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Brazil Macro Compass

Copom Decision: Paving the Way for Rate Cuts?

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Upcoming Data: BCB Rate Decision

Brazil's Monetary Policy Committee (Copom) meets next Wednesday. We expect the benchmark Selic rate to stay at 6.50%, following also market consensus, but, in our view, it is likely that the statement will be adjusted to leave room for a rate cut in July 31, should the pension reform passes through Congress (at least in a first floor vote at the Lower House) until then. A cut in July is still not our base-case scenario — we keep believing that there will be no floor vote on the pension reform before the mid-year recess (see more in "Political Agenda" below), which would postpone the cut discussion until at least September — but we acknowledge that the probability of our scenario of a stable Selic rate until year end materializing has decreased significantly since the last rate decision, in May 7.

The combination of recent data and market developments points toward a benign environment for the path of inflation. Disappointing economic activity figures (see "What's New" below) suggest that the output gap may take longer than initially expected to narrow, which should contribute to keep core inflation subdued. The recent BRL strengthening and falling oil prices are putting less pressure on prices of tradeable goods. Finally, a flattening yield curve even with the short-end already pricing in cuts and a global environment with many other central banks also easing should abate fears of a lower Selic ending up in tighter financial conditions, through a steeper curve or weakening currency.

Conditioned to our scenario of a lengthy pension reform process, weaker BRL (BRL4.00/USD at year-end), and inflation above the target midpoint (at 4.50%) in 2020, we maintain our view that the Selic rate should stay flat for an extended period. However, relaxing any of those assumptions could lead to a different conclusion — it is not hard to envision a scenario, for example, where the pension reform come to a vote in early July. In this case, even if our 2020 inflation call proves right later (with the impact of the African swine fever on animal protein prices kicking in from 4Q19), probably consensus 2020 inflation expectations will remain well-behaved for some months, which could lead the Central Bank to conclude that an easier monetary policy can be pursued with no damage to its goal.

Although our simulation of the BCB inflation model still forecasts 2020 inflation at 4.0% (with input market variables at current levels), we believe the wording of the statement should reflect this increased probability of a rate cut this year, still conditioned to advances in the fiscal consolidation agenda.

Selected Financial and Economic Indicators, Changes Between Copom Meetings

Market prices	7-May	13-Jun	Change
BRL/USD rate	3.97	3.86	-2.8%
5-year CDS	177	163	-14 bps
1-year rate	6.55%	5.94%	-61 bps
1-year breakeven inflation	3.92%	3.17%	-75 bps
5-year rate	8.55%	7.39%	-116 bps
5-year breakeven inflation	4.19%	3.78%	-41 bps
Crude oil WTI (USD)	61	52	-14.9%
Crude oil WTI (BRL)	244	202	-17.2%
CRB Food (USD)	340	356	4.6%
CRB Food (BRL)	1,351	1,374	1.7%

Market expectations*	3-May	7-Jun	Change
2019 CPI inflation (12m, year-end)	4.04%	3.89%	-15 bps
2020 CPI inflation (12m, year-end)	4.00%	4.00%	0 bps
2019 GDP growth	1.49%	1.00%	-49 bps
2020 GDP growth	2.50%	2.23%	-27 bps

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

What's New: Disappointing Economic Activity in April

The final round of April economic activity data contributed to consolidating the view that the Brazilian economy entered 2Q19 losing steam from an already weak 1Q19. Core retail sales contracted 0.6% m/m (versus -0.2% consensus forecast), with a widespread deceleration among sectors, including supermarket sales. Auto sales, still relatively strong, lifted the headline index to a flat monthly performance (+3.1% y/y). IBC-Br, BCB's monthly GDP gauge, contracted 0.47% m/m. The rolling three-month average growth was -1.5%, a poorer performance than in the period that includes the effect of last year's truckers' strike (-1.0%). Cumulative 12-month growth decelerated from an average around 1.0% in the past 12 months to 0.7%. We expect economic activity to pick up following the approval of the pension reform in Congress, but we continue to attribute a downward bias to our full-year GDP growth estimate (currently at 1.3%).

Political Agenda: Pension Reform Report Released

Representative Samuel Moreira, pension reform's rapporteur in the Lower House special committee, released his report on the government draft this week. The proposal's headline 10-year savings was close to the BRL1.2 trillion initially estimated by the Ministry of Economy, although it masks some watering down that had to be covered with a proposed tax increase over banks' profits (around BRL50 billion) and redirecting resources from BNDES to the pension system (BRL217 billion). Among the changes in the pension system parameters, the largest deviation from our estimates came from a change in the minimum contribution period for women, reduced to 15 years from 20 years in the first draft. Overall, our view is that the report managed to keep the key features of the government's proposal, with most of the dilution limited to the points that were already rejected initially by most of the Center parties (rules for rural workers and teachers, and concession of some social benefits). We believe further dilution in the floor will take 10-year savings to BRL750 billion, which should be enough to stabilize spending with the system for private workers at 9.6% of GDP by 2035, declining onward.

The next steps will be debate sessions helmed by the Special Committee and open to all representatives, followed by a vote among committee members. This process should take at least the three Congressional sessions of the next week, with the vote concluded — at best — during the week of June 24. That would require an agreement to avoid the usual lack of representatives' presence due to the midwinter folk festivities in the Northeast that peak in that same week, and would allow for a floor vote in the two weeks in July before the beginning of the mid-year recess. Although that expedited timeline is feasible, especially given the signals of commitment of the Speaker of the House and most party leaders, it, in our view, considers a best-case scenario, with no obstructions and delays. We still believe that a floor vote in August is still the dominant scenario, given the tight timeline and the inherent postponements related to such complex political negotiations.

In-Depth Research: Investment Perspectives

In our latest report *Highway to Heaven?* (June 7, 2019), we revisited the investment theme and its impact on economic activity. One of main topic of recent studies on Brazil is the question of what sort of impulse would the economy need in order to recover. We believe one of the channels could be this investment agenda.

Assessing GDP from the supply viewpoint, the industrial sector registered a poor performance in recent years, with civil construction activity being the main culprit behind this dismal outcome. Additionally, we have seen a new dynamic in the banking sector in which the dominance of the National Bank for Economic and Social Development (BNDES) has faded, opening room for a greater share of private banks and capital market operations. In order to encourage privatization, concessions and public-private partnerships for investments in infrastructure and industry, in 2016 the government created the Partnerships and Investments Program (PPI), which designates BNDES as a project enabler and no longer as the main financier. This approach gave more space to other players in the market.

Even with the slow economic recovery and the waiting time of Brazilian and foreign entrepreneurs in relation to long-term investments, we see the development of alternatives and transition to this new model of financing without the leading role of BNDES. One of the alternatives that has grown most in recent years is the issuance of incentive debentures that come from Law 12.431/11, which is a government initiative to expand financing alternatives and promote the capital market as a source of long-term resources, especially for infrastructure projects. Thus, with the change from the previous model of BNDES as protagonist to the current role of intermediary, this type of alternative has become more important than the access to public financing itself.

Despite this strong incentive for infrastructure financing, mainly through the actions of the Ministry of Infrastructure and the replacement of public banks by private banks as providers of credit for individuals and companies, we expect this new structure to take a number of quarters to affect the growth of economic activity. In order to estimate the impact of the main investments and concession on GDP in the coming years, we have to evaluate the pessimistic, optimistic and baseline scenarios for concession growth. In our current GDP forecast for 2019 and 2020 (1.3% and 2.5%) we are considering a baseline scenario for this growth and its impact on the gross fixed capital formation component (see our April 22 reports, *No News Is Bad News* for details). Our exercise now is to evaluate what might happen in the optimistic and pessimistic scenarios.

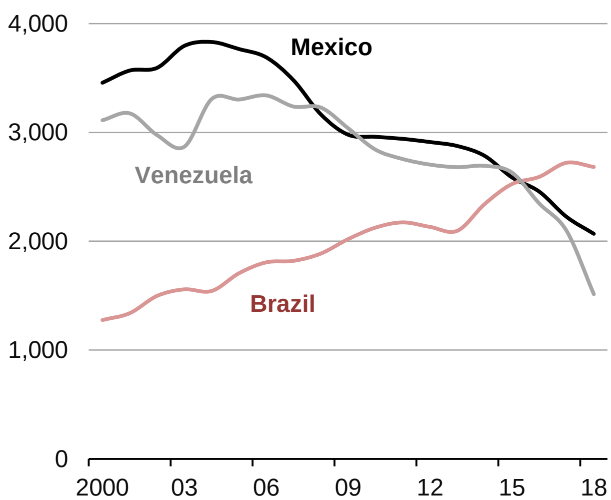
By analyzing a counterfactual scenario, we would expect to see an improvement in the investment component of GDP (demand side) to 6.7% from 5.9%, resulting in an increase for our 2020 GDP projection to 2.8% (also in 2020) from 2.5%.

Therefore, with the possible approval of a robust social security reform, the progress of the other reforms and adjustments, the return to the levels of confidence and financial conditions from the beginning of 2019 and the continuity of the commitment of the Ministry of Infrastructure to the efficiency agenda of industry and infrastructure, we could see a greater impact on economic activity in 2020 and 2021.

Chart of the Week: Oil Production

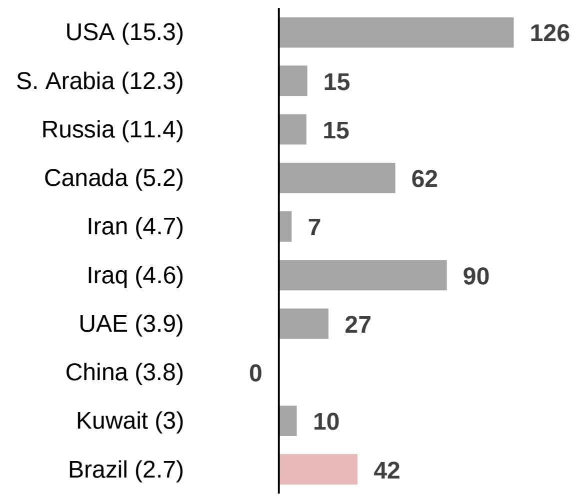
Our "Chart of the Week" uses data from the recently published 2019 *BP Statistical Review of World Energy* to look at recent trends in oil production. Brazil took the lead in oil production in Latin America in 2016, overtaking Mexico and Venezuela. Ever since, the gap has been widening, as the Brazilian pre-salt extraction ramps up and Mexico and Venezuela's industries follow a declining trend. Brazil's oil production increased 42% between 2008 and 2018, putting the country among the top 10 producers according to the latest available data.

Oil Production, Thousand Barrels Daily



Oil Production, 2008-18 % Change

Country (2018 production, m barrels daily)



Sources: 2019 BP Statistical Review of World Energy.

Number of the Week

+49%

Brazilian exports of poultry meat to China surged 49% y/y in volume in May, according to the Brazilian Association of Animal Protein.

Quote of the Week

"*They [lawmakers] have shown that there's no commitment to the new generation. In the past, the Legislature's commitment to public servants was greater than it is now for the new generation.*"

— **Paulo Guedes,** Minister of Finance, commenting on the revised pension reform draft (*Folha de S. Paulo*, June 14, 2019).

What We've Been Reading

- "Just How Damning Are the Lava Jato Leaks? Some Preliminary Reflections on The Intercept's Bombshell Story," by Matthew Stephenson (*The Global Anticorruption Blog*, June 11, 2019). A balanced and well-informed read on the leaked message exchanges.
- "FDI flows into emerging markets fall to lowest levels since 1990s," by Valentina Romei (*Financial Times*, June 12, 2019). FDI flows to EM countries halved since 2007.
- "U.S., Canada, Brazil Oil Output Nearly Doubles in Last Decade," by Alexandre Tanzi and Wei Lu (*Bloomberg*, June 13, 2019). Brazil has been among the countries that most increased oil production over the past decade (see

"Chart of the Week" above).

Recent Publications (Available on Our Website)

- *Economic Activity and Credit: Highway to Heaven?* (June 7, 2019)
- *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)

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