Macro scenario - Brazil

October 4, 2024

Growing risks

- The reduced spending restraint in the latest bimonthly report suggests a limited fiscal adjustment and contributes to the perception of rising domestic risk. From our perspective, the transparency of fiscal policy has deteriorated. For now, our forecasts for the primary budget deficit remain at -0.4% of GDP in 2024 and -0.8% of GDP in 2025. Still, Moody's upgraded Brazil's sovereign credit rating to Ba1, one notch below investment grade, with a positive outlook (thanks mainly to consistently better-than-expected economic activity).
- The rising risk premium is weighing on the local currency, but so far it has been offset by the widening interest rate differential. We have maintained our year-end exchange rate projections at 5.40 reais per U.S. dollar in 2024 and 5.20 in 2025.
- We raised our GDP growth estimate to 3.2% (from 3.0%) in 2024, while maintaining our call for next year at 2.0%. Activity will likely slow down somewhat in 2H24, albeit mildly thanks to household spending, which is supported by the resilience of the labor market and the still-positive credit cycle. Our forecasts for the unemployment rate remain at 6.9% in 2024 and 7.0% in 2025.
- We lifted our 2024 inflation projection to 4.4% (from 4.2%), incorporating the yellow flag surcharge in electricity bills in December and more pressure on costs of meals consumed at home due to the recent hike in animal protein prices. Our call for 2025 increased to 4.2% (from 4.1%) due to greater inertia.
- For the Selic benchmark interest rate, we anticipate a hiking cycle of 150 bps, reaching 11.75% pa by the end of 2024 and 12.00% in early 2025. The contractionary level in interest rates throughout 1H25 should lead to a slowdown in economic activity and some FX appreciation, allowing interest rate cuts starting in 2H25 and reaching 11.00% at the end of 2025. If the economy proves to be even more resilient – perhaps due to credit expansion, or if there is a significant increase in the risk premium with an impact on the BRL – the current hiking cycle could be longer and jeopardize the cuts expected next year.

Fiscal: Increased risk perception

Our forecasts for the primary budget deficit remain at -0.4% (BRL -50 billion) of GDP in 2024 and -0.8% (BRL -100 billion) of GDP in 2025. Notwithstanding fast growth in revenues (reflecting the resilience of economic activity as well as tax collection measures), we do not expect a decisive fiscal consolidation path due to the significant increase in expenses. To meet the lower end of the primary result target for the year (-0.25%), the government will still depend on extraordinary and/or uncertain revenues, such as measures to offset the payroll tax break, and slower mandatory spending.

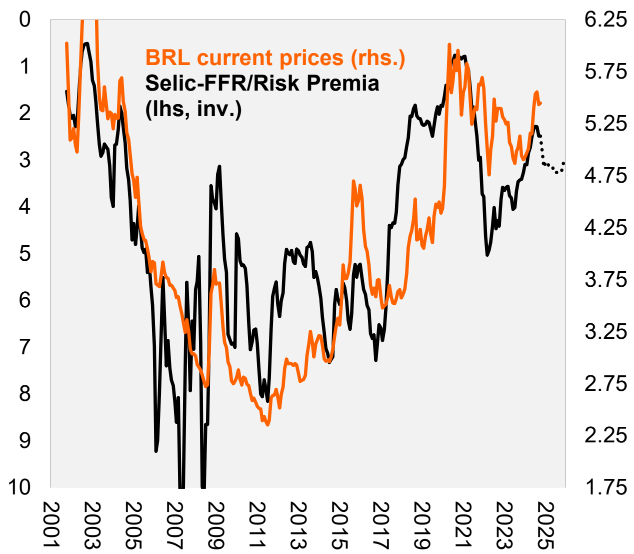
The reduction in the spending restraint in the latest bimonthly report (from BRL 15 billion to BRL 13 billion), even though the government itself anticipates a larger deficit, points to a limited fiscal adjustment and contributes to the perception of higher risk. The increase in exclusions and deductions from fiscal rules, the substantial amount of extraordinary revenues and the incorporation of uncertain or doubtful revenue measures mean deterioration in the transparency of fiscal policy. In particular, the primary balance target became less important for the characterization of the actual fiscal consolidation effort, which tends to drive the perception of greater fiscal risk.

Going forward, it is important to regain control of expenditures, either through an additional block on discretionary spending or by proposing structural measures to make the public spending path sustainable and promote convergence to primary surpluses on a recurring basis. If mandatory spending is not under control, a fiscal adjustment strategy focused on increasing revenues may not be able to create confidence in a sustainable fiscal consolidation that would support the outlook for public debt stability, especially in an emerging-market economy saddled with low growth, high interest rates and a heavy tax burden.

Still, Moody's upgraded Brazil's sovereign credit rating to Ba1, one notch below investment grade, with a positive outlook (thanks mainly to better-than-expected economic activity).

In our view, there should be additional efforts to increase the transparency and credibility of fiscal statistics. Ideally, the actual primary budget result should be close to the proposed fiscal targets, without deductions and exclusions, while revenues and expenses that are recorded as primary should be in line with international standards. Moreover, all public policies should be incorporated for proper monitoring, diligence and control by the authorities. Fiscal policy transparency seems to be a necessary condition for Brazil to eventually recover its investment-grade status.

Widening interest rate differential supports the BRL



Source: Itaú

BRL: Increased risk but a wider interest rate differential

The Brazilian real has appreciated over the past month, following the hike in the Selic rate in Brazil and the interest rate cut in the U.S. Notwithstanding the increase in the risk premium after the disappointing bimonthly revenue and expenditure report in September showing reduced spending restraint, the widening interest rate differential has prevailed.

We have maintained our year-end exchange rate projections at 5.40 reais per dollar in 2024 and 5.20 in 2025. In addition to the widening differential in relation to interest rates in the U.S., diverging monetary policy vs. other emerging markets contributes to the appreciation of the Brazilian currency in the short and medium term. Finally, the possible rebound in economic growth in China, via the new stimulus package announced by the government in September, may support commodity prices and benefit the Brazilian currency going forward.

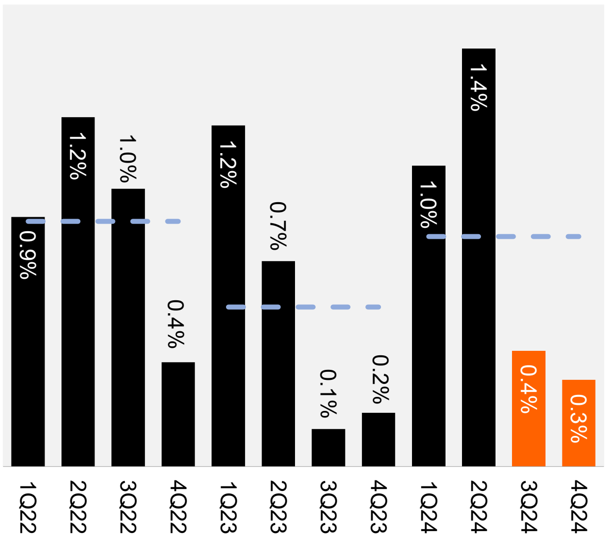
We have reduced our forecasts for the trade surplus to USD 70 billion in 2024 (from USD 75 billion) and to USD 60 billion in 2025 (from USD 70 billion). We have incorporated rising imports due to stronger-than-expected domestic activity. For the current account, we expect the deficit to climb to USD 50 billion in 2024 and USD 58 billion in 2025.

Resilient activity, milder slowdown in 2H24

We have revised our 2024 GDP projection to 3.2% (from 3.0%) after the first monthly indicators came out for 3Q24. Moreover, confidence indicators through September pointed to a milder slowdown in 2H24. This deceleration assumes a gradual reduction in the fiscal momentum and a smaller (albeit still positive) contribution provided by the credit cycle.

For 3Q24, we see GDP expanding 0.4% qoq/sa. Consumer spending was boosted by sharp income gains in 1H24 thanks to extraordinary court-ordered payments and to the real increase in the minimum wage (not to be repeated in 2H24). However, activity will likely decelerate gradually given the recovery in the labor market.

2024 GDP to grow 3.2% with a milder slowdown in 2H24



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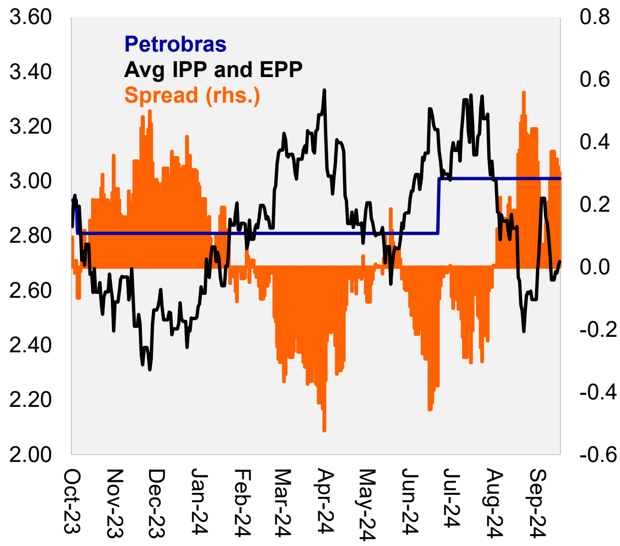
Lagging gasoline prices suggest room for price cuts at refineries



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Our call for 2025 stands at 2.0%, with some deceleration due higher interest rates and weaker fiscal momentum.

Our forecasts for the unemployment rate remain at 6.9% in 2024 and 7.0% in 2025. In August, the seasonally adjusted unemployment rate fell further to 6.6%, this time driven by rising employment, especially in the informal segment, while the participation rate remained stable. After a small decline in July, real wages rebounded, reflecting the strength in the labor market. The wage bill showed the same trend. In the next quarters, the unemployment rate should start to go up, albeit modestly, in line with the economic slowdown in 2H24.

Inflation under greater pressure, high risks

We lifted our 2024 inflation projection to 4.4% (from 4.2%), incorporating the yellow flag surcharge in electricity bills in December and more pressure on costs of meals consumed at home due to the recent increased in animal protein prices. The balance of risks is upwardly asymmetrical, predominantly, with the drought possibly exerting additional pressure on food and electricity prices (if red flag level 1 is triggered in December). On the other hand, these risks could be partially offset by a reduction in gasoline prices, which are lagging behind international prices.

Our forecast for 2025 was revised to 4.2% from 4.1% due to inertia. We also see the balance of risks as upwardly asymmetrical next year if the economy remains buoyant, the exchange rate does not appreciate, or the drought proves more persistent with an impact on the next crop.

Monetary policy: Moving into contractionary territory in the face of a buoyant economy

The Brazilian Central Bank's Monetary Policy Committee (Copom) initiated a new monetary tightening cycle at its latest meeting. The committee unanimously decided to raise the Selic rate by 25 bps to 10.75% pa. This move had been widely expected in the weeks leading up to the meeting due to more hawkish communication by Copom members and strength in economic activity figures. In fact, the committee noted that the output gap is now positive, and that it will monitor its behavior to decide the next steps in its monetary policy strategy, leaving the pace and magnitude of the cycle open. The Copom will be monitoring other variables such as inflation (especially the items most sensitive to economic activity), inflation expectations, its own projections, and the balance of risks (described as upwardly asymmetric).

Given that the inflation projection for the relevant horizon is 3.5%, we expect a total hiking cycle of 150 bps in the benchmark rate. However, the resilience of the economy (reflected by our upward revision in the 2024 GDP growth forecast to 3.2% from 3.0%) carries the risk of a slightly longer cycle. Another possible round of depreciation in the local currency could contribute to additional hikes.

As for the pace, we continue to expect a 50-bp increase at the next Copom meeting. A change in this outlook would require a substantial change in the scenario.

We see the Selic rate at 11.75% at the end of 2024, 12.00% at the end of the cycle in early 2025, and at 11.00% at the end of next year.

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	**3.2**	3.0	**2.0**	2.0
Nominal GDP - BRL bn	7,389	7,610	9,012	10,080	10,856	**11,591**	11,574	**12,305**	12,285
Nominal GDP - USD bn	1,872	1,475	1,670	1,951	2,175	**2,191**	2,189	**2,325**	2,322
Population (millions)	207.9	209.2	210.1	210.9	211.7	**212.6**	212.6	**213.4**	213.4
Per Capita GDP - USD	9,007	7,050	7,949	9,255	10,273	**10,306**	10,299	**10,896**	10,878
Nation-wide Unemployment Rate - year avg, NSA	12.0	13.8	13.2	9.3	8.0	**7.0**	7.0	**7.0**	7.0
Nation-wide Unemployment Rate - year end (*)	11.6	14.7	11.6	8.5	8.0	**6.9**	6.9	**7.0**	7.0
Inflation									
IPCA - %	4.3	4.5	10.1	5.8	4.6	**4.4**	4.2	**4.2**	4.1
IGP–M - %	7.3	23.1	17.8	5.5	-3.2	**4.4**	3.4	**3.9**	3.7
Interest Rate									
Selic - eop - %	4.50	2.00	9.25	13.75	11.75	**11.75**	11.75	**11.00**	11.00
Balance of Payments									
BRL / USD - eop	4.03	5.19	5.57	5.28	4.86	**5.40**	5.40	**5.20**	5.20
BRL / USD - average	3.95	5.16	5.40	5.17	5.00	**5.29**	5.29	**5.29**	5.29
Trade Balance - USD bn	35	50	61	62	99	**70**	75	**60**	70
Current Account - % GDP	-3.5	-1.7	-2.4	-2.1	-1.0	**-2.3**	-2.0	**-2.5**	-2.0
Direct Investment (liabilities) - % GDP	3.7	3.0	2.8	4.7	2.9	**3.2**	3.2	**3.7**	3.7
International Reserves - USD bn	367	356	362	325	355	**370**	340	**370**	360
Public Finances									
Primary Balance - % GDP	-0.8	-9.2	0.7	1.2	-2.3	**-0.4**	-0.4	**-0.8**	-0.8
Nominal Balance - % GDP	-5.8	-13.3	-4.3	-4.6	-8.9	**-7.1**	-7.0	**-8.1**	-7.9
Gross Public Debt - % GDP	74.4	86.9	77.3	71.7	74.4	**77.5**	77.5	**81.1**	81.0
Net Public Debt - % GDP	54.7	61.4	55.1	56.1	60.9	**62.9**	62.9	**67.8**	67.5
Growth of public spending (% real, pa, **)	2.3	29.2	-24.7	6.0	7.6	**4.2**	4.3	**3.4**	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 0.3% in 2024.

Macro Research – Itaú

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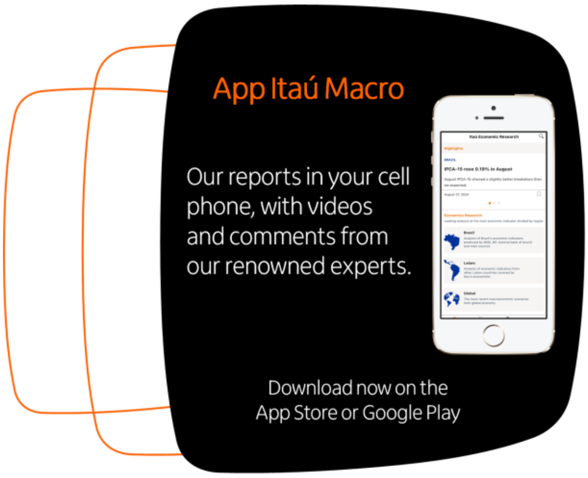

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