Economic outlook

September 1, 2021

Fiscal uncertainties make scenario hazier once again

- **Fiscal issues once again weighed against an improvement in the outlook for the economy and asset prices.** While these issues remain unsolved, we looked at the potential fiscal impact of the measures being discussed, assuming that the current fiscal framework is preserved but assuming some increase in welfare spending by the government. Under our assumptions, our forecast for the primary fiscal deficit in 2022 widens from BRL 73 billion to BRL 122 billion, while the gross public debt would rise from 81.5%/GDP in 2021 to 83.2%/GDP in 2022.

- **Under this scenario, the BRL would likely continue to underperform most other major EM currencies.** Although the fundamentals for appreciation remain in place, it is wise to take on a more conservative stance in our forecast. We revised our exchange-rate forecasts to BRL5.00-5.50/USD by the end of next year, until the exact dimension of fiscal issues is known.

- **Reflecting the added depreciation and new shocks, we revised our IPCA forecast from 7.1% to 7.8% in 2021.** However, we maintained our inflation forecast at 3.3% unchanged for next year. Amidst some contamination of expectations for 2022, the Central Bank of Brazil has reaffirmed its willingness to shift its monetary policy stance to restrictive and we forecast it to raise the Selic policy rate to 7.5%.

- **In this scenario, the deterioration of the financial conditions index affects economic activity.** Domestic uncertainties are compounded by somewhat weaker global growth. Therefore, we lowered our 2022 GDP forecast from 2.2% to 1.8%. As long as fiscal uncertainties persist, the variance of forecasts will tend to be greater than usual.

The Fed's next steps, China and the Delta variant still steer the global scenario.

- **The global scenario remains positive, although some short-term calibrations are needed.** Since July, the market has questioned the growth rate of the world's main economies, especially when it comes to the impacts of the new Covid-19 variant. For now, concerns haven't escalated, since multiple studies have confirmed the efficacy of vaccines. In addition, several countries will roll-out a third dose, and in many places, the upsurge in cases have not led to an increase in deaths, especially among those vaccinated. Still, many Asian countries have rolled back to mobility restriction measures.

- **In response to disappointing data, we lowered our global GDP forecast for this year to 6.1%, from 6.5% previously.** Bearish revisions focused on China and the U.S. For 2022, we have maintained an expected growth rate of 4.5%.

- **Monetary policy normalization in emerging nations will likely remain ahead of developed countries**, especially against a backdrop of greater tolerance to short-term inflation by the FED and the ECB.

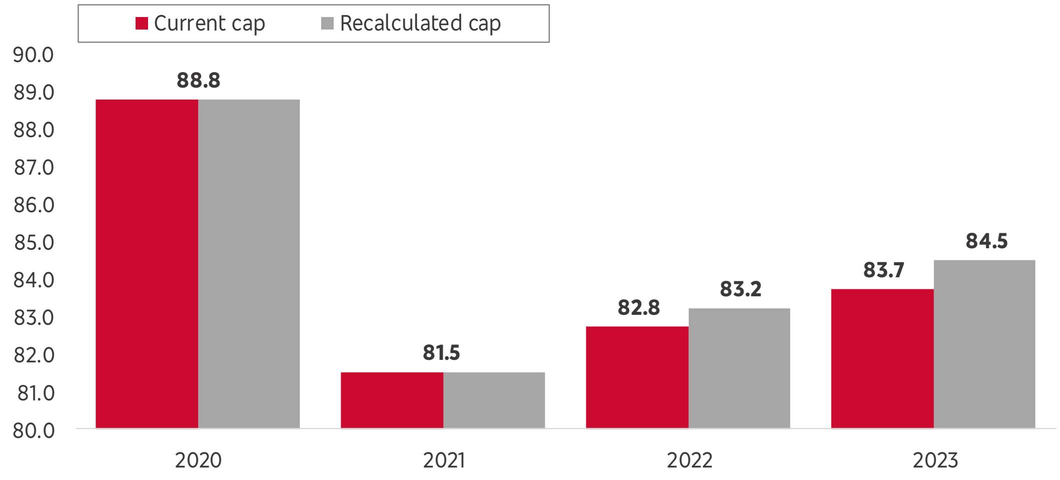
Fiscal uncertainties make scenario hazier once again

Fiscal risks once again curbed the improvement in prospects for the economy and asset prices. Without a stable exchange rate, the convergence of inflation towards the center of the target becomes more uncertain and forces the Central Bank to adopt a more restrictive monetary policy than we had anticipated. At the same time, fiscal uncertainty leads to a deterioration of financial condition indexes, which ultimately suggests a weaker economic expansion for 2022.

There is an extended list of fiscal issues: *precatório* debt (government liabilities created by court rulings), raising *Bolsa Família* benefits, revenue losses due to the tax reform, PIS and Cofins tax exemptions for fuels, among others. In addition, room in the 2022 budget under the spending growth cap rule has been dwindling down as inflation expectations for 2021 rise. What is at stake, ultimately, is whether the current fiscal framework will remain in place. At this point, it is still unclear which solution will be adopted for *precatório* debt or to comply to the Fiscal Responsibility Law in the case of the creation of the *Auxílio Brasil* welfare program, and the debate is ongoing.

Until the outcome materializes, we have simulated the fiscal accounts under a specific set of assumptions. Assuming there will be no additional loss of revenue with the tax reform, or new tax exemptions, making *precatório* debt payments independent from the spending growth rule, which would require the spending cap to be re-estimated since 2016, would open up room for BRL 19 billion in additional spending in 2022. This would be sufficient to cover the increase in welfare spending sought by the administration. Incorporating this into our scenario, our forecast for the primary fiscal deficit in 2022 would rise from BRL 73bn currently to BRL 122bn, with gross public debt rising from 81.5%/GDP in 2021 to 83.2%/GDP by YE 2022[1].

Chart 1: Estimated gross debt
% of GDP



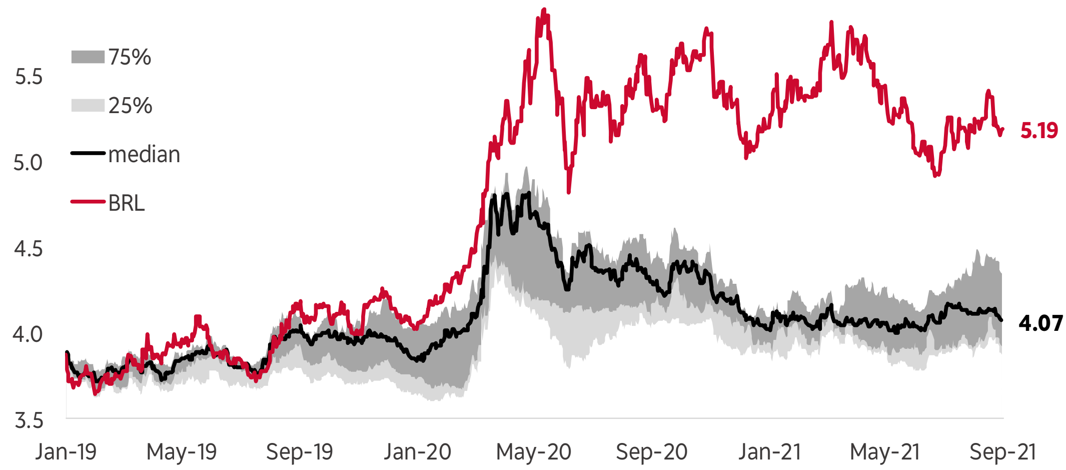
Source: BCB, Bradesco

[1] As we've described, many solutions were proposed for precatório debts and social programs, including a proposal by the CNJ that would allow the government to pay these debts in installments, maintaining the spending cap rule unchanged, and replacement the new social program with the extension of current pandemic-related emergency aid. The fiscal scenario that actually plays out may differ from this simulation, but the forecasts of other variables in the scenario consider this level of deficit, despite it being considered under another fiscal arrangement for this subject.

In this scenario, the BRL underperforms other EM currencies. While just a few months ago we saw several factors that would justify some BRL appreciation, fiscal issues will likely play a determinant role for the currency going forward. The fundamentals justifying BRL strength, such as the balance of payments and higher domestic interest rates, may still play a role. However, in light of the likelihood of greater public deficit, it is wise to adopt a more conservative stance in our forecast. Therefore, we revised our exchange rate estimate, now moving it between BRL/USD 5.00 and 5.50 by the end of next year, until the exact dimension of the fiscal issues is known.

Chart 2: BRL vs basket of 20 EM currencies

Median and percentiles for EM currencies



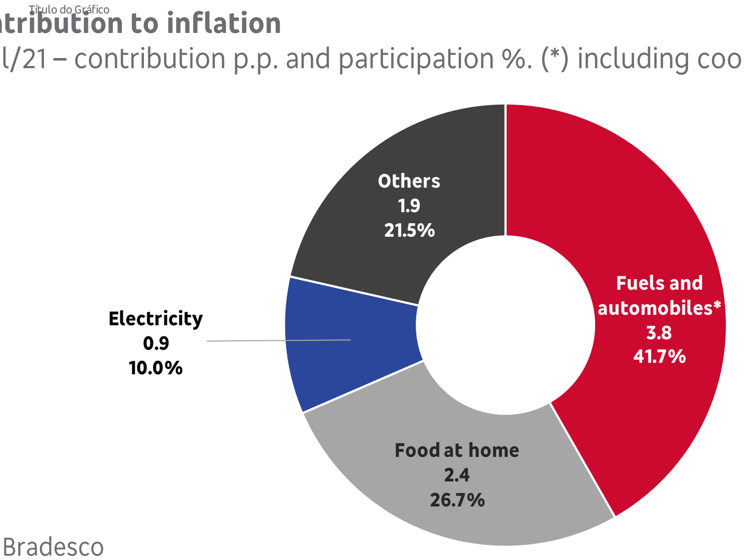
Source: Bloomberg, Bradesco

In line with this depreciation and other short-term surprises, we revised our forecast for IPCA inflation in 2021 from 7.1% to 7.8%. Industrial goods remain under pressure, and the economy's reopening has led to a greater demand for services, especially those linked to mobility. In addition, the unfavorable climate conditions have increased inflationary pressures on electricity, food and ethanol, with indirect impacts also on gasoline prices. Persistent high inflation, concentrated in groups such as food, energy and fuels, increases the risk of inflation inertia and indexation to past inflation. Although wages in the formal sector have been rising below inflation, increases in nominal terms have been significant, making the economy more resistant to disinflation.

Despite this persistence at a high level, a decline in inflation rate is still the most likely scenario for 2022. The expected deceleration of the economic activity, against a backdrop of slack in the job market, should contribute to ease inflationary pressures. In addition, the accommodation of commodity prices, along with the normalization of global production supply chains, may ease pressure from food and industrialized good prices. If an adequate fiscal framework remains in place, monetary and fiscal impulses will be significantly lower in the next few quarters. For now, we therefore maintained our forecast for 2022 inflation unchanged at 3.3%.

Chart 3: Contribution to inflation

Aug/20 to Jul/21 – contribution p.p. and participation %. (*) including cooking gas



Source: IBGE, Bradesco

As a result, the Central Bank's monetary policy committee reaffirmed that it will shift its policy stance to restrictive. The big dilemma for the monetary authority is that uncertainties regarding the domestic and fiscal scenarios could lead to a worsening of the inflation outlook for 2022, despite expectations that growth will be slower. In our view, however, as much as fiscal risks have increased, they have not yet materialized, either to the point of creating a relevant fiscal impulse or resulted in exchange rate depreciation that would lead to a new rise in inflation. In this context, considering that there are lags in the transmission of monetary policy, but that momentary policy has become more potent in Brazil in recent years, and assuming the an adequate fiscal framework is preserved, we forecast that the Central Bank of Brazil to raise the Selic rate to 7.50% and keep it at this level in 2022.

Even if the Selic rate does not rise far above our forecasts, the deterioration of financial conditions indexes affects the economy. Domestic uncertainties, which include electricity rationing risks, are added to the chances of a weaker commodity and global impulse. Therefore, we lowered our 2022 GDP forecast from 2.2% to 1.8%. However, regaining a more favorable prospects for next year does not seem farfetched. After all, credit is still growing, employing is lagging behind the economic cycle, companies are well capitalized and reforms have been implemented in recent years. But a strong expansion cycle in consumption and investments require fewer uncertainties. Otherwise, the variance of forecasts within the scenario will remain higher than usual.

Chart 4: Real interest rate

Swap pre-deflated by IPCA expectation

Source: Bloomberg, Bradesco

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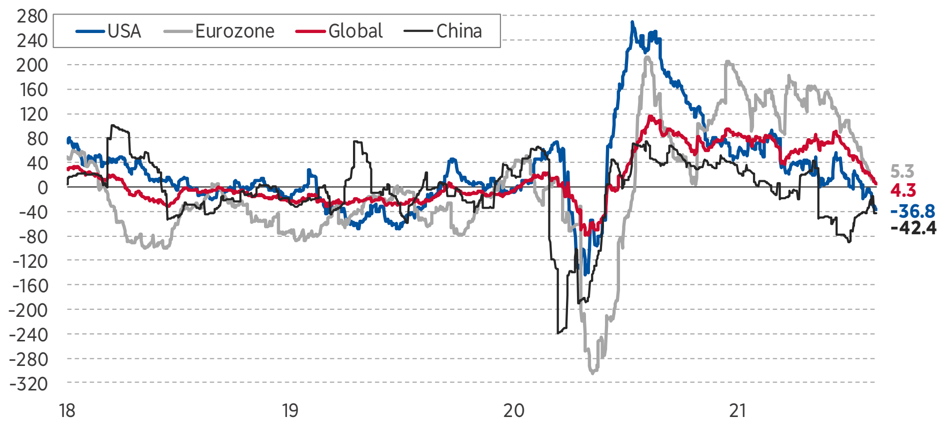
The global scenario remains positive, although some short-term calibrations are needed. Since July, the market has questioned the growth rate of the world's main economies, especially when it comes to the impacts of the new Covid-19 variant. For now, concerns haven't escalated, since multiple studies have confirmed the efficacy of vaccines. In addition, several countries will roll-out a third dose, and in many places, the upsurge in cases have not led to an increase in deaths, especially among those vaccinated. Still, many Asian countries have rolled back to mobility restriction measures, also because vaccination rollout in the region is slower.

In response to disappointing short-term economic data, we revised our global GDP forecast for this year to 6.1%, from 6.5% previously. Bearish revisions focused on China and the U.S. For 2022, we maintained forecast unchanged at 4.5%.

Chart 5: Economic surprise index



Source: Bloomberg

The notion that the growth and inflation peak has passed seems to be confirmed. The reopening of the global economy reopening has advanced significantly, though some restrictions will remain in place until vaccination efforts advance in more countries. Therefore, we should expect to see more moderate growth from now on. Meanwhile, the transitory nature of inflationary pressures has been confirmed, especially with the relief in commodity prices, which should lead to some easing of inflationary pressures over the next few quarters. Issues in supply chains, however, will likely continue to exert inflationary pressure.

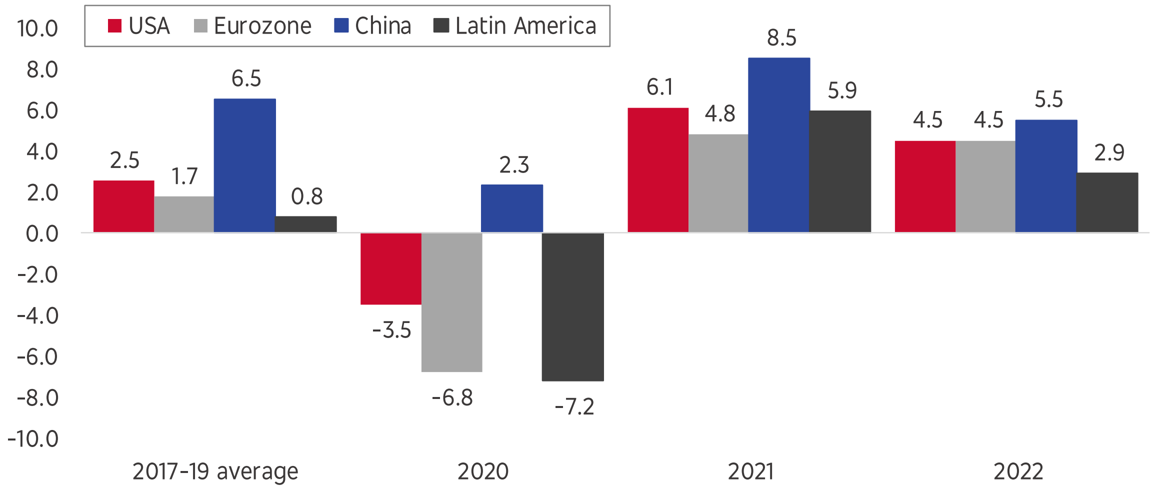
In the U.S., several economic indicators surprised negatively due to supply-side restrictions. Companies continue to struggle to hire and normalize production due to difficulties faced by global supply chains, leading to generalized cost spikes. However, except for some worsening of the pandemic, there has not been much of a decline in demand to speak about. Retail sales were weaker than expected, but remain at high levels in absolute terms. We revised our 2021 U.S. GDP growth forecast from 7% to 6.1%, but most of this downward revision is directly related to the negative surprise with the GDP in the second quarter rather than a weak outlook.

The Federal Reserve gave a clear sign that it will take the first step towards normalizing monetary policy. The minutes of the July Federal Open Market Committee (FOMC) meeting showed that a majority of members believe that if economic progress continues, it will be appropriate for the Fed to start tapering its asset purchases before the end of the year. At the same time, the Fed admitted it is concerned with the effects of the Delta variant on the economy, and members appear to be prepared to change their views if these materialize. Perhaps more important than the beginning of tapering will be how quickly the Fed decides to taper its purchases, as markets may interpret this as a clue regarding the timing of the first interest rate increases in the current cycle.

China's economic cycle, in turn, will fall back to levels closer to those seen before the pandemic, but with added challenges. The already expected economic slowdown will likely be a little more intense, as indicated by the July data[1]. Even so, the economic policy stance will likely remain neutral, with support for some sectors and tightening in others. The new shocks, such as the new pandemic wave and noise related to market regulation, led us to lower our 2021 GDP forecast from 9% to 8.5%.

Understanding the government's current priorities is just as important as the growth rate, which is pointing towards something around 5% and 5.5% by the end of the year. The government seems to be more focused on quality than quantity, with major implications for markets, as well as the political-economic dynamics. There are basically four main agendas: (i) control of systemic risks, including financial, housing sector, information or national security; (ii) geopolitical environment; (iii) social aspects, particularly the new "common prosperity" front; and (iv) implementing a five-year plan, focusing on technology, sustainability and the domestic market. The impact on the market and growth are unclear, but there could be significant volatility of interpretation and in asset prices until they are clarified.

Chart 6: USA, Eurozone, China and Latin America GDP
Annual change



Source: Bloomberg, Bradesco

In the Eurozone, the economy continued to recover on the back of progress on the vaccination front, particularly with regards to the services sector. Industry, on the other hand, continues to face shortages in some raw materials and components. We believe growth in Europe may outperform the U.S. over the next few months, assuming the region handles risks arising from the new Delta variant well. Still, looking ahead, fiscal policy was (and will continue to be) more restrictive. The European Central Bank recently reinforced its forward guidance on interest rates, aligning its strategy to pursue a 2% inflation rate symmetrically. We expected the announcement of some reduction in the pace of asset purchases in September, tapering the emergency purchase program adopted at the height of the pandemic, due to the improved growth and financial conditions.

In Latin America, overall, Q2 GDP surprised to the upside, but peak growth – related to the economic reopening – may now be behind us. We expect some moderation in the second half of the year, albeit still with strong expansion rates. Inflationary pressures have accelerated the normalization of economic policy in the region. With inflation above the target and concerns that temporary shocks could spill out into other prices, Mexico, Chile and Peru have already started to raise interest rates and the central bank of Colombia should follow in their footsteps over the next few months.

In conclusion, despite persistent uncertainties, the global scenario remains favorable, with stronger growth and signs of cooling inflation. Monetary policy normalization in emerging nations will likely remain ahead of developed countries, especially amidst a context of greater tolerance of the FED and the ECB. The evolution of the pandemic, the Fed's next steps and the intensity of China's economic slowdown will likely be the main drivers for asset prices in the coming months.

Table 1: Consumer inflation and interest rate. Selected countries

	Interest Rate (% p.a.)	Inflation (p.a.)	Real Interest Rate	Last Change	Magnitude (p.p.)	Date of last change	2021 Interest Rate (% p.a.)	2022 Interest Rate (% p.a.)	2021-2022 delta cycle (p.p.)
South Africa	3,50	4,60	-1,10	Cut	0,25	Jul-20	3,50	4,25	0,75
Australia	0,10	2,50	-2,40	Cut	0,15	Nov-20	0,10	0,10	0,00
Brazil	5,25	8,99	-3,74	Raise	1,00	Aug-21	7,50	7,50	2,25
Canada	0,25	3,70	-3,45	Cut	0,50	Mar-20	0,25	0,55	0,30
Chile	1,50	4,50	-3,00	Raise	0,75	Aug-21	1,65	2,95	1,45
China	4,65	1,00	3,65	Cut	0,10	Apr-20	4,30	4,30	-0,35
Colombia	1,75	4,44	-2,69	Cut	0,25	Sep-20	2,45	3,70	1,95
South Korea	0,75	2,60	-1,85	Raise	0,25	Aug-21	0,75	1,25	0,50
USA	0,25	5,40	-5,15	Cut	1,00	Mar-20	0,25	0,35	0,10
India	4,00	5,59	-1,59	Cut	0,40	May-20	4,00	4,40	0,40
Indonesia	3,50	1,59	1,91	Cut	0,25	Feb-21	3,50	3,90	0,40
Japan	-0,10	-0,30	0,20	Cut	0,20	Jan-16	0,00	0,00	0,10
Malaysia	1,75	2,20	-0,45	Cut	0,25	Jul-20	1,75	2,05	0,30
Mexico	4,50	5,81	-1,31	Raise	0,25	Aug-21	5,00	5,50	1,00
Norway	0,00	3,00	-3,00	Cut	0,25	May-20	0,45	0,95	0,95
New Zealand	0,25	1,30	-1,05	Cut	0,75	Mar-20	0,75	1,20	0,95
Peru	0,50	2,77	-2,27	Raise	0,25	Aug-21	0,35	0,85	0,35
Poland	0,10	5,40	-5,30	Cut	0,40	May-20	0,15	0,75	0,65
United Kingdom	0,10	3,80	-3,70	Cut	0,15	Mar-20	0,10	0,30	0,20
Czech Republic	0,75	3,40	-2,65	Raise	0,25	Aug-21	1,50	2,00	1,25
Russia	6,50	6,50	0,00	Raise	1,00	Jul-21	6,95	6,05	-0,45
Sweden	0,00	1,40	-1,40	Raise	0,25	Dec-19	0,00	0,00	0,00
Thailand	0,50	-0,02	0,52	Cut	0,25	May-20	0,45	0,50	0,00
Taiwan	1,13	1,95	-0,83	Cut	0,25	Mar-20	1,15	1,25	0,13
Turkey	19,00	19,25	-0,25	Raise	2,00	Mar-21	17,40	12,75	-6,25
Eurozone	0,00	3,00	-3,00	Cut	0,05	Mar-16	0,00	0,00	0,00

Source: Bloomberg

Macroeconomic Projections (2017 – 2022)

	2017	2018	2019	2020	2021*	2022*
DOMESTIC ACTIVITY, INFLATION AND INTEREST RATES						
GDP (%)	1.3	1.8	1.4	-4.1	5.2	1.8
Agriculture (%)	14.2	1.3	0.6	2.0	3.1	2.1
Industry (%)	-0.5	0.7	0.4	-3.5	5.4	1.5
Services (%)	0.8	2.1	1.7	-4.5	4.7	1.6
Private consumption (%)	2.0	2.3	2.2	-5.5	6.0	2.3
Government consumption (%)	-0.7	0.8	-0.4	-4.7	1.1	0.3
Investment (%)	-2.6	5.2	3.4	-0.8	12.8	1.3
Exports of goods and services (%)	4.9	4.1	-2.4	-1.8	2.1	4.5
Imports of goods and services (%)	6.7	7.7	1.1	-10.0	13.7	2.4
GDP (R$ billion - current prices)	6,585	7,004	7,407	7,448	8,537	9,085
GDP (US$ billion)	2,063	1,916	1,878	1,445	1,634	1,711
Population (million)	207.7	209.2	210.7	212.1	213.4	214.7
Per Capita GDP (US$ - current prices)	9,935	9,161	8,914	6,815	7,657	7,968
Industrial Production - IBGE (%)	2.5	1.0	-1.1	-4.5	5.4	1.5
Unemployment Rate - IBGE (%)	12.7	12.3	11.9	13.2	13.8	12.4
Retail Sales - (%)	2.0	2.3	1.9	1.2	5.4	2.0
CPI - IPCA - IBGE (%)	2.95	3.75	4.31	4.52	7.76	3.34
WPI - IGP-M - FGV (%)	-0.52	7.54	7.30	23.14	18.62	4.05
Nominal Interest Rates - Selic target (end of period - %)	7.00	6.50	4.50	2.00	7.50	7.50
Nominal Interest Rates - Selic target (12-month - %)	10.0	6.42	5.9	2.8	4.2	7.4
Real Interest Rates - Selic (12-month - %)	6.8	2.6	1.6	-1.7	-3.3	3.9
EXTERNAL ACCOUNTS AND FX						
Trade Balance (US$ billion)	64.0	53.0	40.5	43.2	71.4	83.0
Exports (US$ billion)	218	240	226	211	284	281
Imports (US$ billion)	154	186	185	167	213	198
Trade flow (exports + imports) (% of GDP)	18.0	22.2	21.9	26.2	30.4	28.0
Current Account Deficit (US$ billions)	-15	-42	-51	-13	9	11
Current Account Deficit (% of GDP)	-1.1	-2.7	-3.5	-1.7	0.5	0.6
Foreign Direct Investment (US$ billions)	69	78	69	34	49	62
FX - end of period (R$ / US$)	3.31	3.87	4.03	5.20	5.00	5.50
FX - yearly average (R$ / US$)	3.19	3.65	3.94	5.15	5.22	5.31
Moody's sovereign credit rating	Ba2	Ba2	Ba2	Ba2	-	-
S&P sovereign credit rating	BB	BB-	BB-	BB-	-	-
FISCAL ACCOUNTS						
Primary Surplus (R$ billions)	-111	-108	-62	-703	-110	-102
Primary Surplus (% of GDP)	-1.7	-1.5	-0.8	-9.4	-1.3	-1.1
Gross Public Debt (domestic and external) (% of GDP)	73.7	75.3	74.3	88.8	81.5	83.2
Net Public Debt (domestic and external) (% of GDP)	51.4	52.8	54.6	62.7	60.1	62.3
CREDIT						
Total Credit growth (% YoY)	-0.4	5.1	6.5	15.6	12.0	9.3
Non-earmarked Credit growth (% YoY)	1.9	10.9	14.0	15.4	14.3	12.3

International indicators (2017 – 2022)

	2017	2018	2019	2020	2021*	2022*
GDP						
World	**3.8**	**3.5**	**2.8**	**-3.3**	**6.1**	**4.5**
Developed markets	**2.4**	**2.3**	**1.6**	**-4.8**	**5.3**	**4.1**
United States	2.3	3.0	2.3	-3.5	6.1	4.5
Euro Area	2.3	1.8	1.1	-6.8	4.8	4.5
United Kingdom	1.7	1.4	1.0	-10.2	6.5	5.0
Japan	1.7	0.8	0.9	-4.8	2.0	2.5
Emerging markets	**4.8**	**4.5**	**3.7**	**-2.2**	**6.6**	**5.0**
China	6.9	6.5	6.1	2.3	8.5	5.5
Latin America	1.2	1.0	0.1	-7.2	5.9	2.9

International indicators – Latin America (2017 – 2022)

	2017	2018	2019	2020	2021*	2022*
Argentina						
GDP (%)	2.7	-2.5	-2.2	-11.0	6.0	2.5
CPI (%)	24.8	47.7	53.8	36.1	45.5	39.7
Interest rate (%)	29.20	60.31	44.85	26.95	40.00	37.00
ARS/US$ (end of period)	18.6	37.7	59.9	84.1	119.0	152.0
Brazil						
GDP (%)	1.3	1.8	1.4	-4.1	5.2	1.8
CPI (%)	2.9	3.7	4.3	4.5	7.8	3.3
Interest rate (%)	7.00	6.50	4.50	2.00	7.50	7.50
BRL/US$ (end of period)	3.31	3.87	4.03	5.20	5.00	5.50
Chile						
GDP (%)	1.2	3.9	1.1	-6.0	7.5	3.5
CPI (%)	2.3	2.6	3.0	3.0	3.8	3.0
Interest rate (%)	2.50	2.75	1.75	0.50	2.50	3.00
CLP/US$ (end of period)	615	694	752	712	720	725
Colombia						
GDP (%)	1.4	2.5	3.3	-6.8	6.0	3.5
CPI (%)	4.1	3.2	3.8	1.6	2.8	3.0
Interest rate (%)	4.75	4.25	4.25	1.75	2.25	3.00
COP/US$ (end of period)	2,987	3,250	3,277	3,430	3,685	3,580
Mexico						
GDP (%)	2.1	2.1	-0.1	-8.2	6.5	3.0
CPI (%)	6.8	4.8	2.8	3.2	5.1	3.5
Interest rate (%)	7.25	8.25	7.25	4.25	5.00	5.50
MXN/US$ (end of period)	19.66	19.65	18.93	19.91	19.90	20.50
Peru						
GDP (%)	2.5	4.0	2.2	-11.0	9.0	4.0
CPI (%)	1.4	2.2	1.9	2.0	2.8	2.2
Interest rate (%)	3.25	2.75	2.25	0.25	1.00	1.50
PEN/US$ (end of period)	3.24	3.37	3.31	3.62	3.90	3.70

(*): (estimate)
Source: IMF, Bradesco

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