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Brazil Macro Compass

Goodbye Monetary Easing, Hello FX Pass-Through

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Upcoming Data: The Final Cut

Goodbye monetary easing: The Brazil Central Bank (BCB) meets next week to decide on its policy rate (Selic). **We maintain our call for a 25-bp cut (to 6.25%)**, which, in our view, will be the last one in a long (19 months) and deep (800 bps, if we are proven right) monetary easing cycle. The recent deterioration in financial markets moved the embedded probability of a 25-bp cut in the futures market from almost consensus to around 72% and triggered a discussion about the adequacy of a new rate cut amid growing uncertainty and risk aversion (see the table below). Nevertheless, we believe that the BCB can still follow the flight plan it traced in the minutes of its March meeting, where it affirmed that, for the following meeting, it "views an additional moderate monetary easing as appropriate". Inflation indicators and expectations remain well-behaved (see "What's New" below), whereas the recovery in economic activity has been looking weaker than previously expected. Moreover, Governor Ilan Goldfajn, in an interview with *GloboNews* last Tuesday night, downplayed the recent BRL weakness (saying that it is more of a matter of a global USD strengthening) and highlighting that "in an inflation target regime, the Central Bank looks at inflation, expectations, and economic activity", adding that "this is what matters for the decision".

Selected Financial and Economic Indicators, Behavior Between Copom Meetings

Market prices	20-Mar	11-May	Change
BRL/USD rate	3.30	3.56	8.0%
5-year CDS	161	181	20 bp
1-year rate	6.60%	6.52%	-8 bp
1-year breakeven inflation	4.07%	4.45%	38 bp
5-year rate	9.22%	9.48%	26 bp
Crude oil WTI (USD)	63	71	12.7%
Crude oil WTI (BRL)	209	254	21.7%
CRB Food (USD)	341	356	4.5%
CRB Food (BRL)	1,124	1,268	12.8%
Market expectations*	**20-Mar**	**04-May**	**Change**
2018 CPI inflation (12m, year-end)	3.62%	3.49%	-13 bp
2019 CPI inflation (12m, year-end)	4.20%	4.03%	-17 bp
12-month CPI inflation, year ahead	3.99%	4.12%	13 bp
2018 GDP growth	2.83%	2.70%	-13 bp
2019 GDP growth	3.00%	3.00%	0 bp

* Median of expectations in the Focus weekly survey. Sources: Brazil Central Bank, Bloomberg, Anbima, Santander.

Hello exchange rate pass-through: Following a 7.8% rise in the BRL/USD exchange rate since the beginning of the year, we economists are revisiting our exchange rate pass-through models, trying to evaluate to what extent rising import prices could contaminate current and expected future inflation. Perhaps not coincidentally, in its latest Quarterly Inflation Report (published in the week after the March rate decision), the BCB itself proposed a model to assess the impact of a weaker BRL on CPI inflation. For a 10% permanent nominal depreciation in the nominal BRL/USD exchange rate, the BCB estimated a 0.9% price increase at the end of the first year following the currency movement. Estimates for that coefficient from our (simpler) models are significantly lower, ranging from 0.5% to 0.6%. In the aforementioned interview , Governor Goldfajn also mentioned that the impact on inflation of rising oil prices and USD depends on economic activity and how well-anchored expectations are – indeed, in our view, an abnormally deep output gap, a feeble demand recovery, and inflation expectations still below the target midpoints for 2018 and 2019 should give the BCB decent leeway to focus on the second-order effects of the currency depreciation to core inflation readings. We keep our forecasts for year-end 2018 and 2019 12-month inflation at, respectively, 3.5% and 4.0%, which, in our view, will lead the BCB to hold the Selic rate at 6.25% until 2H19 (see our report, *Lower for Longer: We Expect 2019 Year-End Selic at 7.5%*, from April 12 for more details).

During the recent bout of market price volatility, BCB has been consistent with the floating exchange rate regime, reaffirming that it will only act to avoid distortions in the market, not targeting any particular FX level. We continue to believe that a BRL/USD rate at 3.50 is compatible with Brazil's (rather strong) fundamentals. That level is still our year-end forecast, though we must recognize that the combination of rising global risk aversion, low interest rate differentials, and the proximity of an uncertain election can keep the real under pressure over the next few months (see our report *Falling Interest Rate Differentials Leading to BRL Weakness*, from March 28). Hence, exchange rate pass-through is likely to remain as a latent concern.

Also next week two relevant data points will be added to the final 1Q18 GDP growth estimates: on Tuesday, IBGE releases its monthly volume of services survey (we expect a -1.5% m/m change); on Wednesday, the BCB publishes its monthly GDP proxy (IBC-Br – we expect a -0.6% m/m change).

What's New: April Inflation Below Expectations

April CPI inflation came in below our expectations, at 0.22% m/m (2.76% y/y). Most of the surprise was explained by meals at restaurants (within the services sub-index), whose prices fell 0.22% in the month. Foodstuff continues to drag headline inflation down (at -4.7% y/y), but in-line with our forecast. Core inflation remains around 3% y/y, still comfortably below the target midpoint. We project May headline inflation at 0.34% m/m (2.79% y/y) and maintain a 3.5% y/y forecast for year-end – recent surprises (-22 bps between March and April) should offset the exchange rate pass-through so far, in our view.

March core retail sales surprised to the upside, growing 0.3% m/m and 6.5% y/y. Household consumption should, in our view, continue to be the main driver of growth on the demand side, and this indicator was a relief to a string of disappointing 1Q18 economic activity indicators. We still attribute a downside risk to our 2018 GDP growth forecast, currently at 3.2%.

In-Depth Research: Time for a Lower Inflation Target

In *Monetary Policy: The Good Convergence (May 9, 2018)*, we defend that the National Monetary Council should set a significantly lower inflation target for 2021, around 3% (the decision is due next June). BCB's renewed credibility on the back of a successful disinflation process should reduce the cost of the convergence towards an inflation target close to the average of other upper-middle income countries, with the benefit of reducing nominal interest rates. Additionally, a permanently lower inflation would be a step toward the goal of removing inflation from the decision-making processes of people and companies.

Political Agenda: No Country for Outsiders

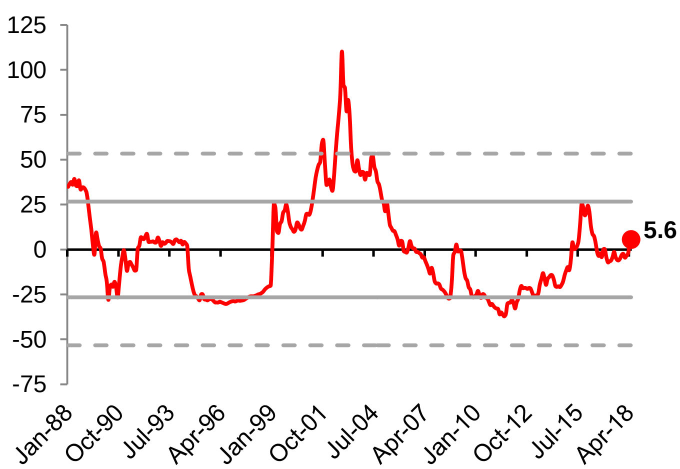
Former Chief Justice Joaquim Barbosa announced this week on Twitter that he is out of the presidential race, significantly reducing the possibility of a strong candidacy from an outsider (potential candidates should have joined a party by April to be allowed to run). Barbosa had between 9% and 10% in the latest Datafolha poll (April 13). Even with such strong contender out, we believe that polls over the next couple of months are unlikely to bring any significant change to the current (fragmented) scenario: it's not evident that someone could capture most of Barbosa's spoils, and coalitions should only start to be formed closer to the beginning of the party conventions/primaries period, on July 20.

After several delays, the Lower House approved last Wednesday night a core version of the *cadastro positivo* (credit bureau) bill, which allows banks to share information on their costumers' creditworthiness and enables the creation of a credit score system. The bill can still amended (thus significantly modified) by the Lower House next week before returning to the Senate, which is responsible to revise it before sending it to presidential sanction. The vote on the amendments is scheduled for next Tuesday, according to the Speaker of the House.

Chart of the Week: BRL Valuation

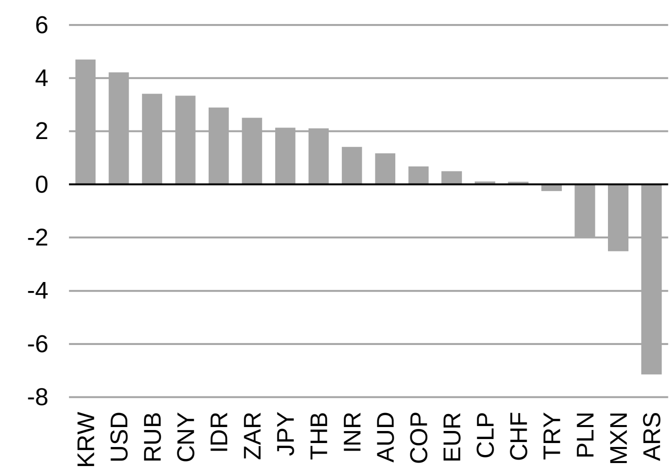
The recent BRL weakening moved the currency back to the undervalued territory against the USD, considering the deviation from the long-term average of the real effective exchange rate index calculated by BCB. Among a sample of other EM and major currencies, only the Turkish lira, the Polish zloty, the Mexican peso, and the Argentine peso devalued against the BRL since the latest DXY trend started, on April 16.

Real Effective Exchange Rate Index BRL/USD -- % Deviation from Long Term Average



Grey lines: +/- 1/2 standard deviations. Sources: Brazil Central Bank, Santander.

BRL Crosses, % Change Since April 16



A positive change indicates that the respective currency strengthened against the BRL. Sources: Bloomberg, Santander.

Number of the Week

73.6%

The share of Argentina in Brazil's exports of light vehicles over the past 12 months was 73.6%, according to data from the Ministry of Industry, Foreign Trade, and Services. The auto sector is likely to be one of the most affected should the neighboring country dives into recession.

Quote of the Week

The Brazilian citizen will constantly be hostage of that [political] system. You cannot change it. That system contains blocking mechanisms that serve to curtail the citizen's choices.

— **Joaquim Barbosa**, former Chief Justice, in interview with *Valor* (May 9, 2018), after announcing that he gave up on running for president.

What We've Been Reading

- "Former Chief Justice withdraws from Brazil election," by Joe Leahy and Andres Schipani (*Financial Times*). Some opinion on the key political event of this week.
- "Will Brazil's Crackdown on Corruption Continue?," by Eduardo Mello and Matias Spektor (*Foreign Affairs*). The authors believe that the October elections can either reform or perpetuate the old political system, with institutional arrangements favoring the latter.

- *Fiscal Adjustment in Latin America and the Caribbean: Short-Run Pain, Long-Run Gain?* (Semiannual Report, Office of the Regional Chief Economist, The World Bank). Though it is not surprising to see the World Bank recommending fiscal prudence, it's interesting to see their results, which include suggesting tax hikes to countries with low initial tax rates (unfortunately not the case of Brazil).
- *Corporate Debt in Latin America and its Macroeconomic Implications*, by Esteban Pérez Caldentey, Nicole Favreau-Negront, and Luis Méndez Lobos (Levy Economics Institute Working Paper No. 904). An analysis of firms' leverage using a Minskyan framework.

Recent Publications (Available on Our Website)

- *Monetary Policy: The Good Governance* (May 9, 2018)
- *Infinite (Trade) War: Does It Matter for Brazil?* (May 2, 2018)
- *Stickernomics – What Do the Prices of Soccer Stickers Around the World Tell Us About Exchange Rates* (April 24, 2018)
- *Lower for Longer: We Expect 2019 Year-End Selic at 7.5%* (April 12, 2018)
- *Falling Interest Rates Leading to BRL Weakness (March 28, 2018)*
- *NPLs Improving More Than Meets the Eye (March 26, 2018)*

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