Santander
Corporate & Investment Banking

ECONOMICS

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Brazil Macro Compass

Copom: Joining the Bevy of Doves?

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What's New: BCB Rate Decision

As expected, on June 19 Brazil's Monetary Policy Committee (Copom) maintained the benchmark overnight rate at 6.5%, but changes in the statement and inflation forecasts were substantial, suggesting that we may be approaching the beginning of a new residual rate cut cycle. The combination of a less adverse external environment, a stalling economic recovery, and well-behaved inflation expectations led the committee to acknowledge that its balance of risks had "evolved favorably" and to remove references to a prolonged period of evaluation of the behavior of the economy. According to Copom's reference scenario (assuming a Selic rate at 6.5% and BRL/USD rate at 3.85), the 2020 inflation forecast fell to 3.7% from 4.0%. Assuming market consensus for those explanatory variables (including a Selic rate at 5.75%), the 2020 inflation forecast moved up to 3.9% (from 3.8%), still below the target midpoint for that year.

Offsetting the dovish tone, the BCB reiterated the importance of advances in the reform agenda: the risk of frustration in the fiscal consolidation process is still "preponderant" in the balance of risks, and a new phrase was added stating that such "concrete advances" are fundamental to consolidate a benign scenario for future inflation.

Our interpretation of "concrete advances" includes at least a first floor vote in the Lower House, which we still believe is more likely in 2H19 (see "Political Agenda" below). We will wait for the minutes and the Quarterly Inflation Report, to be released next week, to reevaluate our rates scenario.

Upcoming Data: Copom Minutes, IPCA-15, Inflation Report

The last week of the first half of 2019 will be intense for Brazilian economic indicators. In addition to data on external accounts, credit data, and labor market indicators, we will have the publication of the minutes of the Copom meeting, which will provide more details about the constraints influencing the Brazilian monetary authority as it considers the probable reduction of the interest rate in coming months. To help us with this task, on Tuesday we expect the mid-June IPCA release to show an increase of 0.07%. If our estimate is confirmed, annual inflation will have dropped from 4.9% in the previous reading to 3.9% in June 2019, giving us an idea about how the end of the impact of last year's truckers' strike will affect price indices from now on. As recent inflation behavior seems to be having some influence on expectations, one could expect a more significant retreat of the projections pointed out by the BCB Focus research from now on – which would reinforce the pressure on the BCB to reduce the Selic rate target.

The end of the effect of the truckers' strike will also be seen in the official projections that will be set by the BCB in the Quarterly Inflation Report to be released next Thursday. In our view, the numbers should not be so different from those presented in the statement of the Copom meeting – 3.6% and 3.7% for 2019 and 2020 in the reference scenario and 3.6% and 3.9% for the same periods in the market scenario. It is worth remembering that both simulations used the median estimates taken from the current Focus report, and that therefore the numbers can also be revised downward if the aforementioned influence of past inflation on prospects for future inflation materializes. Thus, a picture of Brazilian inflation will be designed at lower levels than historical standards, which, in our view, should cause the National Monetary Council to corroborate the general expectation of establishing a 3.50% target for the IPCA for 2022, in addition to reconfirming the objectives of 4.0% and 3.75% for 2020 and 2021, respectively.

Political Agenda: Special Committee Expected to Vote on Pension Reform

We believe an agreement among the centrist parties is likely to keep the Lower House special committee working on the pension reform during a week that is traditionally empty in Brasília due to the midwinter parties in Northeast Brazil. Committee chair Marcelo Ramos expects to conclude the ongoing debates in time to allow for a vote by Thursday, June 27. This committee vote is key to enabling the Lower House to start voting on the reform in the first week of July and conclude voting before the recess, scheduled to start on July 18. Although, in our view, the probability that a vote will take place before the recess has significantly increased over the past few weeks, as evidenced by the optimism among representatives of several parties and the lack of obstruction and filibustering in the special committee, we still think the most likely scenario is that resistance among some of legislators to the final version of the reform will end up pushing a floor vote to August.

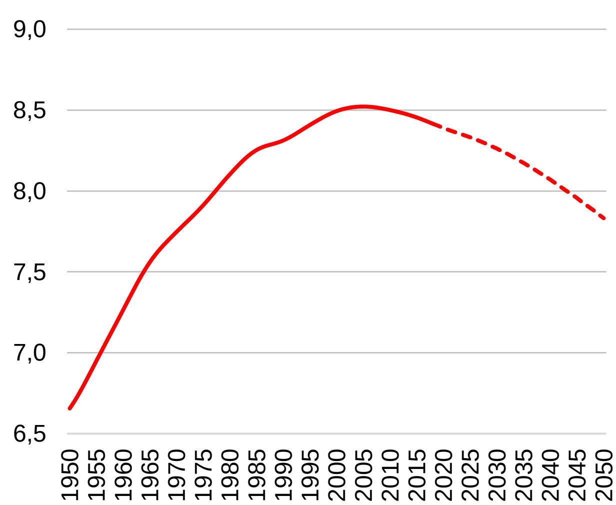
In-Depth Research: Updated Fiscal Outlook

In our report *Climbing the Cliffs in Bad Weather* (June 18, 2019), we incorporate in our government accounts outlook the estimated impact of the pension reform and adjustments on other parameters, such as GDP growth and interest rate. We still see a challenging outlook for the government: even considering strong pension reform (BRL760 billion in savings over 10 years), more austerity measures would have to be implemented to assure a slow flattening of the debt/GDP ratio, which, in our view, will peak only in 2025, at 82.7%. Under the new rules, if approved, social security spending for private sector workers would keep rising until 2035, peaking at around 9.5% of GDP (1 pp of GDP above the current level). We also evaluate the probability of spending reaching the constitutional cap in the next few years: in our view, the risks of non-compliance are low until 2021, non-negligible in 2022, and fairly high from 2023 onward.

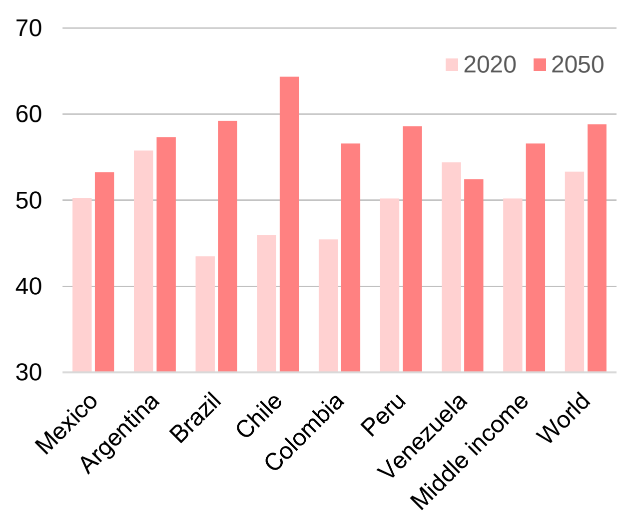
Chart of the Week: Population Trends

Our "Chart of the Week" uses the latest forecasts of the United Nations World Population Prospects to trace some expected demographic trends over the next 30 years. The first chart shows that Latin America's share of the global population may be past its peak (of close to 8.5% around 2005). In the next decades, the region should continue to lose relative weight, like all other regions except fast-growing Africa. The second chart shows how the dependency ratio (the ratio of population aged 0-14 and 65+ per 100 population 15-64) will evolve in some countries in the region until 2050. Brazil and Chile will have the most dramatic demographic transition, with the dependency ratio surging by 16 pp and 18 pp in the period, respectively. All the countries in the sample will have dependency ratios above 50% by 2050, which suggests that pension reform will continue to be a hot topic throughout the region.

Latin America and the Caribbean, Share of World Population (%)



Total Dependency Ratio (%)



Sources: United Nations World Population Prospects 2019.

Number of the Week

82.7%

Incorporating our new assumptions for the fiscal outlook, we now expect Brazil's gross debt/GDP ratio to peak at 82.7% by 2025 (see "In-Depth Research" above).

Quote of the Week

"*If there is a barrier between the possible and the impossible, I went to the limit.*"

— **Representative Samuel Moreira,** rapporteur of the pension reform at the Lower House special committee (*Estadão*, June 15, 2019).

What We've Been Reading

- "Bolsonaro's Brazil in public debt peril," by Desmond Lachman (*AEI Blog*, June 17, 2019). Lachman seems unimpressed by recent fiscal consolidation efforts in Brazil.
- "Halting Latin America's Economic Slide," by Mauricio Cárdenas (*Project Syndicate*, June 11, 2019). More investments in infrastructure and human capital are required to lift Latin America's growth prospects, argues Cárdenas.
- "Is Latin America Ready for the Robot Revolution?" by Ben Miller (*Americas Quarterly*, June 17, 2019). Not at all, according to a new book by CNN's Andrés Oppenheimer.
- "Where to Go in Brazil Beyond Rio," by Megan Spurrell (*Condé Nast Traveler*, June 17, 2019). Where to take advantage of the newly loosened tourist visa restrictions (from June 17, citizens from the United States, Australia, Canada, and Japan are free to enter Brazil with no visa).

Recent Publications (Available on Our Website)

- *Fiscal Policy: Climbing the Cliffs in Bad Weather* (June 18, 2019)
- *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)

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