Brazil Macro Monthly

Fiscal risks and political noise increase likelihood of more negative scenario

April 2021

xp investimentos

Brazil Macro Monthly: Fiscal risks and political noise increase likelihood of more negative scenario

- *The turbulence around the fiscal framework continues, now with the Federal budget deadlock. Our baseline scenario includes the maintenance of the spending cap and public debt stability. But the likelihood of a worsening fiscal scenario has increased.*
- *The pandemic hit the economy in the second quarter. On the other hand, we had a better beginning of the year and vaccination should allow a recovery in the second half of the year. Thus, we changed our GDP forecasts between quarters, but kept 3.2% for the year. For 2022, we raised the forecast from 1.5% to 1.8%, due to higher statistical carry over.*
- *Current inflation remains under pressure, in line with our forecast of 4.9% this year. For 2022, we forecast inflation to slow down to the 3.5% target.*
- *In the base scenario, we continue to see an appreciation of the Brazilian currency to R$ 5.30 at the end of 2021 and to R$ 5.10 at the end of 2022.*
- *On monetary policy, we expect the Selic to reach 5.0% this year and 6.5% in 2022.*
- *On February 21, we published a report presenting an alternative scenario, that included a deterioration in economic policy management. We bring an update to this scenario, which leads to a more depreciated exchange rate, higher inflationary pressure, higher interest rates and another economic recession in 2022.*

XP Forecasts

	2018	2019	2020	2021 (F)	2022 (F)
GDP growth (%)	1.3	1.1	-4.1	3.2	1.8
Unemployment rate (% s.a., end of period)	12.2	11.5	14.7	14.1	12.0
IPCA (CPI, 12m, %)	3.8	4.3	4.5	4.9	3.5
SELIC rate (% p.y., end of period)	6.50	4.50	2.00	5.00	6.50
FX (USDBRL, end of period)	3.9	4.0	5.2	5.30	5.10
Primary fiscal balance (% GDP)	-1.6	-0.9	-9.5	-3.4	-1.8
Gross debt (% GDP)	76.5	75.8	89.3	88.7	91.6
Trade Balance (USD Bn)	46.6	35.2	50.4	74	64
Exports (USD Bn)	231.9	221.1	209.2	259	267
Imports (USD Bn)	185.3	185.9	158.8	184	203
Current Account (USD Bn)	-41.5	-50.7	-12.5	6.9	-15.7
Current Account (% GDP)	-2.2	-2.7	-0.9	0.5	-1.0
FDI (USD Bn)	78.2	69.2	34.2	45.0	60.0
FDI (% GDP)	4.1	3.7	2.4	3.1	3.6

Source: IBGE, BCB, Bloomberg. Estimates (E): XP Investimentos.

Foreword – more turbulence on the fiscal framework

Brazil's primary deficit has been running on negative territory since 2014, leading to one of the largest debt-to-GDP among emerging market peers. Under those circumstances, it is key to provide markets with a credible plan to rebalancing the country's public accounts. Otherwise, interest rates will remain high, feeding back into the negative debt dynamics.

In this sense, the recent challenges surrounding the approval of the 2021 Federal Budget are bad news. The Executive finds itself in a legal and political dilemma, regardless of the choice whether to veto the legislative piece approved in Congress. This is yet another turbulence involving Brazil's fiscal framework. In this context, Brazilian risk assets, such as long-term interest rates and the exchange rate, remain under pressure, reinforcing the scenario adjustment we did last month.

Since our last report, we have also seen a substantial worsening of the pandemic in the Brazil. The impact on activity in the second quarter will be significant. On the other hand, results from the beginning of the year were slightly better, and the expected pick-up in vaccination across the country will contribute to a strong rebound by the second half of the year.

Thus, we changed our GDP forecast within the year, but kept the 2021 forecast at 3.2%. For 2022, the number has improved, from 1.5% to 1.8%, mostly due to the higher statistical carry over generated by the new GDP trajectory.

On monetary policy, our scenario includes the partial adjustment signaled by Brazil's Central Bank, with the Selic rising to 5% this year. We understand that the balance of risks for 2022 still does not call for a complete adjustment (Selic at the neutral level). An additional fiscal deterioration, however, may change this conclusion.

Finally, this report brings a session updating our alternative scenario, in which economic policy management deteriorates. We first introduced this scenario in our February 21 report*, following Petrobras related events, and we have been monitoring it ever since. We understand that, considering the fiscal events mentioned above, the likelihood that this alternative scenario materializes increases by the day.

***Conteúdos XP: Primeiras impressões dos eventos da Petrobrás sobre o cenário econômico. (Portuguese Only).**

GLOBAL BACKGROUND

Long term yields remain key

We believe that the fate of the 10-year UST remains the most important uncertainty now affecting the performance of global financial markets. Long term rate levels will depend on inflation dynamics going forward.

Some believe inflation will continue to rise due to: (1) massive fiscal stimulus; (2) faster than expected reopening of the economy; and (3) extremely accommodative monetary policy.

Others see underlying inflation subdued, considering that: (1) households will decide in favor of saving some of the cash stimulus; (2) the economy needs to go through a "healing" process, which is being underestimated by pundits; (3) longer-term disinflation fundamentals remain, such as lower birth rates, automatization of the services sector, Artificial Intelligence advances, and aging populations; (4) most of current inflation pressure is a function of pandemic-related inefficiencies and supply shocks; and finally (5) that the housing market will slow down on the back of affordability issues.

We tend to align with the second school of though. Thus, we keep our out-of-consensus 1.5% year-end 2021 UST 10-year target. This view is consistent with Latam currencies and gaining ground going into the year-end.

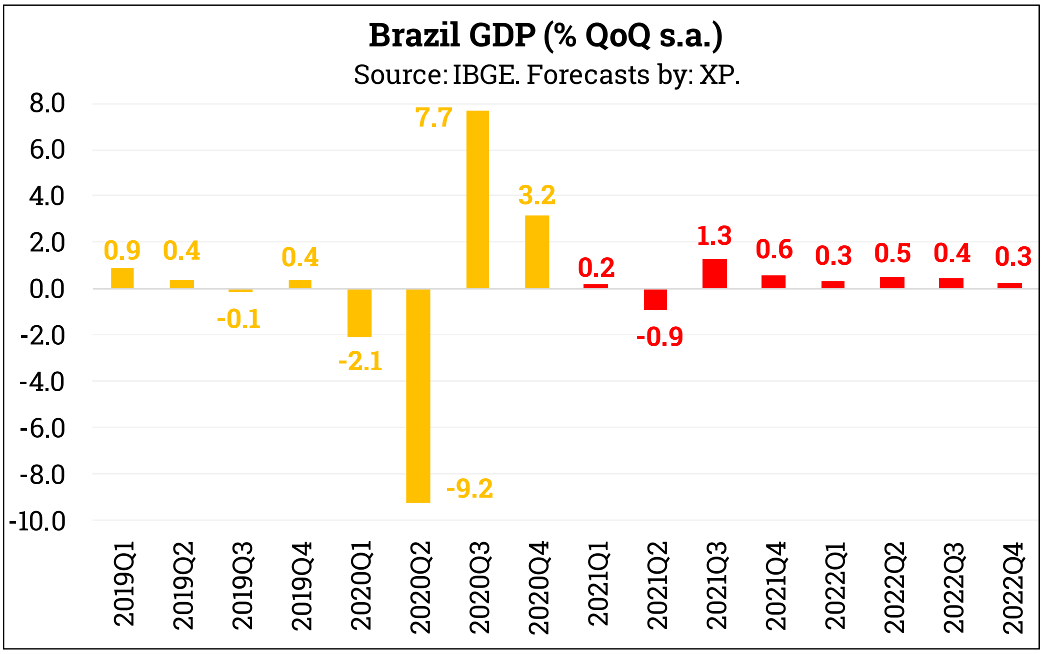
BRAZIL

Economic Activity – dip, but not so deep

Economic activity figures surprised to the upside at the beginning of 2021.

Nonetheless, the recent worsening of the Covid-19 pandemic is likely to lead to a significant contraction of domestic activity in the coming months. Tumbling business and consumer confidence combined with poor results posted by the first March sectoral indicators (e.g. vehicle production and sales) point to a widespread decline in economic activity in the short term. Our preliminary estimate for broad retail sales growth in March is around -10% MoM s.a.

Still unconfirmed results for March main indicators explains the wide range of forecasts for 1Q21 GDP growth. For now, we estimate that total GDP rose slightly last quarter (0.2% QoQ s.a.; -0.7% YoY). It is important to bear in mind that the main activity indicators (except for retail) left a positive statistical carryover effect for 1Q21: for example, 0.9% QoQ s.a. in industrial production and 1.4% in services supply.



As for the 2Q21 GDP, our preliminary forecast is a 0.9% QoQ s.a. contraction. The negative statistical carryover implied by March figures and ongoing social distancing measures throughout April largely explain that projection.

Nonetheless, we reinforce our constructive view for output growth in 2H21. The progress of Covid-19 vaccination, which we expect to reach Brazil's total risk population by mid-June, and a gradual reopening of the economy support this prognosis.

In short, compared to last month, we've altered our quarterly GDP projections throughout this year; however, we did not change our expectation for 3.2% for full-2021 GDP growth.

The new quarterly dynamics within 2021 provides a greater statistical carryover effect for the coming year (nearly 0.9%). This, coupled with the expectation of a robust recovery in the global economy, lead us to revise our projection for Brazil's GDP growth in 2022 - from 1.5% to 1.8%.

GDP Breakdown	**2020**	**2021 (F)**	**2022 (F)**
Agriculture & Livestock	2.0	2.4	2.2
Industry	-3.5	4.3	1.4
Services	-4.5	2.8	1.9
Net Indirect Taxes	-4.9	3.4	1.7
Total GDP	**-4.1**	**3.2**	**1.8**
Household Consumption	-5.5	2.7	2.1
Government Consumption	-4.7	2.3	1.4
Investments	-0.8	3.0	1.6
Exports	-1.8	9.5	3.3
Imports (-)	-10.0	7.6	2.8

Source: IBGE. Projection by: XP.

Still weak labor market

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We expect the national unemployment rate to decline from 14.1% to 12.0% between the end of 2021 and the end of 2022, in seasonally adjusted terms (for annual average, we anticipate 14.2% and 12.6%, respectively).

The recovery of the informal sector from 2H21 onward – driven by the gradual normalization of the economy –will support a gradual recovery of the employed population, which should return to the pre-pandemic levels by the end of 2022.

In turn, average real wage tends to remain at low levels (we forecast mild increases of 0.4% in 2021 and 0.9% in 2022), still reflecting the wide spare capacity in Brazil's labor market

Inflation – upside risk from cost-push pressures and worst financial condition

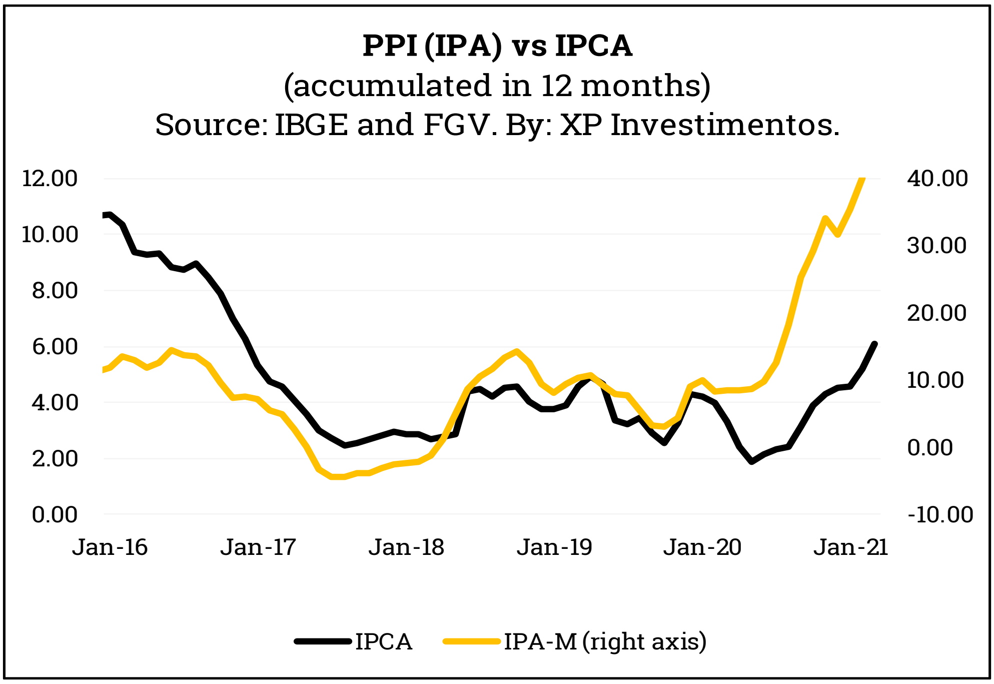
Inflation in 2021 continues to be pressured by high commodity prices, devalued BRL and supply-chain restrictions due to the pandemic. These factors led us to revise our full year IPCA projection last month, from 3.9% to 4.9%. In our view, cost pressures and second-round effects on prices to the final consumer has not changed since then.

March's IPCA came below expectations, at 0.93% (median of expectations was above 1%). Nonetheless, accumulated inflation in the first quarter reached 2.05% and the average core inflation tracked by the Central Bank remains above BCB's target of 3.75%. For the following months, we forecast a deceleration in monthly inflation, mainly thank to a mild deflation of fuels, after 11% increase the last month.

In turn, average real wage tends to remain at low levels (we forecast mild increases of 0.4% in 2021 and 0.9% in 2022), still reflecting the wide spare capacity in Brazil's labor market.

Wholesale inflation are still a source of concern, although we believe that prices will cool down in the coming months. The inflation measured by IGP-M, whose main component (60%) corresponds to producer prices, accumulates an increase of 8.26% in the year. Our models suggest that IGP-M increases are not fully transferred to IPCA. However, the impact is fast: from one to two months. Thus, our scenario considers additional pressure by this channel at least until May.

On the demand side, on the other hand, we should see some relief. Economic activity has been recovering slowly and will be affected by the second wave of Covid-19, as discussed above. In addition, less stimulative monetary policy will help limiting wholesale pass-through.



On the balance of risks, other factors may affect the IPCA in 2021. On the one hand, the suspension of medical price readjustment in Congress and weak rain season may put pressure on energy prices.

For 2022, we forecast inflation to slow down to the 3.5% (inflation target). Despite the inflationary inertia in 2021, still weak labor market conditions and the timely action by the Central Bank should offset this impact.

Another key factor to inflation in 2022 is (as expected) the growing political and fiscal uncertainty, which worsen financial conditions and impact the currency and inflation expectations. Thus, although we don't foresee runaway inflation, and monetary tightening is under way, this should be monitored very closely.

External Sector – pandemic continues to reduce current account deficit

February's Balance of Payments data followed the tune of the last few months. The covid-related restriction measures and the weaker exchange rate continue to push the current account deficit to historically low levels. The 12-month current account deficit reached US$ 6.9 billion (0.48% of GDP) in February, well below the US$ 55.7 billion (3.06% of GDP) recorded in February 2020.

Going forward, we believe that the extension of restrictive measures and the depreciated exchange rate will continue to have positive effects on the current account.

On the financial account side, FDI recorded net inflows of US$ 9.0 billion - the best result since September last year.

On the exchange rate, the BRL remained virtually stable in March, depreciating 0.5% against the dollar and ending the month at R$ 5.63. We continue to see the strengthening of the Brazilian currency under the baseline scenario, to R$ 5.30 at the end of 2021 and to R$ 5.10 at the end of 2022.

Nonetheless, as seen with the other macroeconomic variables, fiscal and political uncertainty could keep the BRL weaker for longer (in line with the alternative scenario discussed in the last session of this report).

Fiscal – Don't be fooled by the short term

Monthly fiscal results continue to surprise to the upside. Tax revenue remains robust, on the back of still strong economic output seen at the start of the year, which also boosted regional governments' accounts. At the same time, with no budget yet approved for 2021, spending is limited to 1/18 of total proposed in the budgetary legislation (PLOA) approved last year.

In this context, we've even seen a mild reduction in the consolidated public sector primary deficit, which reached 9.26% of GDP in the twelve-month accumulated figure in February, from 9.43% in the previous month. Gross debt, in turn, reached 90% of GDP.
Nonetheless, as highlighted last month, the scenario seen in the first two months of this year doesn't portray the real picture of Brazil's public accounts, which remains more than challenging.

Following the contentious approval of the Emergency Constitutional Amendment (PEC), Congress approved a budget legislative piece (LOA) for 2021 which opens room for breaches to the spending ceiling rule. As approved, the budget underestimates mandatory expenditures, especially with social security, in more than R$ 30 billion. As such the piece becomes virtually impossible to implement, unless by the approval of a new legislative proposal which cuts mandatory spending and parliamentary amendments restoring mandatory spending.

The government now seeks a compromise with Congress, given the prominent risks of breaching the fiscal responsibility law (LRF) if approving the budget as it stands. The alternative solution needs to be politically and legally viable – something that looks more than challenging. The president has until 22 April to sanction the legislative piece.
Regardless of how the budget discussion unfolds, the continuous fiscal turbulence illustrates how the pressure for greater spending is strongly building up as the pandemic scenario worsens (or at least, doesn't show signs of improvement).

We now incorporate a new round of the formal employment benefit programme (BEm) and of the subsidised lending programme (Pronampe) to our base scenario – both to be implemented using the extraordinary credit tool, therefore, not accounted in the spending ceiling.

As illustrated below, the programmes' extension adds up to further spending already unaccounted in the spending ceiling rule, totalling more than R$ 140 billion above ceiling projected for the year.

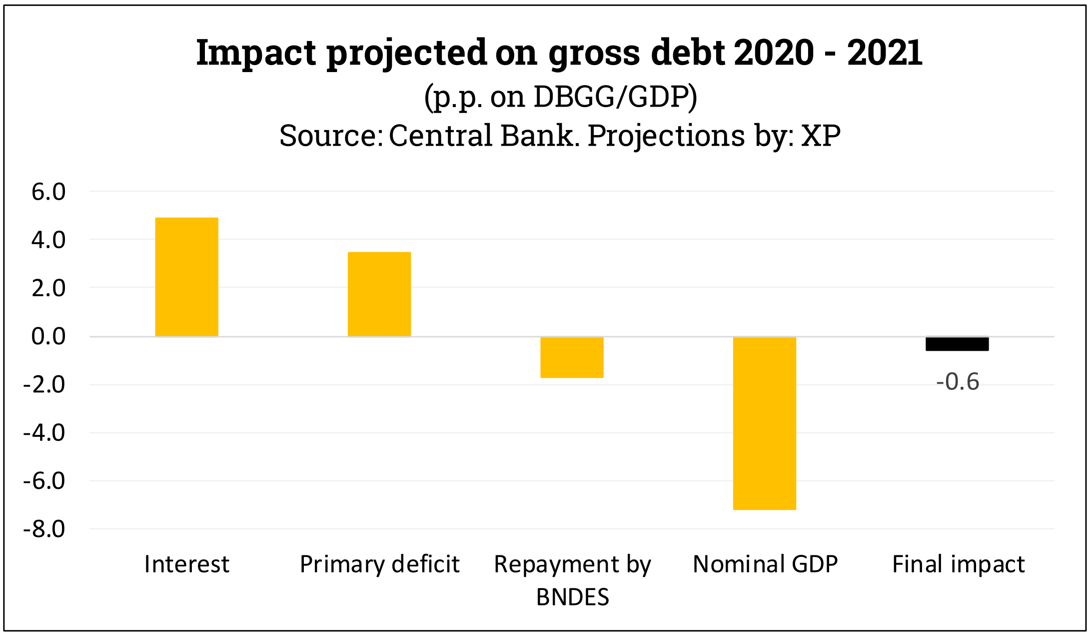
Above Ceiling Expenses (R$ billion)	
New Round Emergency Aid	44.9
New Round employment benefit program (BEm)	10.0
New Round subsidised lending program (Pronampe)	5.0
Extraordinary Credit Health Ministry	5.3
Extraordinary Credit Vaccines	21.6
Unincorred expenses from previous year - War Budget	17.9
Above Ceiling constitutional expenditure	40.6
Total	**145.2**
Source: Ministry of Economy. Projections and ellaboration: XP	

It's worth noticing that the new round of emergency aid won't be accounted in this year's primary deficit target, as approved by the Emergency PEC. Therefore, we understand the government should, for now, have enough space to comply with the primary target as established in the Budgetary Guidelines (LDO) approved last year – thanks to positive surprises on the revenue front.

Despite the challenging fiscal environment, we reduced our primary deficit projection slightly for this year, to 3.44% of GDP from 3.6%. The change is explained by higher tax revenue projected for the year – thanks mostly to the impacts of higher expected inflation and positive surprises at the start of this year.

By the same token, Brazil's debt/GDP will likely fall this year. The reduction will be driven by one off events – especially the restitution of R$ 138 bn from BNDES to the Union – in addition to the effect of a higher nominal GDP, boosted by pressured inflation.

We project gross debt (DBGG) should end the year at 88.6% of GDP, resulting from a primary deficit of 3.5% of GDP. For 2022, we forecast gross debt achieving 91.8% of GDP, with primary deficit at 1.8% of GDP.



Monetary Policy – partial adjustment, if the fiscal outlook allows

The Copom opted in its March meeting for a faster adjustment of monetary conditions, raising the Selic rate by 75 bps. The members of the Committee stressed that the move would reduce the probability of inflation being above the target's upper bound range in 2021.

But they also indicated that, by the next meeting in May, the relevant monetary policy horizon will be 2022. How do we see the balance of risks for next year?

On the one hand, high current inflation and the vaccine-led recovery may pressure inflation in 2022. On the other hand, international commodities and the exchange rate are expected to stabilize (or decline slightly) and the unemployment rate should remain elevated, limiting the rise in wages.

The effect of monetary policy on inflation is also relevant. Inflation in 2021 was influenced by the extremely expansionary conditions of 2020. In 2022, it will be impacted by a Selic rate already closer to its neutral level this year.

All in all, our models suggest that, with the Selic rate reaching 5.0% in the last quarter of this year, the IPCA converges to the target in 2022.

To ensure 2023 IPCA meets the target, we believe the Selic needs reach its neutral level of 6.5% in 2022. However, if the fiscal outlook deteriorates further, the BCB will likely abandon the partial adjustment strategy and will go straight to the neutral level this year - at around 6.50% - or beyond.

Updated alternative (negative) scenario – 2.5 million less jobs

On February 21, we published a report assessing the overall impacts on the economy from Petrobras' change of command. At that point, we stressed it seemed too early to state whether this was "an indication of change in economic policy management". But we warn that, if the outlook continued to deteriorate, "the exchange rate may depreciate between 15% and 20% against the base scenario and the Copom should raise interest rates more quickly".

In our base scenario, current economic policy guidelines stands, under the leadership of Minister Paulo Guedes. However, recent political events, such as the attempt to remove the Bolsa Familia program from the spending cap and the 2021 budget deadlock, have increased the probability of the above-mentioned more negative scenario.

Therefore, we updated our forecasts for this alternative scenario below.

Under this scenario, fiscal discipline is no longer a priority for the government. It would begin with a new decree of a state of calamity or a new Constitutional Amendment, allowing unlimited new extra-cap expenditures this year. And expenditure would continue to increase in coming years, through other legal maneuvers to avoid the cap constraints.

In this scenario, we estimate that the exchange rate would stay at 5.90 reais per dollar this year, rather than 5.3 in our base scenario. Inflation would be more pressured this year, closing at 6.3% in 2021 (4.9% in the current scenario), generating more inertia for 2022.

The Central Bank would be forced to abandon its partial adjustment plan, increasing the Selic rate until (at least) 6.5% by the end of this year. The neutral interest rate is probably higher in this scenario as well.

Economic uncertainty, market volatility and tighter monetary policy would lead to with a new recession in 2022. GDP would decline by around 1% (compared to the projected 1.8% growth). This difference in GDP growth would generate an increase of 2.3pp in the unemployment rate compared to our base scenario.

In other words, a new economic crisis generated by the deterioration of economic policy management could mean 2.5 million fewer jobs next year.

XP Forecasts Adverse Scenario				
	2021		2022	
	Baseline	Adverse	Baseline	Adverse
GDP growth (%)	3.2	2.8	1.8	-1.1
Unemployment rate (% s.a., end of period)	14.1	14.2	12.0	14.3
IPCA (CPI, 12m, %)	4.9	6.3	3.5	5.3
SELIC rate (% p.y., end of period)	5.00	6.50	6.50	7.00
FX (USDBRL, end of period)	5.30	5.90	5.10	5.30
Primary fiscal balance (% GDP)	-3.4	-4.6	-1.8	-2.9
Gross debt (% GDP)	88.7	90.6	91.6	96.4

Source: IBGE, BCB, Bloomberg. Estimates: XP

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