

## Brazil Macro Compass

### 2018 Yearly Inflation at 3.75%

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#### What's New: 2018 Inflation Below Target Midpoint

December CPI inflation was 0.15% m/m, slightly below our forecast (0.18% m/m) and above market consensus (0.12% m/m). With that result, 2018 yearly inflation reached 3.75%, significantly below the inflation target midpoint (4.5%) but above the target's lower bound (3.0%). Inflation in semi-durable goods came in higher than expected (at 1.06% m/m), more than offsetting the November deflation resulting from "Black Week" sales (-0.39% m/m). Services inflation printed below our forecast, with the lowest yearly inflation in healthcare services since 2006.

Yearly core inflation ended 2018 at 2.8%, the lowest since 1998. At the margin (annualized three-month inflation, after seasonal adjustments), core inflation is running at around 2.0% y/y, which reinforces our view that 2019 inflation is likely to remain subdued. We expect year-end headline inflation at 3.7%, which, in our view, is compatible with a flat Selic rate throughout the year.

#### Political Agenda: Waiting for the Pension Reform Proposal

The Congress is still three weeks from returning to its regular activities, so the executive branch has been dominating the news flow. Details about the government's pension reform proposal still have not been officially unveiled – the president's chief of staff, Onyx Lorenzoni, said this week that the economic team will present its proposal to President Bolsonaro early next week, so he can evaluate it before his trip to the World Economic Forum the week of January 21. The next important events to watch are the elections for the leadership of both houses of Congress, starting on February 1.

#### Upcoming Data: November Retail Sales

The week ahead has a light schedule of economic indicator releases. We highlight November retail sales, which we expect to show a boost from "Black Week" discounts. We expect 1.25% m/m growth in core retail sales (+2.3% y/y). The poor performance of auto sales in the month (-4.5% m/m, according to Fenabreve) should lead to much weaker growth of the headline indicator (0.75% m/m), in our view.

#### In-Depth Research: 10 Macro Propositions for 2019

In *10 Macro Propositions for 2019* (January 7, 2019) we present the main assumptions and implications of our economic scenario for this year. A key assumption is that the government will manage to pass meaningful pension reform by the end of the year, significantly reducing the perceived risk of debt insolvency. Once this hurdle is cleared, we see the potential for a year that combines low inflation, low interest rates, and cyclically strong growth, led by domestic consumption. We forecast year-end CPI inflation at 3.8% y/y, 3% GDP growth, and a flat overnight rate at 6.5%. Despite this relative optimism, we believe BRL will trade on the weak side, due to low interest rate differentials and shrinking global liquidity. We forecast the year-end USD/BRL rate at 4.00.

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

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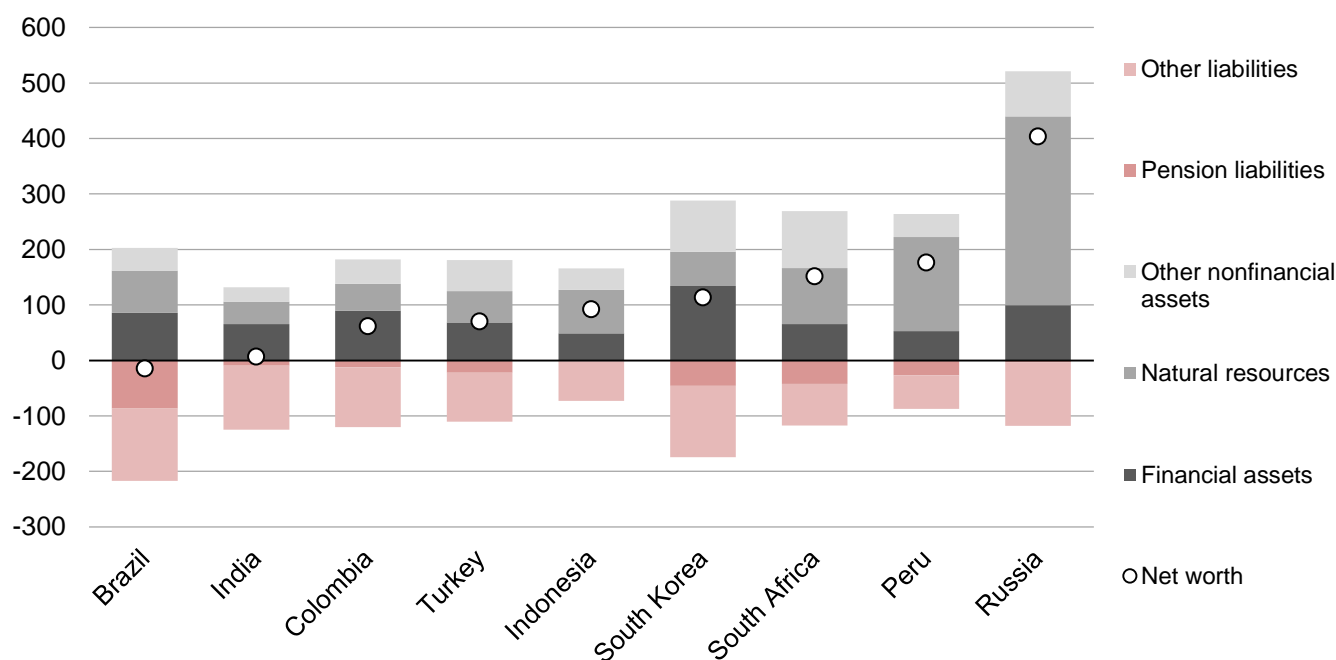
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## Chart of the Week: The Balance Sheet Approach

One of the key features of Minister of Finance Paulo Guedes’s economic policy framework is a “balance sheet approach” to public debt management – the idea that the government should tap into its stock of assets through privatizations, concessions, and securitization, using the proceeds to retire bonds and induce a reduction in interest rates. Our “Chart of the Week” uses data recently compiled by the IMF (in its latest Fiscal Monitor) to catch a glimpse of the potential of such an approach. Brazil has the lowest (and the only negative) net worth in our sample of emerging countries, mostly because of the size of its public sector pension liabilities (87% of GDP, versus an average of 21% for the other countries). Adding the liabilities of the underfunded pension system for private sector workers would only further weaken this already bleak picture, which underscores the importance of comprehensive pension reform.

### Public Sector Balance Sheets (% of GDP)



Sources: IMF, *Fiscal Monitor*, October 2018.

## Number of the Week

# 2

For the second year in a row, 12-month inflation finished the calendar year below the inflation target midpoint. Since the beginning of the inflation target system, in 1999, this is only the second time that has happened (previously in 2006-07).

## Quote of the Week

*“Military is a very distinguished category, in uniform. Military, police, penitentiary agents, Judiciary, Legislative, Public Prosecution have special characteristics that have to be considered and discussed.”*

— **General Carlos Alberto dos Santos Cruz**, Secretary of Government, commenting on pension reform, as reported by *Estadão* (January 9, 2019).

## What We’ve Been Reading

- “Brazil’s Love Affair with Diplomacy Is Dead,” by Omar G. Encarnación (*Foreign Policy*, January 8, 2019). With Bolsonaro, Brazil is set to break a long tradition of championing international liberalism, argues Encarnación.



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- *Bolsonaro and Brazil's Illiberal Backlash*, by Wendy Hunter and Timothy J. Power (*Journal of Democracy*, January 2019). An in-depth account of the rise of Bolsonaro, by two leading Brazilianists.
  - *Top Risks 2019* (Eurasia Group, January 7, 2019). According to Eurasia, Brazil is part of the “coalition of the unwilling,” countries governed by leaders “unwilling to uphold the global liberal order, with some even bent on bringing it down.” The potential for a slide into dictatorship, however, is perceived as a red herring.
  - “Una república disfuncional que aún así puede frenar el autoritarismo,” by Aníbal Pérez-Liñán (*La Nación*, January 3, 2019). According to the author, a fragmented Congress is a powerful counterweight to contain authoritarianism.
  - “How I Fell in Love with São Paulo,” by William O’Connor (*Daily Beast*, December 31, 2018). Yes, that is possible.

### Recent Publications (Available on Our Website)

- *Brazil Macro Scenario: 10 Macro Propositions for 2019* (January 7, 2019)
- *Economic and Political Calendar: What to Watch in Brazil in 2019* (December 5, 2018)
- *Risks for the Selic in 2019 Expected to Become Even Less Asymmetric* (November 6, 2018)
- *20 Charts that Explain Brazil's New Political Power Structure* (October 29, 2018)
- *Brazil Post Elections: Honeymoon and Marriage* (October 25, 2018)



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