ECONOMICS

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Brazil—Copom

Copom: Hoping for the Best but Prepared for the Worst

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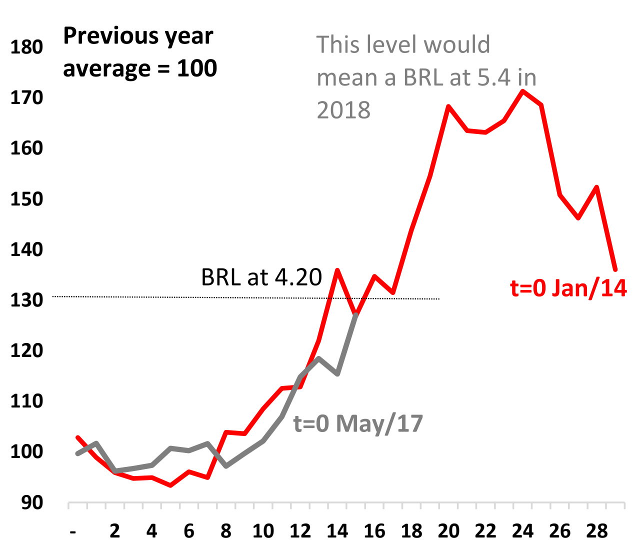
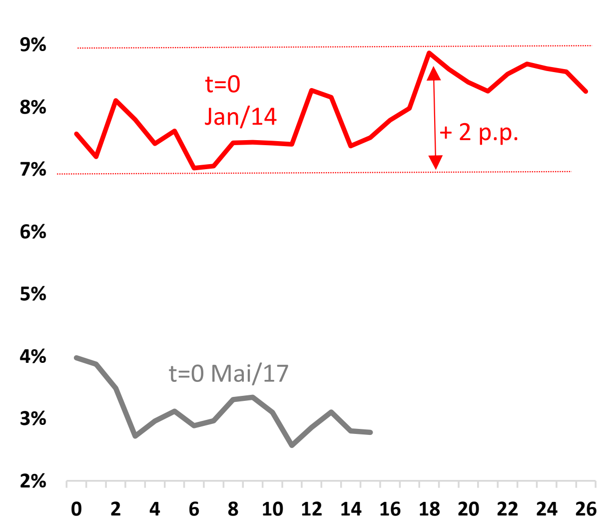
- **In spite of recent meaningful currency depreciation, the inflation outlook for the following years remains fully aligned with the objectives, in our view.**
- **This may be enough for Copom to announce the Selic will remain stable at 6.5% p.a. until the next meeting.**
- **Our estimates suggest that only an exchange rate sustainably weaker than BRL 4.30 / USD could drive the IPCA above the center of target at some point in the near future. (See *Rely on Fundamentals and Carry On*, June 8, 2018.)**
- **However, as an important component of recent BRL variation is related to the political noise, the Copom has reasons to perceive the shock as temporary.**
- **Moreover, there are no indications that it is having an effect on the economy through second-round effects.**
- **However, note that the BRL is dangerously approaching a level and a dynamic that could no longer be comfortable for monetary policy to remain accommodative.**
- **For this reason, we believe the Copom will be more emphatic in signaling, through the statement and minutes, that it is ready to do whatever is required by market conditions to prevent disruptions and stabilize expectations.**

Figure 1. BRL / USD (previous year from t_0 = 100)



Source: Santander based on IBGE data.

Figure 2. Inflation—Non-Tradables IPCA



Source: IBGE

Comfortable Inflation Outlook If . . .

According to consensus and our forecast, the Brazilian Central Bank will announce next Wednesday, September 19, that the Selic rate will remain stable at 6.5% per year until the following meeting. Although current meaningful volatility of asset prices and currency crisis in some emerging economies have led to episodes of interest rate hikes, we see the decision as consistent with the macro environment and the inflation targeting framework in Brazil. We expect the BCB to release the following forecasts for the IPCA:

Expected BCB's projection for the IPCA, assuming BRL is stable at 4.20 / USD and the Selic at 6.5% p.a.

- 2018: from 4.1% (August 1) to 4.6% (September 17); target of 4.5%.
- 2019: from 3.8% (August 1) to 4.3% (September 17); target of 4.25%.

In our view, those projections will be considered fully consistent with the targets for inflation. Remember that, according to the minutes of last meeting: "The Copom judges that it should base its decisions on the evolution of inflation projections and expectations, of the balance of risks, and of economic activity".

In fact, apart from the fact that inflation expectations have not deteriorated to a point in which it requires a monetary policy action, economic activity has disappointed further. The following charts show our financial conditions index[1] has worsened in recent weeks while consumer confidence remains well below the recent historical average after the truck strike. That is strong evidences that demand should not be a concern in the near term.

Figure 3. Financial Conditions Index (Daily)[2]

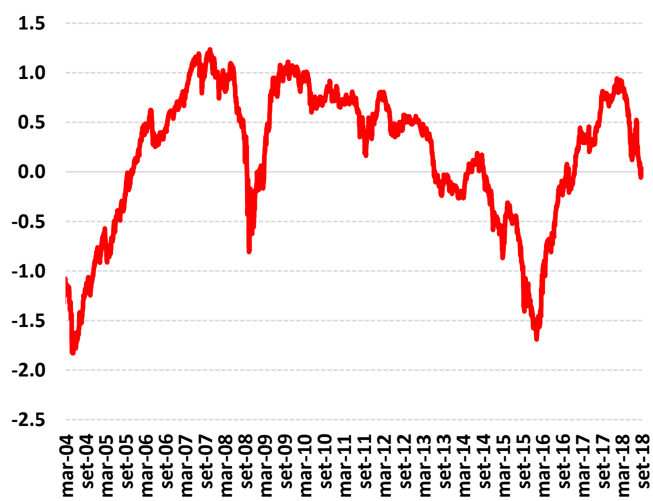
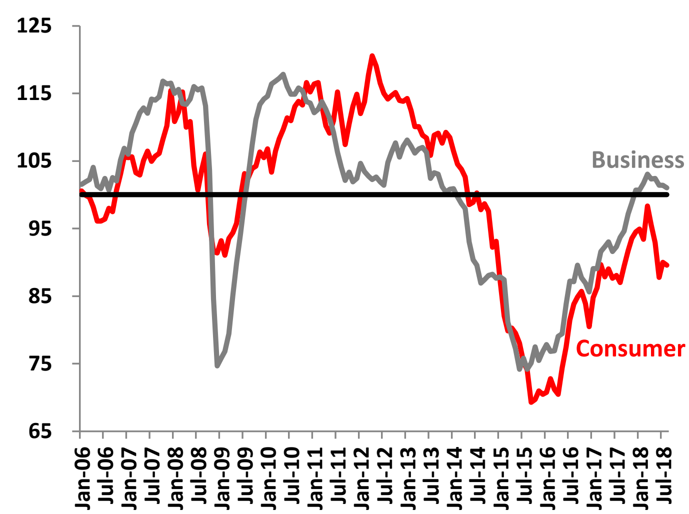


Figure 4. Consumer and Business Confidence



Sources: Santander, BCB and FGV

In terms of the balance of risks, the most important concern is related to the meaningful currency depreciation we have seen in recent months. As for this type of shock, the minutes also bring the Copom's prescription: "Shocks that produce relative price changes should only lead to a monetary policy response to their possible second-round effects (i.e., to the pass through to prices in the economy that are not directly affected by the shock)."

The following figures compare the current episode of substantial BRL variation and the previous one from early 2014 to the end of 2015. These images suggest the following:

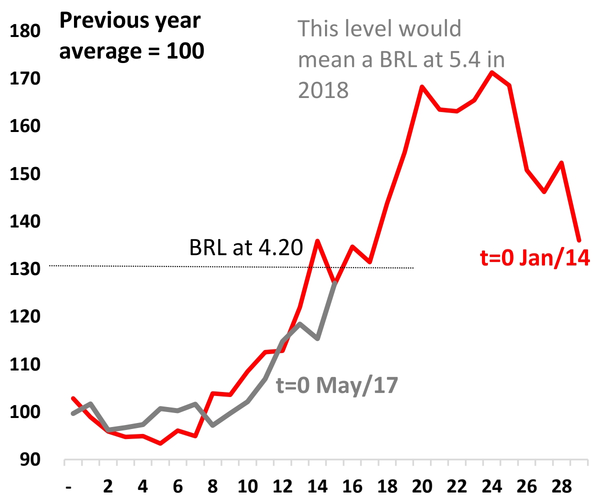
1) It is still early to evaluate the impact of recent depreciation on inflation (the ongoing pass-through to the prices of tradables). Figure 7 illustrates the lag. Inflation will rise at some point as a consequence of recent devaluation.

2) Thus far, the trend of non-tradable goods inflation seems to be completely different from what we experienced in 2015-16. This is probably the most important indication of the absence of second-round effect until this moment.

[1] *Worse Financial Conditions at the Margin Reinforce the Likelihood of Selic Remaining "Low for Long",* August 30, 2018.

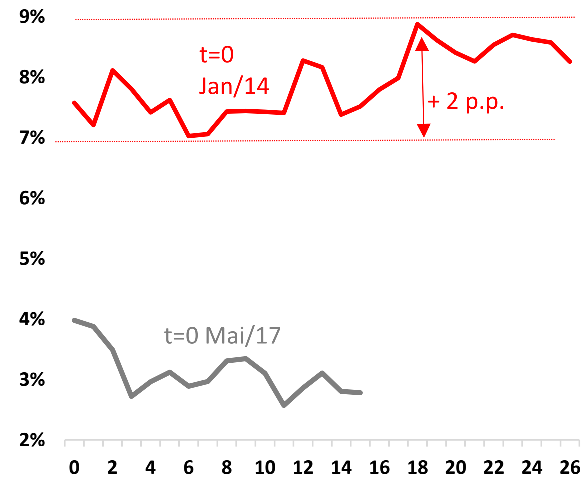
[2] SAN-ICF constructed such that positive values indicate stimulative financial conditions, whereas negative values suggest contractionary conditions. Economic activity as proxied by the IBC-BR, an estimate provided by the BCB of the monthly changes in real GDP, is presented here as the year-on-year changes of its 3-month average. Sources: BCB and Santander

Figure 5. BRL / USD (previous year from t_0 = 100)



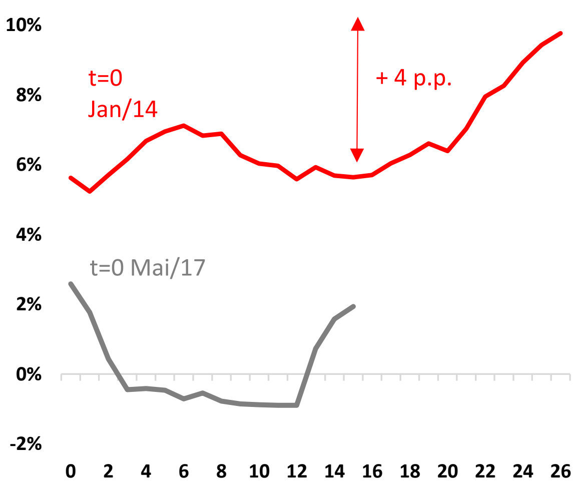
Source: Santander based Brazilian Central Bank data

Figure 6. Inflation—Non-Tradables IPCA



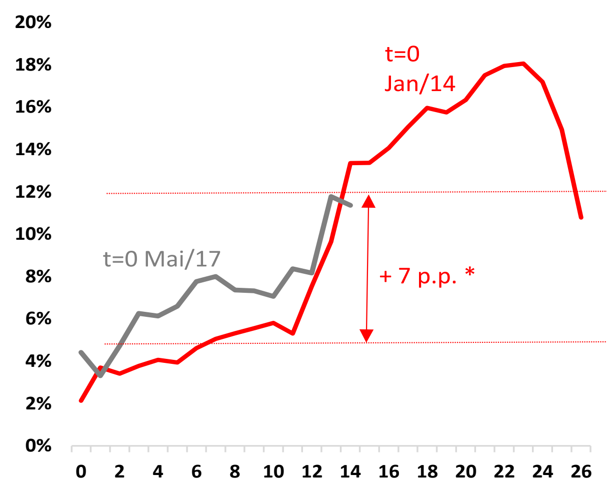
Source: Santander based on IBGE data.

Figure 7. Inflation—Tradables IPCA



Source: Santander based on IBGE data.

Figure 8. Inflation—Administered Prices*



Source: Santander based on IBGE data.

* Remember that this sudden jump in administered prices between t+10 and t+15 (the first 5 months of 2015) was due to a correction of repressed electricity and gasoline prices.

Therefore, we believe that current exchange rate volatility and the magnitude of depreciation we have seen so far are not enough to trigger a monetary policy action. As an important component of the BRL variation is related to the political noise, the Copom has reasons to perceive the shock as temporary. Moreover, there are not indications that it is having a second-round effect to prices in the economy.

Prepared for the Worst (It Happens)

Having stated that inflation is under control and that the magnitude of currency variation so far and up to the Selic decision expected for September 17 do not appear to be enough to trigger a monetary policy response, we cannot rule out further deterioration of asset prices in the near term. Bear in mind that the next Copom meeting will take place on October 30-31, just a couple of days after the second round of presidential elections in Brazil.

By that time, we believe expectations in terms of macro policies to be adopted by the new president and the macroeconomic outlook will be substantially brighter when compared to current uncertainty environment. But it is possible to expect a much more negative outcome, particularly one in which the new leadership is perceived to be not committed to fiscal responsibility and low inflation.

In this case, market instability and the currency depreciation could reach a magnitude that would require more aggressive action in terms of monetary policy. In this case, even if the elected president indicates willingness to maintain or further reduce the interest rate, we believe current Copom members would not hesitate in doing what they believe is right to anchor expectations at least for the reminder of their mandate.

For this reason, we believe the Copom will be more emphatic in signaling, through the statement and minutes, that it is ready to do whatever is required by market conditions to prevent disruptions and stabilize expectations.

In our opinion, this requires a nonsubtle modification of the usual "data dependent" sentence: "The Copom emphasizes that the next steps in the conduct of monetary policy will continue to depend on the evolution of economic activity, the balance of risks, and on inflation projections and expectations." The gravity of the moment and the possibilities likely demands something much more powerful than that.

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