Santander

ECONOMICS October 10, 2017

# Brazil: Monetary Policy and GDP Growth

## Coming – The Lowest Interest Rates Ever?

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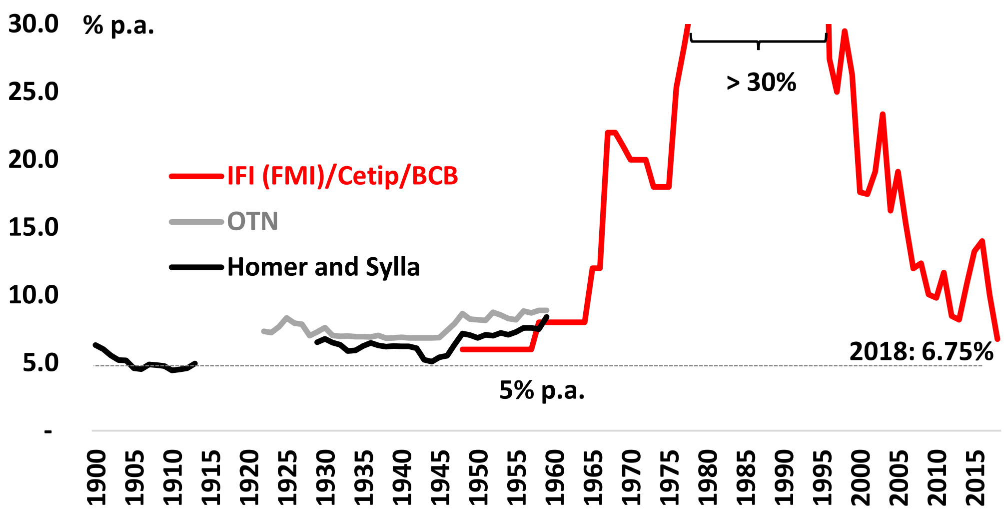
- **We are revising our forecasts for the Selic, to 7.0% p.a. from 7.5% for the end of 2017 and to 6.75% p.a. from 7.5% for the end of 2018. These will be the lowest levels ever recorded for the Selic since its March 1999 inception.**
- **From a longer-term retrospective, this should result in the lowest interbank overnight rate in 60 years, according to our forecasts.**
- **The lowest rate in the history of the Brazilian republic has probably been somewhere around 5%, which prevailed in the initial decades of the 20th century.**
- **Current low and stable inflation suggests to us that, unlike what occurred between 2012 and 2013, it will be possible to maintain the Selic rate close to our forecast for quite some time – in our view, at least until mid-2019.**
- **Brazilian economic fundamentals seem to be in much better shape currently than they were 60 years ago, in our view. Notably, the floating exchange rate regime (in opposition of a fixed one) and almost nonexistent capital controls that prevail currently suggest, in our opinion, that the exchange rate is not far from long-term equilibrium and will probably not be a source of uncontrolled inflation, at least in the next few years.**
- **Nevertheless, we believe it is important to remain focused on rebalancing fiscal accounts. In our view, an expansionary fiscal policy was probably the main cause of a process that ended up in hyperinflation and abnormal interest rates in the second half of last century.**
- **The fiscal adjustment is a necessary condition for Brazil to maintain the overnight interest rate in single digits, in our view.**
- **We have adjusted our GDP forecasts and now expect GDP to grow 0.8% in the current year (vs. our previous forecast of 0.5%) and 3.2% (vs. 2.5%) in 2018.**

**Figure 1. Overnight Interest Rates (% p.a.) since 1900**




Sources: The IMF, Brazilian Central Bank, IPEA and Homer and Sylla ("A History of Interest rates").

## Introduction

There is a widespread consensus among economists that by the end of this year the current monetary policy easing cycle will probably lead to the lowest level for ever recorded for the Selic since its March 1999 inception. There is also a consensus view that existing ample idle capacity in terms of both capital and labor suggests a high probability of low interest rates persisting for years to come. But could these rates be considered the lowest ever in Brazilian history?

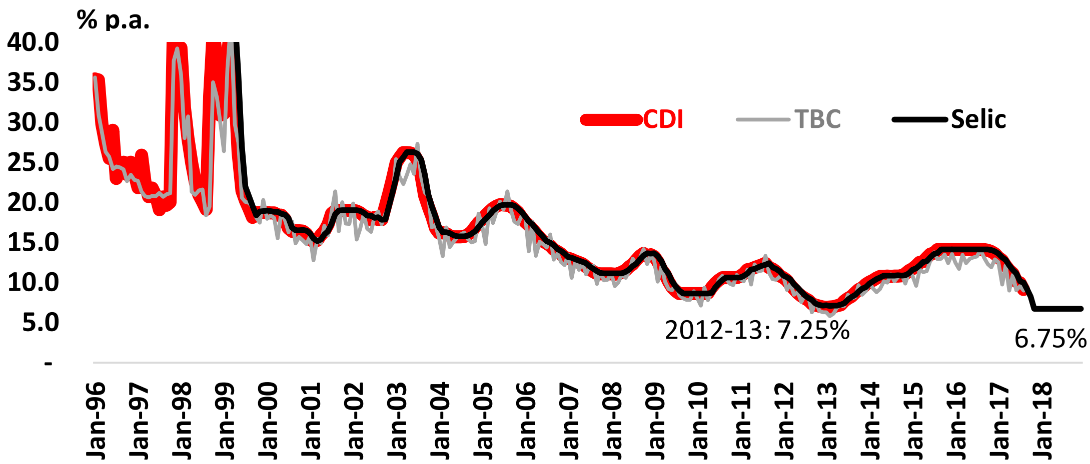
It is almost impossible to come up with a categorical conclusion on this subject. First, it is hard to find reliable data for the early years after the birth of the Brazilian republic. Second, the financial framework and other institutions (such as the exchange rate and trade regimes) have substantially changed over the years, making interest rates data series barely comparable. Third. there are a wide variety of concepts for the interest rates: nominal, real, policy target, overnight, long term, final for consumers, etc.

Having said that, we show in Figure 1 the results of our efforts to find historical data to fill the gaps (not always successfully). We believe **this information is enough to conclude that an overnight interest rate below 7.25% p.a. would probably be among the lowest in history of the Brazilian republic, and certainly the lowest in the last 60 years.**

## Sources of Data

- Most data has been collected from the IFS[1] ("International Financial Statistics"), one of the main databases of the IMF.
- The Brazilian Central Bank releases monthly series for the Selic from March 1999 and for the TBC (the discount rate) from 1996. The CDI (Interbank Overnight Rate) has been collected from Cetip[2].
- The OTN is the implied interest (% p.a.) on Treasury bonds. Cláudio Contador, "Mercado de Ativos no Brasil, pgs 211-222, from ipeadata.gov.br.
- "A History of Interest Rates", from 1986, Home and Sylla. Wiley Research Institute. The authors mention as the original source the "League of Nations Statistical Yearbook", 1939-40, and the Canada Report of Official Board of Enquiry, Cost of Living (1915).

**Figure 2. Overnight Interbank Rates (% p.a.) since 1996**




Sources: The IMF, Brazilian Central Bank, IPEA and Homer and Sylla ("A History of Interest rates").

[1] http://data.imf.org/?sk=4C514D48-B6BA-49ED-8AB9-52B0C1A0179B
[2] http://estatisticas.cetip.com.br/astec/series_v05/paginas/web_v05_template_informacoes_di.asp?str_Modulo=completo&int_Idioma=1&int_Titulo=6&int_NivelBD=2

## What Was Happening in Brazil the Last Time Rates Stabilized Below 8%

The last time Brazil enjoyed a reasonably long period of below 8% p.a. nominal rates was in the early to mid-1950s, during the second term of President Getúlio Vargas (1951-1954). The exchange rate was overvalued and frozen at 18.8 cruzeiros / USD. Meanwhile, trade policy was characterized by rigorous control of imports through the concession of licenses. This position of restrictions on imports led to a comfortable, although not sustainable, position in terms of the balance of payments, illustrated by the low level of net external debt (Figure 3). The flip side of the coin of controlled imports was the scarcity of raw materials in general, which contributed to keep inflation under pressure despite the frozen FX.

Increasing social and political tensions, chiefly from 1953 onward, contributed to a continuous process of easing fiscal and monetary policies (through credit expansion). **Inflation, which remained within the 1-10% range from the end of the 1940s to the beginning of the 1950s, shot up toward an average of 21% per year in the second half of the 1950s. This means that single-digit nominal interest rates ultimately led to unsustainable negative real yields.**

It is useful to highlight some of the important **similarities and differences** between the current situation and the last time Brazil had a nominal rate around 7% for more than one year. On the one hand, both inflation (Figure 4) and external accounts were in good shape 60 years ago, as they seem to be currently. On the other hand, one may notice that those favorable indicators, **in the past**, were **a consequence of a high degree of government control of the exchange rate and imports**. **Furthermore, current inflation conditions are much better not only in terms of the level of inflation but also in terms of its volatility. This is a direct consequence of a credible inflation-targeting monetary policy regime.**

**Figure 3. Net External Debt* / Exports**

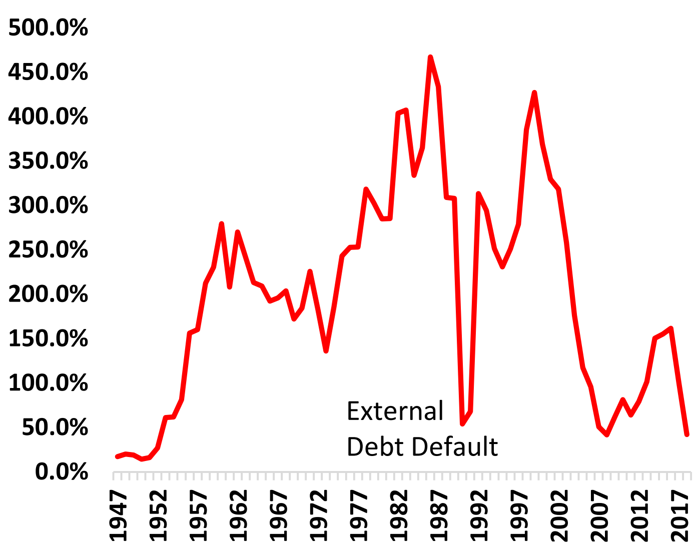
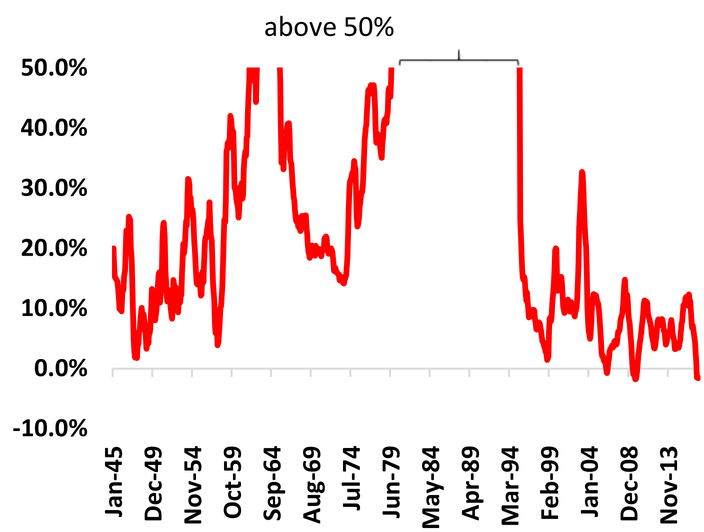



**Figure 4. Inflation**




Sources: FGV and IBGE. * External Debt (-) Reserves

**The most uncomfortable similarity between the two periods, in our view, seems to be the risks associated with fiscal accounts.** The 1950s were, for Brazil, the moment of macroeconomic inflection toward a symbiotic relationship between fiscal accounts and inflation. This would prevail for the following four decades. Fiscal imbalances (Figure 5) fed inflation through monetary expansion and demand pressures. Meanwhile, inflationary surprises contributed to mitigate the impact of fiscal expansion on solvency. In terms of budget balance from the 1950s to 1990s, revenues tended to increase in tandem with inflation, while postponement of payments and long periods of salary readjustments eroded expenditures. Moreover, upward surprises in inflation may bring real ex post interest rates into negative territory and reduce the value of non-indexed debt.

Another interesting characteristic of the current situation compared to 60 years ago is the international outlook, chiefly the very low **prevailing interest rates** (Figure 6). In this case, we believe a process of normalization is almost inevitable for the coming years, which reinforces the urgency and importance of the fiscal adjustment, in our view.

**Figure 5. Federal Government Revenues and Expenditures**

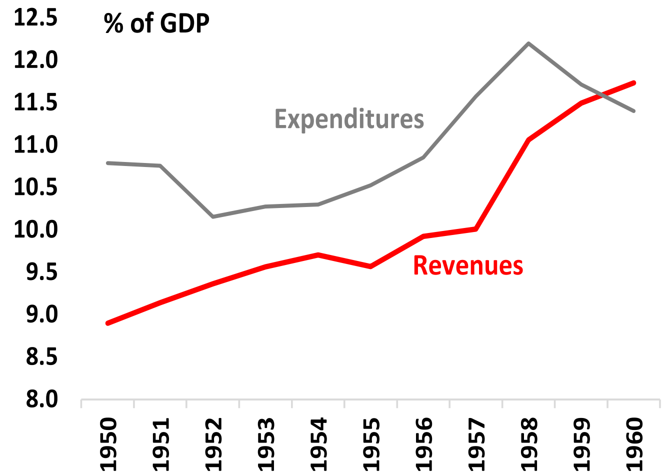
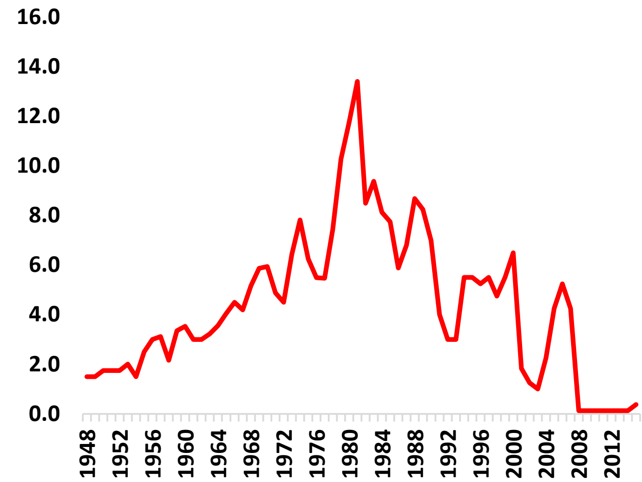



**Figure 6. The U.S. Discount Rate (since 1947) (% p.a.)**




Sources: IBGE and IPEA

## Consistent Recovery of GDP Growth

We expect this "lowest interest rate in 60 years" environment to prevail at least until mid-2019, due to already mentioned strong fundamentals. This prospect is very different from what occurred in 2012-2013, when the monetary authority's attempts to reduce rates were inconsistent with prevailing inflation conditions.

Therefore, we should expect the financial system and capital markets to undergo a period of intense transformation with an immediate impact on economic activity. We believe lower interest rates will likely lead to more direct financing by large companies (thorough bonds and equities), increased access of medium and small companies to credit supply from the banking system, and the opportunity to trigger another cycle of credit for households, particularly mortgages. Lower cost of capital for companies should tend to trigger investments, in our view, just as a reduced debt burden for households will likely drive consumption (see "Understated Consumption Drivers," June 12, 2017 at www.santander.com.br).

We are revising our forecasts for the Selic, to 7.0% p.a. from 7.5% for the end of 2017 and to 6.75% p.a. from 7.5% for the end of 2018. If these levels are reached, they would be the lowest levels ever recorded for the Selic since its March 1999 inception. This leads to a revision as well of our forecast for GDP growth in 2017 to 0.8% from 0.5% and for 2018 to 3.2% from 2.5% (consensus at 2.4%).

**Forecast Revisions**

| | 2016 | 2017E | 2018E |
|---|---|---|---|
| Selic (% year end) | 13.75% | ~~7.5%~~ 7.0% | ~~7.5%~~ 6.75% |
| GDP Growth (%) | -3.6% | ~~0.5%~~ 0.8% | ~~2.5%~~ 3.2% |

Sources: Santander.

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