

Fixed Income & Economics Daily

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FX & RATES STRATEGY RESEARCH

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CHILE: Monetary Policy Rate Preview

- Today, the Central Bank of Chile will announce its monetary policy for March (at 5pm NYT). We expect the Central Bank to remain on hold at 2.50% for the ninth time, in line with expectations.
- In contrast to previous months, we expect the board to change the tone of language to neutral, or to tone down its dovish bias, as the leading economic indicators point to a recovery in the economy. In effect, January's IMACEC grew 3.9% yoy, above expectations. The mining sector grew by a strong 8.6%, but the non-mining sector also expanded rapidly, at 3.5% yoy. We expect the economic recovery to consolidate in the coming months, as February and March readings should be even better than January's.
- Inflation, on the other hand, remains low. February CPI surprised slightly to the downside, decreasing to 2.0% yoy from 2.2%. All in all, we expect inflation to remain low in the coming months, as the CLP remains strong and the transmission of higher growth to prices will take some time.
- In this outlook of an improved growth environment and low inflation, we believe that the MPC will opt to remain on hold for longer, and will not hike until 3Q18 or later.

COLOMBIA: Monetary Policy Rate Preview

- Today, the Central Bank will make its second monetary policy decision of the year. We expect BanRep to remain on hold at 4.50%, in line with expectations.
- In its previous meeting, the Central Bank cut the interest rate in a split vote (4-3) by 25bps, but unanimously decided to signal the end of the easing cycle.
- The Central Bank has not closed the door on further cuts, yet additional easing remains highly dependent on growth

and inflation indicators. So far, the leading economic indicators continue to point to an economic recovery, with retail sales growing a strong 6.2% yoy in January and industrial production increasing 1.0% yoy.

- On the other hand, some members of the board have expressed their concern regarding inflation inertia. In February, headline inflation moderated to 3.37% yoy from 3.68% yoy in January. However, non-tradable inflation, in particular, remains high and sticky at 4.95% yoy, indicating that there are still pressures from indexation and inertia dynamics.
- Given the concern on inflation, we expect that the majority of the board will vote to remain on hold in March.

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LATAM ECONOMICS

Brazil - Monetary Policy

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TJLP: Less Discretion, More Volatility?

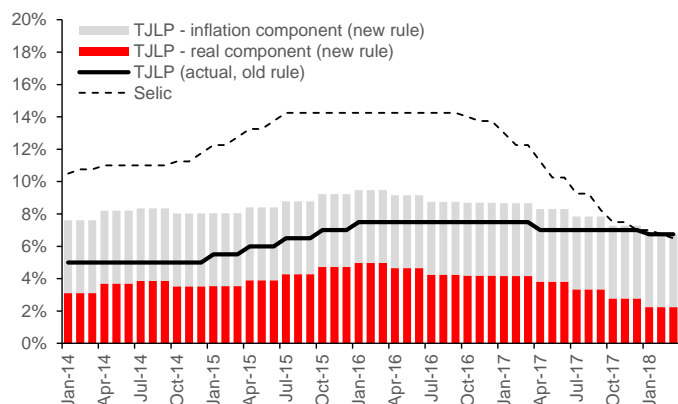
- The CMN recently announced a change to the way the TJLP is set. Recall that the TJLP is the rate used on past BNDES loans granted until Dec 2017; from Jan 2018, the new loans will be indexed to the new TLP.
- With this change, the rate becomes more market-based, in a rationale similar to the new TLP. Also, its setting becomes more insulated from political pressures to increase off-budget subsidies to past loans. The other side of this coin is that the new formula reduces the scope for the CMN to force the convergence of the TJLP to the Selic, a convergence that could be helpful in fiscal terms.
- In this new formula, there is an embedded subsidy of up to 2pp in comparison to market rates, and under our base-case scenario the rate could stabilize around 6.5% pa. However, the fact that the rate is somewhat market-based will increase its sensitivity to market conditions – although the rule attempts to mitigate part of this potential volatility, an eventual shift in sentiment regarding economic policy in the years ahead could imply risk of a higher TJLP.

The new formula: how it works

On March 16, the CMN (National Monetary Council) announced a change in the way the TJLP is calculated. Recall that the TJLP is the rate to which BNDES loans granted until December 2017 are indexed; since early 2018, the new loans are indexed to a different rate, called TLP¹. However, the TJLP still holds some relevance, for its impact on the financials of past BNDES borrowers and for the incentives it carries for prepayment of those loans.

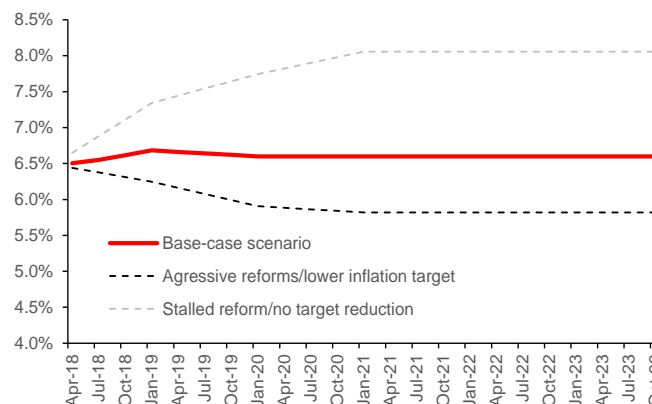
In recent years, even though the rate in theory follows a rule, in practice the rate has been set arbitrarily by the National Monetary Council² on a quarterly basis. From now on, the rate will be set on a quarterly basis as well, but automatically, following a rule established last Friday: **a market-based gauge of real interest rate + average inflation target for the following 12 months.**

Figure 1. TJLP: old versus new rule



Sources: CMN, Bloomberg, Santander.

Figure 2. TJLP: scenarios



Base-case scenario: neutral rate at 4%, inflation target stable at 4% from 2020 on. Aggressive reform/lower inflation target scenario: neutral rate declining to 3%, inflation target reduced to 3% by 2023. Stalled reform/no target reduction scenario: neutral rate reverting to 2010-2018 average (5.4%), inflation target stable at 4% from 2020 on. In all exercises, the 3-year term premium is assumed as 0.5%. Source: Santander.

Some additional rules were defined to reduce volatility of the rate:

- The real component of the rate will be based on the public sector cost of funding, more specifically on the **6-month average of the 3-year NTNBS** (inflation-linked bond), but a “discount” will be embedded in the rate so as to keep it lower-than-market: whenever this 3-year yield is at or above 4% pa, there will be a “discount” of 2pp; whenever the 3-year yield is below 4% pa, the real component will be half of this yield;

¹ Infrastructure projects approved until Dec 31, 2017 can apply for TJLP-based loans this year, according to the rules.

² For some background on the TJLP rules and its recent history, please refer to our reports *TJLP: Rules and Discretion* (June 27, 2016) and *TJLP: What it is and why it matters* (June 27, 2012).



- The inflation component will be the **average inflation target for the 12 months ahead** (targets are set by the CMN for the upcoming 3 years; so far, CMN has set 4.5%, 4.25% and 4% as the targets for 2018, 2019 and 2020 respectively);
- **The upper limit for the TJLP will be the prevailing target overnight rate (Selic) whenever the Selic is at or above 8.5% pa** (note that this constraint would not be binding now, when the Selic is at 6.75% pa; it seems to be there simply to ensure market participants that the rate for past loans will be always lower than the Selic).

How would the TJLP have evolved under this rule? An exercise

One important implication of moving towards a market-based rationale is that it reduces the room for discretionary moves in the TJLP. In the past, the rate was set by the CMN at artificially low levels. In fact, a simple exercise suggests that, if this new formula had been adopted before, the TJLP would have been much higher than it actually was. We compute the new formula back to early 2014 – the results are shown in Figure 1 (the estimated TJLP under the new rule is given by the sum of the two bars). Note that throughout this period it would have been higher than the TJLP actually observed. The smaller difference happens in the latest two quarters, when the new rule would imply a TJLP very similar to the actual level. Considering that the new formula already embeds a generous subsidy, the fact that the actual TJLP was an additional 2-3pp below these levels for most of these years is a good indication of the strong subsidy in BNDES operations, with a massive fiscal cost (recall that the difference between the government's cost of funding – proxied by the Selic – and the TJLP represents an implicit subsidy on BNDES operations).

Looking ahead: a slightly declining trend, sensitive to economic conditions

A simple extrapolation of the last observed 3-year NTN yield (3.86% pa last Friday) could be suggestive of a TJLP close to 6.3% (real component of 1.93% + average inflation target of 4.4%), but there are two points of caution here. First, what counts is not the latest point, but rather a 6-month average (for the Oct17-March18 period, the average is 4.08% until the latest data point, March 16, implying a 2.08% real component and therefore a TJLP closer to 6.5%). Second, because the 3-year yield reflects to a large extent the short-term monetary cycle, the current estimates are contaminated by the fact that the Selic is expected to remain below neutral, and therefore exceptionally low for at least until mid-2019 (more than one third of the 3-year period). Therefore, for forecasting the rate over a longer period, it is more useful to think in terms of the neutral interest rate and typical term premium. We work with the following assumptions:

1. The neutral interest rate for Brazil will remain at around 4%, in real terms¹;
2. The term premium for the 3-year horizon will oscillate around 0.5%, consistent with its historical average;
3. The inflation targets already set for the 2018-2020 period will be maintained.

Under these assumptions, the real component of the TJLP would likely stabilize around 2.5% (4% of the neutral rate + 0.5% term premium = 4.5%, minus the 2pp subsidy for this level of rate). If the inflation target stabilizes at 4%, this would imply a TJLP at 6.5%, with some oscillation around these levels depending on the prevailing market conditions in each quarter.

Having said that, the market-based component makes it sensitive to perceived shifts in economic policymaking.

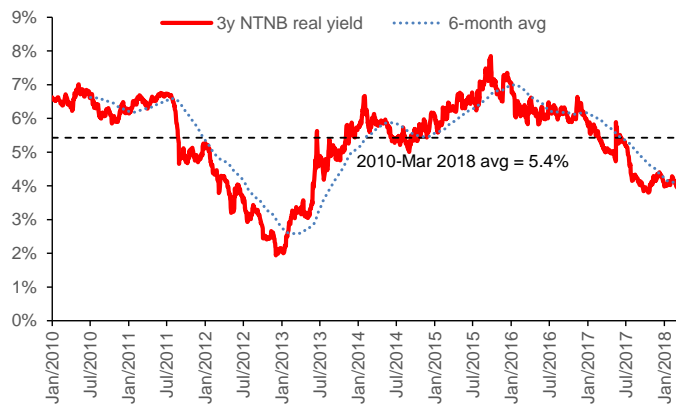
Our base-case scenario assumes the maintenance of the current economic policy in the years ahead, and some advances on the reform front, plus U.S. rates normalizing to 3%. Should markets perceive a high risk of change in economic policy and/or a stalled reform agenda and/or U.S. monetary normalization to a higher level of rates, the 3-year NTN yield will likely respond by going higher, and the TJLP would likewise rise. On the other hand, a faster-than-anticipated improvement in macro and fiscal conditions and/or a slower-than-expected rise in U.S. rates could tip the 3-year NTN lower. Two alternative scenarios are outlined in Figure 2 – and should be taken as simple exercises, not alternative forecasts.

In any case, it is worth noting that, under this rationale, the TJLP will capture some of the market volatility (even if with a lag, induced by the 6-month average). This is illustrated by the evolution of the 3-year NTN real yield in the 2010-2018 span, as depicted in Figure 3. In this relatively short period, the rate oscillated from a low of 1.9% to a high of 7.8%, with an average of 5.4%; under normal circumstances, the rate is expected to be less volatile than this, but there is still some room for oscillation. Finally, we also run an exercise on how the difference between TLP, TJLP and Selic will evolve over time (Figure 4), all under the assumption of neutral rates of 4% in real terms, current inflation targets and historical term premia. Note that while the TJLP would potentially stabilize around 6.5% in this exercise, the TLP would rise over time as the embedded subsidy is reduced over the next 5 years, eventually surpassing the Selic at the end of the period.

¹ For further detail on our estimate of the neutral interest rate, please see our report *Monetary Policy and the Last Crusade* (August 30, 2017).

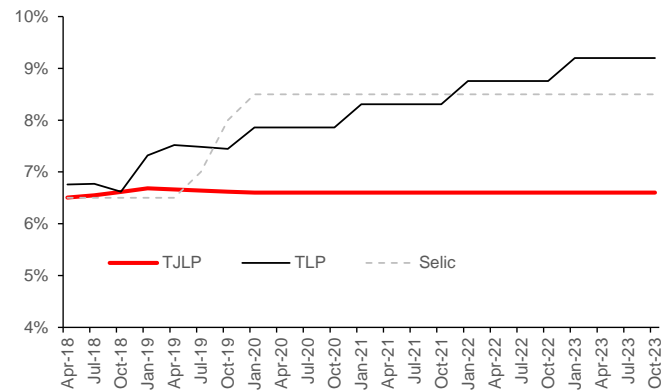


Figure 3. 3-year NTNB: real yield



Sources: Bloomberg, Santander.

Figure 4. TJLP, TLP and Selic: base-case scenario



Base-case scenario for TJLP and Selic. For the TLP, for simplicity the estimate assumes the actual inflation will be equal to the 12-month target, except for the Apr 18-Jan 19 period, for which we assume our inflation forecasts for the 12-month period starting at each date. Recall that the TLP has a pre-fixed real component (set at the moment the loan is granted) and a floating inflation component (the period's inflation). Assumptions: neutral rate of 4% in real terms, inflation targets stabilizing at 4% from 2020 on, term premia at 0.5% and 1% for 3 and 5 years respectively.
Source: Santander.



CEE ECONOMICS

POLAND

ECONOMICS

Demand Boom in Construction Sector Continues

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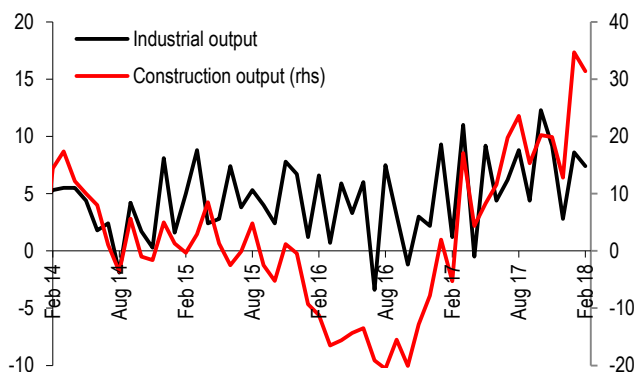
Construction output rose in February by 31.4% y/y vs. consensus of 29.8%. Industrial production (+7.4% y/y) was below market expectations (+8.1% y/y), while we forecasted a slowdown to +6.7% y/y. Civil engineering output rose 65% y/y, despite the extremely low temperatures for half of the month. This demonstrates the strength of demand before local government elections (planned for autumn) and the stronger utilization of EU funds vs. year ago. However, **we still do not expect the above-30% pace of construction output growth in the first two months of the year to continue.** In January and February, the level of activity is relatively low compared to the rest of the year, which makes it easier for the sector to achieve a high rate of growth. In the coming months, we believe construction output will likely be limited by the supply side. Going forward, we expect the construction sector to be facing further capacity constraints.

February's seasonally-adjustment industrial output grew 7.3% y/y, roughly equal to the 2H17 average and well above January's 6.2%. Detailed data showed that production of energy had a big positive contribution, which may have been due to the cold weather. "Other transportation" fell 7.2% y/y, and this was the biggest factor putting downward pressure on the headline. However, this category is highly volatile and does not accurately reflect the overall economic situation. Production of machinery and equipment, which is largely export-oriented, was very strong, growing 20.5% y/y. This, however, may suggest not only that external demand is strong, but also that investments are recovering in Poland.

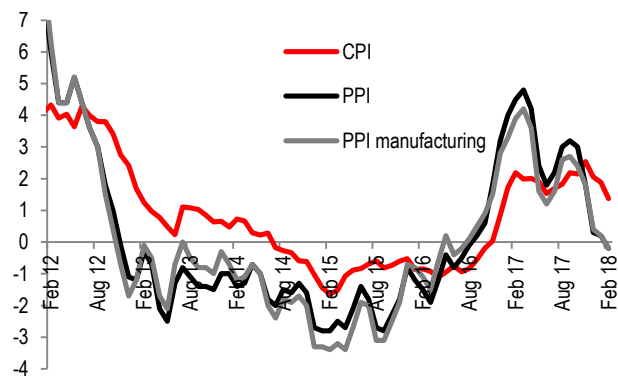
We maintain our view that the pace of GDP growth in 1Q18 will be comparable or slightly below the +5.1% y/y recorded in 4Q17.

PPI declined to -0.2% y/y in February from +0.2% y/y in January. Thus, PPI returned to deflationary territory for the first time since August 2016. In monthly terms, producer prices fell 0.3%, mostly due to a decline in oil prices and a stronger zloty versus the dollar (oil prices in PLN fell 7.5% m/m). In the coming months, we expect PPI to return to positive growth rates driven by a weaker zloty and an end to the downward trend of commodity prices. In the preceding quarters, PPI was a good predictor of CPI trends. As such, we believe the low PPI readings suggest no major growth in CPI inflation in the coming quarters.

Polish output growth, % y/y



Consumer and producer price indices, % y/y



Source: Stats Office, BZ WBK.



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