Inflation Report – 1Q19

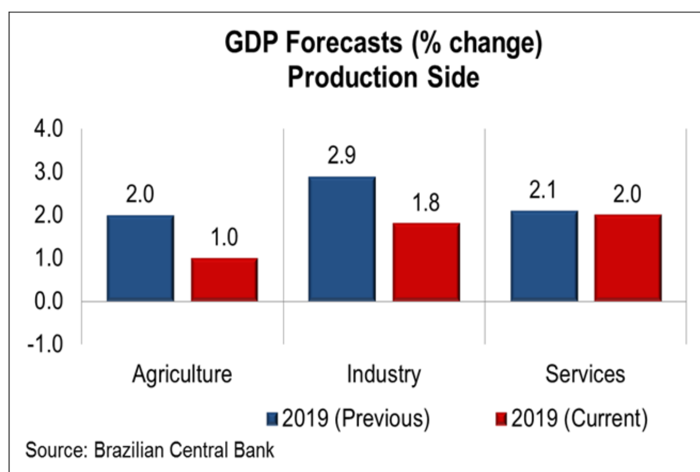
28 March 2019

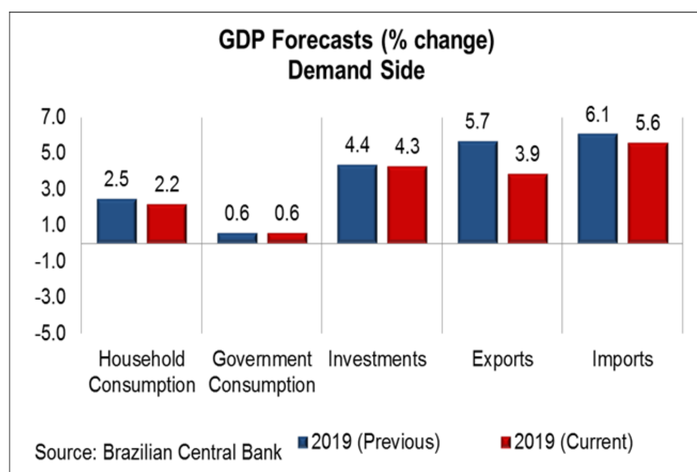
Inflation models suggest Selic rate hike in 2020

What happened

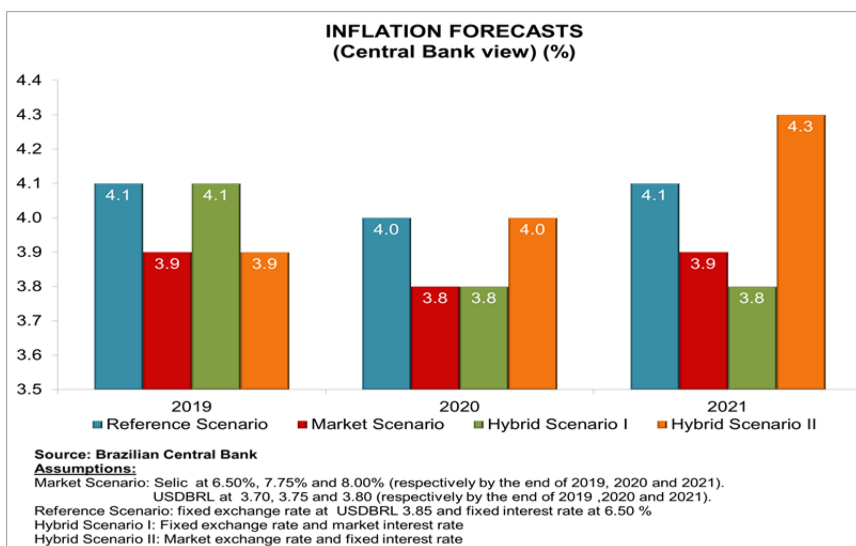
Global: sharper risks of global economic slowdown and more dovish stance on monetary policy in advanced economies.

Economic Activity: Central Bank (CB) reduced its GDP growth projection for this year to +2.0% from +2.4%. This revision was influenced by: i) the weaker-than-expected GDP in the 4Q18 leading to lower carry-over to this year; ii) impact of the dam rupture in Brumadinho leading to shutdown of old mines; iii) reduction on the agricultural crop estimate; iv) weaker-than-expected activity in the beginning of this year.





Inflation Forecasts: Broadly speaking, Central Bank in its 4 models shows that inflation forecasts are slightly below the 4.25% target for this year, at around the 4% target set for next year and slightly above the 3.75% target set for 2021.



Source: Brazilian Central Bank
Assumptions:
Market Scenario: Selic at 6.50%, 7.75% and 8.00% (respectively by the end of 2019, 2020 and 2021).
USDBRL at 3.70, 3.75 and 3.80 (respectively by the end of 2019 ,2020 and 2021).
Reference Scenario: fixed exchange rate at USDBRL 3.85 and fixed interest rate at 6.50 %
Hybrid Scenario I: Fixed exchange rate and market interest rate
Hybrid Scenario II: Market exchange rate and fixed interest rate

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Risks to the inflation scenario: CB assesses that the balance of risks to inflation is symmetric. The downward bias relies on high idle capacity that might lead to lower than expected inflation. And upward bias is mainly related to the risk of hurdles to pass the reforms and to continue the economic adjustments, which might increase risk premium. And this risk is amplified in case of deterioration of the external sector

Our expectation

The tone of the Inflation Report was quite similar to the Copom minutes and communiqué, what was widely expected once those reports were released just few days ago. In this sense, we keep our view that Selic policy rate will be kept at current 6.5% level until the end of this year.

Furthermore, we keep our view that the Central Bank might withdraw monetary stimuli at a gradual pace during the first half of next year, assuming a scenario of higher GDP growth rate (2% this year and 3% in 2020). In our analysis of the Central Bank inflation forecasts, it is interesting to see that in the reference scenario (assuming Selic rate constant at 6.5% and FX rate constant at USDBRL 3.85 until the end of 2021), the inflation forecasts would be at 4.1%, thus above the 3.75% target in 2021. In this sense, considering the lagged impact of monetary policy on inflation, Central Bank would have to increase its policy rate already next year. So, looking at the hybrid scenario I (USDBRL constant at 3.85 and market expectation for Selic rate -- on the cut-off date for this inflation report, market expected Selic rate hike only in 2020 reaching 7.75%), then inflation forecasts for 2021 would be at around the 3.75% target.

However, considering that our FX rate expected by the end of 2020 is at USDBRL 4.00, thus more depreciated than the USDBRL 3.85 in this reference and hybrid I scenario, then there could be higher inflationary pressures coming from the FX pass-through to inflation, in times of higher GDP growth rate. So, we keep our view that Central Bank might need to hike rates along the 1st half of 2020 until 8% in June in order to guide inflation expectation towards the target midpoints.

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