Macro scenario - Brazil

September 12, 2024

No leeway

- We now expect a rate-tightening cycle (150 bps), starting at the September meeting, in a context of still-pressured exchange rate, unanchored inflation expectations and a revision (albeit small) of the output gap. We see the Selic rate at 11.75% by YE24, with an additional hike in January, to a terminal level of 12.00%.
- A contractionary interest rate throughout 1H25 is likely to cause a slowdown in economic activity, in addition to some appreciation of the BRL, allowing interest rate cuts to start in 2H25. We see the Selic rate at 11.00% by YE25.
- We have revised our GDP growth forecasts to 3.0% (from 2.5%) for 2024 and to 2.0% (from 1.8%) for 2025. Household spending will likely continue to drive economic growth, supported by a resilient labor market. Our estimates for the unemployment rate have been lowered to 6.9% (from 7.3%) for 2024 and to 7.0% (from 7.5%) for 2025.
- We have also revised our exchange rate projections to 5.40 reais per U.S. dollar by YE24 and to 5.20 reais per dollar by YE25 (from 5.50 in both cases). The prospect of a widening interest rate differential with the start of a (potentially more aggressive) easing cycle by the U.S. Federal Reserve and a tightening cycle by the Brazilian Central Bank (BCB) tends to favor the BRL in the medium term.
- We maintained our 2024 inflation forecast at 4.2%, while lowering 2025 our call to 4.1% (from 4.2%) after incorporating the impact of a stronger currency on industrial goods prices next year. The balance of risks for both years seems symmetrical. For 2024, we see upward risk in services and energy prices (with a possible “yellow flag” in the electricity tariff system at the end of the year) and downward risk in gasoline prices (with the price lag making room for price adjustments at refineries).
- We have revised our projections for the primary budget deficit to -0.4% of GDP (from -0.6%) for 2024 and to -0.8% of GDP (from -0.9%) for 2025, thanks to stronger economic growth and additional extraordinary revenues. In our view, a fiscal adjustment strategy centered on boosting revenues without a corresponding effort to control mandatory spending will fail to create the conditions necessary for sustainable public debt stabilization.

Monetary policy: tightening cycle in sight

After weeks of intense volatility, the Monetary Policy Committee (Copom) will meet again in September, facing fundamentals that justify beginning a cycle of interest rate hikes. The Brazilian real has remained under pressure and near its recent lows, reflecting the noise in the BCB's recent communication and the ongoing uncertainty about the direction of public finances. In addition, the latest activity reports suggest a stronger economy than the BCB anticipated at its last meeting, while inflation expectations remain unanchored.

The tightening cycle seems unlikely to be large at first, and we expect it to total 150 bps. We simulated the model used by the Copom, assuming an exchange rate of 5.60 reais per dollar, incorporating the deterioration in 12-month inflation expectations since the last meeting, and taking into account a small revision in the output gap – which should not be large because the signs that stronger activity is contaminating services inflation are still incipient. This simulation yielded an inflation projection of 3.4% – above the target – in the relevant horizon. Based on this projection, we estimate that the benchmark interest rate needed to bring the consumer price index IPCA back to the target is at least 12.00%. **We see the Selic at 11.75% by YE24 after a 25-bp hike in**

September followed by two hikes of 50 bps later this year, with a final increase of 25 bps at the first meeting of next year.

A contractionary interest rate level throughout 1H25 is likely to cause a slowdown in economic activity, in addition to some appreciation of the BRL, allowing interest rate cuts to start in 2H25, when the relevant horizon for monetary policy will be the end of 2026. We forecast the Selic rate at 11.00% by YE25.

Widening interest rate differential tends to favor the BRL

The BRL remained under pressure over the last month, decoupling significantly from other currencies. Despite some relief on the international scenario, with the USD depreciating against several currencies, the BRL underperformed, reflecting the elevated risk premium, falling commodity prices and uncertainties surrounding the possible monetary tightening cycle.

We have also revised our exchange rate projections to 5.40 reais per dollar by YE24 and to 5.20 reais per dollar by YE25 (from 5.50 in both cases). Notwithstanding the still-high risk premium and the deterioration in external accounts throughout 1H24, we believe that, ahead of an easing cycle by the Fed (greater than we previously expected) and a rising Selic rate in Brazil, the interest rate differential is likely to become more attractive, encouraging USD inflows and leading to a stronger BRL in the medium term.

Activity continues to deliver positive surprises

We have revised our call for GDP growth this year to 3.0% (from 2.5%), **after another positive surprise in 2Q24.** In the last quarter GDP expanded by 1.4% qoq/sa (3.3% yoy), once again driven by rising domestic demand: household spending rose by 1.3% qoq/sa, while government spending increased by 1.3% and investments grew by 2.1%. The economic growth during 1H24 was driven by rising household incomes, bolstered by the resilient labor market and fiscal transfers.

Nevertheless, we anticipate an economic slowdown in 2H24, with GDP growing by 0.3% qoq/sa in 3Q24. The expected deceleration takes into account a gradual reduction in the fiscal stimulus and weaker support from the credit cycle. However, the still-heated labor and capital markets represent upward risks to this outlook.

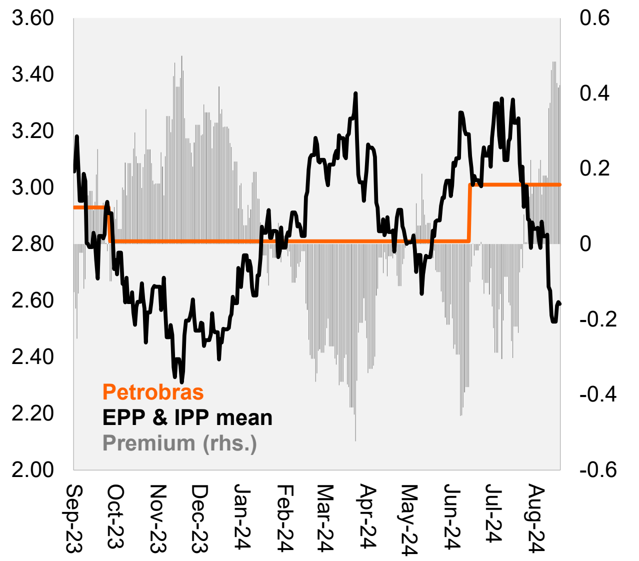
We have also lifted our GDP growth projection for 2025, to 2.0% (from 1.8%). Average quarterly growth next year will likely be in line with that of 2024. Given the stronger-than-expected performance this year, we project a quarterly average GDP growth of approximately 0.7% qoq/sa in 2025. Although the scenario of rising interest rates may hold back growth during the year, the labor market will probably be resilient.

Our estimates for the unemployment rate have been lowered to 6.9% (from 7.3%) for 2024 and to 7.0% (from 7.5%) for 2025. In July, the unemployment rate declined further, to 6.7%, pulled downward by a lower participation rate even as employment remained stable, suggesting some accommodation. Effective real wages interrupted the string of positive readings seen in recent months, and the real wage bill fell for the first time since May 2023. According to our estimates, the unemployment rate probably bottomed out at mid-year and is likely to go up, albeit modestly, in the coming quarters – in line with some economic deceleration in 2H24.

A lower inflation estimate for 2025

We maintained our IPCA forecast for 2024 at 4.2%. The balance of risks is symmetrical. On the one hand, the tight labor market could push underlying services inflation closer to 6% (vs. 5.5% in our scenario), and energy prices could come under further pressure from a possible “yellow flag” in the electricity tariff system at the end of the year. On the other hand, these risks could be offset by a possible reduction in gasoline prices, given their recent lag relative to international price movements.

Gasoline price lag makes room for price cuts at refineries



Source: Itau

We revised our IPCA forecast for 2025 to 4.1% from 4.2%, incorporating the effect of a stronger BRL. The balance of risks for next year also seems symmetrical, with upward risk from services inflation due to a resilient labor market and downward risk in energy prices if the COVID-19 and water shortage accounts are eliminated.

Fiscal accounts: more revenues, faint expense control

We have reduced our primary budget deficit projections from -0.6% to -0.4% of GDP (BRL 50 billion) for 2024 and from -0.9% to -0.8% of GDP (BRL 100 billion) for 2025. Our revision was triggered by stronger revenues generated by more resilient economic activity and by higher extraordinary revenues from dividends paid by the development bank BNDES (limited to the current year). For this year, if the government manages to obtain extraordinary revenues in addition to those considered in our scenario – for example, from possible measures to offset the payroll and municipal tax relief – it could reach the low end of its primary result target range (we expect a deficit of 0.4% of GDP, vs. the target of -0.25% of GDP). In 2025, the government will likely continue to depend on revenue-collection measures focused on reducing tax litigation and avoidance, which are not certain to be implemented. We expect only BRL 30 billion (0.2% of GDP) in additional revenue from such measures, compared with the BRL 166 billion (1.4% of GDP) forecasted by the government in the annual budget.

Regarding the spending limit, it will be important for the government to block an additional BRL 10 billion in its September bimonthly report. Social security spending, considering preliminary data up to August, remains above government estimates and, according to our projections, has been underestimated by BRL 19 billion. If implemented and combined with the phasing of discretionary spending and execution of other below-budget mandatory expenses, blocking these expenses would ensure compliance with the limit in 2024, reaffirming the credibility of the fiscal framework.

Going forward, it is essential to implement structural measures to make the public spending path sustainable and foster convergence to primary budget surpluses on a recurring basis. Without mandatory spending control, a fiscal adjustment strategy centered on boosting revenues may fail to inspire confidence in sustainable fiscal consolidation and public debt stability, particularly in an emerging market economy that already faces low growth, high interest rates and a heavy tax burden.

Brazil | Forecasts and Data

	2019	2020	2021	2022	2023	2024F		2025F	
						Current	Previous	Current	Previous
Economic Activity									
Real GDP growth - %	1.2	-3.3	4.8	3.0	2.9	**3.0**	2.5	**2.0**	1.8
Nominal GDP - BRL bn	7,389	7,610	9,012	10,080	10,856	**11,574**	11,560	**12,285**	12,267
Nominal GDP - USD bn	1,872	1,475	1,670	1,951	2,175	**2,189**	2,180	**2,322**	2,230
Population (millions)	207.9	209.2	210.1	210.9	211.7	**212.6**	217.7	**213.4**	219.0
Per Capita GDP - USD	9,007	7,050	7,949	9,255	10,273	**10,299**	10,013	**10,878**	10,183
Nation-wide Unemployment Rate - year avg, NSA	12.0	13.8	13.2	9.3	8.0	**7.0**	7.1	**7.0**	7.4
Nation-wide Unemployment Rate - year end (*)	11.6	14.7	11.6	8.5	8.0	**6.9**	7.3	**7.0**	7.5
Inflation									
IPCA - %	4.3	4.5	10.1	5.8	4.6	**4.2**	4.2	**4.1**	4.2
IGP–M - %	7.3	23.1	17.8	5.5	-3.2	**3.4**	3.8	**3.7**	3.6
Interest Rate									
Selic - eop - %	4.50	2.00	9.25	13.75	11.75	**11.75**	10.50	**11.00**	10.50
Balance of Payments									
BRL / USD - eop	4.03	5.19	5.57	5.28	4.86	**5.40**	5.50	**5.20**	5.50
BRL / USD - average	3.95	5.16	5.40	5.17	5.00	**5.29**	5.30	**5.29**	5.50
Trade Balance - USD bn	35	50	61	62	99	**75**	75	**70**	70
Current Account - % GDP	-3.5	-1.7	-2.4	-2.1	-1.0	**-2.0**	-2.0	**-2.0**	-2.1
Direct Investment (liabilities) - % GDP	3.7	3.0	2.8	4.7	2.9	**3.2**	3.2	**3.7**	3.8
International Reserves - USD bn	367	356	362	325	355	**340**	340	**360**	360
Public Finances									
Primary Balance - % GDP	-0.8	-9.2	0.7	1.2	-2.3	**-0.4**	-0.6	**-0.8**	-0.9
Nominal Balance - % GDP	-5.8	-13.3	-4.3	-4.6	-8.9	**-7.0**	-7.1	**-7.9**	-7.6
Gross Public Debt - % GDP	74.4	86.9	77.3	71.7	74.4	**77.5**	77.7	**81.0**	81.0
Net Public Debt - % GDP	54.7	61.4	55.1	56.1	60.9	**62.9**	62.8	**67.5**	66.8
Growth of public spending (% real, pa, **)	2.3	29.2	-24.7	6.0	7.6	**4.3**	4.3	**3.1**	3.1

Source: IBGE, FGV, BCB and Itaú

(*) Nation-wide Unemployment Rate measured by PNADC.

(**) We do not consider the 2023 payment of extraordinary court-ordered debts (precatórios). Including it, spending grew by 12.5% in 2023 and fell by 0.2% in 2024.

Macro Research – Itaú

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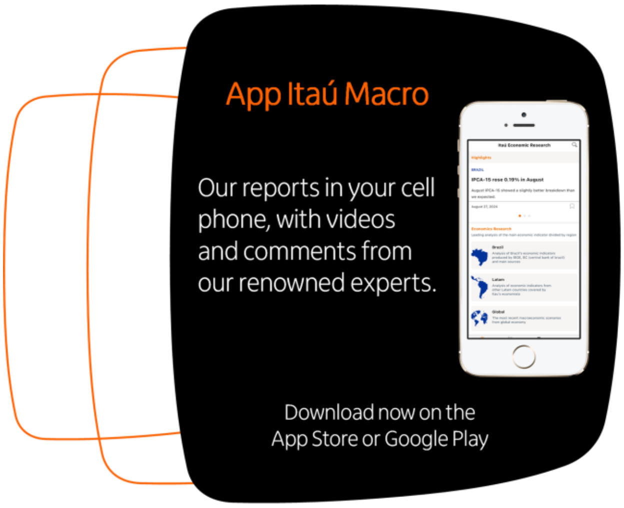

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