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Brazil Macro Compass

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A Little Box of Surprises

- **After presenting soothing inflation forecasts in Copom's post-decision communiqué, the Brazilian Central Bank (BCB) detailed these projections further in the minutes of the meeting as well as in its quarterly inflation report released last Thursday. In our view, both documents continued to convey the message that there is room for further interest rate cuts ahead—notwithstanding risks related to both the domestic reform agenda and jitters on the international front.**
- **Amid pressures over the Brazilian currency—which pushed the FX rate back to the level of about USD/BRL4.20—the BCB published an unexpected review of external sector data that unveiled a less favorable, albeit still comfortable, picture of the country's balance of payments situation, a review that initially helped to keep FX rate volatility at high levels.**
- **Although net creation of formal jobs in August 2019 positively surprised market participants—and ourselves—it has not led market labor conditions to register a substantial improvement in the period, as the marginal retreat in the unemployment rate would seem to indicate, thus reinforcing our perception of a gradual recovery for the Brazilian economy. That is what we expect the industrial production figures for the last month—due to be released next Tuesday—to show as well.**
- **By dividing into two separate parts the original constitutional amendment bill that addressed conditions referring to the transfer of oil rights, the Brazilian Congress found an ingenious way to allow the auction scheduled for November 6 to go forward, an event that we believe is likely to inject nearly U$$12 billion into the coffers of the federal administration this year.**

BCB's documents and prospects for monetary policy: To cut a long story short, we think the considerations and outcomes of the simulations presented by the BCB in the minutes of the most recent Copom meeting released last Tuesday and its quarterly inflation report (QIR) reinforced our view that there is room for providing the Brazilian economy with additional monetary stimuli and for keeping an accommodative monetary stance for in the medium term. It is true that the Brazilian monetary authority alluded to several risks in the forecasts it obtained in its simulations—the international environment, trajectory of the FX rate, increasing level of uncertainty, etc.—but it is notable that the projections pointed to smooth paths under any of the four scenarios displayed in the QIR. (i) The baseline scenario considered that both Selic and FX rates would remain stable for the foreseeable future at the levels observed at the Copom meeting (6.00% pa and USD/BRL4.05, respectively). (ii) A second simulation assumed market participants' forecasts for the base interest rate (5.00% pa in December 2019 and 2020, and 7.00% for December 2021 and 2022) and FX rates (USD/BRL3.90 for December 2019, 2020, and 2021; and USD/BRL3.95 for December 2022). In addition, (iii) there was a hybrid simulation (H-1) that assumed the path expected by market participants for the Selic rate in tandem with the stability of the FX rate at USD/BRL4.05, and (iv) another hybrid simulation (H-2) that assumed stability of the base interest rate at 6.00% pa and market participants' projections for the FX rate.

In all of these simulations, the IPCA annual change is expected to be below the targeted level in 2019 and 2020—which is the pivotal time horizon for monetary policy. As for 2021, all but the H-2 simulation indicated an IPCA annual change in line with the goal, while the exception pointed at inflation below the targeted level for that year. According to the QIR, inflation would run above the goal only in 2022, but (curiously) with the H-1 simulation being the scenario that would present the smallest deviation from the targeted level. That is, if the BCB decides to grant further monetary stimuli now

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and then starts normalizing the monetary policy stance in 2021, it will not jeopardize meeting its inflation goals in the coming years. So, why should it refrain from taking that approach? All in all, given our expectation for favorable price dynamics in 2020, we maintain our call that the Selic target rate is likely to reach 4.50% pa by the end of this year and to remain at that level during 2020.

FX volatility and balance of payments: Market participants have been somewhat worried about the performance of the BRL, which has returned to the vicinity of USD/BRL4.20—the level at which the BCB has resumed selling greenbacks in the spot market. International jitters were the main reason for the move in the BRL, as the domestic reform agenda continued to show progress. Nonetheless, the BCB's decision to release a new methodology for the measurement of the Brazilian external sector data provoked some controversy, as the process has led to substantial changes in the previous figures–yet without reversing the perception of a sound situation in the Brazilian balance of payments. The main reason for the introduction of the new methodology was the availability of more reliable sources for resident and nonresident transactions abroad.

For example, with the new methodology, the current account balance for 2018 was revised to a US$21.9 billion deficit from a deficit of US$14.5 billion. By the same token, the net flow of direct investments into the country was revised to US$76.8 billion versus the US$88.3 billion previously released. Despite significant revisions, the perception of a sound situation for Brazilian external sector data remains unchanged: the country has no problem in financing its small current account deficit. However, the new methodology has led us to revise our forecast for the current account deficit in 2019 to a US$29.5 billion deficit, up from a deficit of US$20.6 billion.

Economic activity: Data released this week showed a slight recovery in the labor market. The formal employment survey—dubbed CAGED—pointed to net creation of 48.7k positions in August 2019 (in seasonally adjusted terms), above our projection and the market median expectation, with the services segment being the main growth driver (it has generated 30k positions). Factoring in these figures, the Brazilian economy has generated an average of 37.4k jobs per month over the last 12 months ended in August 2019, which represents a marginal improvement compared to the monthly average of 33.4k jobs observed in December 2018, in the same terms. Thus, it should not have come as a surprise that the unemployment rate released by the IBGE, at 11.8% for August, remained unchanged from July 2019 in seasonally adjusted terms. This result reinforces our view that the economic recovery in Brazil continues to be gradual.

Incidentally, next Tuesday (October 1), the IBGE will release the Monthly Industrial Survey (PIM) for August, and we project a contraction of 2.7% in YoY terms—which would mean a slight increase of 0.7% in MoM seasonally adjusted terms. The positive performance in the last month is related to the resumption of mining activities as the effects of the collapse of the Brumadinho mine come to an end.

Therefore, the data described above underpin our scenario of broad idleness in the Brazilian economy and a gradual recovery for GDP in the country. This assessment is in line with the one provided by the BCB in the QIR, which implies less inflationary pressure and room for greater monetary policy easing.

Political Agenda: There has been gridlock between the Senate and the Lower House about how much money states and municipalities will receive from the auction of transfer of oil rights scheduled for November 6. The standoff could have delayed the auction and, consequently, prevented public coffers from receiving an injection of ~US$18 billion in 2019. However, where there's a will, there's a way, and Congress surprisingly chose to leave the definition about the subnational sharing for another time and to allow the federal government to proceed with the auction. Consequently, regardless of how much money states and municipalities will receive, we believe the public sector is likely to obtain a substantial injection of capital before the end of 2019.

Number of the Week

US$26B

Total amount expected to be collected by the Brazilian government with the auction of transfer of oil rights on November 6.

Quote of the Week

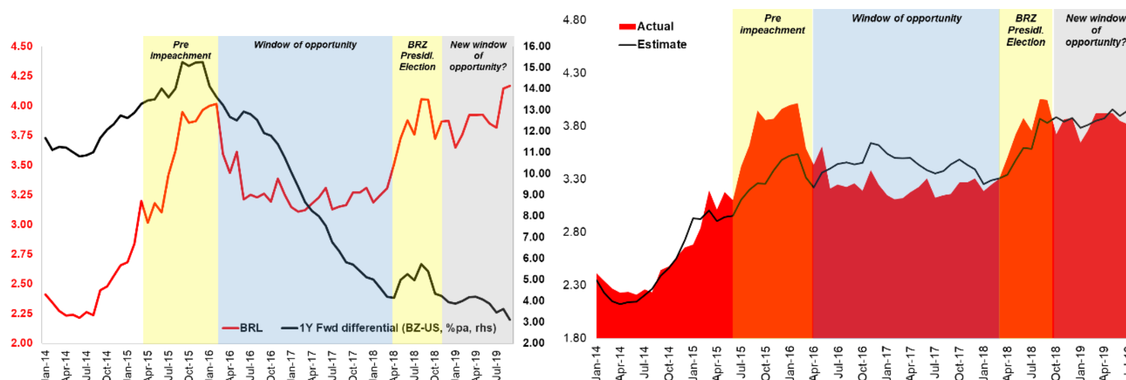
You've stolen my dreams and my childhood with your empty words, and yet, I'm one of the lucky ones.

— **Greta Thunberg**, sixteen-year-old Swedish activist, during the United Nations 2019 Climate Action Summit.

Charts of the Week: Do Things Work Differently in Brazil?

Our "Charts of the Week" show that—unlike what many observers would expect—the Brazilian FX rate and the one-year forward interest rates differential between domestic and international markets do not follow opposite trends. Indeed, it is not unusual to witness times when they follow a similar path. In our view, this is because the narrowing of interest rate differentials usually takes place in tandem with periods when there is progress on the domestic front, which leads to a strengthening of the currency. We have highlighted some periods when those trends are more visible.

Interest rate differentials vs. USD/BRL



Sources: Bloomberg, elaborated by Santander.

Recent Publications (Available on Our Website)

- *In Search of Growth* (August 29, 2019)
- *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)

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