Benign scenario for emerging markets supports the BRL and reduces inflation

- We revised our estimate for the exchange rate due to the decline in risk premia over the recent months, notwithstanding recent volatility in international markets. We forecast the exchange rate at BRL 3.25 per USD by YE18 and 3.30 by YE19.

- We reduced our 2018 inflation estimate to 3.5%, due to the revision in our outlook for the exchange rate and for electricity bills under the tariff flag system later in the year. For 2019, our call remains at 4.0%.

- The recovery in economic activity continues. We expect GDP to grow 3.0% in 2018 and 3.7% in 2019. We cut our estimate for the average unemployment rate in 2018 to 12.0% from 12.1%, and to 11.0% from 11.2% in 2019, incorporating a lower participation rate.

- We narrowed our estimate for the primary budget deficit to 2.0% of GDP from 2.1% in 2018, and to 0.9% from 1.0% in 2019. However, the sustainability of improved fiscal results still depends on reforms.

- The Monetary Policy Committee cut the Selic rate in early February by 25bps and signaled, quite clearly, the intention to stay put at the current level of 6.75%pa in the March policy meeting.

Benign global environment supports the BRL

The Brazilian currency continued to appreciate against the dollar in the past month and, in January, it reached its strongest level since October. The external environment remains very supportive of emerging markets, notwithstanding recent volatility in some global asset prices. In our view, this volatility is temporary, reflecting basically a correction in some prices, given that fundamentals in the global macro scenario remain sound. In particular, synchronized global growth supports raw material prices, helps reduce leverage among corporations and governments, and encourages lower risk aversion, explaining the dollar’s losses against several currencies, including Brazil’s.

We revised our exchange rate forecasts to BRL 3.25 per USD by YE18 (from 3.50) and to 3.30 by YE19 (from 3.60). Externally, broad global economic growth, along with still-moderate inflation in developed nations, should provide support for risk assets, including emerging market currencies, for a longer period of time. Domestically, although there is heightened uncertainty (especially over the approval of fiscal reforms), fiscal readings have been improving at the margin and the rebound in economic activity is becoming more robust, so that meeting the fiscal target in 2018 will be less challenging than in past years. Thus, risk premia for investing in Brazil tend to remain at historically low levels, contributing to a stronger exchange rate than we had anticipated.

A more favorable external financing profile also reduces risks related to eventual external and internal shocks. The current account deficit shrank to 0.5% of GDP in 2017 (USD 9.8 billion) from 1.3% of GDP in 2016 (USD 23.5 billion), mainly because of the positive contribution provided by the trade balance, with a USD 64 billion surplus. In terms of financing, the hallmark of the year was resilient foreign direct investment in the country (3.4% of GDP), which fully (and multiple times) covered the current account deficit and eased Brazil’s dependence on volatile capital flows.

The greatest risk to our forecast stems from developments regarding the reforms agenda, particularly reforms related to adjustments in fiscal accounts. If this agenda advances more quickly than we anticipate, there may be a swift appreciation of the BRL. On the other hand, a reversal may trigger a depreciating trend in the exchange rate.
For the next few years, we have revised our forecasts to a wider current account deficit, but not to the point of compromising Brazil’s external accounts. In our view, a slightly stronger exchange rate (on average) and the rebound in domestic demand will produce wider current account deficits. We estimate trade surpluses\(^1\) of USD 55 billion in 2018 and USD 42 billion in 2019 (vs. USD 50 billion). For the current account, we forecast a USD 32 billion deficit in 2018 (vs. USD 31 billion) and USD 51 billion deficit in 2019 (vs. USD 45 billion).

We reduced our 2018 inflation forecast to 3.5% and kept our estimate for 2019 at 4.0%

For 2018, we reduced our forecast for the consumer price index IPCA to 3.5% from 3.8%. We were driven by the revision in the expected path for the exchange rate (to BRL 3.25 per USD from 3.50 by YE18) and a new assumption for the tariff flag system affecting electricity bills in December (to yellow mode from red mode level 1), with impacts on the IPCA of -0.2 pp and -0.1 pp, respectively. Throughout the year, we expect increases of 1.0% in inflation in 1Q18 (3.0% yoy), 1.1% in 2Q18 (3.9% yoy), 0.5% in 3Q18 (3.9% yoy) and 0.8% in 4Q18.

Breaking down further, we anticipate increases of 3.2% in market-set prices (1.3% in 2017) and 4.5% in regulated prices this year (8.0% in 2017). We expect inflation to come in still below the target due to lower inertia from past inflation, a relatively stable exchange rate, expectations of a still-favorable (albeit smaller than last year) agricultural crop, anchored inflation expectations and a negative output gap. For market-set prices, we anticipate a 3.7% increase in costs for food consumed at home (previous forecast: 4.5%), after a 4.9% slide in 2017. We expect industrial prices to climb 2.3% (following an unusually low reading of 1.0% in 2017), with some cost pressure due to higher steel prices, especially in the automotive and appliance segments. Service prices are expected to slow down again, to 3.5% from 4.5%, largely because of lower inflationary inertia. Regarding regulated prices, the main products are set to post smaller increases than in 2017, particularly gasoline, bottled cooking gas, electricity, and water and sewage tariffs. Addressing electricity in particular, we changed our assumption for the tariff flag mode late in the year to yellow from red level 1, taking into account the publication of monthly allocation of physical electricity guarantees from hydro power plants during the year, with lower-than-expected levels in December. For gasoline, we expect it be impacted by a decline in oil prices from current levels to USD 58/bbl for Brent crude by year-end.

For 2019, our forecast for the IPCA remains around 4.0%. We expect market-set prices to rise 3.7% and regulated prices to climb 4.8%. Despite lower inertia due to the revision in this year’s inflation forecast, in 2019 we expect a payback related to the downward effect associated with the tariff flag in 2018.

The main risk factors of the inflation scenario are still tied to domestic politics and the evolution of the international scenario. Despite some improvement at
the margin, political uncertainty has hindered progress in reforms and adjustments required for the economic rebound — particularly the pension reform — and, at some point, may heighten risk premia and impact the exchange rate. A setback in reforms, besides its negative effect on economic activity, could also require alternative fiscal measures in the future, such as tax hikes and/or reversal of tax breaks. As for the external situation, despite promising signs (with upward revisions in global growth estimates and sustained risk appetite for emerging market assets), one cannot rule out economic policy changes in the developed world, which could eventually cause deterioration in risk premia, impacting the local currency and domestic inflation. Such policy reversals may have a deeper impact on prices of assets that appreciated more sharply in recent months. As for regulated prices, oil poses some upside risk to our baseline scenario, if the recent pressure lasts longer than expected.

Substantial slack in the economy may contribute to a sharper inflation decline in 2018. The negative output gap and, consequently, unemployment above its equilibrium level for a longer period — notwithstanding some recent improvement — may cause faster disinflation in market-set prices, particularly those more sensitive to the economic cycle, such as services and industrial items.

More favorable inflation inertia also presents downside risk to 2018 inflation. The sharp slide in agricultural and retail food prices last year – thanks to a favorable supply shock — contributed to a 2.9% increase in the IPCA that hit below the lower bound of the inflation target range, as well as to even lower readings for other inflation indicators, particularly the INPC (2.1%) and IGP-M (-0.5%). The INPC, whose basket is focused on a tighter income bracket of households earning up to five monthly minimum wages, is used to calculate adjustments in the minimum wage and is also a benchmark for most wage adjustments in the private sector. Hence, lower year-over-year readings than for the IPCA, which are likely at least until mid-year, may cause inertial effects that are even more favorable for official inflation in 2018. Some other favorable effects could come from low readings for the IGP-M, used to adjust some regulated prices and home rental contracts.

Inflation expectations remain anchored, with breathing room in relation to the 2018 target. The median of market expectations, as per the central bank’s Focus survey, slid a bit, to 3.94% from 3.95% in 2018. Median estimates for 2019 and 2020 remained at 4.25% and 4.00%, respectively, anchored to the targets set for these years.

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**Drop in the participation rate reduces forecasts for the unemployment rate**

We lifted our forecast for GDP growth in 4Q17 to 0.1% qoq/sa from 0.0% (2.2% yoy) due to somewhat better-than-expected data in November and the industrial production result in December. Our estimated average growth for 2017 stands at 1.0%.

We forecast GDP growth of 3.0% in 2018 and 3.7% in 2019, but the balance of risks is tilted to the downside. These forecasts assume that the reform agenda will continue going forward. If an interruption or even reversal of this process is anticipated, the recovery in activity will be in jeopardy, particularly if the tapering of global monetary stimulus becomes more intense.

The gradual recovery in the labor market continues. In December, 328,000 formal jobs were destroyed in net terms (according to the Ministry of Labor’s Caged registry). However, December has intense seasonality and the balance is always negative. The seasonally-adjusted monthly result pointed to the creation of 58,000 jobs. The quarterly moving average rose to 47,000 from 22,000 and has been improving gradually since 2016.

According to the national household survey (PNAD Continua – IBGE), Brazil’s nationwide unemployment rate fell to 11.8% in 4Q17 from 12.0% in the quarter ended in November. Using our seasonal adjustment, unemployment slid 0.1 pp. to 12.4%, reflecting a 0.1 pp decline in the participation rate (ratio of the labor force to the working-age population). The contribution provided by informal employment remains

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**Anchored inflation expectations**

![Inflation Expectations Chart](chart.png)

Source: BCB (Focus Survey)
significant but has lost momentum, while gains in formal employment in the private sector have been improving gradually.

We revised our outlook for the unemployment rate in 2018 and 2019, incorporating the 0.1 pp drop in the participation rate in 4Q17 vs. 3Q17. In our view, the slide will be extended from 61.8% currently to the 61.3% historical average during the next four years, as households see an improvement in their financial situations.

After adjusting our call for the participation rate, we lowered our estimate for the seasonally-adjusted unemployment rate by YE18 to 11.7% from 11.8% (2018 average: 12.0%). Our forecast for YE19 slid to 10.7% from 10.9% (2019 average: 11.0%). The drop in unemployment tends to rely more and more on formal jobs and less on informal jobs.

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Fiscal results improve, but sustainability depends on reforms

In 2017, the public sector posted a primary deficit of BRL 111 billion (1.7% of GDP), better than the BRL 163 billion target (2.4% of GDP). To beat the target, the government made significant effort in terms of extraordinary revenues (about BRL 65 billion), discretionary spending freezes (BRL 35 billion) and a revision in mandatory spending (BRL 10 billion). If these had not materialized, the deficit would be BRL 220 billion (3.3% of GDP).

In 2018, meeting the primary deficit target of BRL 161 billion (2.2% of GDP) and the public spending cap should not be as challenging. As the economy recovers, the primary deficit (excluding extraordinary revenues) will narrow to BRL 170 billion from BRL 220 billion. The gap vs. the target (11 BRL billion) is small, especially because the historical average for extraordinary revenues (last 20 years) is around BRL 30 billion. Also, this year’s budget includes a real increase of about BRL 15 billion in discretionary expenses. Importantly, the increase in spending is compatible with the constitutional cap.

Furthermore, debt dynamics and the so-called golden rule also imply milder restrictions in 2018. As development bank BNDES pays back BRL 130 billion to the National Treasury, the government will be able to meet the golden rule this year. Additionally, although primary budget results are still negative, the payment, along with improved economic growth and lower real interest rates, will help to keep gross debt as a percentage of GDP relatively stable in 2018 (see chart).

However, without reforms, fiscal readings will resume a deteriorating trend starting in 2019. Without the expense control that is necessary to meet the spending cap, the gradual convergence to primary budget surpluses that are compatible with public debt stabilization is interrupted. Maintenance of the currently unsustainable path of public debt means increasing uncertainty over the consistency of the economic recovery and historically low interest rates. The pension reform in particular is a prerequisite for rebalancing public accounts. Congressional debate on the reform is scheduled to resume in late February, but there are questions as to whether there will be political consensus for approval in 2018.
Scenario Review Brazil – February 9, 2018

Gross debt in unfavorable dynamics

Source: Central Bank, Itaú

We reduced our estimates for the primary budget deficit to 2.0% of GDP (BRL 142 billion) from 2.1% of GDP (BRL 150 billion) in 2018, and to 0.9% of GDP (BRL 80 billion) from 1.0% of GDP (BRL 90 billion) in 2019. The revision for 2018 was driven by expectations of greater extraordinary revenues produced by oil auctions and withdrawals from the sovereign wealth fund scheduled for the coming months. As spending is fixed exactly at the constitutional spending ceiling, additional revenues (such as those related to progress in the agenda of asset sales) may lead to an even better primary reading than the target set for 2018. The revision for 2019 reflects expectations of sharper growth in recurring revenues. Meeting next year’s spending cap will require an adjustment of about BRL 30 billion, set to be carried out through discretionary spending cuts and the reversal of payroll tax breaks.

Monetary policy: Signaling the end

The Brazilian Central Bank’s Monetary Policy Committee (Copom) met again this week and decided to reduce the benchmark Selic interest rate to a new all-time low of 6.75% p.a. There was firm consensus in the market about the decision, given the committee’s recent communications establishing that, if the scenario unfolded as expected, it would be appropriate to reduce the pace of monetary easing from the 50-bp cut announced in the previous meeting. As there were no significant changes in the baseline scenario or in the balance of risks since that meeting, the decision confirmed expectations of a 25-bp reduction.

The statement published after the Copom meeting signaled, quite clearly, the intention to stay put at the current level of 6.75%pa in the March policy meeting. The committee stated that, with the economy continuing to perform as expected, it would be proper to interrupt the monetary easing process. Thus, we revised our call for the end-cycle Selic rate from 6.5% to 6.75%, a level we expect to prevail throughout the year. As usual, the statement also highlighted that this assessment may change if the basic scenario does not evolve as expected or if the balance of risks changes. Released shortly after the Copom’s decision, January’s IPCA inflation reading came in much lower than expected, but given the Copom’s signaling, one weak reading will probably not be enough to change the committee’s flight plan. That said, it will be important to follow any hints that may appear in coming official communications of the monetary authority. We will know more about the rationale for this decision with the release of the minutes next week.
### Forecast: Brazil

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<tbody>
<tr>
<td>Real GDP growth - %</td>
<td>1.9</td>
<td>3.0</td>
<td>0.5</td>
<td>-3.5</td>
<td>-3.5</td>
<td>1.0</td>
<td>3.0</td>
<td>3.7</td>
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<td>Nominal GDP - BRL bn</td>
<td>4,815</td>
<td>5,332</td>
<td>5,779</td>
<td>5,996</td>
<td>6,259</td>
<td>6,586</td>
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<td>7,670</td>
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<td>Nominal GDP - USD bn</td>
<td>2,463</td>
<td>2,468</td>
<td>2,455</td>
<td>1,800</td>
<td>1,795</td>
<td>2,063</td>
<td>2,198</td>
<td>2,341</td>
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<tr>
<td>Population (millions)</td>
<td>199.2</td>
<td>201.0</td>
<td>202.8</td>
<td>204.5</td>
<td>206.1</td>
<td>207.7</td>
<td>209.2</td>
<td>210.7</td>
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<tr>
<td>Per Capita GDP - USD</td>
<td>12,362</td>
<td>12,278</td>
<td>12,106</td>
<td>8,804</td>
<td>8,710</td>
<td>9,936</td>
<td>10,505</td>
<td>11,110</td>
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<tr>
<td>Nation-wide Unemployment Rate - year avg (*)</td>
<td>7.4</td>
<td>7.1</td>
<td>6.8</td>
<td>8.5</td>
<td>11.5</td>
<td>12.7</td>
<td>12.0</td>
<td>11.0</td>
</tr>
<tr>
<td>Nation-wide Unemployment Rate - year end (*)</td>
<td>7.5</td>
<td>6.8</td>
<td>7.1</td>
<td>9.6</td>
<td>12.6</td>
<td>12.4</td>
<td>11.7</td>
<td>10.7</td>
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</table>

### Inflation

| IPCA - %                           | 5.8  | 5.9  | 6.4  | 10.7 | 6.3  | 2.9   | 3.5   | 4.0   |
| IGP-M - %                          | 7.8  | 5.5  | 3.7  | 10.5 | 7.2  | -0.5  | 3.8   | 4.2   |

### Interest Rate

| Selic - eop - %                     | 7.25 | 10.00| 11.75| 14.25| 13.75| 7.00  | 6.75  | 8.00  |

### Balance of Payments

| BRL / USD - eop                     | 2.05 | 2.36 | 2.66 | 3.96 | 3.26 | 3.31  | 3.25  | 3.30  |
| Trade Balance - USD bn              | 19   | 2    | -4   | 20   | 48   | 67    | 55    | 42    |
| Current Account - % GDP             | -3.0 | -3.0 | -4.2 | -3.3 | 1.3  | -0.5  | -1.5  | -2.2  |
| Direct Investment (liabilities) - % GDP | 3.5  | 2.8  | 3.9  | 4.2  | 4.4  | 3.4   | 3.8   | 3.5   |
| International Reserves - USD bn     | 379  | 376  | 374  | 369  | 372  | 382   | 382   | 382   |

### Public Finances

| Primary Balance - % GDP             | 2.2  | 1.7  | -0.6 | -1.9 | -2.5 | -1.7  | -2.0  | -0.9  |
| Nominal Balance - % GDP             | -2.3 | -3.0 | -6.0 | -10.2| -9.0 | -7.8  | -7.0  | -5.5  |
| Gross Public Debt - % GDP           | 53.7 | 51.5 | 56.3 | 65.5 | 70.0 | 73.7  | 73.8  | 73.4  |
| Net Public Debt - % GDP             | 32.3 | 30.6 | 33.1 | 36.0 | 46.2 | 51.4  | 55.0  | 56.0  |

Source: IBGE, FGV, BCB and Itaú

(*) Nation-wide Unemployment Rate measured by PNADC

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Macro Research – Itaú
Mario Mesquita – Chief Economist
Tel: +5511 3708-2696
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