

Brazil Macro Compass**A New Inflation Target for 2021?**

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Upcoming Data: A Profusion of Information on Monetary Policy

Following this week's monetary policy decision (see "What's New" below), we believe Brazil's Central Bank (BCB) will spill a lot of ink to explain its actions and signal its next steps to markets. Next week, besides the regular minutes of the June 19-20 meeting (to be released on June 26), BCB is scheduled to release its Quarterly Inflation Report (on Thursday, June 28), with detailed and updated inflation forecasts. Also on June 26, the National Monetary Council (CMN), composed of the central bank governor, the finance minister, and the planning and budget minister, meets to define the inflation targets to be pursued in 2020 and 2021. In our view, the 2020 target midpoint, already set last year, will be confirmed at 4.0%. For 2021, we expect the target to be reduced to 3.75%, following a strategy of convergence toward a target compatible with other emerging countries that adopt the inflation target system (for more on that, see our report *The Good Convergence*, May 9, 2018).

What's New: Copom on Hold; Inflation after the Truck Drivers' Strike

BCB's Monetary Policy Committee (Copom) unanimously decided to keep its policy rate (Selic) at 6.5%, in line with market consensus. In doing so, Copom pointed out that the balance of risks continues to warrant a stimulative monetary policy, with the pass-through of the weaker currency limited by the current economic slack. BCB's own updated forecasts are consistent with this perception: assuming BRL and Selic remain stable at current levels, BCB's models point to year-end 12-month inflation at 4.2% in 2018 and 4.1% in 2019, in both cases below the respective target midpoints (4.5% and 4.25%). Assuming market consensus (according to the Focus survey) for BRL (3.63/USD at end-2018 and 3.60/USD at end-2019) and Selic (6.5% and 8.0% respectively), BCB's models point to inflation at 3.7% in 2019, well below the center of the target (4.25%); these figures suggest that, under the current conditions, BCB is unlikely to act in line with the tightening priced in by the futures markets, which is significantly higher than analysts' consensus.

The door to a rise in the Selic has not been entirely shut, though, as the BCB places substantial weight on inflation expectations (in line with the theoretical framework of the inflation target policy). In this sense, it is critical to observe how these expectations evolve over the course of the coming six weeks until the next Copom meeting (scheduled for August 1). In our view, three factors may influence inflation expectations within this time frame: (i) the evolution of the BRL, (ii) a surprise in the June inflation reading, (iii) analysts' assessment of potential changes both in the international environment and in economic policy from 2019 on. If the BCB continues to succeed in containing BRL volatility, we think inflation expectations should remain anchored (that is, at or below next year's target) at least within this time frame. Thus, we continue to see the Selic stable at 6.5% until 2H19 – recall that ample idle capacity, even during a moderate recovery, tends to keep inflation down, provided that economic policy remains compatible with the continuation of long-term fiscal consolidation.

June IPCA-15 came in at 1.11% m/m, slightly above consensus (1.00% m/m) and our estimates (1.05% m/m). The reading was contaminated, as largely expected, by the supply disruptions following the May truck drivers' strike: foodstuff and fuel prices rose in June by 2.3% and 5.9%, respectively. Core inflation readings remained around 3% y/y. We believe that monthly headline inflation will normalize in July and August to levels compatible with our year-end forecast (3.5% y/y) and that second-order effects of the May shock should be negligible.

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

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Political Agenda

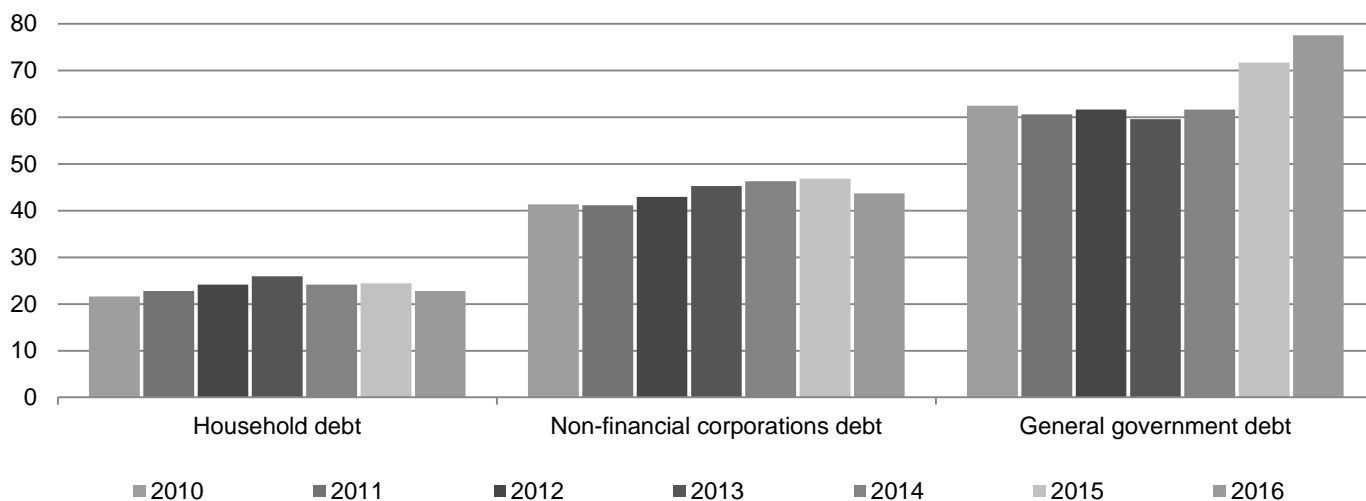
This week the Lower House approved a bill that allows the national oil company to auction exploration licenses for oil fields that exceed the production volume agreed to in the original contract with the government, set in 2010. The auction, which is expected to bring a substantial volume of extraordinary revenue to government accounts this year, is scheduled for November 29, although some regulation is still pending.

No major electoral polls are scheduled to be released next week, and the legislative agenda is expected to remain light.

Chart of the Week: A New Debt Database

IMF recently launched its Global Debt Dataset, a herculean effort to put together cross-country aggregated debt statistics dating back to 1950. Our “Chart of the Week” shows recent data for Brazil. Household and corporate marginal leverage was negligible from 2010 to 2016, while the growth of government debt accelerated from 2014.

Brazil, Debt/GDP ratios (%)



Source: IMF Global Debt Dataset.

Number of the Week

45%

According to the latest IPCA-15, potato prices rose 45% in June, making potatoes the food item most affected by the shortages caused by the truck drivers' strike.

Quote of the Week

The picture of the present moment is somber, but the Brazilian democracy movie is good and can have a happy ending.

— **Justice Luís Roberto Barroso**, in a seminar promoted by *O Globo* newspaper.

What We've Been Reading

- “Ciro Gomes: ‘Brazil Cannot Endure a Leftist Government,’” by Matt Sandy (*Americas Quarterly*, June 21, 2018). An interview with the leading presidential candidate from the left of the political spectrum.
- “Why Markets Should Be Skeptical of Jair Bolsonaro,” by Pedro Abramovay (*Americas Quarterly*, June 13, 2018). Bolsonaro’s actions throughout his long career as a lawmaker are very different from his liberal speech, argues the author.



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- “Corruption thrives in a globalized world,” by Gideon Rachman (*Financial Times*, June 18, 2018). “. . . it turns out that the Brics do have something in common after all – corruption. In all five countries, popular rage about graft is at the very heart of politics. And because these countries are increasingly important to the world economy, their corruption problems have global implications.”
 - “Will Groups of 3 Ruin the World Cup?” by Julien Guyon (*SSRN*, June 20, 2018). In 2026, 48 teams will be divided in 16 groups of 3, which will create incentives for match fixing, according to Guyon, a mathematician.

Recent Publications (Available on Our Website)

- *“Lethal Weapon”: How Far Can the BCB Go with Swaps?* (June 15, 2018)
- *Rely on Fundamentals and Carry On* (June 8, 2018)
- *Truck Strike: A Preliminary Assessment* (May 29, 2018)
- *Copom Capitulates to Changing Balance of Risks* (May 16, 2018)
- *Monetary Policy: The Good Governance* (May 9, 2018)
- *Infinite (Trade) War: Does It Matter for Brazil?* (May 2, 2018)



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