

Macro Monthly Letter OCTOBER 2020

Choices and noises

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September confirmed its historical reputation for being a month of market volatility. The approaching US election, the advance of a second wave of Covid-19 in Europe and doubts about the pricing of various assets since the global recovery is as yet incomplete were the main drivers of a correction and significant volatility on global markets. In Brazil the instability was bolstered by fresh noise relating to the fiscal consolidation process.

In the US, attentions turned to the political arena. With the end of the additional unemployment insurance payments in July and the deadlock in negotiations on a new round of fiscal stimulus, the economic recovery began showing signs of deceleration. The economic impact of each candidate's proposals moved to the fore as election day approaches and the polls continued to show Joe Biden leading the presidential race. In particular, the markets were concerned with the effect on corporate profitability of the Democrats' proposals to raise business taxes by partially reversing the Trump administration's tax cuts, and to tighten regulation of the tech giants.

The naturally volatile climate of a presidential election campaign was made even more uncertain by noise relating to the counting of mail-in votes. The prospect that a larger-than-usual proportion of the electorate will vote by mail rather than in person in order to avoid exposure to the coronavirus points to a strong likelihood that the outcome of the election may not be known for some time after November 3, and that the name of the next president may have to be decided by the Supreme Court – as anticipated by Trump's warnings about "voter fraud" and a "corrupt" election – and that the US will become even more politically polarized as a result.

In Brazil, the noise again emanated above all from the issue of fiscal choices. With the debt-to-GDP ratio set to reach 95% this year – far above the emerging-market country average, which is 62% – hard decisions must be made if a firm signal is to be sent that debt sustainability is on the horizon. The tax burden is already high for the nation's level of income, and a revision of tax breaks and mandatory expenditure would be not just the most economically efficient way forward but the one most compatible with the philosophy of the spending cap, which is designed to induce a more efficient and societally desirable use of limited public funds. However, the choices made in recent weeks by the president and other political leaders have proved contrary to any such revision, or indeed any moves that would affect vested interests. The exotic proposal floated late in the month involving the creation of a new cash transfer program funded by postponing debts payable by court order ("*precatórios*") would have added even more mandatory expenditure to an already bloated budget.

However, in light of the fact that net government receipts fell by about 2 percentage points of GDP between 2013 and 2019 while expenditure rose 3 pp – resulting in seven consecutive years of central government primary deficits if we include 2020 –

it is increasingly possible that the political establishment may end up considering tax hikes as a solution to raise revenue to pay for additional spending commitments.

Political resistance to choices that take us in the right direction undermines confidence in future solvency and fiscal equilibrium, driving up the cost of financing the debt and tarnishing Brazil's attractiveness to investors. It also places constraints on the Central Bank, which has repeatedly said in its forward guidance that keeping interest rates low for a long period is conditional upon fiscal consolidation. The wrong fiscal choices could therefore also be damaging on the side of monetary policy, which would have to become less accommodative sooner than expected, negatively affecting economic activity in mid-recovery.

ECONOMIC FORECASTS	2016	2017	2018	2019	2020F	2021F
GDP Growth (%)	-3.3%	1.3%	1.3%	1.1%	-5.0%	3.3%
Inflation (%)	6.3%	2.9%	3.7%	4.3%	2.5%	3.2%
Unemployment Rate, SA (eoy, %)	12.6%	12.4%	12.2%	11.7%	14.8%	12.5%
Policy Rate (eoy, %)	13.8%	7.0%	6.5%	4.5%	2.0%	3.5%
External Accounts						
Trade Balance (US\$ bn)	48	67	53	39	61	58
Current Account Balance (US\$ bn)	-23	-10	-42	-51	11	2
Current Account Balance (% of GDP)	-1.3%	-0.7%	-2.2%	-2.8%	0.8%	0.1%
Fiscal Policy						
Fiscal Primary Balance (% of GDP)	-2.5%	-1.8%	-1.6%	-0.9%	-12.2%	-3.0%
Government Gross Debt (% of GDP)	69.4%	73.7%	77.2%	75.9%	94.5%	95.5%