ECONOMICS

March 29, 2019

Brazil – Monetary Policy

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Low for (Much) Longer

- **We believe that there are both structural and transitory factors that have been preventing Brazil's economy from recovering faster in the aftermath of the substantial impulse provided by monetary policy and the recovery in household and business confidence.**
- **Among structural factors, we highlight the meaningful deceleration of government spending and the role of public-owned banks, with the latter having turned much more conservative in recent years in terms of their propensity to lend.**
- **As for the transitory elements, we highlight confidence indicators and manufacturing exports. The first were drastically affected in mid-2018 by the truckers' strike and uncertainty surrounding elections. The second were affected by the substantial worsening macro scenario in Argentina, leading to a collapse in manufactured goods exported to that country.**
- **Another major factor is that although approval of social security reform by YE2019 is still likely, in our view, the political difficulties will be significant.**
- **Although we estimate that the current level of interest rates is stimulative, we do not believe it is enough to speed up the pace of growth in the short term.**
- **We do believe, however, that the Selic rate will not be lowered before we gain clarity on whether the outcome of social security reform is favorable.**
- **Our downward GDP growth revision has led to a different path for output gap expectations, which we now expect to probably narrow only in 2021. Therefore, we are changing our YE2020 Selic rate forecast from 8.5% to 6.5%, while maintaining our 2019 projection at 6.5% p.a.**

GDP Breakdown and Selic Rate (%)

Components	2018	2019F	2020F
Total GDP	**1.1**	**2.3**	**3.0**
Agriculture and Livestock	0.1	2.0	2.5
Industry	0.6	1.6	3.3
Services	1.3	2.4	2.9
Household Consumption	1.9	2.2	3.0
Government Consumption	0.0	-0.2	0.6
Gross Fixed Capital Formation	4.1	4.5	7.0
Exports	4.1	2.7	3.2
Imports (-)	8.5	3.5	3.7
Selic Rate	**6.5**	**6.5**	**6.5**

Source: IBGE, BCB and Santander forecasts

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Revising Selic

We still believe that the current slowdown of household consumption is mostly related to a transitory shock that negatively affected confidence and financial conditions in 2Q18 and 3Q18. As the situation has already improved in terms of the overall economic mood, **we expect to see better figures related to sales, credit and services in the coming months** (see *Is Monetary Policy Stimulative for Consumption?, March 6, 2019).*

However, we recognize that a slowdown in GDP will likely be more intense than previously expected in 1Q19, probably as a result of an already disappointing performance from the manufacturing sector in 4Q18, specifically associated with those segments more sensitive to exports to Argentina (see *Economic Derby: Rivals or Teammates?,* February 19, 2019). For 1Q19, we QoQ GDP of 0.3% in seasonally adjusted terms.

As we have highlighted in *10 Macro Propositions for 2019, January 7, 2019,* another major factor contributing to a lower GDP is that **although we expect social security reform to be approved by YE2019, the political difficulties will be significant.** We understand that the framework of the reform is unpopular and that the government does not have a comfortable majority in Congress. Hence, government leadership faces a challenging scenario in coordinating support for its proposal, which could lead to asset price volatility.

In our February 27, report, *Is The Glass Half Empty or Half Full ?,* February 27, 2019), we revised our 2019 GDP forecast from 3% to a modest 2.3% in 2019 and maintained our forecast of 3.0% expansion in 2020.

Under normal circumstances, we would expect an additional monetary policy impulse. However, we do believe that the Selic rate will not be lowered before we have clarity on whether the outcome of social security reform is favorable or not. We do not expect this clarity before the second half of the year. By then, we expect to see the materialization of a stronger impulse from consumption, making additional monetary impulse unnecessary.

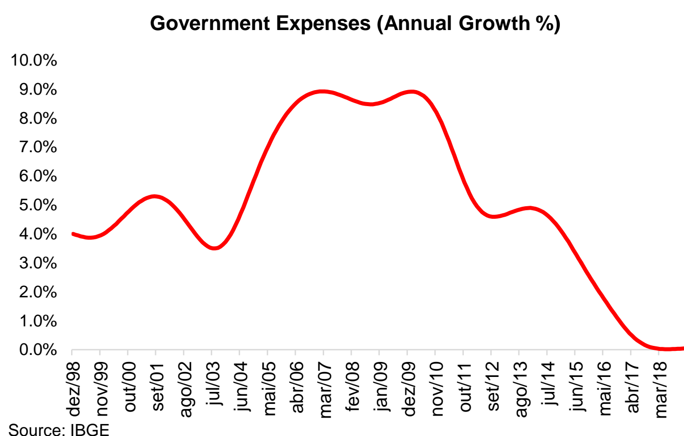
In any case**, Our downward GDP growth revision has led to a different path for output gap expectations, which we now expect to probably narrow only in 2021.** Hence, an increase of Selic rate next year is not going to be necessary, in our view. **Therefore, we are changing our YE2020 Selic rate forecast from 8.5% to 6.5%, while maintaining our 2019 projection at 6.5% p.a.**

Economic Activity Weakness: More than Meets the Eye

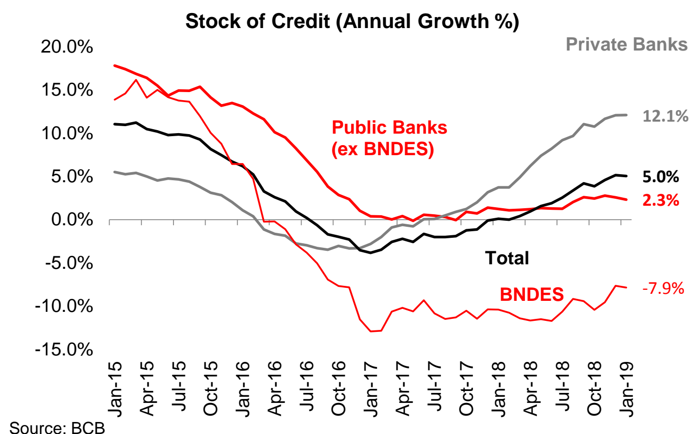
We believe that there are both structural and transitory factors that have been preventing Brazil's economy from recovering faster in the aftermath of the substantial impulse provided by monetary policy and the recovery in household and business confidence.

Permanent Drivers

Among structural factors, we highlight the meaningful deceleration of government spending, illustrated below by the pace of expansion of central government expenditures at constant prices. It is important to emphasize that, although this measure suggests a contraction of public sector demand for goods, services and labor, it is still debatable whether fiscal policy has turned contractionary in recent years. Most central banks (including the Central Bank of Brazil) commonly take into account the primary surplus when developing a fiscal policy stance (see the box from the *Quarterly Inflation Report, BCB, June, 2011*).



Source: IBGE



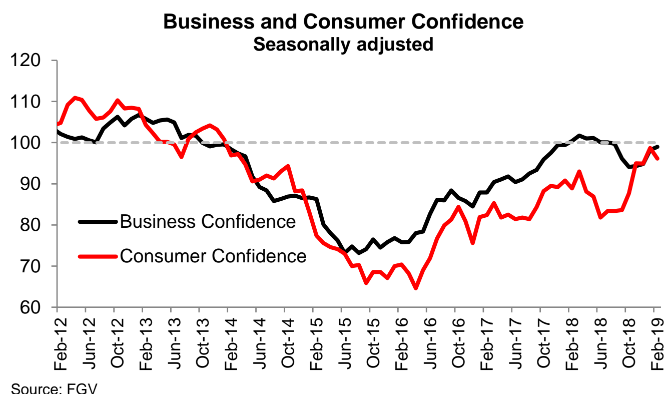
Source: BCB

Another structural factor that could be creating difficulties for an acceleration of GDP growth is the role of public-owned banks. These institutions, which account for 51% of total assets in the financial system, have turned much more conservative in recent years in terms of their propensity to lend, in a clear opposition to the stance that prevailed before 2017. (see chart above).

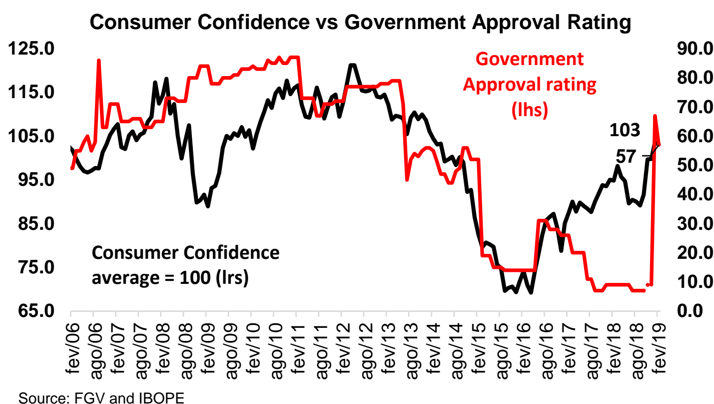
Those aspects have been recently mentioned as reasons behind a likely reduction in neutral interest rates in Brazil. **Apart from fiscal and parafiscal considerations, the level of interest rates compatible with stable inflation is probably lower at present** as a consequence of diminished interest rates in the world, lower Brazilian risk premiums, and anchored inflation expectations granted by a credible Central Bank.

Transitory Drivers

As for the transitory elements that have been contributing to frustrated expectations for recovery, we highlight confidence and manufacturing exports. The first was drastically affected in mid-2018 by the truckers' strike and uncertainty surrounding elections. We have already detailed this particular issue in *"Is Monetary Policy Stimulative for Consumption?", March 6, 2019*. The bottom line is that we believe that the current slowdown of household consumption is a direct consequence of the observed deteriorating expectations between the second and third quarters of last year. A recovery in confidence has already begun; however, in our view it will gain momentum with the approval of a solid social security reform and, consequently, we may see retail sales, credit for individuals, and demand for services picking up again from 4Q19 onward.

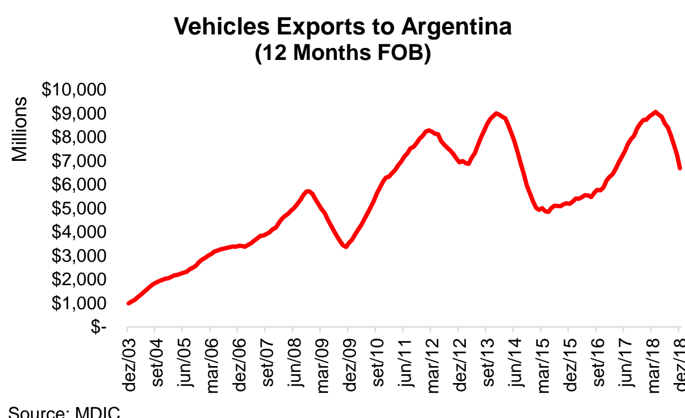


Source: FGV



Source: FGV and IBOPE

Apart from confidence, there has been substantial worsening on the scenario in Argentina, also from mid-2018 onward, which resulted in a deep recession and led to a collapse of manufacturing exports to that country. We have also explored this issue in *"Economic Derby: Rivals or Teammates?", February 19, 2019.* Although Brazil remains a closed economy, with total trade accounting for no more than 29% of GDP, manufacturing exports are relevant for the dynamics of industrial production (they represent around 15%). The impact of contracted sales abroad contributed to the sectors reversal of the upward trend that prevailed until May 2018.



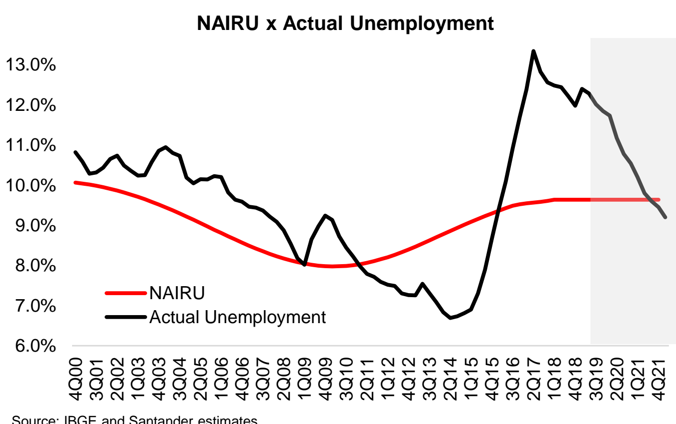
To add insult to injury, the tragic dam collapse in Brumadinho has already reduced mining activity in the first quarter. Weaker labor demand has been one of the most significant consequences of weakening industrial production and has helped interrupt unemployment downward trend in 4Q18.

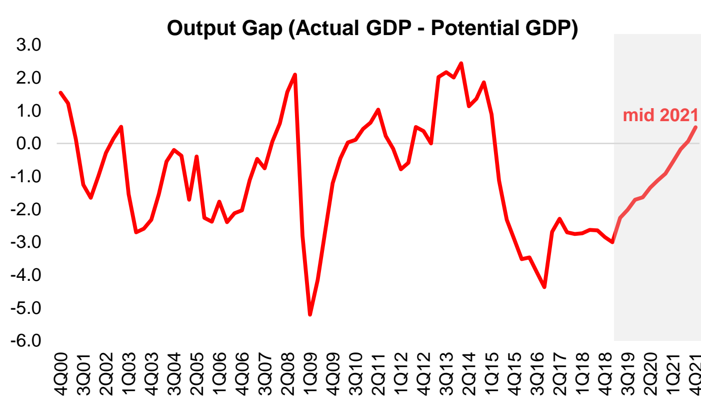
Monetary Policy: Low for (Much) Longer

Considering both permanent and temporary shocks, we believe that current monetary policy is not enough to support substantial growth in economic activity. Although we see the current level of interest rate as stimulative, in our view, it would not be enough to speed up the pace of growth in the short term.

Nonetheless, despite consensus inflation forecasts being considerably below the Central Bank's target, **we do not expect the monetary authority to reduce interest rates in order to increase stimulus because for three primary reasons:** (i) the challenging international scenario (see our recent report, *Substantial Challenges and Risk in the Global Outlook – How Do They Affect Brazil, January 29, 2019)*; (ii) eventual frustration regarding social security reform leading to deteriorating assets prices in Brazil (including the exchange rate) and requiring a drastic monetary policy stance reaction, which would not positive for the credibility of the Central Bank; and (iii) expected turbulence in the social security reform process bringing volatility to assets prices, as we have seen recently. Worsening financial conditions, especially higher exchange rate levels, reduce significantly the appeal of lower interest rates.

It is worth noting that we believe a watered-down version of social security reform will be approved by the end of this year. Hence, by that time, we expect higher confidence levels, better financial conditions and, consequently, improved household consumption and a more effective expansionary monetary policy. In this scenario, any reduction in interest rates for further stimulus in economic activity would no longer be necessary.





Source: IBGE and Santander estimates

Last but not least, considering our revised scenario of slower growth in this year and a gradual decline in unemployment, we estimate that the narrowing of the output gap will take longer (it will happen only in 2021, in our view). **Therefore, it seems reasonable that the Central Bank maintains interest rates at the current low level for much longer.**

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