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ECONOMICS: LATIN AMERICA PERSPECTIVES

BRAZIL: NOT SO FAST

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Eager to get inflation expectations under control, Brazil's central bank said it won't be easing monetary policy just yet. Given the current inflation environment and the uncertainty surrounding policy adjustments, the decision is a welcome one.

Central Bank Under New Management

In its first policy meeting under its new president, Ilan Goldfajn, the monetary policy committee (Copom) of Brazil's central bank kept its target interest rate at 14.25%. In a far more detailed press release than those typically issued by the previous administration, Copom stressed that Brazil's year-over-year inflation rate of nearly 9% means now is not the time to begin an aggressive easing cycle.

While the central bank's latest weekly survey showed that inflation expectations have declined, the committee members stressed that they remain well above the 4.5% medium-term target. The year-end expectation that peaked at 7.6% in early February slipped to 7.2% in July, while the 12-month forward expectation dropped from 7.2% in mid-November to 5.7% in July (*Display 1*).

Copom admitted that the ongoing contraction in economic activity should help dampen inflationary pressures. It also acknowledged that several economic indicators suggest a scenario of gradual economic stabilization in the near term. But it said that the global growth outlook remains challenging.

A More Gradual Approach

Before Goldfajn took office, the market expected him to engineer a swift rate reduction strategy, taking the benchmark Selic rate to 12.75% by year-end. Now the market expects a decline to 13.25%, and maybe not even that far. It all boils down to new leadership that wants to rebuild the central bank's reputation at a time when inflation is improving slightly but still well above target.

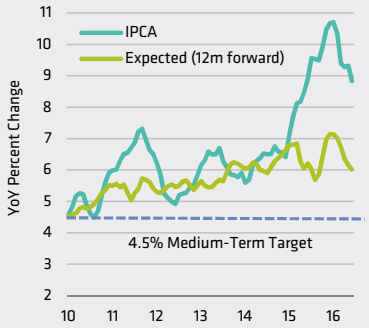
The market still expects the policy rate to go down, likely to 11% by the end of 2017. But market participants no longer expect to see a flurry of rate cuts in the near future. Given the current environment of very low interest rates globally, we believe that Brazil has significant room to reduce rates (*Display 2*). But Copom's message is that monetary easing will be executed with caution.

The central bank decision is a welcome one, in our view. Rebuilding credibility is important and will allow the bank to be more effective down the road at anchoring inflation expectations.

Goldfajn vowed to bring inflation within target by the end of 2017, a message that

Display 1
Inflation Easing but Still Above Target

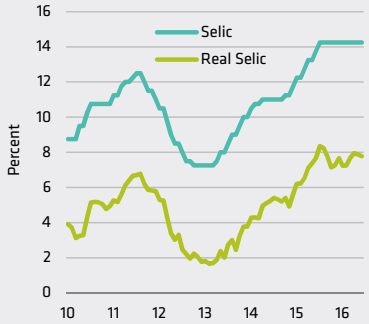
Actual and Expected Consumer Price Indices



Through June 1, 2016
Source: Banco Dentral do Brasil

Display 2
Brazil Rates Show Substantial Risk Premium

Nominal and Expected Inflation-Adjusted Target Selic Rates



Through June 1, 2016
Source: Banco Central do Brasil

was already clear in the latest central bank quarterly inflation report.

Although it can be argued that next year's expectation is already within target (because the 4.5% target has an admissible deviation band of 200 b.p.) it is reassuring that Copom decided, by unanimous vote, that it was still too early to start cutting rates. The decision implicitly suggests that the target is 4.5% rather than the band.

It makes sense for the authorities to play it safe. Food prices, which represent a quarter of the headline inflation index, have been rising and indexation mechanisms are still alive and well.

The Fiscal Backdrop

Copom highlighted in its press release that there are risks for the baseline inflation outlook, including "uncertainties regarding the approval of needed adjustments." That is code for doubt about the intensity and timeliness of fiscal tightening. The new government of President Michel Temer announced spending limits, but the policy has yet to be endorsed by Congress, something that may not happen until later in the year. Another temporary impediment to policy discussions with lawmakers is the fact that the impeachment of former President Dilma Rousseff is not complete, and may not be until late August.

Last month, the new administration announced a primary deficit target of BRL 139 billion (roughly 2.1% of gross domestic product [GDP]) for next year, versus an estimated deficit of BRL 171 billion (2.7% of GDP) for 2016. Markets welcomed the number, which suggested that investors expected a less favorable projection. The figure is realistic but it confirms that the new authorities will not turn the fiscal situation around in the near term.

Instead, the administration will focus on setting the stage for discussion and eventual approval of structural reforms aimed at stoking higher long-term growth and a permanent improvement in the fiscal accounts.

Temer's team is also working on a much-needed social security reform plan, but its approval, let alone its implementation, will take time.

The focus on the long term suggests that the debt ratios will continue deteriorating in 2017 and most likely until the end of Temer's term, which in turn means that Brazil is not anywhere near a rating upgrade despite the reform talk of the new administration.

To stabilize the gross public debt/GDP ratio, we estimate that Brazil will have to grow by about 2.5% and generate a primary surplus of at least 2% of GDP. Finance Minister Henrique Meirelles did not rule out tax increases for the coming year, a decision that will likely be made within the next couple of months. However, tax pressure on the formal sector is already high, so fiscal improvements compatible with a growth recovery should lean on spending reduction rather than revenue increases.

All in all, next year's modest fiscal projections appear achievable. GDP forecasts of 1.2% seem plausible. In addition, the silver lining is that there could be large below-the-line revenues that may result in a better-than-projected economic performance in 2017.■