ECONOMICS **February 1, 2019**

Brazil Macro Compass

Goldfajn's Swan Song

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Upcoming Data: First Copom Meeting of 2019; January Inflation

Next week's Copom meeting (on February 6) should be the last one chaired by Ilan Goldfajn (we expect Roberto Campos Neto, the chairman appointed by the new government, to be confirmed by the Senate before the March 20 meeting). Goldfajn will hand over the baton amid well-anchored inflation expectations, easing financial conditions, and markets starting to ascribe some probability to residual rate cuts this year (after this week's tightening, one-year rates are now trading below the overnight rate). We believe it is highly unlikely that the Selic rate will be changed next Wednesday: nothing in Copom's official communication suggests that it will happen, inflation and growth expectations have barely moved since the December meeting (see the table below), and, in our view, an outgoing governor has little incentive to change the monetary policy stance in a surprising move.

We continue to believe that our year-end scenario, with yearly inflation at 3.7% and GDP growth at 3.0%, is compatible with a flat Selic rate (at 6.5%). The current widespread rate-cut expectations are, in our view, based on three assumptions: (i) inflation in the short term may surprise to the downside, increasing the risk of an extended period of undershooting the target midpoint; (ii) economic activity will remain subdued into 1Q19; and (iii) the proposed pension reform will go through at least one floor vote in the Lower House of Congress in the first half of the year, leading to a reassessment of the neutral rate of interest. We believe that point (i) is reasonably plausible, but there is still little evidence of (ii) and especially (iii). Moreover, the inflation outlook could change significantly before May, which is when many market participants are expecting cuts. In addition, we believe it is unlikely that a new board will start cutting at its first meeting, on March 20. The statement following the rate decision and the minutes in the following week may bring an acknowledgement that the balance of risks has marginally tilted toward lower inflation/slower growth, but we believe it is still too early to forecast further easing.

Selected Financial and Economic Indicators, Changes Between Copom Meetings

Market prices	**12-Dec**	**31-Jan**	**Change**
BRL/USD rate	3.85	3.66	-4.9%
5-year CDS	202	165	-37 bps
1-year rate	6.71%	6.41%	-30 bps
1-year breakeven inflation	3.99%	4.02%	3 bps
5-year rate	9.54%	8.52%	-102 bps
Crude oil WTI (USD)	51	55	7.8%
Crude oil WTI (BRL)	196	201	2.5%
CRB Food (USD)	329	331	0.7%
CRB Food (BRL)	1,265	1,210	-4.3%
Market expectations*	**07-Dec**	**25-Jan**	**Change**
2019 CPI inflation (12m, year-end)	4.07%	4.00%	-7 bps
2020 CPI inflation (12m, year-end)	4.00%	4.00%	0 bps
2019 GDP growth	2.53%	2.50%	-3 bps
2020 GDP growth	2.50%	2.50%	0 bps

*Median of expectations in the Focus weekly survey. Sources: Brazil Central Bank, Bloomberg, Anbima, Santander.

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January CPI inflation data will be released after the Copom decision, on February 8. We expect monthly inflation at 0.37%, with 12-month inflation reaching 3.83%, below the target midpoint (4.25%). The main highlight of the release will be, in our view, food inflation accelerating to 0.96% m/m, in line with its seasonal pattern. Also, core inflation should continue subdued due to the still weak labor market, negative output gap and modest economic recovery. We expect year-end CPI inflation at 3.7% y/y, allowing for a flat Selic rate throughout 2019.

What's New: 2018 Industrial Production and Fiscal Data

December industrial production surprised slightly to the upside, at +0.2% m/m (our forecast was a monthly contraction of the same magnitude). With that result, industry expanded by only 1.15% in 2018, a marked deceleration from 2017 (2.5% growth), led by durable goods (yearly growth at 7.6%, down from 13.2% in 2017). Although better than expected, the data supports our expectation of slow (close to zero) marginal GDP growth in 4Q18 – in the quarter, industrial production contracted 1.3%, from a 2.5% expansion in 3Q18.

2018 primary budget balance came in well below the set target (BRL 108.3 billion deficit vs. BRL 161.3 billion deficit target), mainly due to extraordinary revenue (especially oil royalties) and lower realized expenditures. The ceiling on public spending (approved in late 2016) has been crucial for controlling expenditure in Brazil (in real terms), while tax collection has been showing more consistent signs of recovery. However, we see little reason to celebrate: the fiscal effort required to stabilize the public debt-to-GDP ratio corresponds to around 3 pp of GDP, and we believe it is impossible to achieve that without structural reforms (especially pension reform).

We believe the government will have no difficulty in achieving the primary balance target (BRL 132 billion deficit) and in sticking to the spending ceiling rule in 2019. Indeed, we believe that the difference between the actual primary balance and target will be significant this year – we expect a primary deficit of BRL 95 billion, or 1.3% of GDP. We think the figure could be even better depending on the extent of (i) the oil transfer rights deal (up to BRL 80 billion in an optimistic scenario); (ii) 5G wireless auction (government's estimate of BRL 18 billion); and (iii) concessions and privatizations exceeding the budget (which considers privatization resources below BRL 15 billion).

Nevertheless, we believe 2020 should be much more challenging in terms of meeting key fiscal targets. We have emphasized that Brazilian fiscal imbalances extend well beyond social security (see our report *10 Macro Propositions for 2019*, January 7, 2019). Even assuming the approval of pension reform this year (as in our baseline scenario), additional fiscal measures would have to be implemented in order to prevent a drastic reduction in non-mandatory spending (approaching shutdown levels) or a failure to meet the spending ceiling in 2020. A broader reversal of tax exemptions, changes in the minimum wage adjustment rule, and changes in unemployment benefits and salary bonuses are some examples of additional fiscal measures that we believe could be carried out. Overall, we think that the government will succeed in balancing public finances despite these challenges. Our baseline scenario points to primary surpluses from 2021 onward and public debt-to-GDP ratio peaking in 2023.

In-Depth Research: Risks to Growth and Explaining Tightening CDS Spreads

In *Substantial Challenges and Risks in the Global Outlook: How Do They Affect Brazil?* (January 29, 2019), we try to assess the sensitivity of the expected economic recovery in Brazil to various scenarios for the global economy, through trade and financial channels. Our baseline scenario, with Brazil's GDP growing at a yearly average of 3% in 2019-2020, has as its premise average annual global growth of 2.8% in the period. A slowdown in global growth to 1.2% annually would reduce our yearly forecasts for Brazil's growth by 90 bps (to 2.1%).

In *Brazilian Asset Prices: How Much "Over" Has the Performance Been?* (January 31, 2019), we update our model, which disentangles external and domestic factors behind movements in sovereign CDS spreads. We conclude that almost 100% of the year-to-date tightening in Brazil five-year CDS (from 206 bps to 163 bps) is explained by external factors, such as global risk appetite, commodity prices, and U.S. interest rates. This, in our view, is both a problem and an opportunity: a problem because the country remains quite sensitive to gyrations in global financial conditions, and an opportunity because advances in the fiscal consolidation agenda may trigger a decrease in the idiosyncratic component of country risk that is still not priced in.

Political Agenda: Congress's New Year

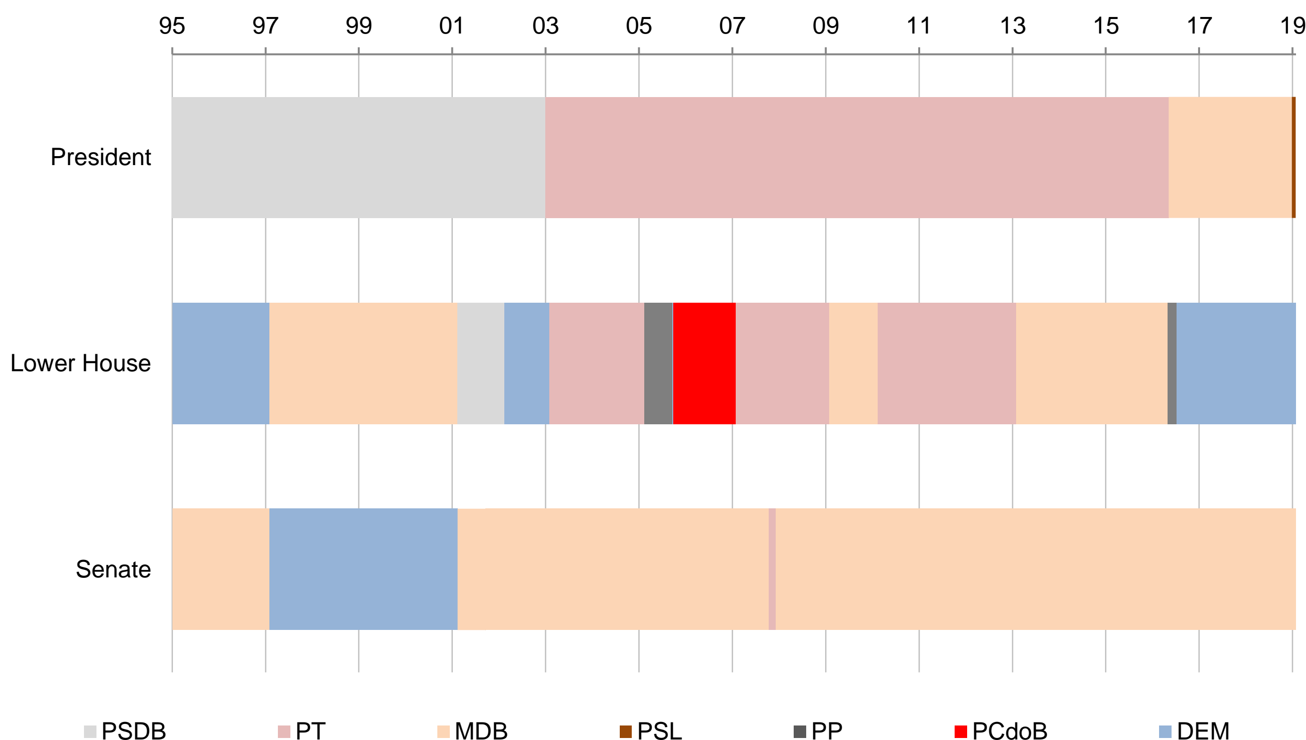
The Brazilian Congress resumes its activities today (February 1), with elections for the leadership (speakers and board) of both houses. The elections start at 6 p.m. Brasília time, and a run-off will take place if no candidate reaches 50% plus one of total votes in the first round. In the Lower House, the current speaker, Rodrigo Maia (DEM-RJ), is running for reelection and has, so far, amassed support from 14 parties (including Bolsonaro's PSL) that adds up to 271 representatives (out of 513). Another six candidates have announced their intention to run (final registration ends one hour before the voting starts). In the Senate, historically the party with more seated senators is able to elect the president of the upper house, which would favor MDB's candidate, Renan Calheiros (see the "Chart of the Week" below). Another eight legislators have declared their candidacies, which should be confirmed by the time the voting starts.

In an interview on January 29, the government's Special Secretary for Social Security and Labor, Rogério Marinho, said that the government is planning to present its pension reform proposal to Congress in the second or third week of February – the last word will be with the government's political coordination team. The reform will probably only begin to be discussed in the Lower House after the Carnival holiday, in March, since we expect most of February to be dedicated to the formation of the house committees and other administrative issues.

Chart of the Week: Executive and Legislative (Mis)Alignment

Our "Chart of the Week" plots the trajectory of the leadership of the executive and both houses of the legislature since 1995. Whereas the presidency of the Senate in the period has been dominated by only two parties (the Brazilian Democratic Movement, or MDB, and the Democrats, or DEM), the party affiliation of the speaker of the Lower House is much more changeable, having shifted among six different parties. It is also notable that it is relatively rare that the party of the president has led at least one of the houses of Congress – it happened briefly during Cardoso's government (Party of the Brazilian Social Democracy, or PSDB), on and off under presidents Lula and Rousseff (Workers' Party, or PT), and for the whole of the Temer period (MDB).

Brazil, Party Affiliation of President, Speaker of the Lower House, and President of the Senate



Sources: Brazilian Lower House, Senate, Santander.

Number of the Week

894k

According to IBGE's monthly household survey, around 894,000 jobs were created in Brazil in 2018, barely enough to cover the increase in the labor force (778,000 more people). As a result, the unemployment rate fell by only 20 bps (to 11.6%) year-over-year.

Quote of the Week

"You knew old Renan. The new one arrives on Friday and will disagree with the other on a lot of things. The other was more statist. This will be a liberal Renan, who will help make the reforms."

— **Renan Calheiros,** MDB candidate for the presidency of the Senate, in an interview with *Valor* (January 30, 2019).

What We've Been Reading

- "Bolsonaro's Deal-Making in Spotlight as Brazil Congress Returns," by Samy Adghirni and Raymond Colitt (*Bloomberg*, January 31, 2019). Bolsonaro's "new politics" starts to be tested with the beginning of the legislative year.

- "Brazil reclaims status as an emerging-market darling among investors amid new leadership," by Fred Imbert (*CNBC*, January 29, 2019). What's behind Brazil markets' ascension to being the hottest in the world currently.

- "Why Brazil Must Build a (Fiscal) Wall," by Otaviano Canuto (*Americas Quarterly*, January 30, 2019). "Fiscal walls" (to sustain the spending ceiling) need to be built this year for the markets' optimism to continue, argues Canuto.

- "The rise of the right-wing globalists," by Quinn Slobodian (*New Statesman*, January 31, 2019). Interesting hypotheses about the relationship between the latest wave of elected right-wing leaders and transnational capitalism.

- *Public Debt Through the Ages* by Barry Eichengreen, Asmaa el-Ganainy, Rui Esteves, and Kris James Mitchener (*NBER Working Paper No. 25494*, January, 2019). Eichengreen and coauthors take a long view on cycles of fiscal expansion and consolidation. One interesting takeaway: "Today, financial repression is unlikely to be as effective as after World War II. Repression then relied on tight financial regulation, capital controls, and limited investment opportunities. Today a much larger share of advanced economy debt is held by non-residents, and a lower share by banking systems, making it more difficult to maintain a captive investor base that accepts debt offering sub-market returns. In addition, regulatory measures compelling banks to hold domestic government debt and then attempting to inflate it away could threaten financial stability in the financially-competitive low-growth environment of the 21st century."

Recent Publications (Available on Our Website)

- *Brazilian Asset Prices: How Much "Over" Has the Performance Been?* (January 31, 2019)
- *Substantial Challenges and Risks in the Global Outlook: How Do They Affect Brazil* (January 29, 2019)
- *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)

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