Macro scenario - Brazil

July 12, 2024

Near the limit

- With a sharp increase in spending and the revenue growth agenda near the limit, the perception of fiscal risk has worsened. To signal the sustainability of the framework's expenditure rule, cost-saving initiatives – like the ones being reportedly considered by the country's economic team – are vital; these include a spending restriction of at least BRL 20 billion, ideally closer to BRL 30 billion. For now, our primary deficit forecasts remain at 0.6% of GDP for 2024 and 0.9% of GDP for 2025.
- Given the deterioration of domestic fundamentals, rising risk perception, we revised our exchange rate projections to BRL/USD 5.30 for 2024 (from 5.15) and 5.40 for 2025 (from 5.25).
- Our GDP growth estimates remain at 2.3% for 2024 and 1.8% for 2025. The major flooding in the South region of the country affected some sectors in May, but our activity indicator suggests a recovery in June.
- We raised our inflation projections to 4.0% for both 2024 and 2025 (from 3.8% and 3.7%, respectively), to incorporate the effect of the weaker currency on food and industrial prices and the fuel price adjustment recently announced. The balance of risks for both years continues to show upward asymmetry, with a weaker currency and still-tight labor market possibly putting even more pressure on inflation. We also see a risk of rising food inflation in 2024, if the fresh-food price shocks are not reversed during the winter.
- The Brazilian Central Bank signaled its intention to maintain contractionary interest rates until the disinflation process is consolidated and expectations are anchored. We continue to expect a stable Selic rate of 10.50% pa until the end of 2025, but with heightened risks related to the potential impact of the recent exchange rate dynamics on future inflation.
- We highlight that the forecasts presented here are based on the assumption that the bimonthly Treasury report, to be released on July 22, will announce a significant spending restriction of BRL 20 to 30 billion. Any frustration on this front could significantly undermine the credibility of the country's fiscal framework and economic policy, which could in turn affect asset prices – perhaps similar to the moves seen in recent weeks.

Fiscal: increase in mandatory spending threatens the framework's spending limit

Our primary deficit forecasts remain unchanged at 0.6% of GDP for 2024 (BRL 75 billion) and 0.9% of GDP for 2025 (BRL 105 billion). On the one hand, revenue collection has increased following the measures implemented by the government last year. On the other hand, the already heavy tax burden in the country leaves little room for fiscal adjustments on the revenue side. The rapid growth in expenditures – pressured by the dynamics of social security and other minimum-wage-related expenses, as well as healthcare and education outlays – are threatening the framework's spending cap.

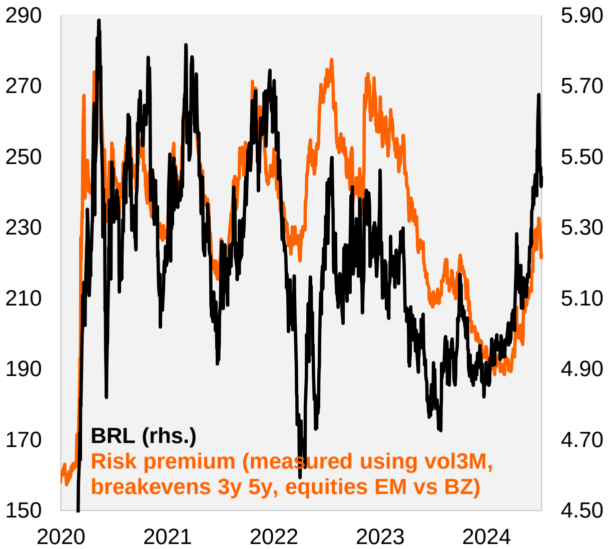
Initiatives to contain spending are vital to avoid breaching the expenditure limit in 2024 and to signal the sustainability of the fiscal framework, including a spending restriction of at least BRL 20 billion (ideally BRL 30 billion) by July 22. In a recent report (Macro Vision – Expenditure Control: A fundamental support to the fiscal framework), we presented an analysis of the rising expenses and proposals to control them going forward. In the short term, expense control could come from administrative measures such as a reduction of discretionary expenses and a review of irregularities in the Bolsa Família program for low-income households. However, to prove its commitment to the 2.5% limit on real spending growth set by the fiscal framework, the government must announce structural measures to provide sustainability as well as correct distortions and possible irregularities in public spending.

An alternative scenario of no announced measures and/or only a small restriction on spending would likely significantly undermine the credibility of the government's fiscal adjustment strategy. A lack of confidence in the enforceability of the framework's spending rule going forward would significantly increase the risk of a return of public debt to an unsustainable path. This scenario – in an emerging market economy with low growth, high interest rates and a heavy tax burden – would mainly affect the country's most vulnerable population.

Impact on BRL of worsening fiscal perception

The Brazilian real (BRL) has depreciated sharply over the last month, decoupling from other currencies. The exchange rate reached 5.70 BRL/USD, not far from the periods of greatest stress at the onset of the pandemic, while the risk premium rose significantly, reflecting the fiscal challenges.

Significantly higher risk premium and FX depreciation



Source: IBGE, Itaú

We revised our exchange rate estimates to BRL/USD 5.30 for 2024 (from 5.15) and 5.40 for 2025 (from 5.25), reflecting the deterioration in the market's perception of domestic uncertainties. We anticipate some appreciation from current levels, but the magnitude will depend on the announcement of the spending restriction. If the expected scenario does not materialize, the currency could return to its recent lows or even further.

We lowered our estimates for the current account deficit to USD 27 billion in 2024 (from USD 43 billion) and USD 37 billion in 2025 (from USD 53 billion). The downward revision reflects the change in the Central Bank's methodology, which will classify crypto assets in the capital account instead of the trade balance.

Resilient activity

Slight moderation in growth in 2Q24. We see GDP growth of 0.6% qoq/sa (2.0% yoy) in 2Q24, after a gain of 0.8% in 1Q24. Note that some monthly indicators for May were weaker due to the impact of the floods in the state of Rio Grande do Sul, but in general, economic activity has been resilient, especially the consumption of goods. Our daily IDAT-Activity indicator suggests continuity of this movement in June.

Our GDP forecast for 2024 remains unchanged at 2.3%, with sustained consumption and recovering investments. The tragic flooding in Rio Grande do Sul, so far, doesn't seem to have affected the aggregate GDP growth for FY24. Consumer spending should continue to be supported by income gains, given the resilient job market, and credit expansion. Investments are rebounding, albeit from historically low levels.

For 2025, we continue to anticipate a slowdown in GDP growth to 1.8%. The prospect of higher interest rates at the end of the easing cycle and decelerating loans are likely to result in negative monetary momentum for economic growth next year. Fiscal momentum is expected to remain positive in 2025, but slower than this year. The floods in the South region of Brazil also generate uncertainties regarding the destruction of production capacity and the need for reconstruction, which could affect the growth projections for 2025.

Finally, the resilient labor market figures support our call of a historically low unemployment rate of 7.8% in 2024. The latest data showed no signs of deceleration, with expanding employment driven by the formal sector, pressuring real wages. For 2025, we expect a slight increase in the unemployment rate to 8.0%, due to the slowdown in GDP.

Higher inflation projections

We revised our inflation projection for 2024 to 4.0%, from 3.8%. The impact of a weaker currency on food and goods prices has a lag of three months to one year. Some of the effects of the FX depreciation has therefore already been incorporated in 2024. We also incorporated the 7% gasoline adjustment recently announced by Petrobrás. However, there is still an upward asymmetry in the balance of risks to our call, given that an even weaker exchange rate could have additional effects on food and industrial products. Furthermore, the tight labor market could drive underlying services inflation closer to 6% (vs. 5.5% in our scenario). To make matters worse, additional delays in the reversal of the fresh food price shocks could raise our food inflation estimate to 6% (from 5% in our current scenario). On the other hand, the increase in Eletrobras' contribution to eliminate the pandemic and water-scarcity accounts poses downside risk to our projection.

Weaker exchange rate has a lagged effect on prices

Pass Through - effect of a 10% depreciation on IPCA (bps)			
Weights	Lag	IPCA	79
26	Regulated		20
5,1	Immediated	Gasoline	20
74	Market set		59
15	2 - 3 months	Food	26
23	4 - 12 months	Industrials	33
37	Through inertia	Services	0

Source: Itaú

For 2025, we raised our inflation projection to 4.0% (from 3.7%) to incorporate the effect of a weaker currency and higher inertia. Note that the balance of risks is also tilted upward, given that an even weaker currency could have additional effects on inflation next year and the resilience of the labor market could put more pressure on services inflation.

Monetary policy: Stability at risk

The Brazilian Central Bank's Monetary Policy Committee (Copom) will meet again at the end of July, in a potentially even more turbulent context than the previous meeting, when the authorities decided to halt the easing cycle. The BRL has depreciated in recent weeks and other domestic assets have also experienced sharp pressure, especially the yield curve, driven by the perception of increased uncertainty about the direction of economic policy – particularly (but not exclusively) the dynamics of public accounts.

Simulating the model used by Copom, with the recent FX lows, we estimate an above-target inflation of 3.3% for the relevant horizon. This exercise assumes a constant Selic rate of 10.50% pa, an exchange rate of BRL/USD 5.70 (vs. 5.30 at the last Copom meeting), and no further deterioration in expectations for 2025 and 2026. This inflation estimate should no longer be described as "near the target." We therefore estimate that the interest rate level required to return the consumer price index IPCA to the target would be at least 11.50% pa. Current pricing in future interest rate contracts – which include a potential increase in the Selic rate in upcoming monetary policy decisions – reflects a real risk.

For now, we maintain our projections for the benchmark rate at 10.50% pa for 2024 and 2025, assuming some exchange rate accommodation after convincing fiscal decisions and signals.

Nearing the edge

We emphasize that our entire scenario assumes the announcement of measures to mitigate fiscal uncertainty in the short term. In particular, we are waiting for the National Treasury's bimonthly report on primary revenues and expenditures, when we expect the government to announce a spending restriction. As previously noted, we assume a restriction of at least BRL 20 billion, but ideally BRL 30 billion.

Any frustration on this front could significantly undermine the credibility of the government's fiscal framework and economic policy, with a potentially considerable impact on asset prices – perhaps similar to the moves seen in recent weeks. In this case, we could see the exchange rate at BRL/USD 5.70, inflation above 4% in 2024 and 2025, and a need to raise the interest rate (by at least 1 pp) before the end of the 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	**2.3**	2.3	**1.8**	1.8
Nominal GDP - BRL bn	7,389	7,610	9,012	10,080	10,856	**11,531**	11,524	**12,210**	12,188
Nominal GDP - USD bn	1,872	1,475	1,670	1,951	2,175	**2,212**	2,263	**2,280**	2,342
Population (millions)	210.1	211.8	213.3	214.8	216.3	**217.7**	217.7	**219.0**	219.0
Per Capita GDP - USD	8,910	6,964	7,830	9,084	10,055	**10,162**	10,394	**10,412**	10,693
Nation-wide Unemployment Rate - year avg, NSA	12.0	13.8	13.2	9.3	8.0	**7.4**	7.5	**7.9**	7.9
Nation-wide Unemployment Rate - year end (*)	11.6	14.7	11.7	8.5	8.0	**7.8**	7.8	**8.0**	8.0
Inflation									
IPCA - %	4.3	4.5	10.1	5.8	4.6	**4.0**	3.8	**4.0**	3.7
IGP–M - %	7.3	23.1	17.8	5.5	-3.2	**3.3**	3.0	**3.1**	3.0
Interest Rate									
Selic - eop - %	4.50	2.00	9.25	13.75	11.75	**10.50**	10.50	**10.50**	10.50
Balance of Payments									
BRL / USD - eop	4.03	5.19	5.57	5.28	4.86	**5.30**	5.15	**5.40**	5.25
BRL / USD - average	3.95	5.16	5.40	5.17	5.00	**5.21**	5.09	**5.35**	5.20
Trade Balance - USD bn	35	50	61	62	99	**85**	85	**70**	70
Current Account - % GDP	-3.6	-1.9	-2.8	-2.5	-1.3	**-1.2**	-1.9	**-1.6**	-2.3
Direct Investment (liabilities) - % GDP	3.7	3.0	2.8	4.7	2.9	**3.2**	3.1	**3.8**	3.7
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	**-0.6**	-0.6	**-0.9**	-0.9
Nominal Balance - % GDP	-5.8	-13.3	-4.3	-4.6	-8.9	**-7.2**	-7.1	**-7.5**	-7.4
Gross Public Debt - % GDP	74.4	86.9	77.3	71.7	74.4	**77.9**	77.5	**81.4**	80.9
Net Public Debt - % GDP	54.7	61.4	55.1	56.1	60.9	**63.5**	63.7	**67.4**	67.3

Source: IBGE, FGV, BCB and Itaú

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

(**) We await the release of the complete statistics of the demographic census of 2022 by IBGE. Thus, we have not yet incorporated the estimate of 203.1 million inhabitants in 2022.

Macro Research – Itaú

Mario Mesquita – Chief Economist

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