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Brazil—Monetary Policy

On the Way Back to Single-Digit Rates

Revising Selic to 13.5% and 9.5% for 2016 and 2017

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- **Copom's decision to cut the Selic rate by 25bps recognizes a more benign inflation outlook, marked by positive developments in all three key domestic factors listed in the communication that followed August's monetary policy meeting.**
- **Considering the current economic recessive scenario, the perceived current inflation downward trend that should continue throughout 2017, and well-anchored inflation expectations for 2018 and the following years, there will be room, in our opinion, for reducing the Selic rate to one digit by year-end 2017. Thus, we are revising our 2017 year-end Selic rate forecast to 9.5% pa (from 10.0% pa).**
- **We see a positive inflationary scenario evolution that opens room to increase the pace of monetary easing to 50bps in the November Copom decision. Because of this, we expect the year-end 2016 benchmark Selic rate at 13.50% pa. Furthermore, we see the post-meeting statement reinforcing our call that the current easing cycle will be long.**

Introduction

The BCB started a monetary easing cycle in the October Copom decision (October 19) by cutting 25bps, and reducing the Selic rate to 14.00% pa. from 14.25% pa, earlier than we previously expected (in the November meeting). Thus, we are revising our monetary policy outlook. The current disinflation process and its effect on the behavior of inflation expectations, coupled with the favorable evolution of the fiscal agenda in Congress, lead us to edge down our forecast for the year-end 2016 benchmark Selic rate to 13.50% pa (from 13.75% pa) and the year-end 2017 rate to 9.5% pa (from 10.0% pa).

The post-meeting statement unveiled a parsimonious monetary authority, which maintained the next steps in monetary policy — in particular, the pace, dependent on some conditions in the domestic scenario, as follows:

(i) that disinflation of IPCA components that are the most sensitive to monetary policy and economic slack resumes clearly and at an appropriate pace.
(ii) that the pace of approval and implementation of the necessary economic adjustments contribute to inflation dynamics that are compatible with inflation converging to target;

Almost the same conditions set in the previous statement (described in the next section).

We believe these two conditions will be fulfilled up to the next Copom meeting (on November 30), and the monetary authority will speed the pace of cuts to 50bps. We see more intense disinflation of IPCA items more sensitive to economic activity in the upcoming months and the fiscal agenda moving forward in Congress.

Revision of Monetary Policy Forecasts

	2013	2014	2015	2016F	2017F
Selic rate target (eop)	10.00	11.75	14.25	~~13.75~~ 13.50	~~10.0~~ 9.50

Sources: BCB and Santander estimate.

Backdrop

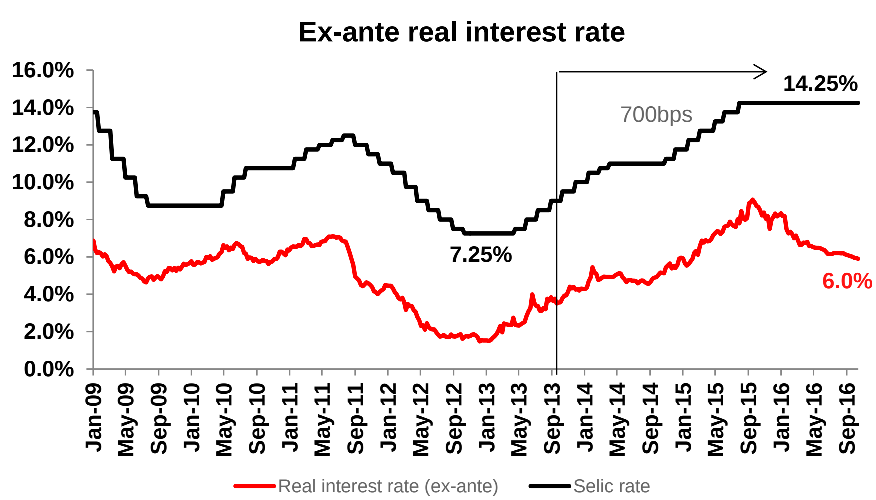
The previous Copom statement unveiled that a monetary easing cycle would depend on the combination of three factors (instead of simply 2017 inflation at the target):

(i) that the persistence of the impact of the food price shock on inflation be limited.
(ii) that IPCA components that are most sensitive to monetary policy and economic slack show disinflation at an appropriate pace.
(iii) that the uncertainty regarding the approval and implementation of the necessary economic adjustments be reduced, including the composition of fiscal measures, and their effects on inflation.

We assessed our scenario hypotheses and concluded that all factors cited in the last BCB minutes are already in place, which, in our opinion, explains the monetary authority's decision.

First, between Copom meetings, running monthly inflation fell close to zero with the beginning of a reversion in the foodstuff shock and disinflation in other items more sensitive to economic activity. Second, the 3Q16 *Inflation Report* (*IR*) revealed a positive assessment of inflation and fiscal agenda by the BCB, and the *Focus* survey revealed a downward revision trend for inflation expectations as well. The 3Q *IR* showed that the expected inflation (according to the BCB's proprietary models) in the relevant monetary policy horizon is below the target in the BCB's reference scenario (4.4% and 3.8% for 2017 and 2018, respectively), and is slightly above the target in the BCB's market scenario, which considers a 425-bp easing cycle (4.9% and 4.6% for 2017 and 2018, respectively). In the last *Focus* survey, the consensus forecast for 12-month IPCA at year-end 2016 was revised down to 7.01%, whereas 2017 year-end inflation was revised to 5.04%. Third, the fiscal agenda moved forward in Congress. The fast approval of the New Fiscal Regime's constitutional amendment proposition in the first round in the Lower House (by 366 votes against 111), with no relevant changes to the government's original proposal, increased the chances of its final congressional approval still this year, in our opinion. The second round in the Lower House is already scheduled for Tuesday, October 25.

Regarding our call for the 2017 year-end Selic rate, we believe that the current inflation trajectory and the behavior of inflation expectations will play a key role in the definition of monetary policy. We believe that the ex-ante real interest rate (one-year future rate discounted by the 12-month IPCA expectations) is around 6%, which—considering the current recessive backdrop, the downward current inflation trend, and well-anchored inflation expectation from 2018 onwards— will create room for a significant easing cycle. Assuming that the neutral level of the ex-ante real interest rate is within the 4-5% range, the nominal Selic rate could be cut to one-digit in the next year, should inflation maintain the current benign trajectory and expectations remain anchored. We foresee annual inflation at the target (4.5%) from 2018 onward. This level of inflation is compatible with a one-digit nominal interest rate, maintaining the real interest rate at the neutral level (i.e., without bringing monetary policy into expansionary territory).



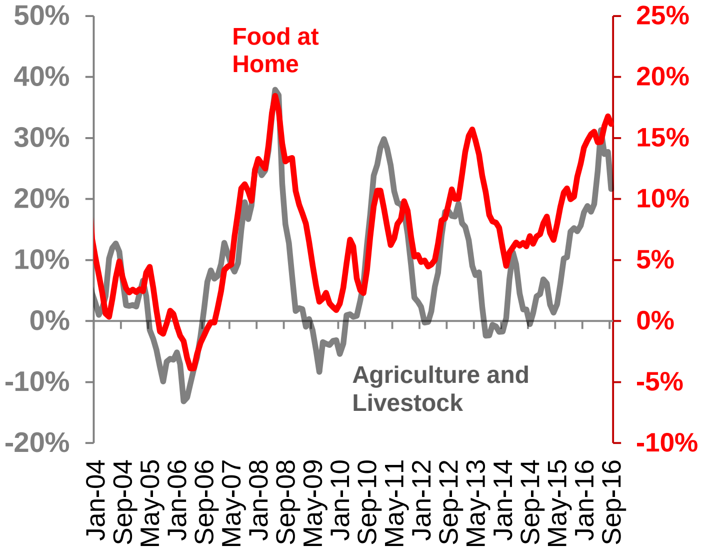
Sources: BCB, IBGE, and Santander.

Inflation outlook: short-term improvements

We believe current inflation is showing clear signs of improvement. Food inflation is in negative territory in monthly terms and started falling year over year. This means that the inflationary effects of the negative supply shock of mid-2016 are fading, fulfilling Copom's condition (i)—that the persistence of the impact of the food price shock on inflation be limited. Inflation on the producer front is also in a sharp downtrend, as shown in the left chart below.

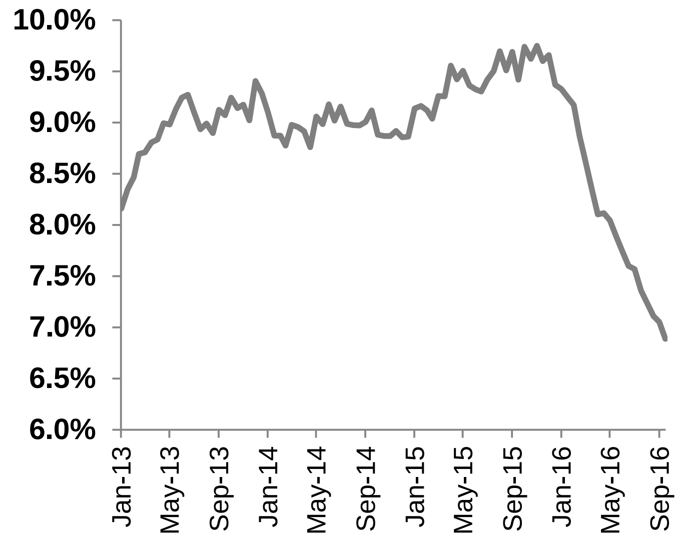
Moreover, September headline IPCA showed the lowest monthly variation since July 2014 and drove 12-month accumulated inflation to 8.5%. However, contrary to what happened in previous results, when food inflation was the main highlight, a major role was played by the industrial goods and services components. The disinflation of IPCA components more sensitive to monetary policy and economic slack, as condition (ii) requests, has been presenting a meaningful relief in the latest releases. The BCB's core services component, proposed in the last *Quarterly Inflation Report* and replicated by us in the chart (right side), for instance, is plunging.

Food at Home (IPCA) and Agriculture and Livestock Inflation (IPA), YoY



Source: FGV, IBGE; Santander Estimates.

BCB's Core Services Inflation, YoY



Source: BCB, IBGE; Santander Estimates.

Fiscal Agenda: New Fiscal Regime

The approval of the New Fiscal Regime (also known as the "spending growth cap") by the Lower House's Special Commission was at the 18th session, well before the maximum period of 40 sessions. Moreover, the easy approval in the first round on the House floor, without relevant changes in the original text, led most political and market observers to believe that this reform will pass in Congress by the end of December, before Congress' annual recess. Evidence of strong governability is crucial for economic stability, which includes, necessarily, the monetary easing cycle.

The proposal in question is a constitutional amendment that creates a rule limiting primary spending growth to the level of past inflation. This rule represents a spending freeze in real terms, with the goal of reducing the primary spending ratio to GDP through the next 20 years. In our base-line scenario (GDP growth around 2.5-3% in the long term), the New Fiscal Regime assures a reversal of primary deficit to surplus in the next four years, resulting in downward trends for net and gross debt in the medium term. Thus, this rules out concerns regarding debt sustainability. (For further details, see our report *Spending Cap – The New Fiscal Regime*, published on October 7, 2016).

For 2017, we believe we will see the approval of the constitutional amendment of social security reform throughout the year, particularly if the government sends to Congress, after intense backstage negotiation, a reform focused on the most important issues of social security benefits such as a minimum age for retirement in the private sector, different retirement ages for men and women, and a transition rule for current employees in the private sector. (For further details, see our report, *Closed for Renovation: The Challenging Reform Agenda*, published on October 3, 2016).

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