Brazil’s central bank signals interruption of easing cycle, but further cuts remain possible

- Yesterday evening, the Brazilian central bank (BCB) cut its policy rate by 25 bps to 6.75%, stating that an interruption of the monetary easing cycle seems appropriate.
- Our macro and financial market based model shows a very large downward divergence between the current and the implied equilibrium SELIC rate. However, this may be the result of a downward shift in the neutral policy rate assumed by the BCB and it is unlikely to abate anytime soon.
- Our baseline scenario is for the BCB to maintain the SELIC rate unchanged throughout 2018. However, further cuts cannot be ruled out as January inflation data point surprised on the downside.

Yesterday evening; the central bank of Brazil (BCB) cut the policy rate (SELIC) by 25 bps to 6.75%, in line with market expectations. Following a cumulative 750 bps rate cuts since October 2014, the SELIC rate hit the lowest level in two decades. The BCB also signaled that an interruption of the monetary easing process seems appropriate at this stage, as the baseline scenario involves risks in both directions. On the one hand, second-round effects of the favorable past food price shock and the prolonged period of below-target inflation may lower inflation expectations and impact the price trajectory. On the other hand, frustration on the structural reform process – with the pension reform still pending – and a possible reversal of the benign global environment may put upward pressure on price dynamics. We also note that the disinflation impact of lower global food prices, combined with a stronger Brazilian real is likely to abate in the coming months, favoring an upward adjustment of headline inflation towards 4% yoy.

Our macro and financial market based model for the SELIC rate includes data on inflation, slack in the economy (proxied by the dynamics in the unemployment rate) and risk measures (sovereign rating and hard-currency bond spreads). The model had a very good fit between 2000 and mid-2017 but the current divergence from the theoretical equilibrium level is unprecedented.

The large divergence may suggest a structural shift in the BCB’s monetary policy setting, namely a significant reduction in the neutral rate. This can partly be explained by the reforms implemented under president Temer’s presidency – in particular the reform of subsidized loans by public banks – and the expected decline in the BCB inflation target (from the current 4.5% to 4.25% in 2019 and 4.0% in 2020). Given the benign inflation and external environment, we do not expect such a divergence to be reabsorbed anytime soon.
Our baseline scenario is for the BCB to maintain the SELIC rate on hold at 6.75% throughout 2018, before embarking on a mild tightening cycle later in 2019. That said, inflation data surprised on the downside in January. The headline inflation slowed to +2.86% yoy (from +2.95% in December 2017) vs an expected +2.98%. Moreover, our underlying price measure – computed by excluding the food, housing and transportation components from the IPCA basket – slowed to 4.0% yoy, the lowest level since April 2008. A more benign outlook for inflation or the (unlikely) approval of the pension reform would provide further room for rate cuts, while a rapid shift towards a more hawkish stance seems unlikely despite the stronger-than-expected economic recovery.

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