Santander

ECONOMICS April 10, 2017

BRAZIL – Inflation and Monetary Policy

The Waves

Tatiana Pinheiro*
tatiana.pinheiro@santander.com.br
5511-3012-5179

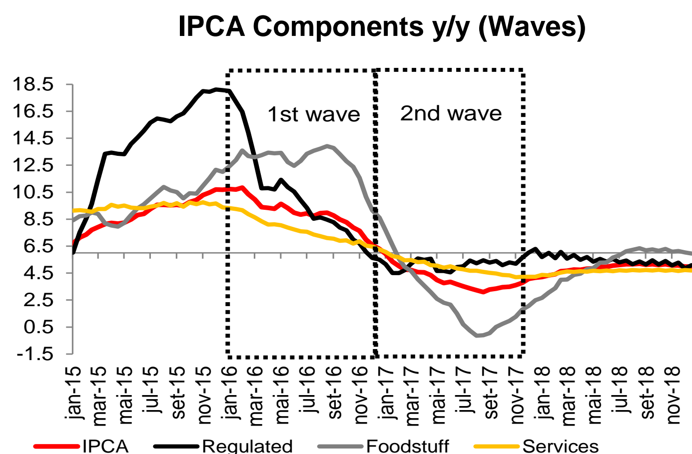
- **We see inflation at 4.2% in 2017 and 2018, due to the surprising BRL appreciation in 1H17, foodstuff deflation in 1Q17, likely foodstuff disinflation through 2017, and the absence of disinflation waves in the 2018 inflation scenario.**
- **The first wave was the regulated disinflation, pushing inflation down to the 6% level in 2016, and the second wave was the foodstuff disinflation in early 2017 that shifted inflation down towards the target of 4.5%.**
- **We believe the reduction of the inflation target for 2019 will help to curb inflation expectations for 2018 to under 4.5%, which will help to offset inflationary pressures.**
- **We forecast the Selic rate at 8.5% at the end of 2017, with cuts of 100 bps in the April and June Copom meetings, then being held at 8.5% throughout 2018.**

Introduction

Finally, after eight years, inflation is at the target again. After a very long widespread inflationary process, since the beginning of 2016, IPCA components most sensitive to economic activity level, such as services and industrial goods, have declined – services inflation plunged to 5.3% in March 17 from 9.4% posted in December 15, and industrial goods inflation fell to 2.5% from 6.2%. The highlight since the beginning of 2017 has been the deflation of foodstuff prices due to much better weather than in 2016 and a record-setting harvest of seeds.

In order to better predict the inflation scenario, we believe it is helpful to understand what happened over the last two years. Regarding inflation behavior, there were some significant events that drove the inflation trend. In 2015, the upward trend of inflation was determined by the adjustment of regulated prices that resulted in 18% inflation (contribution of 4.4 p.p. to 2015 IPCA of 10.7%), which pushed inflation up to 10% from the 6% level registered in the previous five years. In 2016, the downward trend of inflation was driven by regulated disinflation that resulted in 5.5% inflation (contribution of 1.3 p.p. to 2016 IPCA), which was the first wave pushing inflation back to the 6% level. Also, economic policy got back on track, with both monetary and fiscal policies aligned in the same direction, reducing economic stimulus and helping to reestablish the trade-off between activity and inflation, which resulted in significant disinflation of services, and consequently, disinflation of market prices. In 2017, the second wave is the foodstuff disinflation due to a positive supply shock of agricultural production, which could bring inflation back to the target.

IPCA Components y/y (Waves)



Forecasts y/y

	2015	2016	2017 (f)	2018 (f)
Regulated	**18.1**	**5.5**	**5.8**	**4.9**
Water and Sewage	14.8	20.1	6.5	6.0
Electric energy	51.0	-10.7	9.0	5.0
Urban transportation	9.2	7.8	7.4	6.0
Gasoline	20.1	2.5	2.0	4.0
Diesel	13.3	2.2	5.0	5.0
Medicines	6.9	12.5	6.1	5.0
Healthcare plan	12.2	13.6	10.0	7.0
Fixed telephone	-1.6	-1.2	-3.1	-2.0
Market	**8.5**	**6.6**	**3.7**	**3.9**
IPCA	**10.7**	**6.3**	**4.2**	**4.2**

Sources: IBGE and Santander estimates.

IMPORTANT DISCLOSURES/CERTIFICATIONS ARE IN THE "IMPORTANT DISCLOSURES" SECTION OF THIS REPORT.

U.S. investors' inquiries should be directed to Santander Investment at (212) 350-0707.
*Employed by a non-US affiliate of Santander Investment Securities Inc. and is not registered/qualified as a research analyst under FINRA rules.

In 2017, the downward trend of inflation will be determined by foodstuff disinflation, which should result in 2.5% inflation (contribution of 0.6 p.p. to 2017 IPCA compared to 2.4 p.p. of foodstuff inflation to 2016 IPCA). Again, the impact of the recession on inflation coupled with BRL appreciation play important role on the disinflationary process in 2017, and services inflation should fall to 4.5% (contribution of 1.4 p.p to 2017 compared to 2.3 p.p. in 2016) and while tradable inflation falls to 4.5% (contribution of 1.5 p.p. to 2017 compared to 2.4 p.p. in 2016). These two waves (foodstuff and services-tradables) should more than offset the pressures from the tax increase on gasoline price (CIDE) and hikes in electric energy tariffs associated with higher costs of energy during the dry season (April-November).

IPCA - Contributions (Waves)

	2015	2016	Δ	2017 (f)	Δ	2018 (f)
IPCA	**10.7**	**6.3**	**-4.4**	**4.2**	**-2.1**	**4.2**
Regulated	4.4	1.3	-3.0	1.4	0.1	1.2
Market	6.5	5.0	-1.4	2.8	-2.2	3.0
Tradables	2.9	2.4	-0.5	1.5	-0.9	1.7
Non-tradables	3.6	2.6	-1.0	1.3	-1.3	1.3
Food at home	3.3	2.4	-0.9	0.6	-1.8	1.2
Services	2.9	2.3	-0.6	1.4	-0.9	1.3

Sources: IBGE and Santander estimates.

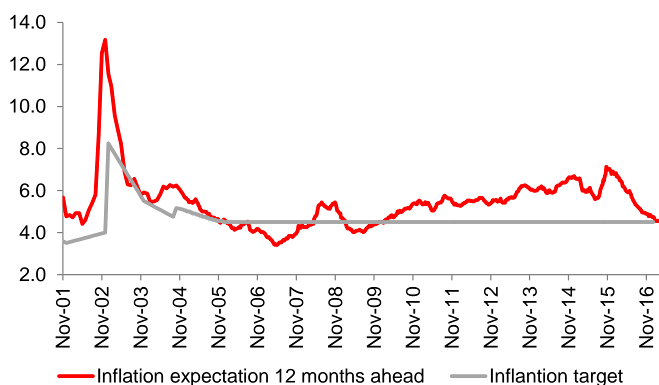
For 2018, we do not expect either wave to produce a significant shift in inflation. Therefore, we believe that inflation in 2018 will be similar to inflation in 2017 (consumer prices). **We are revising downward our inflation forecasts for 2017 and 2018, to 4.2% and 4.2%, respectively, based on the surprising BRL appreciation in 1H17, foodstuff deflation in 1Q17, likely foodstuff disinflation through 2017, and the absence of waves in the 2018 inflation scenario.**

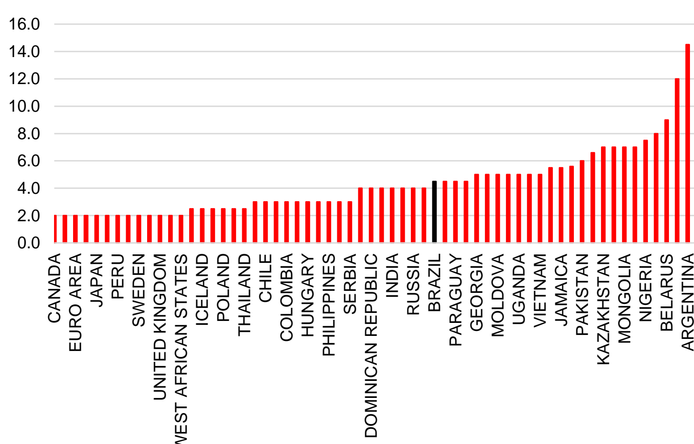
Inflation trend – No waves

Significant shifts in inflation used to be a rare event in Brazilian consumer price indices, mainly because of the important contribution of inertia, as services prices represent 35% and regulated prices represent 24%, which sum to 59% of IPCA. Also, there is an important cyclical item: foodstuff prices (at home), which represent 17%, and depends on an unpredictable factor (weather) and on demand. **Thus, the other 24% of IPCA – a mix of durable, semidurable and non-durable (ex-food) goods – there is no clear deflationary or inflationary trends. Because of this, we believe that the most likely scenario is 2018 inflation at the same level registered in 2017.**

We believe inflation will not head south forever, for instance reaching 2% in 2018. We do not believe it is reasonable to expect the third wave (the disinflationary wave) to shift inflation down. Also, because of the high contribution of inertia, the current environment of a well-behaved exchange rate and weak economy contribute to inflationary pressures to be offset by deflation of other consumer staples. Even in our scenario that assumes a depreciating trend for the BRL from 2H17 onwards, we do not see the exchange rate pass-through effect on inflation and the normalization of foodstuff inflation as sufficient to more than offset the disinflationary impact of the lower inertia of 2017 and high output gap on regulated and services prices, inflation expectations, and the possibility of a lower inflation target for 2019.

Our scenario also assumes a reduction of the inflation target to 4% for 2019. As the inflationary target system was constructed, the target aims to influence inflation expectations, helping to minimize the economic activity costs of using monetary policy to reduce inflation. During periods of high confidence by the market regarding the monetary authority's ability to control inflation within the inflation target, inflation expectations have historically remained at the target. We believe the reduction of the inflation target for 2019 will help to curb inflation expectations for 2018 to under 4.5%, which would help to offset inflationary pressures.





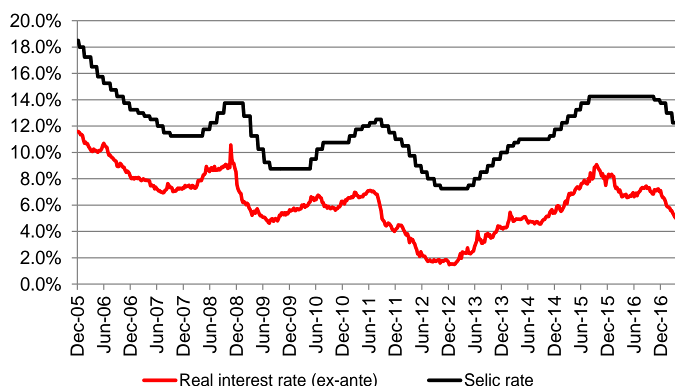
Sources: BCB, Central bank news and Santander estimates.

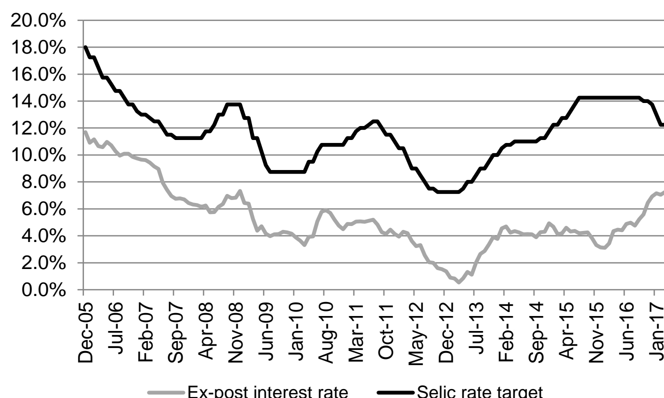
Moreover, the Brazilian inflation target of 4.5% is one of the highest among the countries that adopt the inflation target system. The advanced economies experience points to an average of 2-3%. In the right-hand chart above, Brazil's inflation target is closer to the bottom of the distribution of inflation targets across the world; the current target of Brazil's 17 year-old inflation target system is only lower than inflation-targeting countries that recently adopted this system.

… which means a faster pace for monetary easing

We are revising downward our call for the 2017 year-end Selic rate to 8.5% p.a. from 9.75% p.a. Previously, our scenario was for the Selic rate being cut to single-digits this year, to 9.75% p.a., and then, to 8.5% throughout 1H18. The consecutive waves pushing inflation towards the target leave room for faster monetary easing, in our opinion – mainly because monetary policy remains in a contractionary mode due to the current disinflationary process and its impact on the behavior of inflation expectations.

For instance, the ex-ante real interest rate (one-year future rate discounted by the 12-month IPCA expectations) is around 5% and the ex-post interest rate (Effective annualized Selic discounted by IPCA accumulated in the last 12 months) is around 7% – both above the neutral level that we estimate in the 4-5% range. There are some important empirical signals from the tight stance of monetary policy: (a) the current output gap is among the widest in history and unemployment continues to deviate from NAIRU (Non- Accelerating Inflationary Rate of Unemployment) estimates; (b) final average interest rates for consumers and companies have increased and credit is still contracting, suggesting financial conditions are adverse and biased towards additional deterioration, and, moreover, credit from state-owned banks, notably the BNDES, which has been a major source of ex-interest rate monetary expansion in recent years, is trending down faster than those from privately-owned banks.





Sources: BCB, Bloomberg and Santander estimates.

The still tight current monetary stance, combined with the current recessionary backdrop, the downward current trend of inflation, and well-anchored inflation expectation from 2018 onwards, create room for a significant easing cycle. **Assuming a positive evolution of the fiscal adjustments measures, with Congressional approval for at least 60% of the government's original social security reform proposal, and the convergence of inflation towards 4.5%, safely allows for the reduction of the real ex-ante interest rate to the bottom of the neutral rate range (at 4%). Therefore, we forecast Selic rate at 8.5% at the end of 2017, with cuts of 100bp in the April and June Copom meetings, then being held at 8.5% throughout 2018.**

Revision of Forecasts

	2015	2016	2017	2018	2019	2020
IPCA (y/y %)	10.7	6.3	~~4.8~~ 4.2	~~4.5~~ 4.2	~~4.5~~ 4.0	~~4.5~~ 4.0
Selic rate (end of period %)	14.25	13.75	~~9.75~~ 8.50	8.50	8.5	8.5

Sources: IBGE, BCB and Santander estimates.

CONTACTS / IMPORTANT DISCLOSURES

Macro Research			
Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@bzwbk.pl	48-22-534-1888
Sergio Galván*	Economist – Argentina	sgalvan@santanderrio.com.ar	54-11-4341-1728
Maurício Molan*	Economist – Brazil	mmolan@santander.com.br	5511-3012-5724
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
Brendan Hurley	Economist - Colombia	bhurley@santander.us	212-350-0733
David Franco*	Economist – Mexico	dafranco@santander.com.mx	5255 5269-1932
Tatiana Pinheiro*	Economist – Peru	tatiana.pinheiro@santander.com.br	5511-3012-5179
Piotr Bielski*	Economist – Poland	piotr.bielski@bzwbk.pl	48-22-534-1888
Marcela Bensión*	Economist – Uruguay	mbension@santander.com.uy	5982-1747-5537
Fixed Income Research			
Brendan Hurley	Macro, Rates & FX Strategy – Latin America	bhurley@santander.us	212-350-0733
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778
Nicolas Kohn*	Macro, Rates & FX Strategy - LatAm	nicolas.kohn@santandergbm.com	4420-7756-6633
Aaron Holsberg	Head of Credit Research	aholsberg@santander.us	212-407-0978
Equity Research			
Christian Audi	Head LatAm Equity Research	caudi@santander.us	212-350-3991
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Valder Nogueira*	Head, Brazil	jvalder@santander.com.br	5511-3012-5747
Pedro Balcao Reis*	Head, Mexico	pbalcao@santander.com.mx	5255-5269-2264

Electronic Media	
Bloomberg	SIEQ <GO>
Reuters	Pages SISEMA through SISEMZ

This report has been prepared by Santander Investment Securities Inc. ("SIS"; SIS is a subsidiary of Santander Holdings USA, Inc. which is wholly owned by Banco Santander, S.A. "Santander"), on behalf of itself and its affiliates (collectively, Grupo Santander) and is provided for information purposes only. This document must not be considered as an offer to sell or a solicitation of an offer to buy any relevant securities (i.e., securities mentioned herein or of the same issuer and/or options, warrants, or rights with respect to or interests in any such securities). Any decision by the recipient to buy or to sell should be based on publicly available information on the related security and, where appropriate, should take into account the content of the related prospectus filed with and available from the entity governing the related market and the company issuing the security. This report is issued in Spain by Santander Investment Bolsa, Sociedad de Valores, S.A. (“Santander Investment Bolsa”), and in the United Kingdom by Banco Santander, S.A., London Branch. Santander London is authorized by the Bank of Spain. This report is not being issued to private customers. SIS, Santander London and Santander Investment Bolsa are members of Grupo Santander.

ANALYST CERTIFICATION: The following analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed, that their recommendations reflect solely and exclusively their personal opinions, and that such opinions were prepared in an independent and autonomous manner, including as regards the institution to which they are linked, and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report, since their compensation and the compensation system applying to Grupo Santander and any of its affiliates is not pegged to the pricing of any of the securities issued by the companies evaluated in the report, or to the income arising from the businesses and financial transactions carried out by Grupo Santander and any of its affiliates: Tatiana Pinheiro*.

*Employed by a non-US affiliate of Santander Investment Securities Inc. and not registered/qualified as a research analyst under FINRA rules, and is not an associated person of the member firm, and, therefore, may not be subject to the FINRA Rule 2242 and Incorporated NYSE Rule 472 restrictions on communications with a subject company, public appearances, and trading securities held by a research analyst account.

The information contained herein has been compiled from sources believed to be reliable, but, although all reasonable care has been taken to ensure that the information contained herein is not untrue or misleading, we make no representation that it is accurate or complete and it should not be relied upon as such. All opinions and estimates included herein constitute our judgment as at the date of this report and are subject to change without notice.

Any U.S. recipient of this report (other than a registered broker-dealer or a bank acting in a broker-dealer capacity) that would like to effect any transaction in any security discussed herein should contact and place orders in the United States with SIS, which, without in any way limiting the foregoing, accepts responsibility (solely for purposes of and within the meaning of Rule 15a-6 under the U.S. Securities Exchange Act of 1934) for this report and its dissemination in the United States.

© 2017 by Santander Investment Securities Inc. All Rights Reserved.