Macro scenario - Brazil

November 18, 2024

Recalculating the route

- Domestic risk perception has increased on expectations that sharp growth in mandatory expenses will significantly hinder compliance with the fiscal framework in its current format until 2026. We estimate that, to comply with the original format of the fiscal framework, expenses will require an adjustment of at least BRL 60 billion (BRL 25 billion in 2025 and BRL 35 billion in 2026). We maintained our forecast for the primary budget deficit at -0.4% of GDP in 2024 but we revised our call for 2025 to -0.7% of GDP (from -0.8%), amid higher revenues due to a resilient labor market. Without the prospect of convergence to primary results compatible with public debt stability, the adoption of measures that ensure compliance with the framework becomes even more important. These should ideally include topical as well as structural initiatives.
- Fiscal and external uncertainties and the outlook for a stronger USD globally led us to revise our FX projections to BRL 5.70 per U.S. dollar in 2024 and also 2025 (from 5.40 and 5.20, respectively), despite the widening interest-rate differential.
- We maintained our 2024 GDP projection at 3.2% but revised our call for 2025 to 1.8% (from 2.0%). The economy should decelerate somewhat in 2H24 and 2025 due to higher interest rates, reduced fiscal stimulus and downward revisions in global growth forecasts. We see symmetric risks around our growth forecast for 2025.
- We have increased our inflation estimates for this year and the next. For 2024, we now see 4.8% (4.4% previously), amid more pressure on food consumed at home due to higher protein prices. Our projection for 2025 was revised to 5.0% (from 4.2%), incorporating mainly the effect of a weaker currency on industrial goods prices, more pressure on underlying service prices and the announcement of the increase in the ICMS tax on fuels in February.
- Faced with a weaker currency, still-resilient activity, unanchored inflation expectations (for a prolonged period) and mounting risks, the Central Bank will need to reassess the degree of monetary tightening and move further, and faster, into contractionary territory. We now expect the Selic benchmark rate to reach 13.50% pa in 2025 (12.00% previously) and remain at that level until the end of next year.

Fiscal: Risk of non-compliance with the framework increases the need for adjustments

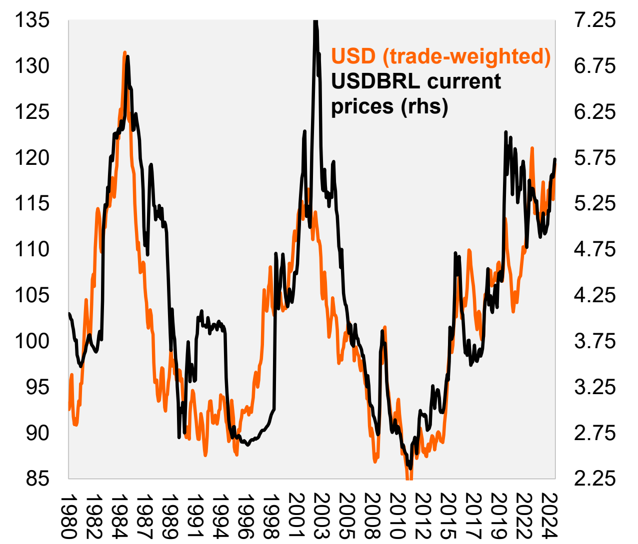
With the growing perception that rising mandatory expenses will significantly hinder compliance with the fiscal framework's spending cap until 2026, we estimate an adjustment of at least BRL 60 billion will be necessary (BRL 25 billion in 2025 and BRL 35 billion in 2026). Next year, the amount can be achieved if the already announced measures to find irregularities in social security benefits are successful, implying slower growth in the number of people receiving benefits under social security and BPC programs. For 2026, an additional adjustment of at least BRL 35 billion would still be required. Because of the need for legislative approval, these measures should be addressed in the coming months, as intended in the fiscal package in discussion by the government and to be sent to Congress in the coming days. Measures with short-term impact that ensure compliance with the framework in 2026 must be combined with structural changes that ensure lower growth in expenditures in the medium term (reduced indexations and links to public expenditures) and reinforce the transparency and credibility of fiscal rules.

We maintained our projection for the primary budget result at -0.4% of GDP (BRL -40 billion) in 2024 but revised our call for 2025 to -0.7% (from -0.8%) (BRL -80 billion) in 2025, still indicating a fiscal deterioration (higher public debt) over the next year. To meet the lower end of the tolerance interval for the 2024 primary result target (-0.25%), the government will still depend on extraordinary revenues, such as those from measures to offset the payroll tax break. For 2025, despite including higher revenues linked to a tight labor market, we still foresee a fiscal deterioration versus the current year. Going forward, structural measures will be necessary to promote convergence to primary surpluses on a recurring basis.

BRL: Strong global USD and fiscal uncertainties

We have revised our FX projections to 5.70 reais per USD for 2024 and also 2025 (from 5.40 and 5.20, respectively). Domestic and external uncertainties have weighed on the BRL, which tested its weakest levels of the year over the last month, despite the widening of the interest rate differential. The election results in the US and their potential impact on economic activity and inflationary dynamics limit the prospect of a fall in interest rates in the country and favor the strengthening of the dollar globally – which justifies a more depreciated real than we previously expected – despite the increase in the interest rate differential in relation to the US. In order to prevent further weakening of the BRL, an announcement of spending cuts of at least R$35 billion in 2026 is essential, which would help contain the increase in the risk premium, signaling a greater commitment to fiscal adjustment.

Stronger USD pressures the BRL



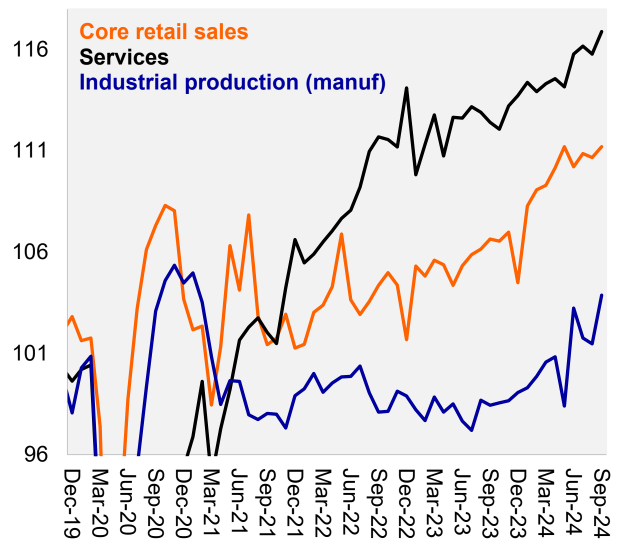
Source: BBG, Itaú

We revised our current account deficit projection to USD 56 billion in 2024 (from USD 50 billion) and maintained it at USD 58 billion in 2025. The revision is mainly due to a greater outflow of resources through the services balance. Part of this worsening is explained by the still strong domestic activity, but part appears to be structural, linked to the greater use of streaming services, mobile apps and online gambling. In addition, our revision for 2024 includes a further deterioration in the income account, with higher interest payments and remittance of profits and dividends abroad. The worsening of the current account also helps to explain the so far timid reaction of the exchange rate to monetary policy.

Slowing activity in 2H24

We have maintained our 2024 GDP growth projection at 3.2%. Monthly activity indicators in 3Q24 are showing incipient signs of a slowdown. GDP should continue to grow, albeit at slower pace than in 1H24. The deceleration should also be triggered by a gradual reduction in the fiscal impulse and by a smaller (but still positive) contribution from the credit cycle.

Activity slowing down in the 2H24



Source: IBGE, Itaú

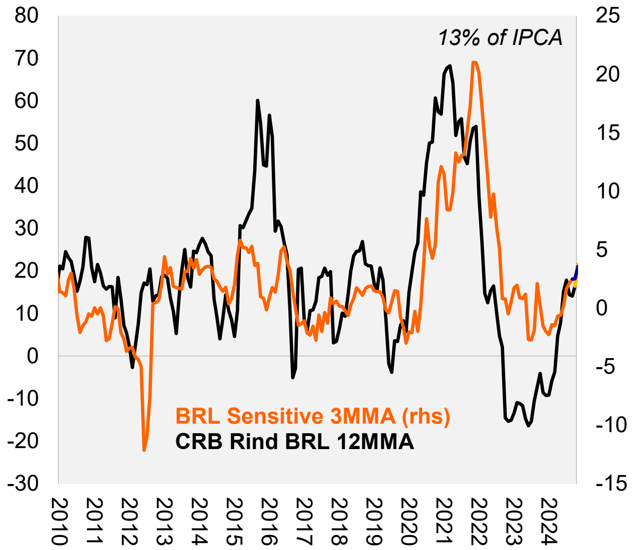
Our 2025 projection decreased to 1.8% (from 2.0%). We expect slower growth due to higher interest rates, a smaller fiscal momentum, and downward revisions in global growth forecasts. This slowdown, however, is cushioned by a high household savings rate and by a still-resilient labor market, as well as a robust credit impulse, which may recede less than expected (as in 2024).

Meanwhile, we reduced our unemployment-rate estimate to 6.5% (from 6.9%) in 2024 but maintained our call for 2025 at 7.0%. In September, the seasonally adjusted unemployment rate fell further to 6.5%, driven again by growing employment (in both the formal and informal segments), even as the participation rate remained stable. Effective real wages declined slightly and remained stable in recent months. However, the wage bill continued to expand, due to rising employment. In our view, the unemployment rate should remain at the current level even with a slowing economy in 2H24.

More pressure on inflation, higher risks

We have increased our 2024 inflation projection to 4.8% (from 4.4%) amid greater pressure on prices for food consumed at home due to rising protein prices.

Weaker BRL exerts pressure on industrial goods inflation



Source: Itaú

Our 2025 forecast climbed to 5.0% (from 4.2%). We incorporated mainly the effects of a weaker currency on industrial goods prices, more pressure on underlying services prices (especially food away from home, driven by the recent hike in protein prices) and the expected announcement of an increase in the ICMS tax on fuels in February. The balance of risks for next year will remains upwardly asymmetrical with the possibility that the economy remains resilient and the exchange rate continues to depreciate.

Greater degree of monetary tightening is needed

At its last monetary policy meeting, the Brazilian Central Bank's Monetary Policy Committee unanimously decided for an increase of 50 bps, as widely expected, taking the Selic rate to 11.25% pa. The Copom's inflation forecast advanced to 3.6% from 3.5% in the relevant horizon (which shifted from 1Q26 to 2Q26) and the balance of risks remained upwardly asymmetrical.

The statement and minutes of the last meeting kept the size of the cycle and the adjustment pace open, but made clear the relevance of structural fiscal measures, yet to be presented, as well as the behavior of inflation expectations.

We now expect the Selic rate to reach 13.50% per year in 2025 (previously, 12.00%) and remain at that level until the end of next year. Regarding the pace, we expect a more vigorous stance from the monetary authority at the next meeting, increasing the pace of adjustment to 75 bps. This change is due to the aforementioned revisions in the exchange rate projections for this year and next, and the resulting additional pressure that comes mainly from commodity prices in BRL – against a backdrop of still clearly upward risks for services inflation, and expectations that remain unanchored and worsening significantly at the margin.

It is worth noting, however, that if there is a significant reduction in the risk premium with the announcement of a more ambitious spending cut that signals a greater commitment to fiscal adjustment, the interest rate cycle may be shorter and the cuts may eventually be resumed in the second half of 2025 or early 2026. Alternatively, a longer cycle can not be ruled out depending on the evolution of the exchange rate and economic activity going forward.

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**	3.2	**1.8**	2.0
Nominal GDP - BRL bn	7,389	7,610	9,012	10,080	10,856	**11,591**	11,591	**12,415**	12,305
Nominal GDP - USD bn	1,872	1,475	1,670	1,951	2,175	**2,169**	2,191	**2,178**	2,325
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	**10,202**	10,306	**10,205**	10,896
Nation-wide Unemployment Rate - year avg, NSA	12.0	13.8	13.2	9.3	8.0	**6.8**	7.0	**6.8**	7.0
Nation-wide Unemployment Rate - year end (*)	11.6	14.7	11.6	8.5	8.0	**6.5**	6.9	**7.0**	7.0
Inflation									
IPCA - %	4.3	4.5	10.1	5.8	4.6	**4.8**	4.4	**5.0**	4.2
IGP–M - %	7.3	23.1	17.8	5.5	-3.2	**5.7**	4.4	**5.3**	3.9
Interest Rate									
Selic - eop - %	4.50	2.00	9.25	13.75	11.75	**12.00**	11.75	**13.50**	11.00
Balance of Payments									
BRL / USD - eop	4.03	5.19	5.57	5.28	4.86	**5.70**	5.40	**5.70**	5.20
BRL / USD - average	3.95	5.16	5.40	5.17	5.00	**5.34**	5.29	**5.70**	5.29
Trade Balance - USD bn	35	50	61	62	99	**74**	70	**68**	60
Current Account - % GDP	-3.5	-1.7	-2.4	-2.1	-1.0	**-2.6**	-2.3	**-2.7**	-2.5
Direct Investment (liabilities) - % GDP	3.7	3.0	2.8	4.7	2.9	**3.2**	3.2	**3.9**	3.7
International Reserves - USD bn	367	356	362	325	355	**370**	370	**370**	370
Public Finances									
Primary Balance - % GDP	-0.8	-9.2	0.7	1.2	-2.3	**-0.4**	-0.4	**-0.7**	-0.8
Nominal Balance - % GDP	-5.8	-13.3	-4.3	-4.6	-8.9	**-7.6**	-7.1	**-8.5**	-8.1
Gross Public Debt - % GDP	74.4	86.9	77.3	71.7	74.4	**78.2**	77.5	**81.7**	81.1
Net Public Debt - % GDP	54.7	61.4	55.1	56.1	60.9	**62.6**	62.9	**67.6**	67.8
Growth of public spending (% real, pa, **)	2.3	29.2	-24.7	6.0	7.6	**3.6**	4.2	**3.1**	3.4

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 0.9% in 2024.

Macro Research – Itaú

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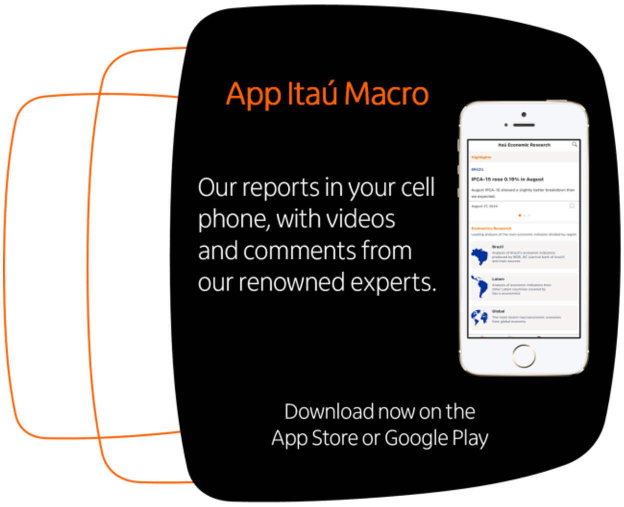

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