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Testing New Limits

- **Besides confirming general expectations of a 50-bps cut in the Selic target rate—which brought it to 5.50% pa—we think the Brazilian Central Bank (BCB) has signaled that there is room for additional cuts further down the road.**
- **We expect the release of two documents next week—the minutes of the last Copom meeting and the inflation quarterly report—to confirm this view, as we think they will detail the comfortable inflation dynamics that the BCB sees currently. Incidentally, the IPCA-15 reading for September should also reinforce this perception, in our view.**
- **Likewise, we expect labor market data slated for the coming week—we will learn net formal job creation and the unemployment rate for August 2019—to point toward plenty of slack, thus reinforcing the extremely gradual nature of the economic recovery, allowing further monetary stimuli.**
- **Not even the complex situation seen on the international front seems likely to be a hindrance for additional stimuli at the moment, despite the impact of the Fed's repo operations in recent days. In our view, the FOMC's decision on Wednesday 18 September dimmed market participants' fear of a more serious problem in the US financial system.**
- **In our view, the partial unfreezing of public resources announced on Friday is likely to mean only short-term relief from the threat of a shutdown in public services, as the growth of mandatory expenditures will increasingly limit the maneuvering room for the execution of the public budget.**

Monetary policy: As broadly expected, on Wednesday the Brazilian Central Bank (BCB) board members cut the Selic target rate to 5.50% pa from 6.00% pa by unanimous vote based on a favorable inflation balance of risks for 2019 and especially for 2020. According to the BCB, under its baseline simulation—which assumes the maintenance of both FX and interest rates for the relevant time horizon at the levels prevailing on the eve of the Copom meeting (USD/BRL4.05 and 6.00%, respectively)—the IPCA annual change would reach 3.4% in 2019 and 3.6% in 2020 compared to targets of 4.25% and 4.00% for those respective years. That is quite a comfortable safety margin, in our view, allowing Copom members to extend the monetary easing resumed in July. However, in our opinion, more important than the decision that led the Selic target rate to a new historical low was the fact that the BCB answered two important questions: (i) "What is the expected influence that the external environment is likely to have on inflation dynamics?" and (ii) "What is the impact that the weaker FX rate is likely to have on inflation dynamics?"

Regarding the former, the monetary authority stated that recent monetary stimuli granted by the central banks of advanced economies may be taken as relatively favorable for emerging markets—because it provides ample liquidity conditions,. However, the BCB warned that there are risks of a stronger than expected deceleration on the international horizon and noted that there is still plenty of uncertainty abroad. We believe those comments were an attempt to forestall criticism that the BCB is downplaying potential setbacks overseas. Nonetheless, we think it is likely that the external environment will need to worsen substantially from the current situation in order to prevent additional cuts by the BCB.

As for the impact of the BRL's recent weakening, the BCB found a resourceful way to respond, by resorting to the use of so-called hybrid scenarios. This time, the Brazilian monetary authority presented the results obtained with its

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simulations when assuming the maintenance of the FX rate at USD/BRL4.05 for the long term and with the Selic target rate following the trajectory displayed in the Focus report—which pointed toward the base interest rate reaching 5.0% pa by October 2019 and remaining at that level until December 2020. Under these assumptions, the BCB obtained IPCA annual forecasts of 3.4% for 2019 and, extremely important, 3.8% for 2020. That is, even with additional easing of the monetary grip and the maintenance of a weaker FX rate than that observed at the previous meeting, we think Copom members would not jeopardize meeting the inflation target in the next year. Indeed, they would still have some safety margin, as the goal set for 2020 is 4.0%.

All in all, the message conveyed by the post-decision communiqué left us comfortable with the change we made last week in our forecast for the Selic target rate, as well as with the reason for our revision: not even recent developments were able to spoil our sanguine inflationary outlook for the next year, which is likely to open room for the BCB to bring the Selic target rate to 4.50% pa by the end of 2019 and to keep it at that level during all of 2020. In that sense, we expect our comfort level to be buttressed by the minutes of the last Copom meeting and the Quarterly Inflation Report that are due to be released next week and that are likely to bring a more thorough disclosure of simulations and discussions that guided Copom members.

Inflation: Squeezed between the two important documents the BCB will release in the coming days, we think the IPCA-15 for September is likely to add to evidence of tranquil inflation dynamics in Brazil. According to our calculations, the mid-month preview of the officially targeted index (IPCA) is likely to have registered a 0.09% MoM change in the period, which—if our forecast proves right—would have led inflation to register a 3.22% change in YoY terms. That is, the current level of inflation in Brazil is likely to be running 100 bps below the targeted level for 2019 (4.25%), a backdrop that indicates how stable the recent behavior of price indices has been lately.

What's more, looking at underlying inflation gauges, we deduce that the sanguine inflation scenario is not likely to be short lived. For example, inflation of free market prices—which account for roughly 75% of the consumer price indices—should have reached 3.2% in YoY terms in the IPCA-15 reading based on a meager change in prices of tradeable items (1.3%, also in YoY terms), which indicates a low pass-through of FX depreciation to domestic prices. Taking a look at the segment more sensitive to monetary conditions—services—the picture is no different, as we see it as likely to show 3.8% inflation in the last 12 months to date, a level below the targets set for both 2019 and 2020. In a nutshell, wherever one looks, one finds signs of (positive) structural change in inflation dynamics in Brazil.

Labor Market: While we believe price indices are likely to keep on providing upbeat news, activity indicators should continue to deliver far from cheering figures, thus reinforcing our view that the pace of the Brazilian economic recovery continues to be gradual. In the next week, updates on labor market conditions are likely to provide additional evidence for this assessment, as we expect the formal job survey—dubbed CAGED in Brazil—to point toward the net creation of 40.6k positions in August 2019 in seasonally adjusted terms. If confirmed, the number will mean the Brazilian economy generated 36.7k jobs per month on average in the last 12 months to date, which is a small improvement compared to the 33.4k monthly average seen in December 2018 in the same terms. Thus, we think it should not come as a surprise that the unemployment rate is likely to have continued to recede only slowly in the period. According to our calculations, the jobless rate should have declined to 11.7% last month compared with 11.8% in July 2019—both in seasonally adjusted terms. This backdrop suggests to us that there is still plenty of slack in the Brazilian economy, which should also help curb inflationary pressures, thus paving the way for further monetary easing.

International Environment: The drone attack on Saudi Arabian oil facilities and the repo operations carried out by the US Federal Reserve in the last few days raised fears that higher risk aversion could materialize. However, after an initial spike in the aftermath of the drone attack, oil prices receded based on statements made by Saudi Arabian officials that it will not take much for oil production to return to its normal rate. Regarding Fed repo operations—which had not occurred for more than a decade—there was an initial negative reaction, as they looked like an emergency measure to prevent potential damage from the cumulative effects of the shrinkage of the Fed's balance sheet. That is, given that the Fed is reducing the size of its balance sheet by selling assets that were previously acquired under past quantitative easing programs, it looked as if this approach would drain too much liquidity from the financial system—which could lead to a hike in market interest rates at a time when the Fed wants interest rates to go in the opposite direction. Nonetheless, after explanations provided by the US monetary authority alluding to temporary influences that led to the liquidity shortage—concentration of corporate tax payments, among others—market participants' concerns were eased, especially as Chairman Powell advocated the Fed is prepared to use all tools in order to ensure that liquidity conditions are going to be compatible with the new range set for the Fed fund target rate last Wednesday—from 1.75% to 2.00% pa. Therefore, we may see the shrinkage of Fed's balance sheet losing momentum in the coming months, but it does not look like the US monetary authority is on the verge of reversing this strategy as some analysts have claimed. After all, the post-decision statement conveyed a less dovish wording than most market participants expected, as it outlined a relatively robust environment whose main threats are associated with "implications of global developments for the economic outlook" (as Chairman Powell noted). That is, US domestic

conditions do not seem to be a reason for more Fed cuts, in our view.

Fiscal Policy: The official publication of the 4th Bimonthly Report on the Evaluation of Primary Revenue and Expenses today (September 20) indicated the release of BRL12.5 billion from the federal public budget. It is worth noting that, due to the disappointment about tax revenue (reflecting the weak performance of domestic economic activity) and continued strong growth of mandatory spending, the Brazilian government has significantly compressed discretionary expenditures in the recent period (it has postponed BRL34.2 billion in the 2019 public budget to be spent conditional upon the evolution of revenue in the coming months), which has affected the operation of some public sector activities. According to official sources, the government continues to aim for a total release of approximately BRL20 billion by the end of the year (i.e., it still expects a further release between BRL7 billion and BRL8 billion).

However, this release of funds will offer only limited short-term relief for the public sector. We reiterate our view that the Brazilian fiscal situation remains challenging, mostly due to the strong expansion of mandatory expenditures. Compliance with the current fiscal rules in Brazil will be possible, in our view, only with the continuity and deepening of structural reforms, including items such as the reduction of the public servants' payroll, reversal of tax exemptions, de-indexation of expenses, and de-earmarking of revenue.

Number of the Week

3.8%

The inflation forecast for 2020 provided by the BCB's simulation assuming Selic target rate at 5.0% pa and USD/BRL4.05, thus suggesting room for additional monetary easing.

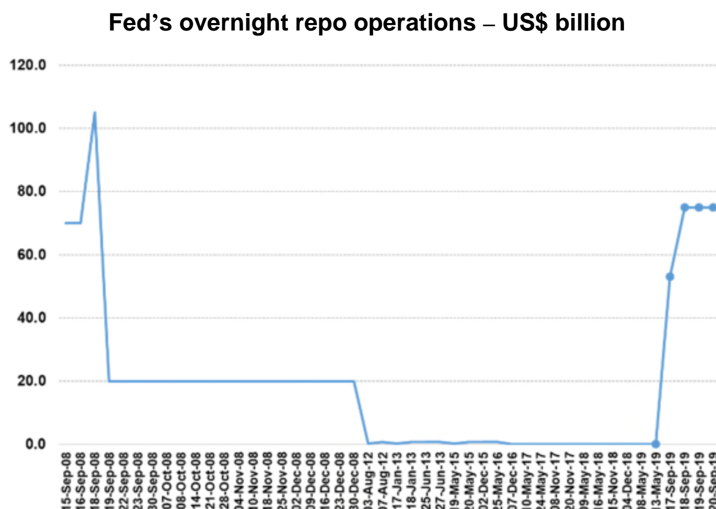
Quote of the Week

I'm not going to change my practice here today of not responding to comments or addressing comments made by elected officials.

— **Jerome H. Powell**, FOMC Chairman, about Mr. Trump's criticism of his handling of monetary policy.

Chart of the Week: When It Rains, It Pours

Our "Chart of the Week" shows the timeline of the Federal Reserve's overnight repo operations that were resumed this week after more than a decade. According to the Fed, a mix of temporary events, such as a concentration of corporate tax payments and US Treasury auctions, squeezed liquidity conditions, pushing short-term interest rates up at a time when the US monetary authority wants them to decline. After four repo operations this week, the Fed has already announced another operation for Monday 23 September, which will inject US$75 billion into the system.



Source: Federal Reserve Bank of New York.

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