Scenario Review - Brazil

April 13, 2018

Higher uncertainties

- Notwithstanding signs of weak GDP in 1Q18, underlying growth indicators remain sound. For now, we maintain our GDP forecasts at 3.0% for 2018 and 3.7% for 2019.

- We estimate the primary budget deficit at 1.9% of GDP for 2018 and 0.9% of GDP for 2019.

- Our exchange rate forecasts are BRL 3.25 per USD by YE18 and 3.30 by YE19, but we see downside risks for the Brazilian currency.

- We maintained our inflation forecasts at 3.5% in 2018 and 4.0% in 2019.

- We anticipate a 25-bp cut in the Selic benchmark rate in May, ending the easing cycle at 6.25%, but we do not rule out the possibility of an unchanged rate instead.

Activity: weaker growth in early 2018

We reduced our 1Q18 GDP forecast, incorporating poorer indicators from the two first months of the year. We slashed our estimate to 0.5% qoq/sa from 1.0%, given disappointing results in real revenues from services in January (-1.9% mom/sa) and mining and extraction activity in February (-5.2%).

Notwithstanding weak hard data indicators at the margin, we believe that annualized underlying growth still hovers around 3.0%. This assessment is based on the recent evolution in confidence surveys and diffusion in the main monthly indicators, which, in turn, reflect more favorable fundamentals for economic growth, such as faster global expansion, lower leverage among companies, and expansive monetary policy. Additionally, indicators related to domestic demand continue to accelerate. The following chart shows the evolution of GDP growth that is compatible with the evolution of each of the three indicators (confidence, diffusion and domestic demand).

For now, our GDP forecasts are 3.0% for 2018 and 3.7% for 2019, assuming some reversal of the weak recent data in the coming months and, especially, the expectation that the reform agenda will be back on the table in the future.

For now, we maintain this scenario for growth, as confidence levels rise and financial conditions remain stimulating.

However, the balance of risks is tilted toward disappointment. If the election situation increases uncertainties related to the resumption of reforms, the ensuing deterioration in financial conditions and business and consumer confidence tends to slow down economic activity before year-end.

According to the national household survey (PNAD Contínua - IBGE), Brazil’s nationwide unemployment rate climbed to 12.6% in the quarter ended in February from 12.2% in the quarter ended in January. Using our seasonal adjustment, unemployment fell 0.1 pp to 12.4%, influenced by a small decline in the participation rate. Informal
employment has remained virtually stable in the last four reports (in seasonally adjusted terms), interrupting a sequence of eight increases in 2017. PNAD Continua pointed to another small decline in formal employment in the private sector, but the Labor Ministry’s CAGED registry showed net monthly creation of about 35,000 jobs. The chart below shows that such decoupling is common, but CAGED usually captures the predominant trend.

We maintain our estimate for the primary budget deficit in 2018 at 1.9% of GDP (137 billion reais). Meeting the primary deficit target of BRL 161 billion (2.2% of GDP) and the public spending cap will be less challenging this year. Fiscal results in 2018 will benefit from about BRL 20 billion (0.3% of GDP) in extraordinary revenues, with BRL 8 billion (0.1% of GDP) provided by oil-field auctions held in March.

Debt dynamics and the “golden rule” will not be a concern this year. As development bank BNDES repays BRL 130 billion to the National Treasury, the government will be able to comply with the so-called golden rule this year. Notwithstanding still-negative primary results, this repayment, better economic growth and lower real interest rates will contribute to keep gross debt as a share of GDP virtually stable in 2018.

Fiscal results improve, but sustainability depends on reforms

Using models that assume our GDP growth scenario and the sensitivities of different kinds of occupations to the pace of economic activity, we expect the unemployment rate (using our seasonal adjustment) to recede to 11.7% by YE18 and 10.7% by YE19, as formal jobs provide a growing contribution. Our forecasts for the average unemployment rate are 12.0% in 2018 and 11.0% in 2019 (2017: 12.7%).

However, without reforms, fiscal results will go back to a deteriorating trend from 2019 onward. The pension reform, a prerequisite to rebalance public accounts, is no longer being pushed through Congress and, most likely, will only get back to the table in the next administration. If controlling public expenses (as set by the spending cap) is not made feasible, gradual convergence to primary surpluses that are compatible with public debt stabilization will be halted. If the currently unsustainable trend in public debt goes on, the rebound in economic activity and sustainability of interest rates at historically low levels will be in jeopardy.
For 2019, we estimate the primary deficit at 0.9% of GDP (BRL 80 billion). Compliance with the spending cap will require an adjustment of about BRL 30 billion, which, in our view, will come in the form of discretionary spending cuts and reversal of payroll tax breaks.

**BRL depreciated amid international and domestic volatility**

The Brazilian currency depreciated against the U.S. dollar in the past month and reached its weakest level for the year. After trading around BRL 3.25 per USD in the earliest months of 2018, the exchange rate weakened to 3.35-3.40. Both international and domestic scenarios became more volatile. Escalating trade tensions between the U.S. and China fueled concern about growing protectionism that could impact emerging markets. Domestically, political uncertainties and doubts regarding the approval of reforms are also high.

The first risk involves the political and macroeconomic scenario (both internal and external). In Brazil, there are many uncertainties regarding the evolution of reforms, particularly those that could influence public debt dynamics in the coming years. Overseas, a heated trade war between the U.S. and China could trigger corrections in some asset prices, including the Brazilian currency.

The second risk is specific to the FX market operation. The interest rate differential has reached historically low levels and could impact the BRL in a sharper way than our models assume, representing downside to our call for the BRL.

At the margin, data continue to show that external accounts are healthy. The trade surplus remained large in 1Q18, thanks to manufactured products and crude oil shipments.

For the next few years, we expect larger current account deficits, but not to the point of compromising Brazil’s external accounts. In our view, the rebound in domestic demand will produce somewhat wider current account deficits. Trade surpluses, which were behind low current account deficits in recent years, are set to weaken in the future. We estimate trade surpluses1 of USD 57 billion in 2018 (up from USD 55 billion previously, as exports were slightly larger than anticipated in 1Q18) and USD 42 billion in 2019. For the current account, we anticipate deficits of USD 30 billion in 2018 (down from USD 32 billion previously) and USD 51 billion in 2019.

We maintain our inflation forecasts at 3.5% for 2018 and 4.0% for 2019

For 2018, our forecast for consumer price index IPCA remains at 3.5%. The index was up by 0.7% in 1Q18 and 2.7% yoy. We expect increases of 1.1% in 2Q18 (3.6% yoy), 0.7% in 3Q18 (3.8% yoy), and 0.9% in 4Q18.

Breaking this down further, we anticipate increases of 3.0% in market-set prices (1.3% in 2017) and 4.8% in regulated prices this year (8.0% in 2017). We expect the inflation print to still be below the target due to: lower inertia from past inflation; a relatively stable exchange rate; a still-favorable agricultural crop (albeit smaller than last year), ensuring good inventory levels; anchored inflation estimates; and a negative output gap. As for market-set prices, we anticipate a 3.7% hike in costs for food consumed at home, after a 4.9% slide in 2017. Although the change in costs for food consumed

---

1. UN data on trade balances are net of fuel.

---

**Country-risk premium rises and BRL reaches its weakest level since 2016**

For now, we maintain our exchange rate forecasts at 3.25 by YE18 and 3.30 by YE19. Despite rising international tensions, we believe that robust and widespread global growth will continue to support risk assets, including emerging market currencies.

There are two different risks to our call, and both point to a potentially weaker BRL.

---

**Source:** Bloomberg, Itaú
at home in 1Q18 was much milder than the seasonal pattern (just 0.3%), we anticipate stronger upward pressure during 2H18, due to the recent advance in grain prices. We expect industrial prices to climb 1.9% (following an unusually-low reading of 1.0% in 2017). Service prices are expected to slow down again, to 3.4% from 4.5%, largely because of lower inflationary inertia and the negative output gap. 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. For electricity, we estimate an 8% increase this year (10% in 2017), assuming that the tariff flag system will be in yellow mode in December. Gasoline prices are expected to rise 1% this year (10% in 2017), assuming that crude prices fall from current levels.

For 2019, our forecast for the IPCA remains at 4.0%. We expect market-set prices to rise 3.8% and regulated prices to climb 4.4%.

**Below-target inflation rate**

The main risk factors for the inflation scenario are still tied to domestic politics and the evolution of the international scenario. Uncertainties surrounding the political/election scenario may disappoint expectations regarding the approval of reforms and other adjustments needed to revive the economy, triggering deterioration in risk premiums and impacting the exchange rate and the inflation path. A setback in reforms, despite 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 still-promising current developments, with the outlook for stronger and synchronized global growth and sustained risk appetite for emerging market assets, one cannot rule out economic policy changes in the developed world and tighter global financial conditions eventually. In addition to these risks, the historically low interest rate differential represents downside to our call for the BRL.

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

**More favorable inflation inertia also adds downside risk to inflation.** The sharp slide in agricultural and retail food prices since last year – thanks to a favorable supply shock – is contributing to the keep the IPCA (2.7% yoy) below the lower bound of the inflation target range (3.0%), as well as to even lower readings for other inflation indicators, particularly the INPC (1.6% yoy) and IGP-M (0.2% yoy). 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. Some favorable effect should also arise from low readings for the IGP-M, used to adjust some regulated prices and home rental contracts. Hence, year-over-year inflation readings below those captured by the IPCA, which should prevail at least until mid-year, may cause an even more favorable inertial effect on headline inflation in 2018.

**Inflation expectations remain anchored, with breathing room in relation to the targets for 2018 and 2019.** The median of market expectations for 2018, as per the central bank’s Focus survey, slid to 3.53% (almost 1.0 pp below the 4.50% target) from 3.70%. The median estimate for 2019 receded to 4.09% (somewhat below the 4.25% target) from 4.24%, and remained anchored at the 4.00% target for 2020.
Monetary policy: one more step towards the end

In March, the Monetary Policy Committee (Copom) delivered, unanimously, the expected 25-bp rate cut, taking the Selic to an unprecedented 6.5% p.a. level. The core message of the Copom minutes is that a final moderate cut in the May meeting is warranted. Additionally, the central bank’s latest inflation report showed inflation forecasts at 3.8% in 2018 and 4.1% in 2019 in the active scenario, with interest and exchange rates forecasts in line with market expectations (according to the Focus report), which currently assumes the Selic rate stable, at 6.50%, until the end of 2018, and rising to 8.0% in 2019. Inflation forecasts below their targets (4.5% for 2018 and 4.25% for 2019) are consistent with the central bank’s recent communication that the base-case for now is one more 25-bp cut in May, taking the Selic rate to 6.25%.

However, policymakers stressed that this assessment can change if it becomes clear that this mitigation of risks is no longer required, leading to the interruption of the easing cycle as early as in May. Sharper depreciation in the local currency (driven by a less benign external background for emerging markets or more conviction that fiscal reforms will not be approved) may push the committee to keep the benchmark rate unchanged in its next meeting.

For meetings after the next one, that is, from June onwards, the Copom signaled that, with the economy evolving as expected, it would be proper to interrupt the monetary easing process, given that the relevant horizon for monetary policy would have largely shifted to 2019. Some members urged the committee to express that it would wait for more information about the economy before taking new action. Thus, going forward, we need to monitor high-frequency inflation and activity data in Brazil, as well as the exchange rate, and the extent to which these figures impact expectations and the prospective scenario.

At this time, we do not anticipate significant changes in the scenario, so we stick to our view that 6.25% p.a. should be the “resting place” of the Selic at the end of this cycle. We expect the rate to be cut to this level at the Copom meeting in May and remain there until at least the end of the year.
**Forecast: Brazil**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<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>
</tr>
<tr>
<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>6,560</td>
<td>7,058</td>
<td>7,615</td>
</tr>
<tr>
<td>Nominal GDP - USD bn</td>
<td>2,463</td>
<td>2,489</td>
<td>2,455</td>
<td>1,800</td>
<td>1,795</td>
<td>2,055</td>
<td>2,167</td>
<td>2,324</td>
</tr>
<tr>
<td>Population (millions)</td>
<td>199.3</td>
<td>201.1</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>
</tr>
<tr>
<td>Per Capita GDP - USD</td>
<td>12,356</td>
<td>12,274</td>
<td>12,103</td>
<td>8,803</td>
<td>8,710</td>
<td>9,896</td>
<td>10,357</td>
<td>11,030</td>
</tr>
<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>12.7</td>
<td>12.4</td>
<td>11.7</td>
<td>10.7</td>
</tr>
</tbody>
</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  | 4.0   | 4.2   |

**Interest Rate**

| Selic - eop - %   | 7.25  | 10.00 | 11.75 | 14.25 | 13.75 | 7.00  | 6.25  | 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    | 57    | 42    |
| Current Account - % GDP | -3.0 | -3.0  | -4.2  | -3.3  | -1.3  | -0.5  | -1.4  | -2.2  |
| Direct Investment (liabilities) - % GDP | 3.5  | 2.8   | 3.9   | 4.2   | 4.4   | 3.4   | 3.9   | 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  | -1.9  | -0.9  |
| Nominal Balance - % GDP | -2.3  | -3.0  | -6.0  | -10.2 | -9.0  | -7.8  | -6.9  | -5.5  |
| Gross Public Debt - % GDP | 53.7 | 51.5  | 56.3  | 65.5  | 70.0  | 74.0  | 74.2  | 73.9  |
| Net Public Debt - % GDP | 32.3  | 30.6  | 33.1  | 36.0  | 46.2  | 51.6  | 55.2  | 56.4  |

Source: IBGE, FGV, BCB and Itaú

(*) Nation-wide Unemployment Rate measured by PNADC

Macro Research – Itaú
Mario Mesquita – Chief Economist

Tel: +5511 3708-2696
[Click here](#) to visit our digital research library.

**App Itau Economic Analysis**
Our Research on your mobile.
Download it on the App store or Google Play.
Relevant Information

1. This report has been prepared and issued by the Macro Research Department of Banco Itaú Unibanco S.A. (“Itaú Unibanco”). This report is not a product of the Equity Research Department of Itaú Unibanco or Itaú Corretora de Valores S.A. and should not be construed as a research report (‘relatório de análise’) for the purposes of the article 1 of the CVM Instruction NR. 483, dated July 06, 2010.

2. This report aims at providing macroeconomics information, and does not constitute, and should not be construed as an offer to buy or sell, or a solicitation of an offer to buy or sell any financial instrument, or to participate in any particular trading strategy in any jurisdiction. The information herein is believed to be reliable as of the date on which this report was issued and has been obtained from public sources believed to be reliable. Itaú Unibanco Group does not make any express or implied representation or warranty as to the completeness, reliability or accuracy of such information, nor does this report intend to be a complete statement or summary of the markets or developments referred to herein. Opinions, estimates, and projections expressed herein constitute the current judgment of the analyst responsible for the substance of this report as of the date on which it was issued and are, therefore, subject to change without notice. Itaú Unibanco Group has no obligation to update, modify or amend this report and inform the reader accordingly.

3. The analyst responsible for the production of this report, whose name is highlighted in bold, hereby certifies that the views expressed herein accurately and exclusively reflect his or her personal views and opinions and were prepared independently and autonomously, including from Itaú Unibanco, Itaú Corretora de Valores S.A. and other group companies.

4. This report may not be reproduced or redistributed to any other person, in whole or in part, for any purpose, without the prior written consent of Itaú Unibanco. Additional information on the financial instruments discussed in this report is available upon request. Itaú Unibanco and/or any other group companies is not, and will not be liable for any investment decisions (or otherwise) based on the information provided herein.

Additional Note to reports distributed in: (i) U.K. and Europe: The sole purpose of this material is to provide information only, and it does not constitute or should be construed as a proposal or request to enter into any financial instrument or to participate in any specific business strategy. The financial instruments discussed in this material may not be suitable for all investors, and are directed solely at Eligible Counterparties and Professionals as defined by the Financial Conduct Authority. This material does not take into consideration the objectives, financial situation or specific needs of any particular client. Clients must obtain financial, tax, legal, accounting, economic, credit and market advice on an individual basis, based on their personal characteristics and objectives, prior to making any decision based on the information contained herein. By accessing the material, you confirm that you are aware of the laws in your jurisdiction relating to the provision and sale of financial service products. You acknowledge that this material contains proprietary information and you agree to keep this information confidential. Itaú BBA International plc (IBBAInt) exempts itself from any liability for any losses, whether direct or indirect, which may arise from the use of this material, from its content and is under no obligation to update the information contained in this document. Additionally, you confirm that you understand the risks related to the financial instruments discussed in this material. Due to international regulations not all financial instruments/services may be available to all clients. You should be aware of and observe any such restrictions when considering a potential investment decision. Past performance and forecast are not a reliable indicator of future results. The information contained herein has been obtained from internal and external sources and is believed to be reliable as of the date in which this material was issued, however IBBAInt does not make any representation or warranty as to the completeness, reliability or accuracy of information obtained by third parties or public sources. Additional information relative to the financial products discussed in this material is available upon request. Itaú BBA International plc registered office is 26th floor, 20 Prisoner Street, London, United Kingdom, EC2A 2EW and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority (FRN 575225) – Itaú BBA International plc Lisbon Branch is regulated by Banco de Portugal for the conduct of business. Itaú BBA International plc has representative offices in France, Germany, Spain which are authorised to conduct limited activities and the business activities conducted are regulated by Banque de France, Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), Banco de España respectively. For any queries please contact your relationship manager; (ii) U.S.A: Itaú BBA USA Securities, Inc., a FINRA/SIPC member firm, is distributing this report and accepts responsibility for the content of this report. Any US investor receiving this report and wishing to effect any transaction in any security discussed herein should do so with Itaú BBA USA Securities, Inc. at 767 5th Avenue, 50th Floor, New York, NY 10153; (iii) Asia: This report is distributed in Hong Kong and Japan by Itaú Asia Securities Limited, which is licensed in Hong Kong by the Securities and Futures Commission for Type 1 (dealing in securities) regulated activity. Itaú Asia Securities Limited accepts all regulatory responsibility for the content of this report. In Hong Kong, any investors wishing to purchase or otherwise deal in the securities covered in this report should contact Itaú Asia Securities Limited at 28th Floor, Two IFC, 8 Finance Street – Central, Hong Kong; (iv) Middle East: This report is distributed by Itaú Middle East Limited. Itaú Middle East Limited is regulated by the Dubai Financial Services Authority and is located at Suite 405, Level 3, Al Fattan Currency House, Dubai International Financial Centre, PO Box 482034, Dubai, United Arab Emirates. This material is intended only for Professional Clients (as defined by the DFSA Conduct of Business module) no other persons should act upon it; (v) Brazil: Itaú Corretora de Valores S.A., a subsidiary of Itaú Unibanco S.A. authorized by the Central Bank of Brazil and approved by the Securities and Exchange Commission of Brazil, is distributing this report. It is necessary, contact the Client Service Center: 4004-3131* (capital and metropolitan areas) or 0800-722-3131 (other locations) during business hours, from 9 a.m. to 8 p.m., Brasilia time. If you wish to re-evaluate the suggested solution, after utilizing such channels, please call Itaú’s Corporate Complaints Office: 0800-570-0011 (on business days from 9 a.m. to 6 p.m., Brasilia time) or write to Caixa Postal 67.600, São Paulo-SP, CEP 03162-971 * Cost of a local call.