Macro scenario - Brazil

November 18, 2021

Persistent inflation, more monetary tightening and clear signs of a slowdown

- Recent declines in industrial production and retail sales suggest that the goods sector is already shrinking. We revised our GDP growth forecasts down to 4.7% for 2021 (from 5.0%) and kept it at -0.5% for 2022.
- We expect inflation of 10.1% in 2021 and revised our estimate for 2022 to 5.0% from 4.3%. The shock in industrial goods related to supply bottlenecks is likely to persist, intensifying the secondary effects on other prices, particularly services costs.
- We now expect the benchmark Selic rate to reach 11.75% by the end of 1Q22, after two 150-bp hikes and a final increase of 100 bps. The significantly restrictive level of the final Selic rate and expectations of a sustained hiking pace at the upcoming policy meetings are justified by more persistent inflationary pressures, given the stage of the cycle and signs of economic slowdown.
- We expect primary budget deficits of 0.6% of GDP in 2021 (from 0.8% previously) and 1.5% of GDP in 2022, with gross debt reaching 82% and 86% of GDP, respectively. We expect Congress to approve constitutional amendment proposal PEC 23/21, which will allow for an increase in expenses of around BRL 80 billion (0.9% of GDP) within the expanded spending ceiling for next year.
- We maintained our year-end exchange rate forecasts at BRL 5.50/USD for 2021 and 2022. A rise in the Selic rate beyond the benchmark rates in other emerging markets would justify some currency appreciation, but domestic and external uncertainties are likely to continue to weigh on the BRL.

Activity: Initial signs of a slowdown in the goods sector

The goods sector has begun to decelerate in 2H21. Industrial production began to decline in 2Q21, amid supply constraints caused in part by input shortages and the reaching of peak capacity in some segments. Demand for goods has also started to slow down in recent months, led by the declines in retail sales in August and September – and we expect further declines in October and November.

Declining contribution from the goods sector (industrial + retail) to GDP

GDP growth (QoQ/sa)			
Breakdown	2Q21	3Q21	4Q21
GDP	-0.1%	0.0%	0.0%
Services ex-retail sales	0.7%	2.5%	0.4%
Industry + retail sales	-0.1%	-0.4%	-1.1%
Agriculture and livestock	-2.8%	-4.4%	1.6%

We expect GDP growth at 0.0% qoq/sa in both 3Q21 and 4Q21. These estimates suggest a 4.5% GDP expansion in 2021, but we estimate 4.7% based on the assumption that a revision of the labor market data from the PNAD Contínua survey will trigger an upward revision of this year's GDP series.

For 2022, we maintain our GDP growth forecast at -0.5%, mainly due to the expected contraction in aggregate demand in response to higher interest rates. Compared with our previous forecast, it seems that the additional increase in the benchmark rate should offset possible positive factors such as the continued fiscal expansion at the subnational level. Figures for 1Q22 will benefit from solid one-off growth in agricultural GDP and the effect of a higher minimum wage on household purchasing power. That said, we anticipate GDP to contract in subsequent quarters.

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Goods shock indicates more persistent inflation, which affects other prices

With only the November and December results left for the year, we expect the consumer price index IPCA to end 2021 at 10.1%. Inflation remains under pressure so far in 4Q21, mainly affected by auto fuels, fresh food, some services (e.g., airfare and rent) and a more persistent goods shock. Regarding the 10.1% increase expected for the IPCA this year, almost 7 p.p. will be driven by fuels (gasoline, ethanol, diesel and bottled cooking gas), electricity (water-scarcity mode in the tariff flag system) and food prices. Core inflation measures also remain under pressure. The October reading showed that underlying service inflation remained near 7.0% at the margin, on a seasonally-adjusted annualized basis, while goods inflation remained under pressure with no signs of deceleration, hovering near 10% yoy at the margin. November is likely to see a new high in year-over-year inflation, close to 10.8%.

Given the greater persistence of the goods shock, we revised our forecast for the IPCA to 5.0% in 2022 (from 4.3% previously). Industrial inflation remains under pressure, with more persistent effects from production bottlenecks in some segments (notably the automotive sector) as well as the impact caused by items that experienced a pandemic-driven increase in demand (such as electronics and household items). We therefore assume higher inflation for this group next year, now estimated at about 6.0%. Given the impact of the shock on year-over-year inflation, we also revised our projections for services and regulated prices in 2022 to 5.5% and 4.0%, respectively. Inflation will remain under pressure in 1Q22, adding up to almost 2.0% during the quarter, with core industrial and service measures still running high. We maintained our scenario for the tariff flag system in December 2022 at red mode level 1.

Selic to reach 11.75% amid persistent inflationary pressure

The COPOM decided at the October meeting to raise the Selic rate by 150 bps to 7.75% p.a. The faster pace (from 100 bps in September) reflected an above-average variance in the balance of risks due to questions regarding the fiscal framework as well as worsening inflation expectations and a considerable increase in the Central Bank inflation forecasts. At that time, the authorities indicated that the 150-bp pace would be compatible with the convergence of inflation toward the target in 2022.

We now expect the Selic rate to end 1Q22 at 11.75% p.a. and to end the current tightening cycle at that level, with increases of 150 bps in December, 150 bps in February, and 100 bps in March. Although there has been no significant deterioration in the fiscal scenario since the last meeting, inflationary pressure remains intense and widespread, contaminating inflation expectations and the Central Bank's own forecasts, justifying a higher terminal rate. We believe that maintaining the 150-bp pace and the Selic rate at a significantly contractionary level will help the disinflation process, even if not to the point of ensuring convergence of inflation to the target in 2022.

Change in fiscal framework in 2022 amid quantitative improvement in 2021

For 2021, we updated our estimate for the primary budget deficit to 0.6% of GDP (BRL 55 billion) from 0.8% of GDP (BRL 70 billion), and expect gross debt to reach 82% of GDP (vs. 89% last year). The revision of our expectation for the current year can be attributed to higher-than-expected revenues, mainly related to the higher dividends paid by state-owned companies. The revision also reflects rising fuel prices, with Petrobras' dividends amounting to BRL 22 billion of the BRL 38 billion in revenues.

For 2022, Congress is currently debating PEC 23/21, which limits annual court-ordered payments (precatórios) and retroactively alters the mechanism that establishes the annual adjustment of the constitutional spending ceiling. If approved, the proposal will allow the government to increase expenditures by around BRL 80 billion (0.9% of GDP) within an expanded spending ceiling.

We expect the PEC to be approved and the primary deficit to reach 1.5% of GDP (BRL 140 billion), with debt reaching 86% of GDP next year. Rising debt and public spending, amid high interest rates and low economic growth, pose a greater risk of a return to an unsustainable fiscal path going forward.

BRL: domestic and external uncertainties prevail despite a rising Selic rate

We maintained our year-end exchange rate forecasts at BRL 5.50/USD for 2021 and 2022. An increase in the benchmark interest rate in Brazil that substantially exceeds the levels seen in other emerging countries would allow for an appreciation of the currency. That said, domestic uncertainties (particularly the evolution of

public accounts in the coming years) and a challenging global scenario for risky assets (rising global inflationary pressures and expectations of higher interest rates in the U.S.) put pressure on the BRL.

Given the scenario of weak economic activity and a depreciated exchange rate, we revised our forecast for the current account deficit to USD 23 billion in 2022 (from USD 30 billion), assuming some stability in export prices. For 2021, we estimate a current account deficit of USD 14 billion.

Brazil | Forecasts and Data

	2016	2017	2018	2019	2020	2021F		2022F	
						Current	Previous	Current	Previous
Economic Activity									
Real GDP growth - %	-3.3	1.3	1.8	1.4	-4.1	**4.7**	5.0	**-0.5**	-0.5
Nominal GDP - BRL bn	6,269	6585.5	7,004	7,407	7,448	**8,596**	8,615	**9,241**	9,194
Nominal GDP - USD bn	1,798	2063.3	1,916	1,877	1,443	**1,598**	1,609	**1,680**	1,672
Population (millions)	205.2	206.8	208.5	210.1	211.8	**213.3**	213.3	**214.8**	214.8
Per Capita GDP - USD	8,764	9977	9,189	8,932	6,816	**7,491**	7,543	**7,821**	7,781
Nation-wide Unemployment Rate - year avg (*)	11.5	12.7	12.3	11.9	13.3	**13.1**	13.1	**12.9**	12.9
Nation-wide Unemployment Rate - year end (*)	12.7	12.4	12.2	11.6	14.3	**12.2**	12.2	**13.3**	13.3
Inflation									
IPCA - %	6.3	2.9	3.7	4.3	4.5	**10.1**	9.0 **	**5.0**	4.3
IGP–M - %	7.2	-0.5	7.5	7.3	23.1	**18.7**	18.4	**5.5**	4.5
Interest Rate									
Selic - eop - %	13.75	7.00	6.50	4.50	2.00	**9.25**	9.25	**11.75**	11.25
Balance of Payments									
BRL / USD - eop	3.26	3.31	3.88	4.03	5.19	**5.50**	5.50	**5.50**	5.50
Trade Balance - USD bn	40	56	47	35	50	**72**	72	**67**	60
Current Account - % GDP	-1.4	-1.1	-2.7	-3.5	-1.7	**-0.9**	-0.9	**-1.4**	-1.8
Direct Investment (liabilities) - % GDP	4.1	3.3	4.1	3.7	3.1	**3.1**	3.1	**3.6**	3.6
International Reserves - USD bn	372	382	387	367	356	**356**	356	**356**	356
Public Finances									
Primary Balance - % GDP	-2.5	-1.7	-1.5	-0.8	-9.4	**-0.6**	-0.8	**-1.5**	-1.5
Nominal Balance - % GDP	-9.0	-7.8	-7.0	-5.8	-13.6	**-6.1**	-6.3	**-9.7**	-9.5
Gross Public Debt - % GDP	69.9	73.7	75.3	74.3	88.8	**82.1**	82.1	**85.6**	86.0
Net Public Debt - % GDP	46.2	51.4	52.8	54.6	62.7	**59.5**	59.5	**65.1**	65.3

Source: IBGE, FGV, BCB and Itaú

(*) Nation-wide Unemployment Rate measured by

(*) This was the figure published in our last macro scenario update (Oct.25). Since then, we have revised this forecast to 9.3%, after the release of the mid-month IPCA-15 for October, and to our current 10.1% call, following the higher-than-expected rise in the full-month IPCA for the same month.

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