery of the economy, the labor market and income of the most vulnerable, with predictability for business and investments, while promoting social equality.

Economic Activity

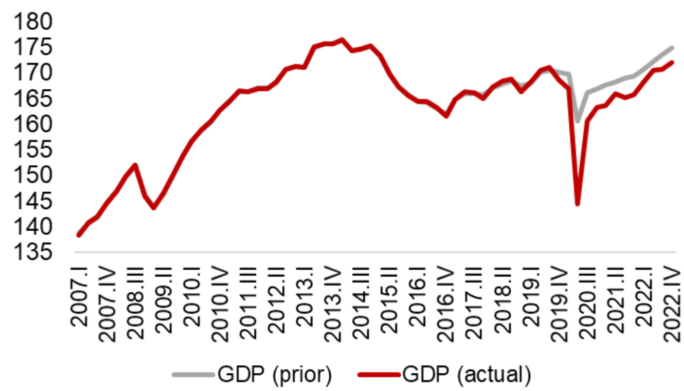
Recent information tells us that the impact of the pandemic is much stronger than anticipated for the Brazilian economy. We believe that the social distancing measures will likely stay in place longer than expected and that the daily drop in economic activity spurred by the lockdown may be larger than previously thought. Moreover, in our view, those sectors less affected by the COVID-19 crisis that could have served as “cushions” seem to have not provided enough of a buffer to avoid a harder hit.

Figure 1. GDP Estimates (%)

	2020	2021	2022
Agriculture & Livestock	3,0	3,0	4,3
Industry	-8,7	5,9	5,2
Services	-6,1	3,9	2,5
Total GDP	-6,4	4,4	3,2
Household Consumption	-4,0	4,7	2,8
Government Consumption	1,7	-0,2	-0,5
Investments	-14,5	15,3	4,2
Exports	-15,2	9,0	3,4
Imports (-)	-20,4	20,2	9,7
Domestic Absorption	-4,8	4,8	2,4
External Sector Contribution	0,8	-0,6	-0,9
Inventory Change	-2,7	0,1	1,6

Sources: Santander Estimates and IBGE.

Figure 2. GDP (Seasonally Adjusted)



In our scenario, we assume that the transmission rate will fall, allowing the social distancing policies to be eased in mid-June in most regions. We also assume that the economy could gradually return to being fully operational by September. Nevertheless, we believe that the policies adopted during the crisis will somehow preserve many jobs and companies, and that Brazil will see a productivity recovery and a fiscally responsible reformist agenda in the post-crisis. Hence, despite an expected contraction for the economy in 2020-2021, the statistical effect in economic growth will be significant for 2021 in our view. And, with reforms, we expect growth fundamentals to improve gradually over time.

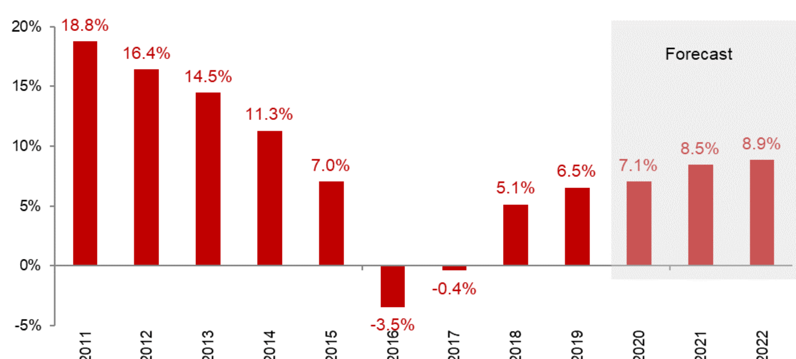
In our revised outlook, a sharp rise in the unemployment rate is unavoidable and should reach an all-time-high full-year average of 14.9% in 2020 before gradually falling to 13.1% and 11.8% in 2021 and 2022, respectively, according to our estimates. Additionally, we updated our GDP forecast from -2.2%, +1.7% and +2.5% to -6.4%, +4.4% and +3.2% in 2020, 2021 and 2022, respectively.

Credit Market

Following measures announced by the BCB and BNDES that aim to lend resources to those sectors most affected by the pandemic, the share of credit granted to companies expanded. This advance was due to the companies' need for cash flow, and BRL depreciation, which increased the value of contracts referenced in USD, generating artificial expansion without economic significance. The household segment lost traction owing to the lower use of credit cards, likely denoting greater consumer caution.

Despite this increase, the likely impact of COVID-19 on the unemployment rate and on companies' solvency makes us believe that risk aversion (on both demand and supply sides) will increase. We estimate non-earmarked defaults could be around 35% higher YoY and believe public banks' share of new lending could increase.

Figure 3. Credit Market Forecast



Sources: Santander Estimates and BCB.

Considering these points, we have adjusted our default estimates for the next three years: 7.1% for 2020; 8.5% in 2021 and 8.9% for 2022, with non-earmarked debt going from 3.7% in 2019 to 4.8%, 4.4% and 3.9% in 2020, 2021 and 2022, respectively.

We expect these changes (driven by the coronavirus impact) to be temporary, with a reversal to the path previously observed in 2019. In our view, the main risk would be the further worsening of the consequences of the pandemic, specifically: increased debt and debt costs, and a drop in banks' risk appetite. In this scenario, access to credit would become more difficult, with public banks becoming the main lenders in the Brazilian credit market.

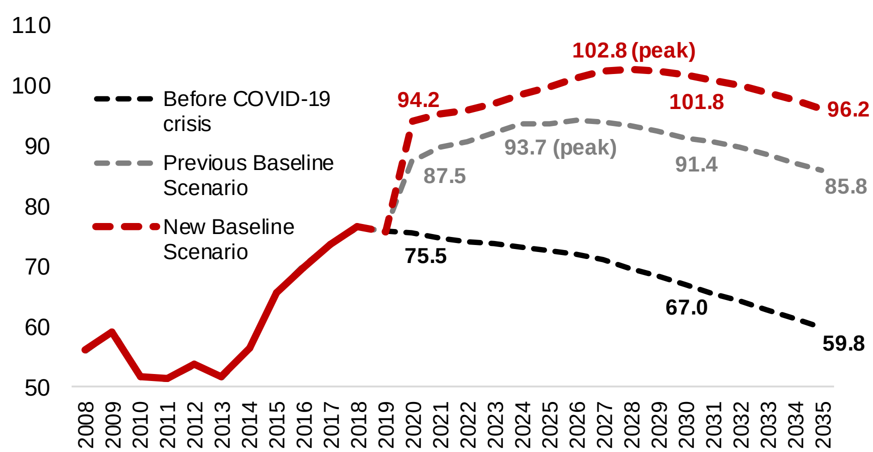
Fiscal Policy

We expect the deepening economic recession to lead to severe deterioration in Brazilian fiscal accounts this year. On the revenue side, we estimate that the direct impact of lower GDP growth on tax collection, combined with longer-lasting temporary tax exemptions (and extended deferral of tax payments), could imply primary revenue losses of around BRL210 billion in 2020, compared to the pre-pandemic outlook. On the expenditures side, we believe that some lifelines for workers, households and companies to combat the COVID-19 outbreak will likely be extended beyond the next few months, as the health crisis has proved to be more acute than previously anticipated.[1] Hence, our new baseline scenario considers that the wide set of primary fiscal spending measures to fight the pandemic will add up to BRL470 billion (6.5% of GDP), an amount considerably higher than our expectation a couple of weeks ago (BRL335 billion, or 4.6% of GDP).

Accordingly, we now forecast the 2020 public sector primary fiscal deficit at BRL810 billion (11.7% of GDP)—much worse than our previous baseline scenario (BRL585 billion, or 8% of GDP). For 2021 and 2022, we expect primary fiscal deficits of ~BRL260 billion (3.5% of GDP) and ~BRL215 billion (2.7% of GDP), respectively. We note that our base-case scenario takes as a crucial assumption that the massive fiscal expansion stemming from the health crisis will be (almost entirely) limited to 2020. In our view, the primary fiscal balance will return to positive territory in 2026.

We estimate that the gross public debt-to-GDP ratio will climb by ~18pp from 2019 to 2020 (from 75.8% to 94.2%), before rising further to 94.8% in 2021 and 96% in 2022. More importantly, we expect the indicator to peak only in 2028 at ~103%, implying a difference of approximately 30pp compared to the pre-pandemic crisis. Henceforth, we project a gradual decline in public debt (see Figure 4). These forecasts illustrate the massive fiscal effort required to substantially reduce public debt in the current context[2]. Lastly, it never hurts to reiterate that our base-case outlook does not anticipate an unsustainable trajectory in public sector debt, reflecting of our fundamental hypothesis that government and Congress will remain credibly committed to the fiscal consolidation agenda, particularly compliance with the spending cap framework, as well as to the structural reforms aimed at increasing productivity in domestic activity. With reforms, low levels of interest rates also favor debt dynamics.

Figure 4. Gross Public Debt (% GDP)



Sources: The National Treasury Secretariat, Brazilian Central Bank and Santander.

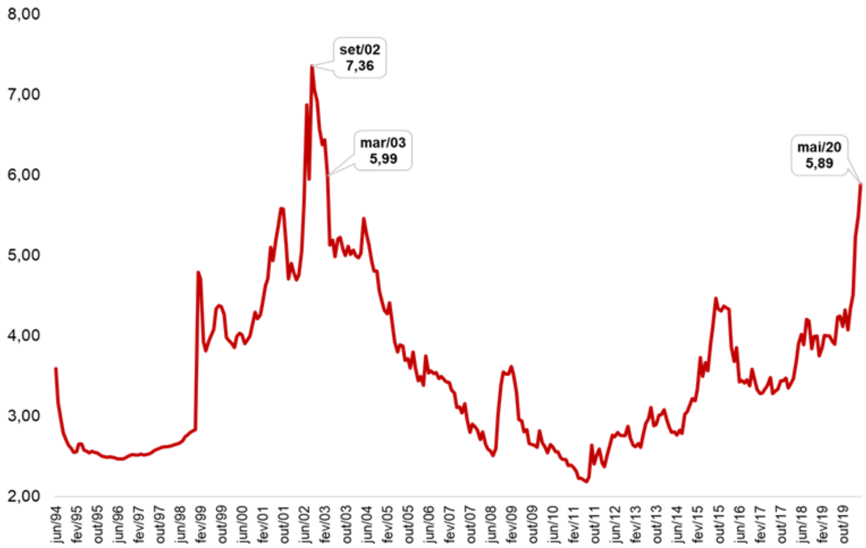
[1] For example, the emergency aid for informal workers and low-income households is expected to be prolonged for at least two months, which would potentially cost additional BRL100 billion for the public coffers

[2] According to our simulations, the stabilization of the gross public debt-to-GDP ratio at ~105% requires a primary fiscal surplus of (at least) 1% of GDP.

External Sector and Exchange Rate

While international factors that influenced the FX rate—commodity prices, U.S. interest rates, other emerging market currencies, global risk aversion, etc.—have behaved relatively in line with our expectations lately (which meant some weakening influence on the BRL), the domestic influence has played a much more important role in the FX market, thus leading the BRL to weaken much more than we had previously anticipated. Turbulence on the political front, doubts regarding changes in the direction of economic policy and uncertainties on the fiscal front have brought the FX rate to the USD/BRL5.90 vicinity—the weakest level in real terms since the early 2000s.

Figure 5. USD/BRL – Inflation Adjusted

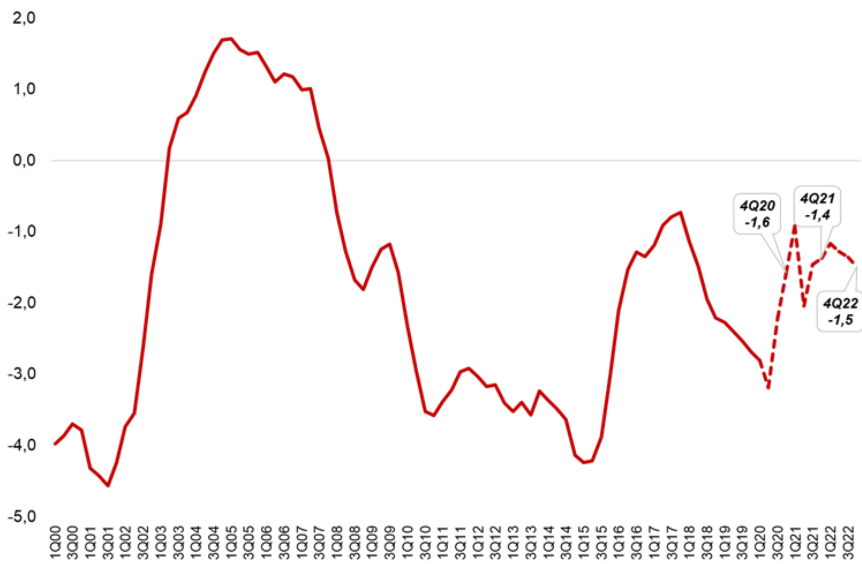


Sources: Santander and Bloomberg.

We do not anticipate a change in this picture in the short term, especially as on the international front the bulk of the economic impact in the western hemisphere stemming from COVID-19 has yet to materialize, in our opinion, suggesting depressed commodity prices, the maintenance of high risk aversion and pressure on emerging market currencies. Additionally, domestic political tension remains high, and initial evidence points toward a much stronger impact from COVID-19 on Brazil's economy. This mix makes it more difficult for the executive and legislative branches to resume in the short run discussions about structural reforms that are required to deal with the significant fiscal deterioration expected this year. All in all, doubts remain on the dynamics of public debt in the more distant future. This risky backdrop led us to raise our projections for the YE2020 and YE2021 FX rate, which we now set at USD/BRL5.80 and USD/BRL5.50 respectively (previously, USD/BRL4.90 and USD/BRL4.05).

On the heels of weaker currency levels and sharper-than-anticipated economic contraction, we believe imported goods and services should shrink more than previously anticipated as well. On top of that, we expect the remittance of profits and dividends to parent companies to dwindle further, as corporate earnings become scarcer and the conversion into USD more expensive. Although we believe that a weaker BRL may favor the exports of goods and services in the medium term—once the world gets to a "new normal" in the aftermath of COVID-19 and resumes growth—the decline in international trade flows and commodity prices in the short term should lead exports to recede as well, albeit less than imports. Consequently, in contrast to our earlier expectation, we forecast the current account annual deficit to shrink to USD20.2 billion in 2020 and to USD19.4 billion in 2021, implying relative stability as a percentage of GDP (1.6% and 1.4%).

Figure 6. Current Account Balance (% of GDP)



Sources: BCB and IBGE.

Inflation

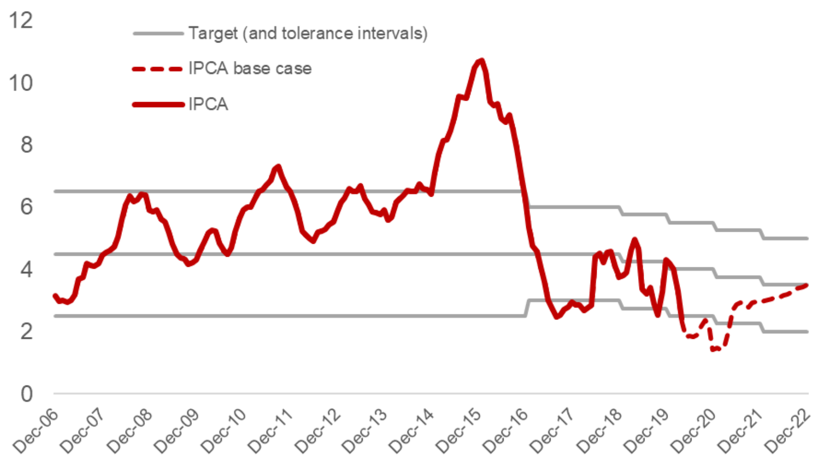
The major change for inflation since our last revision comes from economic activity, as we believe the steeper fall in demand should make the output gap even wider for longer (at least until 2022, per our estimate), hence causing stronger downward price pressure.

Analyzing the other drivers of inflation, we expect inertia and (falling) expectations to support low inflation for the next few years. On "imported" inflation, we point out that the BCB's credibility and the economic slacks translate into only minor pass-through of the currency depreciation on general prices. With respect to the other component of "imported" inflation, commodities, we highlight that the steep fall in oil prices—where pass-through is more direct and intense—more than compensates for the weaker BRL. Even considering a gradual oil price recovery in 2020, "imported" inflation will be one of the main drivers of low inflation this year, in our view. For 2021, we foresee a base effect generating an upward impact from oil on inflation. We also anticipate a considerable rise in electricity prices, which would make administered prices rise around 4.5%. Despite those two particular pressures for 2021, the economic slacks should still dominate the dynamic of inflation, in our view, keeping it at low levels. Reflecting the lack of demand-led pressures, we project the IPCA EX3 core at 1.7% for 2020 and 2.7% for 2021.

Therefore, our new inflation forecasts are 1.4% in 2020 (from 2.2% previously), 2.9% in 2021 (from 3.1%) and 3.5% in 2022. Our forecasts indicate two years with CPI running below the central target path set by the CMN (Monetary Council).

We believe the risks are still tilted to the downside due to economic activity. One possible (and minor) upward risk could come from volatile items such as gasoline and food prices for 2021, in our view. But even in that case, we believe inflation should stay well below the BCB target next year.

Figure 7. IPCA Inflation - % YoY



Sources: Santander Estimates, BCB and IBGE

Monetary Policy

In the May 5-6 policy meeting, the BCB cut the Selic rate by 75 bps, to a new historical low of 3.00% per annum. The decision and tone of the statement pointed to an unexpected amount of additional stimuli.

Copom officials mentioned the necessity of “an unusually large monetary stimulus”, heralding for the next meeting “a final monetary adjustment, not larger than this one [75 bps]” to complete the easing needed to offset the economic consequences of the pandemic. The latter is seen producing a global recession “with few historical precedents” and exerting “a disinflationary impact on the Brazilian economy, together with a sharp increase in economic slack.”

The committee sees “potential limits” for further cuts, with the BCB recognizing that “in light of the elevated uncertainty domestically, the remaining scope for monetary policy is unknown and may be small”. The Copom refers to Brazil’s “relative fiscal fragility” and “uncertainties regarding its prospective fiscal path”, making interest rates “close to a level where further reductions […] could be accompanied by instability in financial markets and asset prices.” We believe this recognition matches our view that the fiscal framework is an important component of the inflation-targeting regime and does impose constraints for the easing cycle at this stage.

The key question here is: what is Brazil’s effective lower bound for interest rates? In our view, probably no less than 2.00%. We now project a terminal Selic of 2.25% for the cycle, and a gradual normalization starting only in 3Q21, assuming still-anchored inflation expectations and a wide-open and slow-closing output gap.

Box: Neutral Interest Rates and Taylor Rules

The best approach to describe and project interest-rate trends in the short term is the Taylor Rule, in our view, which assumes that the BCB sets interest rates based on (i) the output gap (idleness of the economy) and (ii) deviation from inflation expectations in relation to the target. Since the effect of the crisis on prices has been strongly disinflationary, and the decline in economic activity will increase the gap between current GDP and its potential, the direction of rates in the short term is clearly south, in our view, opening room for the BCB to test new historical lows.

Nevertheless, at the end of the easing cycle, we believe the Selic rate may be higher than the Taylor Rule would suggest, since a “functional lower bound” may exist. This limit is likely higher than zero, in our view, considering that, even in the short term, some positive premium risk is required. This borderline is not observable, and could be low; however, the potential effects of crossing this line may lead the BCB to avoid introducing sizable new stimulus measures.

In the long term, the direction of the impact of the pandemic on rates is not so clear. On one hand, a possible consequence is a change in consumer behavior that keeps output below its pre-crisis level for a long period, and even reduces potential growth, which may push international and local rates lower. For example, the memory of the losses incurred during the health crisis may keep saving rates higher for a long period, increasing the money supply. On the other hand, anti-cyclical fiscal packages could drive debt levels much higher, significantly increasing fiscal risks.

This dual effect on structural rates is reflected in our neutral interest-rate models: some of them, more impacted by the first group of factors, are pointing to a decline, while others, more impacted by fiscal risks, are pointing to an increase. In our view, the capacity of the government to correct the fiscal trend and improve the debt outlook is the main driver for the direction of structural rates.

Figure 8. Selic vs. Taylor Rule

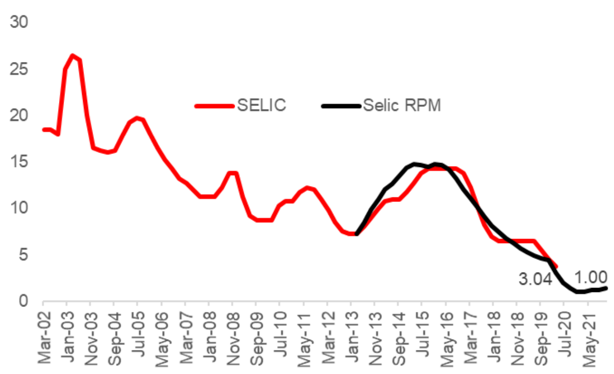
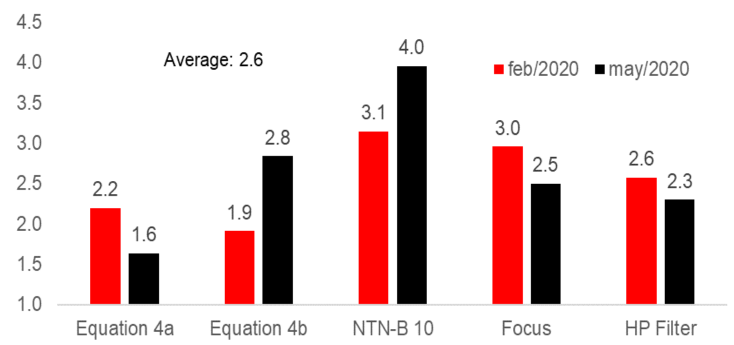


Figure 9. Structural Interest Rate (% p.y.): Alternative Methodologies



Sources for both figures: Santander Estimates, BCB and Anbima[3].

[3] Equation4a: R* = a0 + a1*USrate(1Y) + a2*NECredit/GDP + a3*InflationSurprise + a4*BNDESConc + a5*CDS; Equation4b R* = b0 + b1*Trend + b2*NECredit/GDP + b3*PrimarySurplus + b4* InflationSurprise; Methodological details in our previous report “Structural interest rates why did they fall and where are they now”.

Figure 10. Santander's Projections for the Brazilian Economy

Macro Variables		Baseline	Alternative Scenario
GDP (%)	2020	-6.40	-11.00
	2021	4.40	1.50
	2022	3.20	2.00
CPI (%)	2020	1.40	1.60
	2021	2.90	4.40
	2022	3.50	6.50
Selic Rate (% - eop)	2020	2.25	2.00
	2021	3.00	6.00
	2022	6.00	9.00
Exchange Rate - BRL/USD (eop)	2020	5.80	6.50
	2021	5.50	7.50
	2022	5.30	7.50
Current Account Balance (% GDP)	2020	-1.60	1.50
	2021	-1.40	6.10
	2022	-1.50	8.30
Public Sector's Primary Result (% GDP)	2020	-11.70	-16.30
	2021	-3.50	-7.90
	2022	-2.70	-7.00
Gross Public Debt (% GDP)	2020	94.20	103.50
	2021	94.80	114.30
	2022	96.00	122.50

Source: Santander Estimates

Appendix – Simulating a Hypothetical Scenario

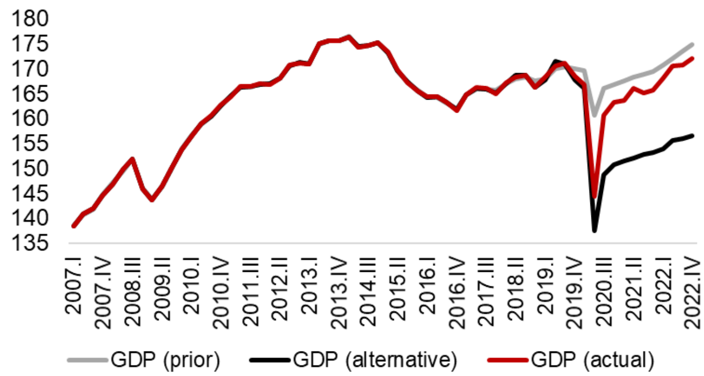
Uncertainty remains high, reflecting the economic damage from the pandemic. We acknowledge that the crisis could be deeper and longer. A stronger economic contraction could lead to structural worsening in the fundamentals and the presence of hysteresis (i.e., more lasting damage) in key segments such as the job market. The lack of reforms could also take a major toll on economic confidence of firms and households, straining domestic demand. In this hypothetical scenario, just as an exercise, we estimate GDP figures at -11.0%, 1.5% and 2.0%, respectively, leading to a level-shift in the annual average of the unemployment rate, to 19.6%, 21.4% and 19.4% in 2020, 2021, and 2022.

Figure A1. GDP Estimates (%)

	2020	2021	2022
Agriculture & Livestock	3,0	3,0	5,6
Industry	-15,5	3,3	2,4
Services	-9,9	1,0	1,8
Total GDP	-11,0	1,5	2,0
Household Consumption	-7,2	1,7	2,2
Government Consumption	1,7	0,7	0,7
Investments	-22,2	8,7	1,8
Exports	-14,8	13,1	6,5
Imports (-)	-30,6	8,4	1,1
Domestic Absorption	-7,7	2,1	1,9
External Sector Contribution	2,4	1,6	0,8
Inventory Change	-5,6	-2,3	-0,7

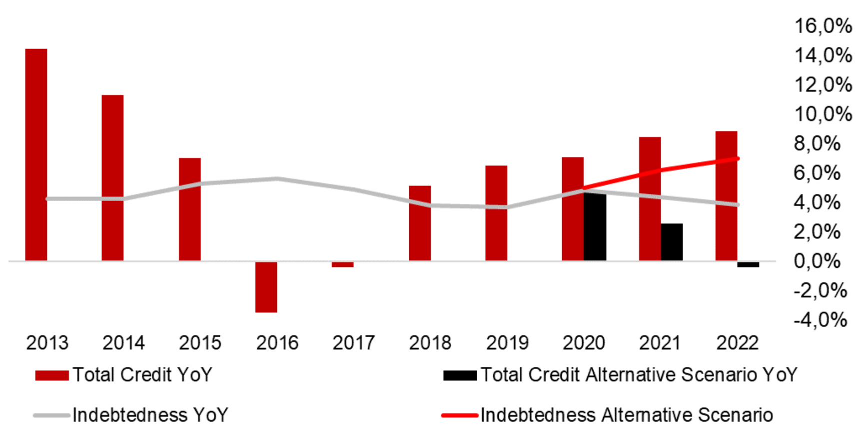
Sources: Santander Estimates and IBGE.

Figure A2. GDP (Seasonally Adjusted)



In addition to the situation described above, prolonging the lockdown's exit could create liquidity shortages, as financial institutions stay less prone to risk (due, for example, to the significantly higher provisions on their balance sheets), and families and companies become unable to access credit due to their high debt. In this scenario, we would expect credit market behavior similar to the Brazilian crisis of 2015. We project, in this extreme scenario, 4.7% growth in the economy's total credit balance in 2020, 2.6% in 2021 and -0.4% in 2022, with non-earmarked default reaching 5.0%, 6.2% and 7.0% in the same period.

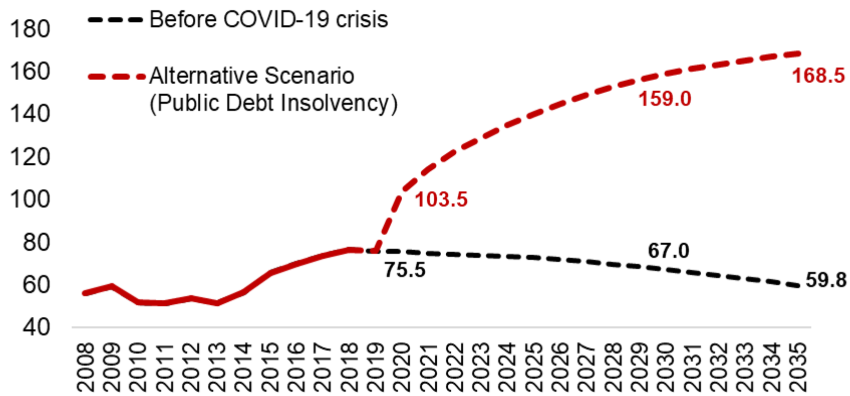
Figure A3. Credit Market and Debt Forecast – Alternative Scenario



Sources: Santander Estimates and BCB.

Challenges regarding Brazil's fiscal policy are plentiful, with a good deal of risks on the radar. We have already seen pressure for more government spending next year, which should gain steam in the wake of the (inevitable, in our view) further deterioration in labor market conditions over the coming months. In our opinion, an intense political debate in 2H20 will focus on how to navigate a deep recession in a context where the fiscal vulnerabilities will increase significantly (likely involving discussions about exemptions to the constitutional spending cap rule in 2021). Considering the stressed hypothetical scenario in which the continuity of the government's reformist agenda is no longer appropriate, particularly the abandonment of the fiscal austerity stance, Brazilian public debt would rise continuously over time (i.e., public debt insolvency); for example, we estimate the gross public debt-to-GDP ratio would jump to around 125% of GDP within three years and to ~160% of GDP by 2030, in our view.

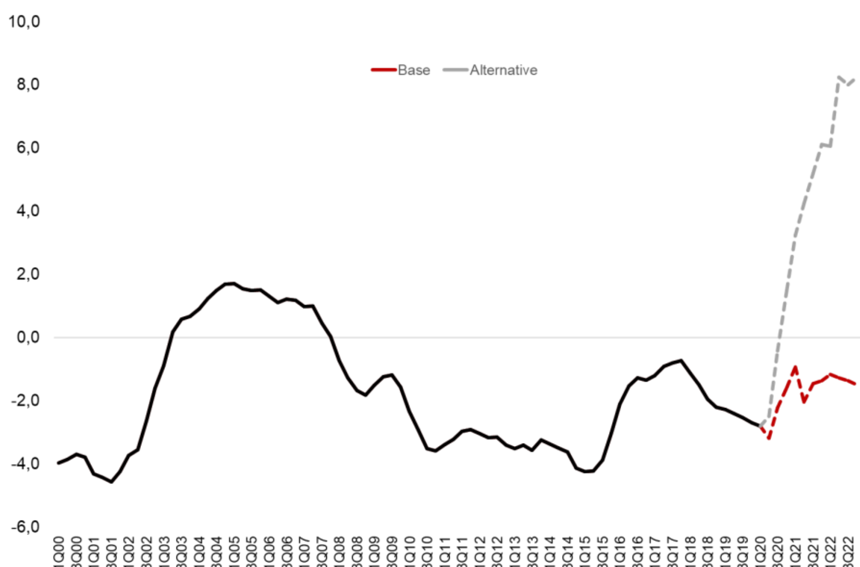
Figure A4. Gross Public Debt (% GDP)



Sources: The National Treasury Secretariat, Brazilian Central Bank and Santander

In our view, a hypothetical combination of an even stronger domestic economic contraction with a perceived abandonment of a reformist agenda would weigh considerably on the BRL, more than offsetting a respite from improvements in global conditions (such as a recovery of commodity prices and international trade flows, some strengthening of emerging market currencies, lower risk aversion, etc.). Our thinking here is that, for a low-savings and low-growth emerging economy, the capacity to use foreign savings (to fund a current account deficit) would be much more limited. Consequently, we believe the BRL would continue to follow a weakening path to a level that would be enough to generate a high current-account surplus in order to partially compensate for the imbalance that would be observed on the fiscal front. In this hypothetical scenario, we see the Brazilian FX rate rising to USD/BRL6.50 by the end of 2020 and moving to USD/BRL7.50 in 2021. These levels would be compatible, in our calculations, with current account surpluses of 1.5% of GDP in 2020 and 6.1% of GDP in 2021.

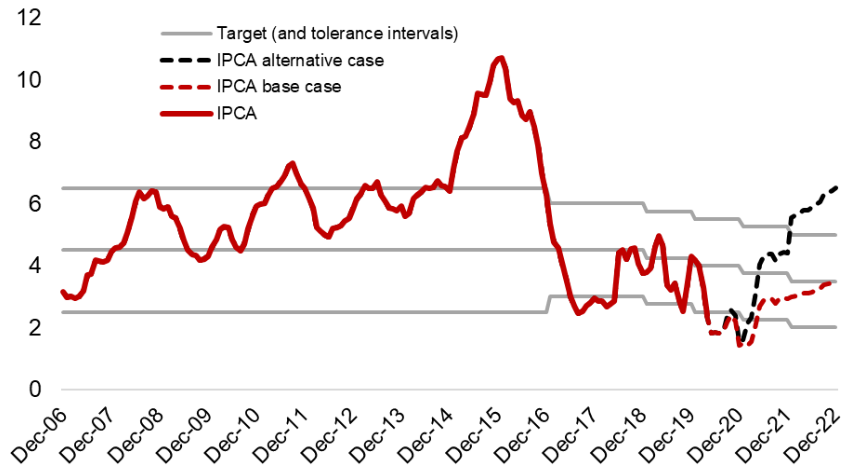
Figure A5. Current Account Balance (% of GDP)



Sources: Santander Estimates, BCB and IBGE

Our hypothesis of maintenance of the reformist agenda is essential for a low-inflation scenario. If the reformist agenda is weakened or abandoned, we believe that inflation could suffer acceleration similar to 2015-2016. During that time, especially from 2014 onward, inflation rose from 4-6% to a peak of almost 11% in 2015-2016, even with a steep decline in GDP in 2015 and 2016. This movement was largely influenced by the release of administered price hikes repressed in previous years, but also driven by higher inflation expectations that de-anchored from the BCB's target. Back then, economists believed Brazil was seeing increased risk of a fiscal-dominance scenario, where monetary policy loses its power to control inflation. Estimates on that alternative scenario are highly uncertain, but we believe inflation could be a bit higher than the central target as early as 2021 (yet below the upper end of the target band) and much higher than the target (and its upper bound) in 2022.

Figure A6. IPCA Inflation - % YoY



Sources: Santander Estimates, BCB and IBGE.

In a scenario with no (fiscal, macro) reforms, difficulties in complying with the constitutional spending cap could lead to a deterioration in the outlook for government debt, contaminating the expectations for inflation and other macro variables, in our view. These developments also could adversely spill over onto Brazilian assets, particularly the exchange rate. In this context, the rise in (expected and actual) inflation, the higher neutral rates and the financing constraints would drive an increase in nominal interest rates from 2021 onward, in our view. Under our simulations, we penciled in a Selic rate at 6.00% for the end of 2021 and 9.00% for the end of 2022. Though it is hard to determine the pace at which that might occur, our point here is that for such record-low interest rates to be sustained in the long run, the country needs to advance a bold set of macroeconomic and budgetary reforms. Without these, we believe nominal interest rates have only one way to go, and that is up.

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