# ECONOMICS

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## Brazil Macro Compass

*'Hell is other people'*.
(Jean-Paul Sartre)

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- **Jitters on the international front continued to weigh on the USDBRL cross this week, especially on the back of developments related to Argentinean politics and frustration with economic activity indicators abroad.**
- **On top of that, the Brazilian Central Bank (BCB) announced a change in its way of intervening in the FX market, which added some noise to an already nerve-wracking environment.**
- **Not even the release of the timeline for the pension reform bill in the Senate and the beginning of discussions regarding tax reform were able to bring any respite to market participants.**
- **However, the release of the IPCA-15 for August 19 (next Thursday) may play such a role, as we expect it to point towards more benign inflation dynamics than BCB's Focus report has shown lately.**

***International environment:*** plenty of news has surfaced abroad recently and, unfortunately, most of it has negatively influenced market participants' sentiment regarding Brazilian financial assets. We started the week with Argentinean primary elections revealing that the opposition had managed to win by a unpredicted large margin—while President Macri got 32% of votes, Mr. Alberto Fernandez obtained 47%—thus signaling that the presidential race due to start next October 27 may not require a run-off to be decided. Given that Mr. Fernandez's running mate is former president Cristina Kirchner—who pursued a heterodox approach in economic terms during her previous mandate—market participants fear that this potential change in Argentinean federal administration may lean once again toward a more populistic policy, which could include review of IMF negotiations and, more important, the just-reached trade agreement between the European Union (EU) and Mercosur, which Mr. Fernandez has already partially criticized. As this possibility may hinder Brazilian intentions to become a more open economy, we saw the Economy Minister, Mr. Paulo Guedes, stating that the country would leave Mercosur if this delay were to materialize, adding a new source of concern for Brazil regarding international issues.

On top of these jitters, we also witnessed the release of several economic activity indicators in important economies, reinforcing the widespread perception that global economic growth is likely to slow down further. For example, German GDP receded 0.1% QoQ in seasonally adjusted terms in 2Q19, which translated into a 0.7% expansion for the last four quarters ended in June 2019—(versus a 2.4% increase in the four quarters ended June 2018). Additionally, Chinese industrial production and retail sales figures for July 2019 in YoY terms have both fallen short of market median expectations (4.8% vs 6.0% and 7.6% vs 8.6%, respectively), thus hinting at more deceleration in 3Q19 in that country. Finally, industrial production in the US for the same month also fell short of market consensus (-0.2% vs 0.1%) and added to evidence that, wherever one looks, there are mounting signs of economic slowdown around the globe. There is little doubt in our minds that uncertainties regarding how long this process will endure are likely to keep market participants uneasy, and hence one should expect price volatility to continue for a while. However, as the deceleration has been gradual so far, the Brazilian economy has been able to get along with it.

***Changes in FX intervention:*** The last time the BCB intervened in the spot FX market was in 2012, when the level of international reserves amounted to approximately US$239 billion. Since then, whenever it was necessary to step in the FX market, the Brazilian monetary authority resorted to derivatives instruments or USD repo lines and refrained from selling greenbacks in the spot market—which allowed international reserves to reach roughly US$389 billion and FX swaps to amount to some US$69 billion (i.e., net long FX exposure of US$320 billion for the BCB). Last Wednesday, the Brazilian monetary authority announced that it will resume interventions in the spot FX market in tandem with tender offers of reverse FX swaps—equivalent to a buyback of former FX swaps—as it has identified a greater demand for greenbacks and a smaller one for FX derivatives. At the end of the day, the net FX exposure of the BCB remains the same, which tends to be neutral for the final level of the Brazilian currency as compared to other currencies, while eliminating an artificial source of short-term pressure on the FX rate derived from the fact that the BRL is not a fully convertible currency. As explained by the BCB deputy governor, Mr. Bruno Serra, in his request to the board of the institution for this change in the way of intervention ***'…it does not aim, necessarily, to reduce the outstanding amount of FX swaps in the BCB's balance sheet, let alone to cease resorting to this instrument, it aims to match larger demand for greenbacks in the spot market thus ensuing the undistorted functioning of the FX market as a whole…'*** (our translation). Therefore, despite market participants' initial daze, in our opinion the measure should not interfere in the underlying trajectory of the FX rate regardless of the direction it pursues, but rather, should increase the range of ways through which the BCB can stabilize the FX market in moments of great tension.

***Pension reform in the Senate:*** The speaker of the Justice, Constitutional and Citizenship Commission of the Senate (CCJ), Mrs. Simone Tebet, released a timeline for the pension reform bill in the Senate that indicated the process should be concluded by October 10 instead of late September as we expected. In our view, it is not a bad omen for the progress of the bill in that chamber, but rather an indication that senators will not speed up the pace in the coming weeks, especially as they seemingly want to include a clause aiming to extend the changes to states and municipalities' pension systems. Although this clause will need to return to the Lower House to obtain representatives' approval, it should not hinder the remaining items to be ready for presidential sanction by mid-October, because the extension should come through a new and independent constitutional amendment.

***Tame inflation dragon:*** Next Tuesday we will have the release of IPCA-15 for August2019, which is a mid-month preview of the officially-targeted IPCA. We expect the gauge to show an acceleration to 0.20% compared with the 0.09% registered in July 2019, which—if our forecast proves right—should translate into a 3.4%YoY change in the period, just a tad higher than the 3.3% seen in the previous month.

The main reason for the expected acceleration is the behavior of managed prices, which should more than offset the slowdown in free market prices. Administered prices should increase due to adjustment in tariffs of inter-municipal transportation and higher electricity rates on the back of the drought observed this month. However, as we expect the latter's influence to dissipate in coming months, this should be just a temporary hiccup in the inflation of administered prices. Another item that we believe may push headline inflation up is apparel, whose prices have increased as major winter fire sales have ended. Despite of that, oil and non-durable prices should help keep inflation at well-behaved levels, which should lead market participants' inflation forecasts for 2019 to continue receding in coming weeks.

## Number of the Week

**$550 mln**

Daily volume of USD the BCB will offer in the spot market from August 21 to 30 in tandem with the supply of the same amount in reverse FX swaps.

## Quote of the Week

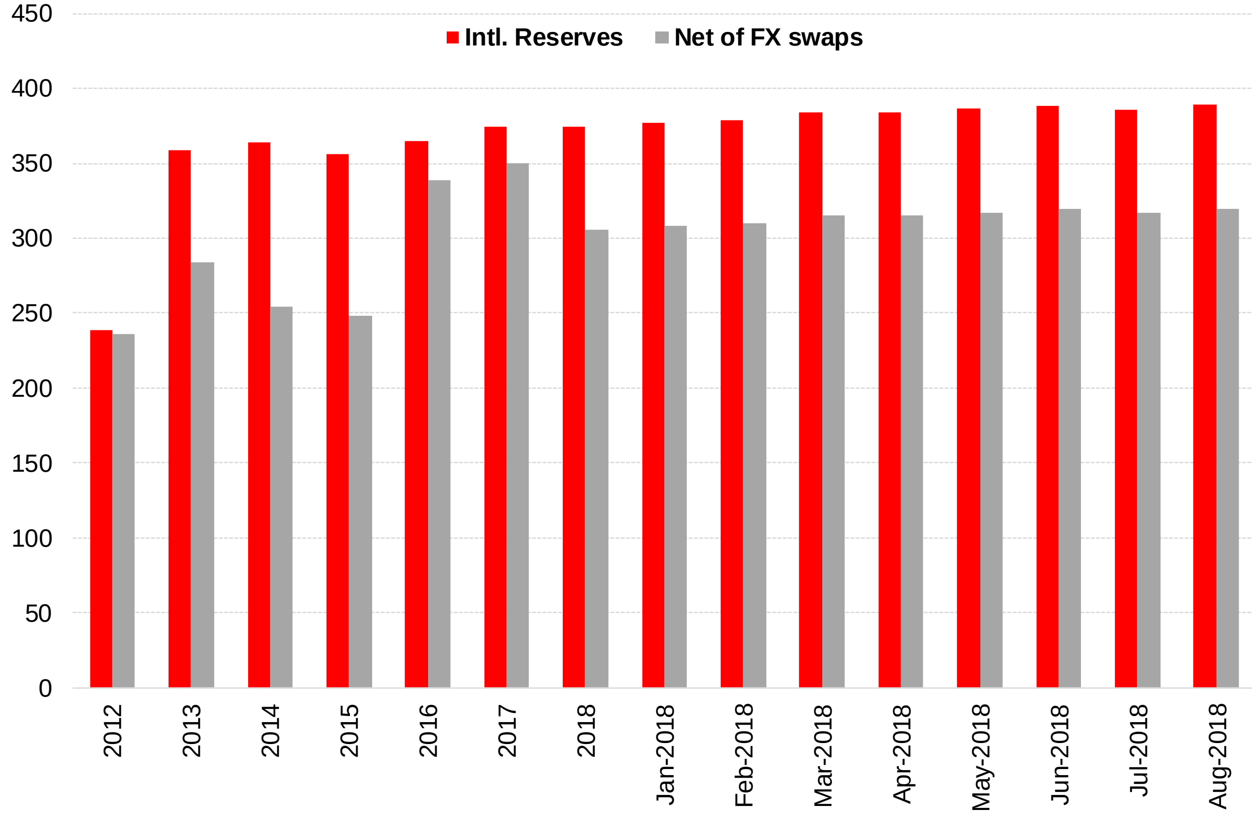
"*If that happens, we'll leave Mercosur.*"

— **Paulo Guedes**, Economy minister, answering what will happen if Argentina's post-election situation starts jeopardizing the trade agreement between the European Union and Mercosur.

## Chart of the Week: The net FX exposure

Our "Chart of the Week" displays the evolution of Brazilian international reserves net of the outstanding amount of FX swaps offered by the BCB, which illustrates the neutral impact the new intervention scheme in the FX market should have.

**Brazilian international reserves vs BCB's FX short exposure**




Source: Banco Central do Brasil, B3, elaborated by Satnander.

## 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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