ECONOMICS **May 24, 2019**

Brazil Macro Compass

The song remains the same

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In-Depth Research: Confirming thesis

We released two pieces this week about FX rate dynamics and a suggestion for an improvement in the inflation-targeting regime in Brazil. In *Is It Time to Upgrade Core Inflation Measures?* (May 21, 2019) we call attention to the fact that headline and underlying inflation gauges have diverged lately and our belief that they should continue to do so in the future due to temporary factors – e.g., the African swine fever that has hit the production of Chinese pigs. This discrepancy may blur prospects for the conduct of monetary policy in the future, as the Brazilian Central Bank's goal is to keep the headline change as close as possible to the targeted level, but we think that in its most recent actions the BCB has made it clear that it continues to be quite at ease with inflation dynamics, notwithstanding the uptick registered by the IPCA headline change in YoY terms.

This posture reinforces our view that the Brazilian monetary authority is likely to refrain from changing the base interest rate for quite a long time – in our scenario, there will be an interest rate hike only by 2021 – despite recent frustration with the pace of economic recovery. After all, notwithstanding the sluggishness that the Brazilian economy has shown of late, the country still lacks structural reforms on the fiscal front that would create a more sustainable path for its public indebtedness. Incidentally, in our view the noise regarding the progress of reforms in the Congress is the reason behind the BRL's weakening against the USD in the last couple of days.

However, the BRL devaluation served to make us more comfortable with our projection of USDBRL4.00 for the end of the year, as the Brazilian Central Bank intervened following the same approach pursued by the former governor: curbing distortions in the FX market, as there was no sign of scarcity of greenbacks. The action thwarted the formation of a speculative wave, especially as we do not see fragility as far as Brazil's balance of payments are concerned. Hence, a perennial devaluation trend does not seem to be likely for the Brazilian currency, in our view – although we think that volatility should remain relatively high – as written in the FX Compass report released this week.

What's New: Inflation Dynamics

This week saw the release of the IPCA-15 for May – a mid-month preview of the officially targeted IPCA – which registered a 0.35% MoM change, below our forecast (0.44%) and the market's median expectation (0.42%). Following this release, inflation in YoY terms has jumped to 4.93% from 4.71% in the previous reading, a level quite a bit above the 4.25% target set for 2019. As mentioned in the previous section, we have not observed signs of concern about that because temporary factors explained the uptick, while core inflation gauges have continued to hover around 3.0%. It is important to bear in mind that the 4.93% YoY change incorporates a 1.26% MoM change observed in June 2018, which was caused by the damaging effects of the truckers' strike. Hence, the YoY change is expected to show a substantial decline in June 2019, when a new reading – free from that impact – will start to be considered. In sum, despite the seeming deterioration seen in YoY terms, we believe inflation dynamics remains fairly calm in Brazil.

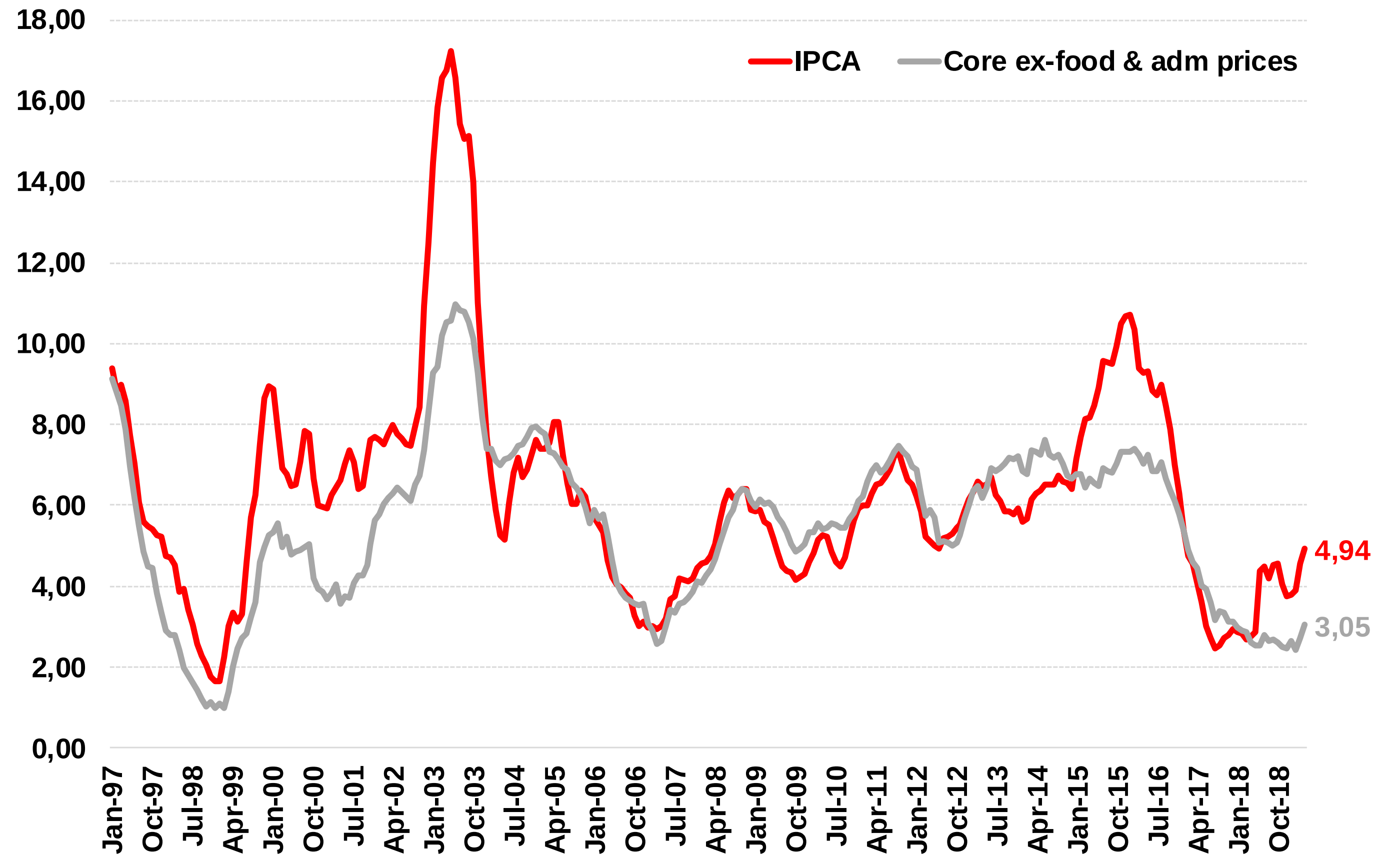
Upcoming Data: GDP Data

1Q19 GDP results will be published next week (May 30), and we expect them to confirm that the Brazilian economy has lost momentum lately. According to our estimates, real GDP contracted 0.3% q/q in 1Q19 (+0.4% YoY). Looking at the supply side, we think industry (-0.8% q/q) exerted the most negative impact, reflecting the slowdown in domestic demand, the Argentine recession, and the Brumadinho dam disaster (severely affecting mining output activities). With regard to the demand side, we highlight the dismal performance of investments (-2.9% q/q), in line with the recent deterioration in business confidence and a lethargic civil construction sector. Furthermore, it is worth noting the deceleration in household consumption (+0.4% q/q) and a negative contribution from the external sector (-0.4pp). We assign a downward bias to our current forecast of 1.3% for 2019 GDP growth.

Chart of the Week: Mind the Gap

This week we present the timeline of IPCA and the simplest underlying inflation gauge – which excludes contributions from foodstuff and administered prices – in order to make crystal clear the benefits of setting up core inflation measures as the most appropriate goal for the monetary authority, because they exclude the impact of temporary shocks on price dynamics.

Inflation dynamics – IPCA headline vs. core inflation (% YoY)



Sources: Banco Central do Brasil, IBGE, Santander.

Number of the Week

1.6%

New government's forecast for the GDP growth rate in 2019 after having revised the fiscal budget for this year.

Quote of the Week

"*If the Congress approves a soft pension reform, it is better leaving my post.*"

— **Paulo Guedes,** Economy Minister's answer to *Veja* weekly magazine about the possibility of his proposal for pension reform being diluted in Congress (May 24, 2019).

What We've Been Reading

- "Brazil's Bolsonaro is blind to his political problems," by Ryan C. Berg (*The National Interest*, May 5, 2019). How the open fronts in the "cultural war" and internal divisions are jeopardizing the government's ability to deliver on the much-needed reform agenda.

- "Explaining Inflation Inertia," by Carmen M. Reinhart (Project Syndicate, May 6, 2019). To Reinhart, patterns of capital flows and real wage adjustments explain inflationary inertia in both Japan and Argentina.

- "As Latin America Gets Poorer, Democracy Itself Is Now Questioned," by Eric Martin and Walter Brandimarte (*Bloomberg*, May 8, 2019) and "Populism and polarization threaten Latin America" (*The Economist*, May 9, 2019). The dire effects of poor economic performance on political stability.

- "How Latin America Is Holding Back Its Own Growth," by Eric Parrado (*Americas Quarterly*, May 8, 2019). IDB's chief economist claims that smart investments in infrastructure are key to accelerating growth in the region.

- "Modern Monetary Theory: Cautionary Tales from Latin America," by Sebastian Edwards (*Hoover Institution Economics Working Papers*, April 25, 2019). Economic policies of Latin America's populist governments look strikingly similar to what MMT proposes, argues Edwards.

Recent Publications (Available on Our Website)

- *Is It Time to Upgrade Core Inflation Measures?* (May 21, 2019)
- *Inflation—Year of the Pig: Good Fortune?* (April 30, 2019)
- *Economic Activity: No News Is Bad News* (April 22, 2019)
- *Will Credit Be Enough to Revive Consumption?* (April 1, 2019)
- *Monetary Policy: Low for (Much) Longer* (March 29, 2019)

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