Let the rate cuts begin

BCB post-meeting comment

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Summary

- The Copom reduced the Selic (policy) rate by 50bp to a new historical low of 6.00% p.a., as we, part of the street, and the local yield curve projected.
- In the statement, the Copom links the decision to the evolution of the scenario, especially the balance of risks – probably in the wake of clearer signals of an effective pension reform. The committee signals room for further stimulus ahead, even though the BCB seeks to retain degrees of freedom by claiming that its assessment "does not restrict its next decision."
- The Copom reiterates that further progress in the process of macro adjustments and reforms "is essential for the reduction of its structural interest rate and for sustainable economic recovery."
- The BCB's newly presented (IPCA) inflation simulations seem to indicate room for a total adjustment of 100-125bp in this cycle. This apparently means a slightly larger space than the 75-100bp adjustment implicitly suggested in previous communications.
- We continue to look for two more Selic rate cuts of 50bp for September and October, taking it to 5.00% for end-2019. We expect no change in monetary policy 2020.

Policy decision and guidance

The Copom[1] reduced the Selic (policy) rate by 50bp to a new historical low of 6.00% p.a., as we, part of the street, and the local yield curve projected. *Refer to this link for the full-version of the Copom statement (in English).*

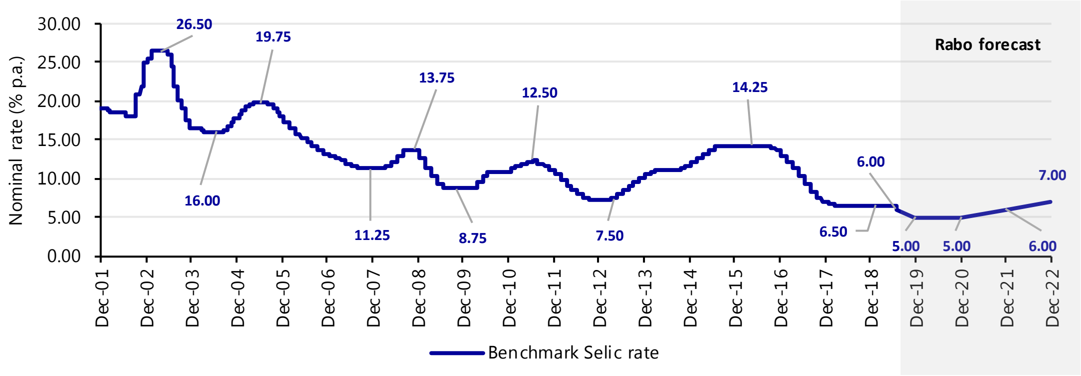
In the statement, the Copom tags the decision to the evolution of the scenario, especially the balance of risks – in the wake of clearer signals of an effective pension reform. The committee signals room for further stimulus ahead, even though the BCB seeks to retain degrees of freedom by claiming that its assessment "does not restrict its next decision." Once again, the authority "reiterates that the next steps in the conduct of monetary policy will continue to depend on the evolution of economic activity, the balance of risks, and on inflation projections and expectations."

On one hand, the BCB recognizes advances in the agenda of macro reforms – with the recent first-round approval of an effective pension reform at the Lower House probably being the tipping point for this policy move. On other hand, **the Copom reiterates that further progress in the process of macro adjustments and reforms "is essential for the reduction of its structural interest rate and for sustainable economic recovery."**

Just as in the previous statement, the committee recognizes that economic conditions prescribe expansionary monetary policy [i.e. interest rate below neutral], with Selic rate at the current level.

[1] Copom is the monetary policy committee of the Brazilian Central Bank (BCB).

Figure 1: Path of the Selic (policy) rate – historical series and Rabo's forecast



Source: Brazilian Central Bank, Rabobank

Assessment and balance of risks

On activity, the BCB believes that **recent data "suggest a possible resumption of the process of economic recovery**." The Copom continues to envision a gradual recovery ahead.

External conditions are now considered "benign" (an upgrade from "less adverse" in the previous statement), on the heels of changes in the monetary policy outlook for advanced economies. Yet the risks of a global slowdown remain in place, according to the BCB.

Core inflation measures (including cycle- or policy-sensitive prices) are seen at "comfortable" levels, which we see as an improvement from the "appropriate levels" referred to in the previous statement.

As per the balance of risks, despite some continued improvement, the Copom see elements in both directions. Downside risks still posed by high level of economic slacks, which could "continue to produce" further inflationary surprises ahead. Upside risks stem from possible frustrations with economic reforms, especially in the event of a reversal in (what is now seen as "benign") global environment facing EMs. **Despite the positive developments related to the pension reform, the authority still thinks that the (upside) inflation risk related to the execution of macro reforms prevails.**

Inflation simulations

The BCB's newly presented (IPCA) inflation simulations seem to indicate room for a total adjustment of 100-125bp in this cycle. This apparently means a slightly larger space than the 75-100bp adjustment implicitly suggested in previous communications.

According to the Copom statement, when the BCB runs its inflation models with Selic rate stable at 6.50% and BRL flat at 3.75/USD all the way until 2020 (in what was previously known as "benchmark" scenario), headline CPI estimate stands at 3.6% both for 2019 and 2020 (very similar to the last release, 19Q2 inflation report[2]).

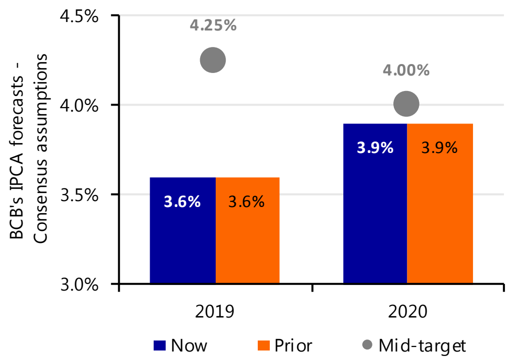
In scenarios where the BCB uses as key inputs the consensus forecasts[3] for the Selic rate (5.50% both for end-2019 and end-2020) and FX rate (3.75 for end-2019 and 3.80 for end-2020), the BCB estimates inflation for this year at 3.6%, and for next year at 3.9% (unchanged).

[2] For 2019, the centre target for the IPCA inflation is 4.25%. For 2020, the mid-point target stands at 4.00%. For 2021 and 2022, the mid-target has been set at 3.75% and 3.50%, respectively.

[3] See here the latest survey of macro forecasts by the BCB, as of Jul 27, 2019.

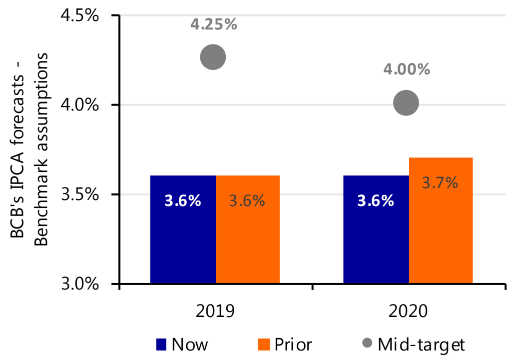
The main difference here is that in previous simulations the BCB would keep IPCA just below the mid-target with a higher level of interest rate – with 5.75% for end-2019 and 6.50% for end-2020. Now the same level of inflation – i.e. 3.9%, just below the centre target for 2020 (4.0%) – is reached with Selic all the way at 5.50%. Importantly, given the slim changes seen in FX levels used in these simulations, the (quantified) improvement in the IPCA outlook is probably much less based on (relatively fluid) BRL trends and much more driven by other (more consistent) fundamentals, such as real activity, inflation expectations.

Figure 2: BCB simulations – consensus scenario



Source: BCB, Rabobank

Figure 3: BCB simulations – benchmark scenario



Source: BCB, Rabobank

Table 1: Key assumptions used in the BCB's simulations for IPCA inflation

		FX Assumptions		Selic Assumptions	
		Now	Prior	Now	Prior
Consensus scenario	2019	3.75	3.80	5.50%	5.75%
	2020	3.80	3.80	5.50%	6.50%
Benchmark scenario	2019	3.75	3.85	6.50%	6.50%
	2020	3.75	3.85	6.50%	6.50%

Note: FX (USD/BRL) and Selic rate assumptions are for the end of year

Source: BCB, Rabobank

What's next?

We continue to look for two more Selic cuts of 50bp for September and October, taking it to 5.00% for end-2019. We expect no change in monetary policy 2020. Today an eventual flight plan could mean less than 150bp of total adjustment. Yet we believe that further progress in the agenda of reforms (e.g. tax reform, BCB independence maybe) and some room for a slight additional GDP disappointment (we look for +0.5% for 2019, vs. BCB and consensus at 0.8%) will increase the space for the BCB to stimulate a bit further.

Inflation-wise, we continue to envision core prices moving much more slowly than the targets for the Copom's policy horizon. Our IPCA estimate for this and next year stands above consensus (at 4.0% for both periods) only because of potential shocks in the food sector (notably the impact of the swine fever in global protein prices).

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