

## Monthly Macro Letter

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# Lower Interest Rates on the Horizon

**Leandro Rothmuller**

Chief Economist

[leandrorothmuller@bocombbm.com.br](mailto:leandrorothmuller@bocombbm.com.br)

**Fernando Teixeira**

Economist

[fernandoteixeira@bocombbm.com.br](mailto:fernandoteixeira@bocombbm.com.br)

The Central Bank of Brazil's Monetary Policy Committee (COPOM) met on June 18-19 to determine the policy rate (SELIC). It decided to leave the rate unchanged on 6.5% p.a. for the eighth consecutive meeting. This decision was widely expected by the markets. However, for the first time the committee signaled that its inflation model allows for lower rates, indicating that rate cuts are in the offing.

According to the scenario described by the COPOM, and with which we agree, the Brazilian economy stalled in the first half of the year, with GDP contracting in the first quarter and growth failing to resume in the second, based on the key economic indicators. In particular, the IBC-BR (the Central Bank's monthly GDP proxy) fell 0.47% in April. We continue to forecast 0.7% growth in 2019. This forecast takes a weaker first half into account and is in line with the Central Bank's latest forecasts, which include a downward revision of GDP growth in the year to 0.8%.

Inflation remains tamed, moreover, both in 12 months (3.8%) and in our forecasts for 2019 and 2020 (3.7% and 3.8% respectively), below the midpoint of the target band in both cases. Potential sources of upside inflationary pressure remain weak, and the output gap has not closed. The economy continues to grow less than it could and the negative supply shocks in food and gasoline are dissipating.

Evidence that a new equilibrium has been reached, with lower neutral rates, has accumulated during the last 12 months, reinforcing the conclusion that monetary policy is not as stimulative as the Central Bank claims, or indeed not at all. The neutral rate appears to be close to 3% in real terms and 7% in nominal terms.

On the external front, the global economy continues to decelerate, causing a reversal of the monetary policy outlook in several countries. The Fed has signaled that it will lower its policy rate at the July meeting of the FOMC in order to protect US growth. In Europe, the ECB has indicated that it may push its rate even further into negative territory. Other central banks have also loosened policy or are about to do so.

The combination of anemic activity, inflation tamed and below target, a lower neutral rate and burgeoning global liquidity creates a case for rate cuts by the Central Bank of Brazil, and our forecasts now assume this will happen. We expect three cuts of 50 basis points each by year-end, taking the SELIC to 5.0% p.a., the lowest ever in Brazil. In our view the Central Bank can act, and the time for caution, serenity and perseverance is past.

For now the Central Bank has indicated that it will lower its policy rate only when Congress passes the pension reform bill. According to its official communication, the main risk to the economy from the monetary policy standpoint is the possibility of a

delay in passing the reform or its significant dilution, which could influence the timing and magnitude of the rate cuts.

However, pension reform proceedings are moving towards a positive outcome: the reform may be voted in the Lower House before the recess and generate savings of around BRL1 trillion in 10 years. If so, the Central Bank will be able to lower the SELIC at the next policy meeting.

| <b>ECONOMIC FORECASTS</b>          | <b>2013</b> | <b>2014</b> | <b>2015</b> | <b>2016</b> | <b>2017</b> | <b>2018</b> | <b>2019 F</b> | <b>2020F</b> |
|------------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|---------------|--------------|
| GDP Growth (%)                     | 3,0%        | 0,5%        | -3,5%       | -3,3%       | 1,1%        | 1,1%        | 0,7%          | 1,9%         |
| Inflation (%)                      | 5,9%        | 6,4%        | 10,7%       | 6,3%        | 2,9%        | 3,7%        | 3,7%          | 3,8%         |
| Policy Rate (%)                    | 10,00%      | 11,75%      | 14,25%      | 13,75%      | 7,00%       | 6,50%       | 5,00%         | 5,00%        |
| Unemployment Rate (%)              | 6,8%        | 7,1%        | 9,6%        | 12,6%       | 12,4%       | 12,2%       | 11,7%         | 10,8%        |
| Trade Balance (US\$ bn)            | 3           | -4          | 20          | 48          | 67          | 58          | 56            | 44           |
| Current Account Balance (US\$ bn)  | -75         | -104        | -59         | -23         | -10         | -13         | -21           | -38          |
| Current Account Balance (% of GDP) | -3,0%       | -4,3%       | -3,3%       | -1,3%       | -0,5%       | -0,8%       | -1,0%         | -1,7%        |
| Fiscal Primary Balance (% of GDP)  | 1,7%        | -0,6%       | -1,9%       | -2,5%       | -1,8%       | -1,6%       | -1,5%         | -1,2%        |
| Government Gross Debt (% of GDP)   | 51,7%       | 57,2%       | 66,2%       | 69,4%       | 74,0%       | 76,7%       | 77,9%         | 78,2%        |