XP Macro Scenario Review: Change in fiscal framework puts pressure on FX and monetary policy

- *We believe that the Brazilian fiscal framework has changed in recent weeks to allow for a higher spending path ahead;*
- *In this scenario, we revised our exchange rate forecast to 5.7 reais per dollar at the end of 2021 and 2022 (previously at 5.2 and 5.1, respectively);*
- *Fiscal deterioration puts pressure on inflation. We raised our IPCA forecast from 9.0% to 9.1% in 2021 and from 3.9% to 5.2% in 2022;*
- *We now expect Copom to accelerate the pace of interest rate hike to 1.5pp next week (before: 1.0pp). The Selic rate should reach 11.0% at the end of the tightening cycle (before: 9.25%);*
- *Deteriorating financial conditions weighs additionally on economic activity. We reduced our GDP forecast for 2021 from 5.3% to 5.0%; and from 1.3% to 0.8% for 2022.*

The Trigger

The current Brazilian fiscal framework has weakened. The constitutional spending cap rule, the main anchor for controlling public expenditures, will be less effective going forward. As a result, risk perception has risen considerably, putting pressure on financial assets and deteriorating the outlook for economic conditions

In our view, we are witnessing a change in fiscal policy framework, rather than a marginal deterioration in the baseline scenario. Since the beginning this year we have been simulating stressed macroeconomic scenarios based on structural changes in the fiscal framework –see, for example, Brazil Macro Monthly: Risks, noise and the approaching adverse scenario (April 14). We believe that this kind of scenario assumes a greater likelihood under current political environment, leading to a worse macroeconomic equilibrium.

This report brings our new macroeconomic forecasts under this backdrop. We will publish detailed estimates of our updated baseline scenario in our monthly report, early next month.

Higher Exchange Rate, Inflation and Interest Rates

We now expect the exchange rate at 5.70 reais per US dollar at the end of 2021 and 2022 (5.20 and 5.10 before, respectively). We also expect FX volatility to remain elevated.

We could have forecasted an even weaker BRL. However, the terms of trade remain favorable to Brazil, and we now expect a higher domestic interest rate, which help to stabilize the currency at current levels.

As a result of weaker BRL and worse inflation expectations due to the fiscal instability, we raised our inflation projections. We expect IPCA at 9.1% in 2021 (9.0% before) and 5.2% in 2022 (3.9% before). For 2023 we see the IPCA slightly above the target, at 3.5%.

Tighter monetary policy (see below) and specific factors, such as the probable significant deflation of electricity given the improvement in the rainfall regime, prevent a further deterioration in inflation outlook.

Under this new fiscal outlook, the Copom should change its baseline scenario and adjust its strategy ahead. We now expect 150-bps hikes in the next two Copom meetings (1 p.p. before), followed by 100 bps in February and 75 pbs in March 2022, taking the Selic rate to 11.0% at the end of the tightening cycle.

Bear in mind that the deterioration of the fiscal framework will probably lead to an increase in the neutral interest rate (beyond the 3% currently estimated by the Copom).

Impact on Economic Activity

Worse financial conditions, tighter monetary policy and higher global production costs means lower growth ahead. We reduced our GDP growth forecast to 5.0% in 2021 (5.3% before) and to 0.8% in 2022 (1.3% before).

We still believe that the labor market will remain on a recovery path in coming months, in line with the economic reopening and favorable dynamics of labor-intensive sectors (e.g., services rendered to families and civil construction). However, the recovery should lose steam next year, leading to a mild decline in the unemployment rate (from 12.6% at the end of 2021 to 12.2% at the end of 2022).

XP Forecasts

	2021 (Previous)	2021 (Revised)	2022 (Previous)	2022 (Revised)
GDP growth (%)	5.3	5.0	1.3	0.8
IPCA (CPI, 12m, %)	9.0	9.1	3.9	5.2
SELIC rate (% p.y., end of period)	8.25	9.25	9.25	11.0
FX (USDBRL, end of period)	5.20	5.70	5.10	5.70

Forecasts: XP Investimentos.

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