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Brazil - Monetary Policy

Copom Capitulates to Changing Balance of Risks

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- **Although BCB's own forecasts and consensus for inflation remain comfortably below the targets, the chances of recent market turbulence intensifying further to the point of threatening inflation targets have clearly increased since the last Copom meeting.**
- **We still expect the BRL to stabilize around 3.50 / USD, which has been our forecast for the end of 2018 since mid-2017.**
- **Prevailing low inflation and a wide output gap, in our view, will allow interest rates to remain at 6.5% p.a. until the second half of next year.**

Outlook Still Favorable, Increased Risk

By deciding to keep the Selic at 6.5% p.a., rather than reducing it by 25 bps as signaled in the minutes of last meeting, Copom shows a cautious bias toward the recent increase of market volatility and toward the depreciation of Brazilian exchange rate.

Although the BCB's own forecasts and consensus for inflation remain comfortably below the targets, the chances of recent market turbulence intensifying further to a point of threatening inflation targets have clearly drifted upward since the last Copom meeting. In fact, the incorporation of the hypothesis of the BRL stabilizing at 3.60 / USD has increased the monetary authority's forecast for the IPCA from 3.8% to 4% in 2018. A more meaningful depreciation of the currency, although unlikely in our view, could threaten the achievement of the target in 2019.

As for market consensus, the median of inflation forecasts for 2019 remains stable at 4%, comfortably below the 4.25% objective. For 2018, a period in which the pass through from BRL depreciation to inflation is greater, the median continues to drift lower, having reached 3.45% in the latest reading. Those figures reflect the existing margin for inflation to absorb a non-extreme depreciation of the BRL and still maintain the IPCA aligned with the objective. According to the BCB's own estimation, if the BRL remains stable at 3.6 / USD, inflation should stabilize at 4% this year and next year.

In our view, the currently very low inflation in Brazil reinforces the idea that a nominal depreciation of the currency will turn into a real depreciation of roughly the same magnitude. For this reason, we expect the BRL to stabilize around the new equilibrium level as long as the U.S. yield curve also stabilizes. According to our forecast, this new level for the Brazilian currency will probably not be far from BRL 3.50 / USD, which has been our forecast for the end of 2018 since mid-2017. Moreover, prevailing low inflation and a wide output gap, in our view, will allow interest rates to remain stable until the second half of next year.

Therefore, we are raising our forecast for the Selic at the end of 2018 from 6.25% p.a. to 6.5% p.a. For December 2019, our projection remains at 7.5% p.a.

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