Santander

ECONOMICS

April 12, 2018

Brazil—Monetary Policy

Lower for Longer: We Expect 2019 Year-End Selic at 7.5%

Luciano Sobral*
lusobral@santander.com.br
5511-3553-3753

Rodolfo Margato*
rodolfo.silva@santander.com.br
5511-3553-1859

- **We are revising our 2019 year-end Selic rate forecast to 7.5% from 8.5%.**
- **In our view, four main factors are contributing to keep inflation expectations anchored, allowing for expansionary monetary policy: (i) a deeper and longer-lasting-than-expected food price deflation; (ii) the slow economic recovery; (iii) the transmission of current low inflation rates to future inflation, through indexed contracts; and (iv) Brazil Central Bank's improved credibility.**
- **Assuming continuity of current policies, those factors are likely to allow for a longer period of expansionary monetary policy, with overnight rates in real terms behind neutral rates estimates, and for a smooth convergence toward a neutral stance.**
- **We expect the Brazil Central Bank to cut the overnight rate to 6.25% next May and hold it until 2H19, when a gradual hiking cycle should start.**
- **Main risks to this scenario include a sharp deterioration in financial markets (rising country risk, weakening exchange rate) and a reversion in the current responsible fiscal and monetary policies.**

Forecast Revisions

Variable	2018	2019
Selic rate (%, year-end)	6.25	~~8.5~~ **7.5**
Unemployment rate (%, year-end, seasonally adjusted)	~~10.8~~ **11.4**	~~9.0~~ **10.0**
Unemployment rate (%, average)	~~11.7~~ **12.0**	~~10.2~~ **10.9**

Source: Santander estimates.

Anchored Inflation Expectations Rely on Four Main Factors

Four main factors, in our view, have been driving current inflation and inflation expectations down, leaving room for expansionary monetary policy. First, the positive supply shock in food prices has been having deeper and more long-lasting effects than we anticipated. Second, a slow economic recovery has been translating into a high level of economic slack (with the unemployment rate taking longer than we were expecting to converge to its "natural" level) and forcing down non-tradable prices. Third, lower-than-expected current inflation has been feeding into lower expectations because of a base effect and lower projected readjustments to indexed contracts (such as tariffs and rents). Finally, the credibility of Brazil's Central Bank was recently boosted by a successful disinflation cycle and improved communication, anchoring market expectations. Below we look at each of these elements individually and conclude with the implications for our monetary policy scenario and associated risks.

The Long-Lasting Food Deflation

Food inflation continues to drag down headline inflation. As we described in a recent report (*Food [Inflation] for Thought: Relative Prices*, March 7, 2018), most of the calendar-year's food inflation is typically concentrated in the first and last quarters, and the indicator for 1Q18 was exceptionally low (at 0.32%), especially considering that 12-month food inflation has been running below a two-standard deviation from its long-term average since August 2017. (See Figures 1 and 2.)

Figure 1. 12-Month Food Inflation (%)

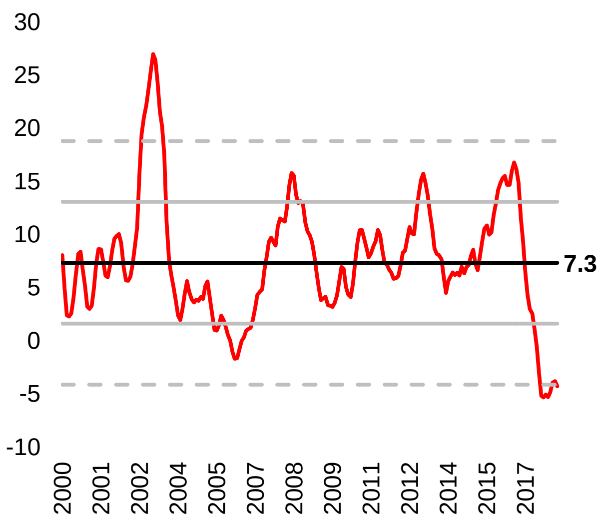
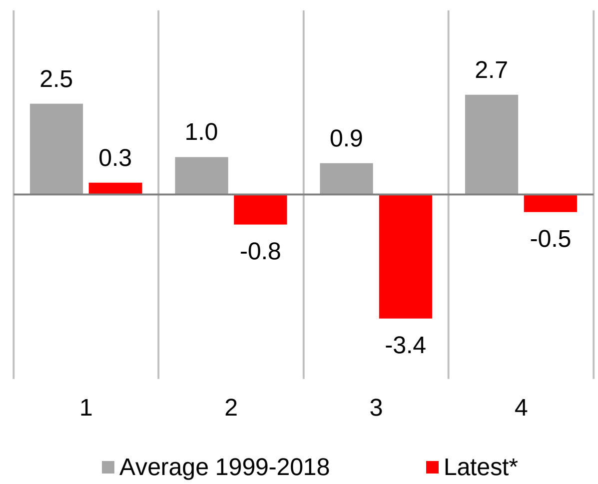


Figure 2. Food Inflation by Quarter (%)



*1Q18, 2Q17, 3Q17, 4Q17. Sources: IBGE, Santander.

The latest data added a downward bias to our 2018 year-end food inflation forecast (currently at 4% y/y), probably helped to reduce market expectations (see below), and will contribute to year-end headline inflation lower than the Central Bank's main projection. (We forecast 3.5% y/y, versus 3.8% as reported in the latest CB's *Quarterly Inflation Report*.)

Indexation: Now a Tailwind

According to our estimates, about 30% of the rises in free market prices and more than 50% of administered prices' inflation in a given year are fed into the following year's inflation, as many contracts (for example, tariffs and some rents) and wages in the economy are somehow indexed to past inflation. 2017 and (probably) 2018 low inflation rates should help to keep inflation under control in 2019, since most of the automatic readjustments in contracts are likely to be close to the inflation target midpoint (4.25% for 2019). For instance, the legal national minimum wage rose, on average, 8.4% per year between 2014 and 2017, but only 1.8% in 2018, and the readjustment formula for 2019 (2018 inflation plus 2017 GDP growth) should yield less than 5%. IGP-M inflation, which adjusts many rent contracts, was -0.5% y/y at the end of 2017 and, according to our forecasts, should accelerate to 4.5% in 2018. If in the past indexation was always a concern, now it should carry forward part of the recent unusually low inflation.

Unemployment Falling Slowly, Adding to Economic Slack

1Q18 economic activity data released so far added a downward bias to our 2018 GDP growth forecast (currently at 3.2%). Furthermore, latest job market data, pointing toward an increasing participation rate and job creation growing at a slower pace, is leading us to revise upward our 2018 and 2019 unemployment rate forecasts. We now expect the average monthly 2018 unemployment rate at 12.0% (from 11.7%), with the same indicator falling to 10.9% (from 10.2%) in 2019. In terms of year-end (seasonally adjusted rates), we now expect 11.4% and 10.0% in 2018 and 2019, respectively (from 10.8% and 9%). This implies that it will take longer than we initially expected (see our report *In Search of Lost Growth: What Is the Extent of Spare Capacity in Brazil's Economy?*, from October 20, 2017) for the output gap to close and to start triggering inflationary pressures, which allows for the Central Bank to keep the policy rate in a stimulative level for longer. We now expect the unemployment rate to stay above its "neutral" level (NAIRU) until 2Q20. (See Figure 3.)

Figure 3. NAIRU and Actual Unemployment Rate (%)

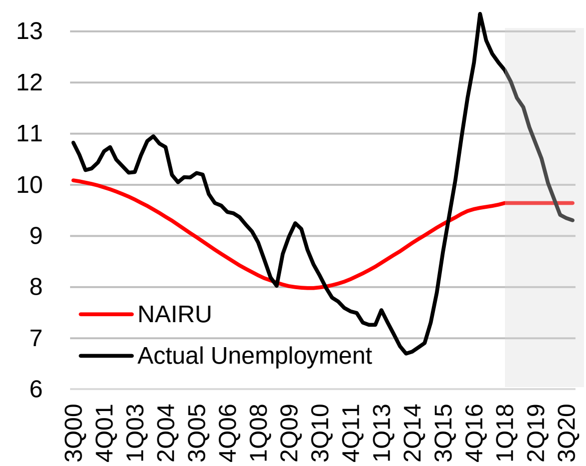
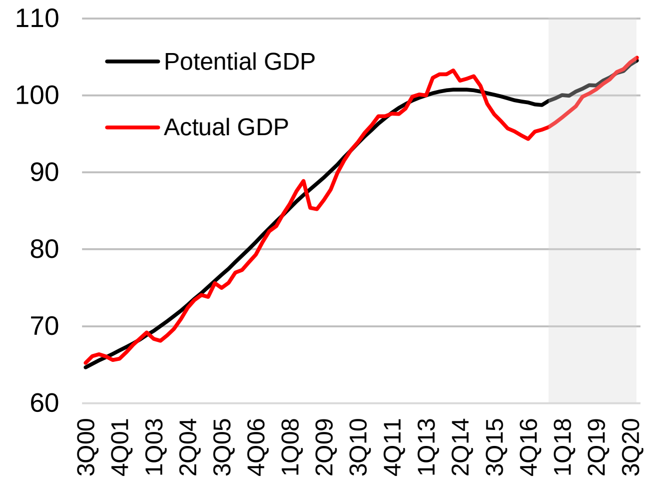


Figure 4. Potential versus Actual GDP (Level, 1Q13 = 100)



Sources: IBGE, Santander estimates.

The Fruits of Regained Credibility

One important indicator of the current Central Bank board's credibility is how expectations for future inflation remain anchored around its targets while the overnight rate, in real terms, is significantly below any estimate for the neutral rate. (For such estimates, see our report *Monetary Policy and the Last Crusade*, from August 30, 2017.) Market participants seem to agree with how the Central Bank has been assessing the economic cycle and are, in our view, confident that monetary policy will be adjusted according a relatively predictable reaction function. This, in our view, is the fruit of the recent success in leading a deep disinflation process and several improvements in communication and transparency. Those gains could be further consolidated if Congress approves the Central Bank's formal independency in a bill that is ready to be voted in the Lower House floor.

Figure 5. Median Inflation Expectations (%)

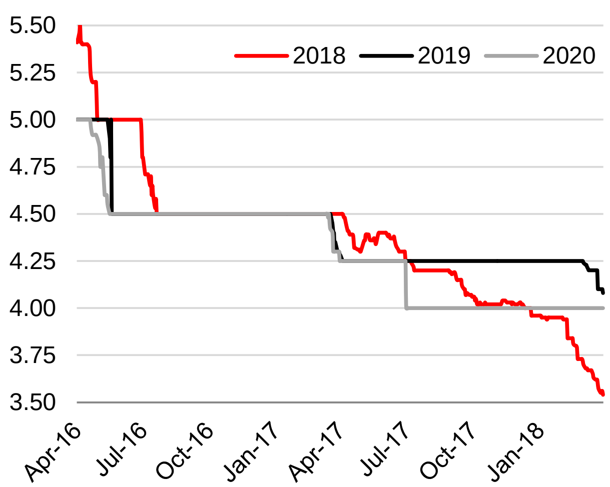
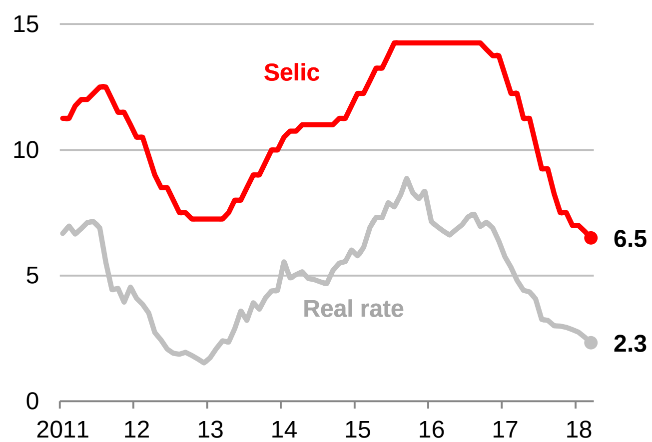


Figure 6. Selic and One-Year Real Ex-Ante Rate (%)



Sources: Brazil Central Bank, Anbima, Santander estimates.

Assuming continuity of the current policies, we believe that inflation expectations will remain well anchored over the next 18 months or so, supported by the scenario we describe above coupled with the Central Bank's credibility. This should allow for (i) a longer period than we initially expected of real overnight rates below their neutral level (which we estimate at around 4%); and (ii) a smooth convergence of monetary policy toward neutrality as the output gap closes,

adding upside risks to future inflation. With that in mind, we are changing our year-end 2018 Selic rate forecast to 7.5% (from 8.5%). We now believe that the Central Bank will keep the policy rate at 6.25% from next May until 2H19, when a gradual hiking cycle should begin. We maintain our view that, in the years ahead, a Selic rate at 8.50% will be compatible with inflation at the target's midpoint (4.0% in 2020, to be defined, but possibly lower, in the following years).

The most relevant risks to that scenario, in our view, are (i) a sharp deterioration in financial markets (leading to BRL weakening and increasing country risk) and (ii) a reversion in the current sound macroeconomic (fiscal and monetary) management. The Central Bank included in its most recent *Quarterly Inflation Report* an interesting study[1] on the effects of rising economic uncertainty and country risk in the exchange rate and inflation. CB's estimate for the exchange rate pass-through (a 10% depreciation in the nominal exchange rate adding 0.9 pp to headline CPI inflation in one year) is higher than other recent estimates[2], reflecting probably BCB's preference for a more complex model, which captures secondary effects of the currency movement, and the impact of the recent liberalization of fuel prices. On the other hand, the resurgence of the fiscal consolidation agenda could contribute to a lower neutral real rate and lower feasible future inflation targets, both leading to lower nominal policy rates, whereas a return to more lax practices would probably lead to higher and more unstable inflation expectations, which would require tighter monetary policy

[1] "Internally consistent conditioning paths for the exchange rate, economic uncertainty and country risk premium." Box in *Inflation Report*, Volume 20, Number 1, March 2018.

[2] See, for example, "Exchange Rate Pass-Through in Latin American," in *IMF Regional Economic Outlook*, April 2016.

CONTACTS / IMPORTANT DISCLOSURES

Macro Research			
Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@bzwbk.pl	48-22-534-1888
Sergio Galván*	Economist – Argentina	sgalvan@santanderrio.com.ar	54-11-4341-1728
Maurício Molan*	Economist – Brazil	mmolan@santander.com.br	5511-3012-5724
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
Diana Ayala	Economist - Colombia	diana.ayala@santander.us	212-350-0979
Tatiana Pinheiro*	Economist – Peru	tatiana.pinheiro@santander.com.br	5511-3012-5179
Piotr Bielski*	Economist – Poland	piotr.bielski@bzwbk.pl	48-22-534-1888
Marcela Bensión*	Economist – Uruguay	mbension@santander.com.uy	5982-1747-5537
Fixed Income Research			
Diana Ayala	Macro, Rates & FX Strategy – Latin America	diana.ayala@santander.us	212-407-0979
Juan Arranz*	Chief Rates & FX Strategist – Argentina	jarranz@santanderrio.com.ar	5411-4341-1065
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778
David Franco*	Macro, Rates & FX Strategy – Latin America	david.franco@santandergcb.com	44-207-756-6633
Aaron Holsberg	Head of Credit Research	aholsberg@santander.us	212-407-0978
Equity Research			
Christian Audi	Head LatAm Equity Research	caudi@santander.us	212-350-3991
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Nicolas Schild*	Head, Chile	nschild@santander.cl	5622-336-3361
Valder Nogueira*	Head, Brazil	jvalder@santander.com.br	5511-3012-5747
Pedro Balcao Reis*	Head, Mexico	pbalcao@santander.com.mx	5255-5269-2264

Electronic Media	
Bloomberg	SIEQ <GO>
Reuters	Pages SISEMA through SISEMZ

This report has been prepared by Santander Investment Securities Inc. ("SIS"; SIS is a subsidiary of Santander Holdings USA, Inc. which is wholly owned by Banco Santander, S.A. "Santander"), on behalf of itself and its affiliates (collectively, Grupo Santander) and is provided for information purposes only. This document must not be considered as an offer to sell or a solicitation of an offer to buy any relevant securities (i.e., securities mentioned herein or of the same issuer and/or options, warrants, or rights with respect to or interests in any such securities). Any decision by the recipient to buy or to sell should be based on publicly available information on the related security and, where appropriate, should take into account the content of the related prospectus filed with and available from the entity governing the related market and the company issuing the security. This report is issued in Spain by Santander Investment Bolsa, Sociedad de Valores, S.A. ("Santander Investment Bolsa"), and in the United Kingdom by Banco Santander, S.A., London Branch. Santander London is authorized by the Bank of Spain. This report is not being issued to private customers. SIS, Santander London and Santander Investment Bolsa are members of Grupo Santander.

ANALYST CERTIFICATION: The following analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed, that their recommendations reflect solely and exclusively their personal opinions, and that such opinions were prepared in an independent and autonomous manner, including as regards the institution to which they are linked, and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report, since their compensation and the compensation system applying to Grupo Santander and any of its affiliates is not pegged to the pricing of any of the securities issued by the companies evaluated in the report, or to the income arising from the businesses and financial transactions carried out by Grupo Santander and any of its affiliates: Luciano Sobral*, Rodolfo Margato*.

*Employed by a non-US affiliate of Santander Investment Securities Inc. and not registered/qualified as a research analyst under FINRA rules, and is not an associated person of the member firm, and, therefore, may not be subject to the FINRA Rule 2242 and Incorporated NYSE Rule 472 restrictions on communications with a subject company, public appearances, and trading securities held by a research analyst account.

The information contained herein has been compiled from sources believed to be reliable, but, although all reasonable care has been taken to ensure that the information contained herein is not untrue or misleading, we make no representation that it is accurate or complete and it should not be relied upon as such. All opinions and estimates included herein constitute our judgment as at the date of this report and are subject to change without notice.

Any U.S. recipient of this report (other than a registered broker-dealer or a bank acting in a broker-dealer capacity) that would like to effect any transaction in any security discussed herein should contact and place orders in the United States with SIS, which, without in any way limiting the foregoing, accepts responsibility (solely for purposes of and within the meaning of Rule 15a-6 under the U.S. Securities Exchange Act of 1934) for this report and its dissemination in the United States.

Santander