Brazil Monthly Economic Report, No. 333

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EXECUTIVE SUMMARY

1. Government
- ✓ Current fiscal figures are worse than expected
- ✓ Government got approved some of the bills to increase revenues
- ✓ But market is still skeptical about zero primary balance in 2024
- ✓ Recently, political pressures arose the possibility of the government easing the target in the short-run

2. Economic Activity
- ✓ Activity figures in the 3rd quarter are coming worse than expected
- ✓ We revised our call for 3rd quarter GDP to -0.5% from +0.2%
- ✓ We also revised our forecast for the whole 2023 to 2.9% from 3.2% and 2024 to 1.7% from 2.1%

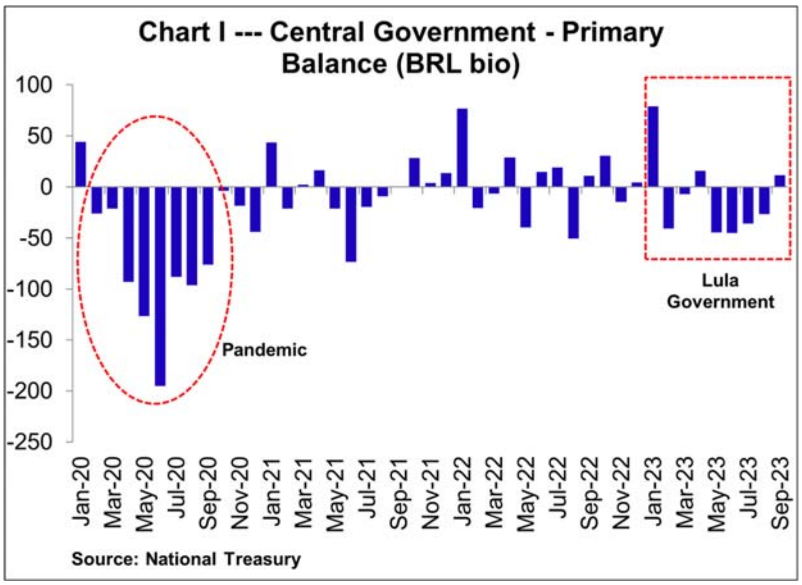
3. Monetary Policy
- ✓ The Central Bank cut the Selic policy rate by 50bps to 12.25%
- ✓ Inflation scenario continues improving, but the Israel-Hamas conflict besides the fiscal situation pose risk to the inflation
- ✓ We keep our call of Selic rate ending 2023 at 11.75% and 2024 at 9.00%

4. External Sector
- ✓ BRL depreciated 1% in October and it has been driven by the impact of USD on EM currencies
- ✓ Interest rate differential might play a fundamental role on BRL as well as the fiscal uncertainty
- ✓ We maintain our expectation of USDBRL ending 2023 at 5.20

1. FISCAL ACCOUNTS CONCERNING AGAIN

The fiscal concerns have emerged again after the recent deterioration of the fiscal figures and comments that the 2024 zero primary balance is too aggressive. Just to remember, when the new fiscal framework passed at the Congress in June, it was set that the primary balance would move from 1% of GDP deficit this year to zero in 2024, a surplus of 0.5% in 2025 and surplus of 1.0% in 2026. Such gradual improvement of the fiscal accounts would be based on revenues increases, once the fiscal framework defined that expenditure would increase each year between 0.6% and 2.5% in real terms. In line with these fiscal goals, the government sent to the Congress a set of measures to increase tax collection.

Starting by the recent situation, the monthly primary balances posted predominantly deficits along 2023, implicating in some deterioration compared to the situation of the public accounts after the pandemic (Chart I). Indeed, while we saw revenues .dropping 3.9% in real terms in 12-month ending in September, expenditures soared 4.4% in the same period, also in real terms. The fourth quarter is seasonally deficient as there are some extra expenditures with payroll and social security. The government official forecast is a deficit of 1.0% of GDP this year, but our call is 1.4%, what means that the starting point to zero the primary balance is worse than expected by the government when they declared be necessary to increase revenues by BRL 168 billion next year. It means, the revenue increase might be even higher than expected by the government to zero the primary balance in 2024.



Besides this worse starting point, the government faced some hurdles to pass the bills that increase revenues, but it has been progressing with the approval of most of the initiatives with minimum dilution of them. The table I summarizes the current status of these bills. The Congress has already approved bills that potentially increase revenues by BRL 97.8 billion in 2024 or 58% to whole amount expected by the government. Other bills have been discussed and analyzed at the Congress and they might be approved soon. The problem here is not the approval process at the Congress, but the government estimate. For example, the CARF tax appeal court represent the lion share of the government forecast, but market considers about 60% of the government estimate as viable once it is likely that collection may be smaller once the company that loses in the judgment at Carf would appeal to the court again or even to the Justice, frustrating 2024 revenue. Moreover, it seems that the court would need to have many extra sessions along the year in order to meet the revenue increase expected. In sum, the market expects that roughly BRL 80-90 billion would be a good estimate for the whole revenue increase, well below the BRL 168 billion number.

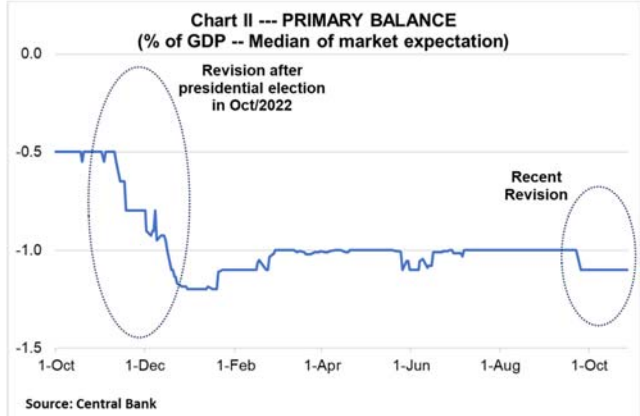
TABLE I
BILLS TO INCREASE THE GOVERNMENT REVENUES IN 2024

bill	expected revenue (BRL billion)	stage at the congress
total	168.1	--x--
tiebreaking vote on the board of tax appeals (CARF)	54.7	approved
flexible rules for tax payments being negotiated at administrative level	43.1	approved
ICMS state tax subventions not being exempted from federal taxes	37.0	at the congress
tax on exclusive funds	13.2	at the congress
tax on offshore funds	7.1	at the congress
end of tax benefits on interest on equity	10.0	at the congress
tax on sports betting	1.0	at the congress
others	2.0	--x--

Source: government

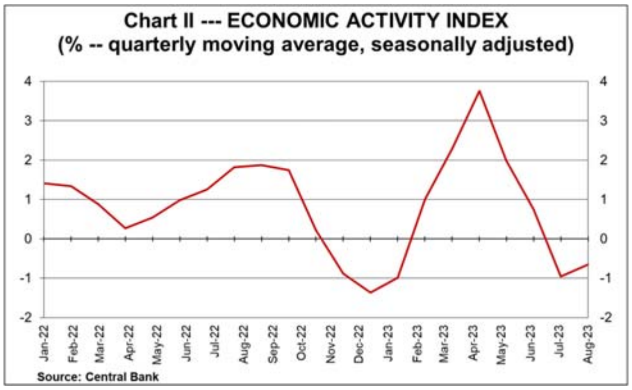
To turn the situation worse, there are government and Congress initiatives that reduce revenues or increase expenditures, making the target of zero primary balance in 2024 even more challenging. From the government side, there is the initiative of advancing the payments of the so called "precatórios", which are expenditures generated by losing legal sues and which payments have been postponed. The amount involved is around BRL 95 billion or 0.87% of GDP. The government is waiting for the Supreme Court decision about how to register these payments, as the government proposed to include the principal in the primary balance and the financial expenses out of it. Although this maneuver reduces the impact in the primary balance, the impact on the debt is fully incorporated. Moreover, it hurts the confidence on the fiscal accounts in terms of credibility of its accuracy. From the Congress, lawmakers passed the bill that maintain payroll tax breaks expected to expire in the end of 2023, but it was renewed until the end of 2027. The impact is a reduction of tax collection by BRL 19 billion per year.

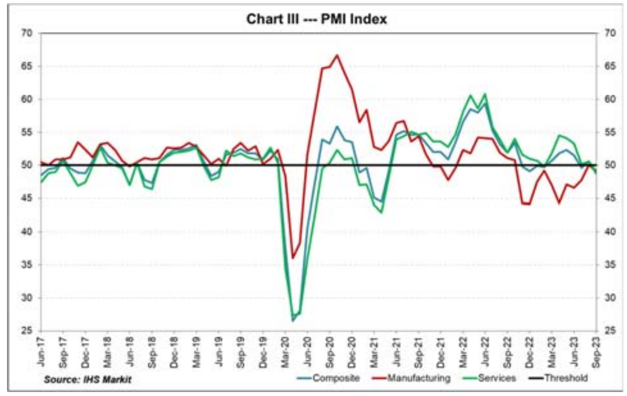
Despite the tough fiscal scenario, market wasn't surprised as since the election of president Lula in October 2022 and even after the approval of the fiscal framework, the expectation was a primary deficit. Chart II depicts this scenario, with market expecting a higher deficit after the election, improving a bit after the details of the new framework was released and worsening a bit more recently with the worse current fiscal figures. In that sense, not meeting the primary balance target in 2024 wouldn't be a surprise and it was already incorporated in the price. However, the situation changed when it was clear that the political wing was pressuring for easing the fiscal target. Rumors that the target would be eased now, during the vote of the 2024 budget in the Congress stressed the market. There are several problems that arise from this political interference: i) the approval of the remaining bills that increase revenues would become more difficult. If the government is not committed to the target, why lawmakers would approve unpopular bills as increasing tax burden; ii) not pursuing next year target a few months after the new fiscal framework is approved is a loss of credibility in the fiscal policy of the government; and iii) minister Haddad would weaken under the higher influence of the political wing of the government, raising doubts about the economic goals supported by the minister. In sum, this context raised the noise about the fiscal situation without changing materially the market expectation for the fiscal accounts.



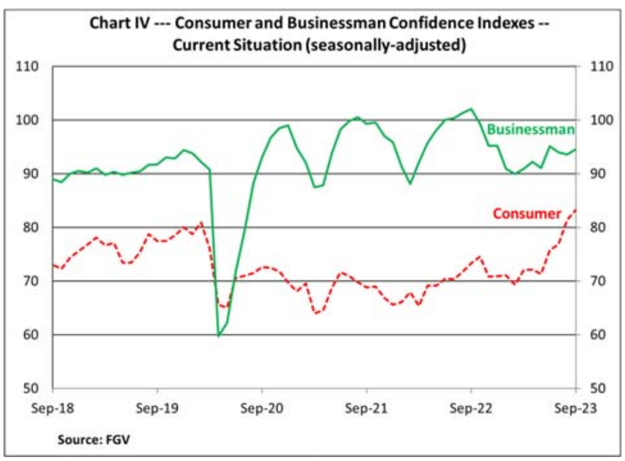
2. SLOWDOWN OF ACTIVITY JUST ARRIVED

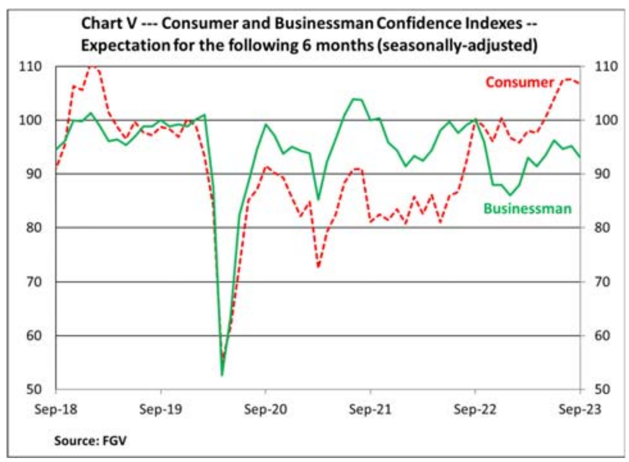
If the first and second quarters surprised positively the market in terms of activity, indicators of the third quarter are posting worse than expected figures. The deceleration was already expected, but it hasn't been translated into GDP figures until now. Such slowdown was already clear looking to the high frequency indicators. Indeed, the quarterly moving average of the economic index peaked in April and entered in the negative territory in July (Chart II). PMI index moved to the contraction area below the 50 threshold in September for services, while manufacturing has been in this area since last year (chart III).





Another indicator of this slowdown is the confidence index. Although the headline indicator doesn't show that, the scenario becomes clearer when we break the index into its two components. The current situation is sustaining some demand (chart IV), but the expectation for the following 6 months has already been posting signs of reduction, specially for the business indicator (chart V).





Under such weaker scenario, we revised down our call for the third quarter to a retraction of 0.5% from a growth of 0.2% over the previous quarter, seasonally adjusted. We also maintained the expectation of a 0.2% growth in the last quarter. As a result, we reduced the 2023 growth expectation to 2.9% from 3.2%. The 2024 call was also affected as of the change of the calculation base: to 1.7% from 2.1%. Looking at the components, the table II shows that growth expected for this year is concentrated on agriculture and services, looking to the production side, and on consumption, looking to the production side. In 2024, growth would be more evenly distributed among the sectors.

TABLE II

GDP Forecast

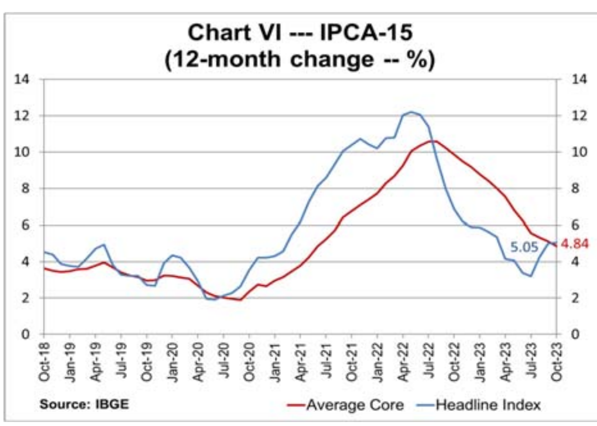
(%)	2023	2024
GDP	2.9	1.7
Production Side		
Agriculture	11.5	1.5
Industry	1.8	1.8
Services	2.3	1.7
Demand Side		
Household Consumption	2.8	1.7
Government Consumption	1.8	1.5
Gross Fixed Capital Formation	-2.0	2.5
Exports	7.0	1.5
Impots	1.1	2.0

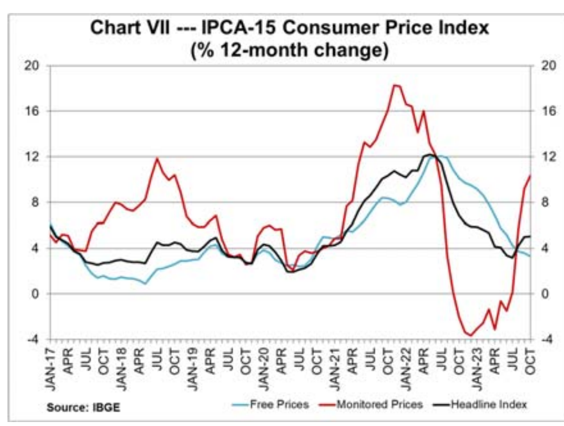
Source: MUFG Brasil

3. FURTHER RATE HIKES AHEAD

On November 01st, the Central Bank (CB) reduced the Selic policy rate by 50bps to 12.25% in a unanimous decision. The communiqué came in line with the previous one, highlighting the positive evolution of the inflation scenario, but reinforcing the risk coming from the external environment and the fiscal situation.

The inflation scenario improved in the last readings, although current inflation is still at high levels, what justifies the Central Bank keeping the monetary policy in the restrictive area despite having already started the easing cycle. Indeed, the average core inflation has reduced meaningfully, while free prices, that reflects better demand, are at a much lower level than monitored ones, as depicted in charts VI and VII. Such improvement was better than we were expecting, making us revise down 2023 inflation to 4.6% from 5.0%, while maintaining our 2024 call at 3.5%





Such improvement made market start to price a speed up to 75bps cuts. However, the beginning of the conflict in the Middle East that may potentially impact inflation through oil prices and BRL depreciation in a risk-off scenario, reversed such bets. The recent deterioration of the fiscal scenario prompted some expectations of slowing down the easing pace to 25bps. We consider it too early to make such a call as the inflation scenario depends on the development of such events. Inflation would be contaminated by the conflict in case of a more sustainable surge on oil prices and also more significant BRL depreciation provoked by a risk-off scenario, conditions that are not still present. On the fiscal side, the political pressure for easing the 2024 fiscal goal seems to damage more the government credibility than have an effective impact once market scenario is much worse than the goal, it means, only further deterioration of the current scenario may produce some impact on inflation.

In sum, we maintain our view of the Central Bank keeping the easing pace at 50bps in the following meetings before slowing down to 25bps by the middle of 2024. Our forecast is the Selic policy rate ending 2023 at 11.75% and 2024 at 9.00%.

4. EXTERNAL ENVIRONMENT DRIVING BRL

In October, BRL depreciated 1% to 5.0575. BRL has been hovering around the psychological 5.00 level since the end of September, not consolidating a weakening or strengthening trend. Basically, BRL followed the mood swings in the international market as there were no domestic drivers to influence the rate. Such mood moved from the expectation of a more hawkish FED to a not so hawkish one, impacting on EM currencies as a whole. In the domestic market, the approval of bills that increases government revenues and helps to meet the fiscal goal of zeroing the primary balance in 2024, was a positive driver but it was reversed after the president Lula declared to the press that it will be very difficult for the government to meet the fiscal target in 2024 and he is not willing to cut expenditure, especially investments, to achieve it. The fiscal concern continues in place. Despite that, the net balance was positive for BRL. However, we continue working with a more weakened currency in the coming weeks as of the shrinkage of the interest rate differential. FED kept FFR unchanged at 5.50% while BCB cut the Selic policy rate 50bps to 12.25%. Recently, part of the market have been working with a reduction of the cutting pace to 25bps, what brought some support to BRL, but after better-than-expected inflation figures, such bets reduced. That means that the interest rate differential might continue to shrink at a point to weigh more on BRL as the return compared to the sovereign risk in a more challenging international environment will drive some depreciation. We keep our call of USD/BRL at 5.20 at the end of the year.

MACROECONOMIC DATA FORECAST

	actual data											forecast	
	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
real GDP growth (%)	1.9	3.0	0.5	-3.5	- 3.3	1.3	1.8	1.2	-3.3	5.0	2.9	2.9	1.7
exchange rate (USDBRL -- yearend)	2.04	2.34	2.66	3.90	3.26	3.31	3.87	4.03	5.20	5.58	5.22	5.20	5.30
(% change)	8.9	14.6	13.4	47.0	-16.5	1.5	17.1	4.1	29.0	7.3	-6.5	-0.4	1.9
exchange rate (USDBRL -- average)	1.96	2.16	2.35	3.33	3.49	3.19	3.65	3.95	5.15	5.39	5.17	5.04	5.25
(% change)	16.7	10.5	9.0	41.5	4.8	-8.6	14.5	8.1	30.4	4.7	-4.1	-2.5	4.2
IPCA (%)	5.8	5.9	6.4	10.7	6.3	2.9	3.8	4.3	4.5	10.1	5.8	4.6	3.5
Selic policy rate (% per annum -- yearend)	7.25	10.00	11.75	14.25	13.75	7.00	6.50	4.50	2.00	9.25	13.75	11.75	9.00
Real rate (Selic/IPCA)	1.4	3.9	5.0	3.2	7.0	4.0	2.6	0.2	-2.4	-0.8	7.5	6.8	5.3

Sources: IBGE; Central Bank; Own Forecast

KEY ECONOMIC AND FINANCIAL INDICATORS

	Oct	Nov	Dec/22	Jan/23	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Year-to-Date
01- GDP Growth (%)													
Quarter over the previous quarter (seasonally adjusted)			0.1			1.8			0.9				--x--
Quarter over the same quarter of the previous year			1.9			4.0			3.4				--x--
Last 12 months			2.9			3.3			3.2				--x--
02 - Central Bank's Economic Activity Index													
% change over the previous month (seasonally adjusted)	-0.2	-1.4	0.8	0.2	3.1	-0.2	1.0	-1.9	0.2	0.4	-0.8		3.1
03 - Industrial Production													
% change over the previous month (seasonally adjusted)	1.3	0.2	0.0	-0.3	-0.2	1.2	-0.7	0.3	0.0	-0.6	0.4		-0.3
04 - Vehicle Production (1,000 units -- excluding CKD's)	206.0	215.8	191.6	152.7	161.5	221.8	178.9	227.9	189.2	183.0	227.0	208.9	1750.8
Domestic Sale (1,000 units)	158.9	174.0	187.2	122.4	112.4	171.4	138.1	149.1	161.6	195.9	173.9	167.8	1392.6
Export (1,000 units -- excluding CKD's)	42.8	43.4	31.2	33.0	35.7	45.4	34.0	45.7	36.6	30.5	34.5	27.4	322.9
Import (1,000 units)	22.0	30.0	29.7	20.4	17.5	27.5	22.7	27.5	27.9	29.7	33.8	30.0	237.1
05 - Retail Sales (% change over the previous month -- seasonally adjusted)	0.2	-0.7	-3.0	4.0	0.0	0.7	0.0	-0.6	0.1	0.7	-0.2		1.6
06 - Services Survey (% change over the previous month -- seasonally adjusted)	-0.3	0.0	2.6	-3.4	0.9	1.1	-1.7	1.5	0.2	0.4	-0.9		4.1
07 - National Unemployment Rate (%)	8.3	8.1	7.9	8.4	8.6	8.8	8.5	8.3	8.0	7.9	7.8	7.7	--x--
08 - Inflation (%)													
IPCA (Brazil Consumer Price Index)	0.59	0.41	0.62	0.53	0.84	0.71	0.61	0.23	-0.08	0.12	0.23	0.26	3.5
FIPE (São Paulo City Consumer Price Index)	0.45	0.47	0.54	0.63	0.43	0.39	0.43	0.20	-0.03	-0.14	-0.20	0.29	2.0
IGP-DI (General Price Index)	-0.62	-0.18	0.31	0.06	0.04	-0.34	-1.01	-2.33	-1.45	-0.40	0.05	0.45	-4.9
IPA-DI (Wholesale Price Index)	-1.04	-0.43	0.32	-0.19	-0.04	-0.71	-1.56	-3.37	-2.13	-0.61	0.10	0.51	-7.8
09 - Overnight (effective % per annum)													
SELIC rate	13.65	13.65	13.65	13.65	13.65	13.65	13.65	13.65	13.65	13.65	13.19	12.97	9.92
CDI (Interbank)	13.65	13.65	13.65	13.65	13.65	13.65	13.65	13.65	13.65	13.65	13.19	12.97	9.92
10 - São Paulo Stock Market Index (% Change)	5.45	-3.06	-2.45	3.37	-7.49	-2.91	2.50	3.74	9.00	3.27	-5.09	0.71	6.22
11 - Exchange Rate (BRL/USD) - End of Period; Selling Rate	5.2570	5.2941	5.2177	5.0993	5.2078	5.0804	5.0007	5.0959	4.8192	4.7415	4.9219	5.0076	--x--
Devaluation (positive) / Appreciation (negative) -- %	-2.77	0.71	-1.44	-2.27	2.13	-2.45	-1.57	1.90	-5.43	-1.61	3.80	1.74	-4.03
12 - SISBACEN Exchange Transactions (USD mio)													
Foreign Trade - Net	-735	-1,226	-1,779	1,791	3,678	7,147	5,961	6,637	3,832	4,688	5,814	3,300	42,848
Financial - Net	506	3,130	-12,029	2,378	1,096	-3,402	-5,333	-7,794	-975	-2,174	-1,020	-4,965	-22,189
Overall Balance - Net	-228	1,903	-13,808	4,169	4,774	3,745	627	-1,157	2,857	2,514	4,795	-1,665	20,660
13 - Foreign Reserve -- international liquidity concept (USD bio)	329,546	335,505	337,703	343,622	338,098	345,658	347,725	344,489	343,620	345,476	344,177	340,324	--x--

Sources and Notes: 01 -- IBGE; 02 -- Central Bank, 03 -- IBGE, Year-to-Date: Cumulative data in the year over the same period of the former year; 04 -- Anfavea
05 -- IBGE, Year-to-date: same note of item 03; 06 -- IBGE, Year-to-date: same note of item 03; 07 -- IBGE/PNAD survey (3-month moving average)
08 -- IBGE, FIPE, FGV -- IGP-M is composed by 60% of IPA (Wholesale Price Index); 30% of IPC (Consumer Price Index) and 10% of INCC (National Civil Construction Index)
09 -- Central Bank, Cetip, Year-to-Date: effective rate in the period; 10 -- Bovespa; 11, 12, 13 -- Central Bank

KEY ECONOMIC AND FINANCIAL INDICATORS

	Oct	Nov	Dec	Jan/23	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Year-to-Date
14 - Foreign Trade Balance (USD mio)	3,375	6,200	4,533	2,310	2,567	10,738	7,929	10,959	10,048	8,213	9,586	8,904	71,254
Export	26,852	27,652	26,342	22,821	20,241	32,810	27,078	32,659	29,582	28,306	31,059	28,431	252,987
Import	23,477	21,452	21,809	20,512	17,674	22,072	19,149	21,700	19,534	20,093	21,473	19,527	181,733
15 - Current Account Balance (USD mio)	-5,808	-1,674	-11,455	-8,946	-4,367	678	-876	199	-1,336	-4,032	-778		-19,459
16 - Domestic Public Security Debt in the market (USD bio)	1,052	1,060.8	1,092.2	1,085.4	1,054.3	1,113.8	1,157.9	1,131.7	1,236.2	1,247.1	1,224.7	1,165.0	--x--
17 - Monetary Base (USD bio)	75.8	74.0	80.4	81.1	77.5	81.4	82.1	77.8	83.6	83.3	81.2		--x--
M1 -- Money Supply (USD bio)	112.0	112.9	122.1	115.9	113.3	115.1	117.8	113.4	122.1	130.0	122.7		--x--
Saving Passbook Accounts (1)	188.6	186.7	191.5	190.7	186.7	191.0	193.9	189.1	200.8	205.2	197.7		--x--
Private bonds (2)	623.4	624.7	645.1	679.0	667.6	699.9	736.4	738.6	801.1	821.7	805.6		--x--
M2 (M1+1+2) (USD bio)	923.9	924.2	958.6	985.6	967.8	1,005.9	1,048.1	1,041.2	1,124.0	1,156.9	1,126.0		--x--
Fixed Income Mutual Fund (3)	866.7	855.7	851.3	872.0	856.7	881.7	894.4	882.9	954.0	983.4	956.5		--x--
Repo Operations with Federal Bill/Bond (4)	27.2	19.6	18.5	22.4	21.3	22.1	23.8	26.7	26.8	28.1	23.9		--x--
Repo Operations with Private Bill/Bond (5)	11.6	12.4	17.0	12.2	11.3	16.6	13.7	15.1	18.3	15.1	16.5		--x--
M3 (M2+3+4+5) (USD bio)	1,829.4	1,811.9	1,845.3	1,892.3	1,857.2	1,926.4	1,980.0	1,965.9	2,123.0	2,183.5	2,122.9		--x--
T Bill/Bond (6)	172.4	180.3	190.6	194.6	211.1	212.2	204.4	212.1	200.6	204.1	193.3		--x--
M4 (M3+6) (USD bio)	2,001.9	1,992.2	2,035.9	2,086.9	2,068.3	2,138.7	2,184.4	2,178.0	2,323.7	2,387.6	2,316.3		--x--
18 - Fiscal Balance (% of GDP -- Last 12 Months)													
Nominal Concept	-4.11	-4.52	-4.64	-4.98	-5.62	-6.09	-5.90	-6.39	-6.41	-6.95	-7.30		--x--
Federal Government and Central Bank	-4.26	-4.48	-4.52	-4.78	-5.30	-5.59	-5.34	-5.65	-5.64	-6.13	-6.31		--x--
State and Municipalities	0.16	-0.04	-0.14	-0.14	-0.25	-0.43	-0.50	-0.67	-0.69	-0.76	-0.92		--x--
Public Owned Companies	0.00	0.00	0.015	-0.05	-0.07	-0.07	-0.07	-0.07	-0.08	-0.06	-0.06		--x--
Primary Concept	1.78	1.40	1.27	1.23	0.93	0.74	0.55	0.38	-0.23	-0.77	-0.70		--x--
Federal Government and Central Bank	0.85	0.64	0.55	0.57	0.37	0.34	0.22	0.19	-0.40	-0.90	-0.67		--x--
State and Municipalities	0.89	0.72	0.65	0.67	0.58	0.41	0.35	0.21	0.19	0.13	-0.02		--x--
Public Owned Companies	0.04	0.05	0.06	0.00	-0.02	-0.02	-0.02	-0.01	-0.03	-0.01	-0.01		--x--

Sources and Notes: 14 -- Development, Industry and Foreign Trade Ministry; 15, 16, 17 -- Central Bank
18 -- Central Bank -- The Nominal Concept includes all financial cost and the primary concept doesn't

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