

## Brazil: Monetary Policy

### Risks for the Selic in 2019 Expected to Become Even Less Asymmetric

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- Although we acknowledge the reduction in the asymmetry in the balance of risks, we believe the minutes of the latest Copom meeting (October 30 and 31) were excessively cautious, suggesting that there is considerable room for improvement in the near term.
- Our inflation projections for the next few months suggest that both the Copom and consensus may be surprised to the downside.
- We maintain our view that the Selic rate will likely remain unchanged for some time to come, including in the second half of 2019.
- This forecast differs considerably from consensus forecasts, which embed +150 bps in this same period.

#### Better, but Still Careful

The BCB revised upward its forecast for 2018 inflation, from 4.1% to 4.4% and from 4.5% to 4.2% in 2019, assuming that the BRL remain around BRL3.70-3.80/USD until the end of this period. In our view, there are reasons to believe short-term inflation will surprise to the downside.

The minutes also reinforce the idea that risks associated with an adverse evolution of macroeconomic reforms have decreased since the previous meeting. As a result, the overall balance of risks, which was previously biased toward a negative scenario, have become more comfortable.

Therefore, the BCB clearly stated that current economic conditions still prescribe stimulative monetary policy, meaning interest rate should remain below neutrality for the moment.

However, the monetary authority remains concerned with global economic conditions, particularly aware of recent increase of risk aversion and prospects of deceleration in international trade. Moreover, 12 months inflation is expected to peak only in April 2019 (at 4.8%, according to our forecast).

For this reason the Copom decided not to provide a clear guidance regarding next steps, maintaining the statement: “monetary stimuli should begin to be removed, depending upon the evolution of economic activity, **the balance of risks and inflation expectations**”.

#### Economic Activity, Balance of Risks and Inflation Expectations Expected To Evolve Favorably

**We do not expect above mentioned factors to evolve in a manner that will require the removal of monetary stimuli by YE2019**

- **Economic activity.** The BCB has maintained its assessment that economic that the recovery of economic activity has been slower than expected. Looking ahead, even considering our above-consensus forecast for 2018 and 2019 GDP growth (1.5% and 3.2%, respectively), the output gap will remain disinflationary (~-2-2.5%). We forecast seasonally adjusted unemployment to be reduced to 10% by YE2019, still above our neutral estimate of 9.5%.
- **Balance of risks, reforms and global financial conditions.** According to Copom members, the evolution of the balance of risks will depend upon social security reform, short-term fiscal adjustments and global risk aversion. However, we should also take into consideration a benign tail risk: discussions regarding Central Bank independence have gained traction in recent weeks. If the market increases the probability of a favorable outcome of this reform going through, this will certainly contribute to strengthening the credibility of the monetary authority and further improve market expectations, in our view.
- **Inflation expectations and forecasts.** We expect inflation expectations and BCB forecasts, which have been on the rise in the past two months, surprise to the downside in the very near term. (i) According to our forecasts, short-term inflation



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(particularly November's and December's IPCA) will be lower than consensus, bringing 2018 full year figure to 4.2%-4.3% (lower than BCB's projection of 4.4%). (ii) In our view, analysts tend to revise BRL forecasts faster than IPCA's, meaning that there may be room further incorporation of the pass-through of a more appreciated BRL. (iii) Core inflation measures remain well below the target, suggesting recent BRL depreciation and the impact of the truckers' strike should be short-lived.



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