Santander

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Brazil — Monetary Policy

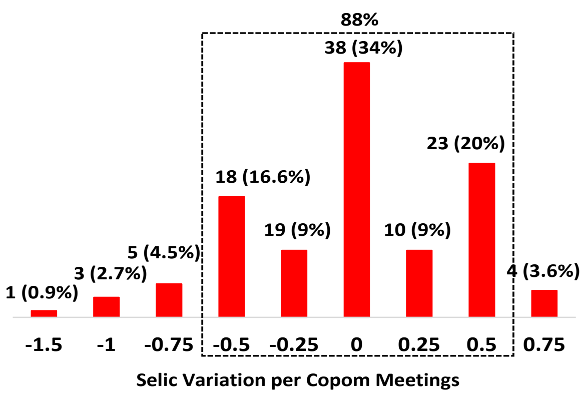
Copom January 2017: “Modus Operandi” vs. “Panic Button”

Maurício Molan*
mmolan@santander.com.br
55113012-5724

- **Markets have been divided on whether the Brazilian Central Bank will accelerate the pace of reduction of the base rate to 50 bps (or more) at this week's meeting of the Monetary Policy Committee (COPOM).**
- **Recent history shows that above 50bps adjustments of the Selic rate in a single Copom meeting tend to be unusual, although it cannot be considered a rare event.**
- **Since 2004 (when the Selic seems to have plunged permanently below 15% p.a.), only 12% of meetings ended with decisions to change the rate by 75bps or more.**
- **An acceleration of 50bps (or more) on the pace of rate cuts has not happened in the last 13 years, with the exception of 2009 — the aftermath of the global financial crisis.**
- **This suggests that a decision to reduce the base rate by 75bps this January would imply a sense of urgency and represent a departure from the Copom’s customary pattern.**
- **As such, we expect a 50-bp rate cut, which would be, in our view, more consistent with the “by-the-book” profile of current Copom members.**
- **In our view, any anxiety related to the current disappointment with economic activity will be dealt with by the communication and signaling of the increased possibility of further acceleration in the pace of monetary policy easing in coming months.**
- **That said, we recognize that the current level of interest rates in Brazil in a context of the balance between the intensity of the recession and inflationary risks could eventually justify a “desperate times, desperate measures” approach.**
- **A more aggressive easing is not off the table and would still be consistent with our single-digit call for the Selic at the end of the year (“Why So Tight? Let’s Put Speed on that Pace”, December 9, 2016).**

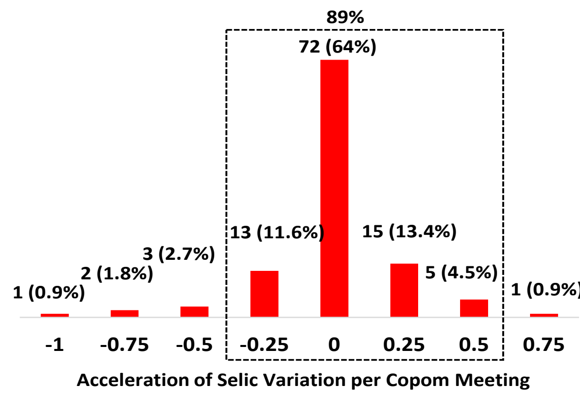
Outcomes of (114) Copom Meetings since 2004

**Selic Variations
Absolute (Relative)**



Source: Brazilian Central Bank.

**Acceleration of Selic Variations
Absolute (Relative)**



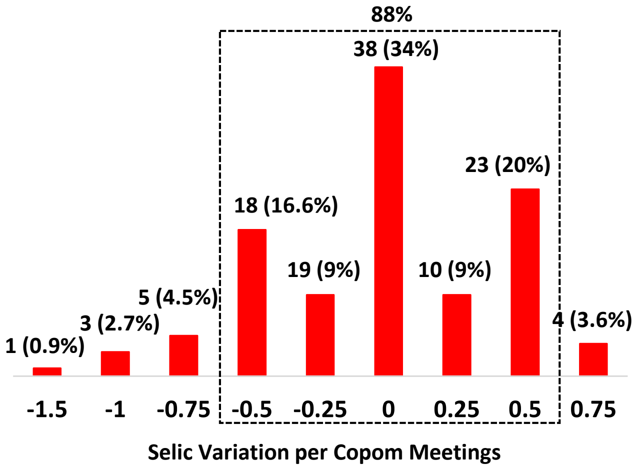
Source: Brazilian Central Bank.

MODUS OPERANDI

The following charts summarize the outcome of 112 Copom meetings in terms of Selic rate decisions since 2004. We have arbitrarily chosen the period after the Selic plunged below 15% p.a. (hopefully for good). It is no secret that Copom has a preference for adjusting monetary policy in increments of 50bps, typically resorting to 25bps when initiating and closing a cycle. **Larger adjustments and aggressive acceleration/deceleration seem to be the exceptions rather than the rule.**

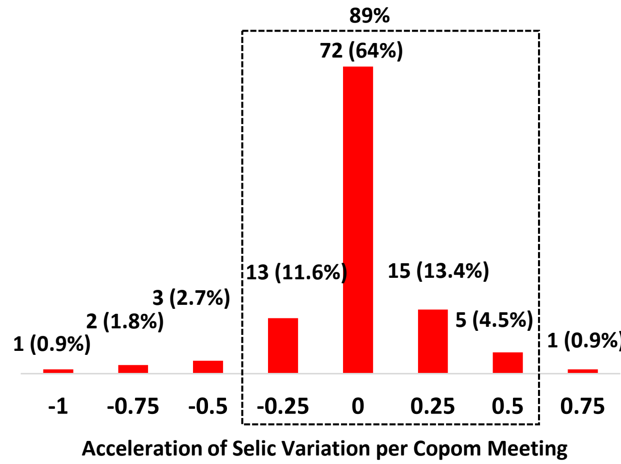
Outcomes of (114) Copom Meetings since 2004

Selic Variations Absolute (Relative)



Source: Brazilian Central Bank.

Acceleration of Selic Variations Absolute (Relative)



Source: Brazilian Central Bank.

Current debate has been about whether the BCB might accelerate the pace of rate cuts from 25bps in previous meeting to 50bps or more. Such a movement (-75bps altogether with an acceleration of 50bps) has not occurred a single time during the last 13 years.

Admittedly, a more aggressive approach was pursued in 1Q09 in the aftermath of the global financial crisis. At the time, the variation of asset prices around the world were considered extreme, certainly justifying an extreme response by policymakers.

With the exception of 2009, the BCB has adopted the 75-bp pace of rate cuts in two cycles of monetary policy easing: (i) 3 x 75bps cuts in January, February and April **2006**, and (ii) 2 x 75bps cuts in March and April **2012**. A summary of prevailing conditions and excerpts from Copom's minutes is presented below.

	Jan, Feb and April 2006	**March and April 2012**
Output Gap	-1.5%	+4%
Inflation Expectations	2006: 4.60 2007: 4.50	2012: 5.24 2013: 5.20
Copom Reasoning	**"A priori" signaling** The BCB has not explained reasons for the acceleration from -50 (Dec/05) to -75 (Jan/06) bps in its January minutes, but signaled "a priori" by dissenting votes in December . **Excerpts from the Minutes of Dec/05 Copom Meeting:** "Two members of the Committee voted for a 75-bp cut considering this would be consistent with **a better assessment of real risk balance between growth and inflation**". "The majority considered that a 50-bp cut would be consistent with optimal speed of monetary easing, and **would contribute to enlarge the total adjustment**".	**"A posteriori" justification** **Excerpts from the Minutes of Mar/12 Copom Meeting.** "The deceleration has been greater than expected" "The financial crisis in Europe has been generating above-usual uncertainties" "Current circumstances suggest it may **be more appropriate to redistribute the expected total adjustment".** "There have been structural changes in the Brazilian economy which have reduced the level of **neutral interest rates**"

Therefore, recent experience suggests that the usual "modus operandi" is more consistent with a 50-bp reduction, rather than a 75-bp rate cut.

PANIC BUTTON

Copom has clearly defined the **conditions for an acceleration of the pace of Selic rate cuts** in the minutes of its latest meeting:

- "The pace of monetary easing will be calibrated according to the BCB's inflation forecasts as well as its main drivers, in order to assure a trajectory consistent with the target for 2017 and 2018".
- "Among the most important determinants of the pace and magnitude of monetary policy easing is the risk of economic activity not reacting in a timely pace".
- "The magnitude of monetary easing and an intensification of its pace will depend on inflation expectations and their risk factors".

In fact, the main inflation **drivers have evolved favorably since the end of November, suggesting an important reduction of the BCB's forecasts and improvement in the balance of risks**.

- The BRL has strengthened from BRL 3.40 / USD to BRL 3.20 / USD (-6%), which affects the BCB's so-called reference scenario (the one that assumes a constant Selic and Exchange Rate). In terms of the market scenario, which incorporates consensus forecasts for the BRL, the evolution has not been as favorable so far, with average projections remaining around BRL 3.40 / USD for the end of the year.
- Recent economic activity data will likely lead to another round of downward revisions for the GDP. Nevertheless, it may take some time before it is incorporated by the market's inflation forecasts.
- Current inflation data has been favorable, particularly showing further deceleration of seasonally-adjusted core measures. Consensus vs. the BCB's forecasts for inflation are, respectively, 0.48 vs. 0.40 in Jan. and 0.61 vs. 0.58 in Feb.
- Market expectations have continued to evolve favorably: from 4.93% to 4.87% for 2017 and at 4.5% for 2018.

The following table summarizes what we see as the most likely outcome in terms of the BCB's inflation forecasts, compared to those presented in the latest Inflation Report (Dec/17). It is an attempt to quantify the improvement of the inflation outlook in the period.

BCB's Inflation Forecasts
(Dec/16 I.R. (Inflation Report)) → Current (According to Santander estimates)

	2017 I.R → Curr.	2018 I.R → Curr.
Reference Scenario - Stable Selic and BRL:	**4.4% → 4.2%**	**3.6% → 3.4%**
Market Scenario - Consensus Selic and BRL:	**4.7% → 4.5%**	**4.5% → 4.3%**
Hybrid 1: Consensus Selic and Stabel BRL:	**4.4% → 4.3%**	**3.7% → 3.5%**
Hybrid 2: Stable Selic and Market BRL:	**4.7% → 4.4%**	**4.5% → 4.3%**

Source: Brazilian Central Bank and Santander estimates.

Based exclusively on our assessment of inflation drivers and on what we see as the main outcome in terms of the BCB's inflation forecasts, our conclusions are:

- Copom will likely remain confident that inflation would undershoot the target if interest rates are maintained, providing room to continue to ease monetary policy.
- The market scenario shows that inflation would be close or slightly below target if Copom reduces rates by a pace consistent with consensus expectations.
- A favorable scenario for much more aggressive monetary easing would require an exchange rate stable around or below current levels.

The bottom line, in our view, once again purely from the point of view of inflation forecasts and its drivers, is that in the majority of scenarios (with the exception of those of the BRL around 3.20), inflation forecasts would not be far enough from the target to allow for a significantly more aggressive pace and magnitude of monetary easing than consensus.

In our view, it would make much more sense to maintain the usual "modus operandi" until an eventual confirmation of a stronger BRL and weaker economic activity is incorporated into inflation expectations.

That said, we recognize that the current level of interest rates in Brazil in a context of the balance between the intensity of recession and inflationary risks could eventually justify a "desperate times, desperate measures" approach. More aggressive easing is not off the table and would still be consistent with our single-digit call for the Selic at the end of the year ("Why So Tight? Let's Put Speed on that Pace", December 9, 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
Brendan Hurley	Economist – Colombia	bhurley@santander.us	212-350-0733
David Franco*	Economist – Mexico	dafranco@santander.com.mx	5255 5269-1932
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

Brendan Hurley	Macro, Rates & FX Strategy – Brazil, Mexico, Colombia	bhurley@santander.us	212-350-0733
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778
Nicolas Kohn*	Macro, Rates & FX Strategy - LatAm	nicolas.kohn@santandergbm.com	4420-7756-6633
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
Valder Nogueira*	Head, Brazil	jvalder@santander.com.br	5511-3012-5747
Pedro Balcao Reis*	Head, Mexico	pbalcao@santander.com.mx	5255-5269-2264

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