ECONOMICS February 2, 2018

Brazil Macro Compass

We Expect the Overnight Rate to Reach a New 60-Year Low

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Forthcoming: 2018 First Rate Decision

We expect Brazil Central Bank to cut the benchmark overnight rate (Selic) to 6.75% (from 7.0%) next Wednesday. That would put the policy rate at a 60-year low (for more details, see our report *Coming—The Lowest Interest Rates Ever?*, October 10, 2017). We continue to expect a positive impact of the easing cycle on economic activity, mainly through the channel of falling household debt burden. (See our report *The Unstoppable Force of Consumption*, January 3, 2018.)

Another aspect worth mentioning is the effect of monetary policy over the exchange rate. It is true that the USD has been weakening against most currencies, and that Brazilian markets have been showing more optimism concerning the result of the presidential elections. Despite that, BRL is currently trading around the same levels of 12 months ago, whereas the majority of other EM currencies strengthened against the USD. We believe that the main cause of this relative underperformance is the **narrowing interest rate differential**. We examined this hypothesis in *Why Has the BRL Weakened in 2017?*, January 8, 2018.

We believe that Brazilian rates will remain low (around the current levels) for the next 18 months. Consequently, we see little room for additional strengthening and some asymmetry towards weakening. We forecast the USD/BRL rate at 3.50 at this year's end.

This scenario of low interest rates is supported by a high degree of economic slack and well-behaved inflation. **January CPI inflation will be released next Thursday; we expect monthly inflation at 0.41%, bringing 12-month inflation to 2.98%**—still below the lower bound of the inflation target.

What's New

December economic activity data released this week reinforced our view of a consistent economic recovery. Industrial production rose 2.8% m/m (above market consensus, at 2.3% m/m), bringing y/y growth to 4.4% and pointing toward 2017 GDP growth above 1%. **The improvement in the labor market has been more gradual, but December marked the eight month in a row of growing employment.** Seasonally adjusted unemployment rate reached 12.3% (from a 13.1% peak in April). The fall in unemployment has been followed by a strong expansion in the labor force (which grew 1.7% in 2017, on average), which is a sign of the recovery's robustness. **We expect the unemployment rate to end this year at 10.8%.**

Political Agenda

Congress is back from the long summer recess, and the government is expected to concentrate efforts in trying to vote the pension reform before the end of February. We continue to believe that the probability of getting the bill approved is low. Several deputies from the ruling coalition (including the speaker of the house) have appeared in the press recently saying that the government does not have enough votes to form a constitutional majority (3/5 of the house), and that the

President’s bargain power seems to be limited as the elections inch closer. Markets seem to largely agree with this assessment, which means that there is no apparent downside to asset prices in case the voting fails, in our view.

This week *Valor*, Brazil’s main financial newspaper, reported, without providing many details, that President Temer decided not to put to a Congress vote the reintroduction of payroll taxes to some sectors that were benefited with breaks during the Dilma administration. This would imply around BRL 3 billion less in tax revenues this year. *Valor* also said that the government gave up on postponing wage increases for public servants as well, which should increase government spending by BRL 4.4 billion in 2018. The impact on the primary deficit is expected to be attenuated by a minimum wage increase smaller than what was budgeted and (in our view) GDP growth above the official forecast (currently at 3%). However, in order to meet the mandatory spending cap, the government will have to cut at least BRL 5 billion in budgeted expenses anytime soon, in our view.

Recent Publications (Available on Our Website)

- *Why Has the BRL Weakened in 2017?* (January 8, 2018)
- *The Unstoppable Force of Consumption* (January 2, 2018)
- *It's Raining Cats and Dogs; Impact of Hydrology on Tariffs and Inflation* (November 29, 2017)
- *Let’s Try Again: The Positive and the Negative in the Latest Attempt to Pass Social Security Reform* (November 28, 2017)

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