Monetary Policy Simplified

September 2024

Dear investors,

It is curious how the discussion about monetary policy — a highly technical and complex field even for market professionals — has become so popular in Brazil. What everyone has already learned is that high interest rates reduce inflation and that the government's fiscal deficit increases inflation. Things get a bit more complicated when we hear that, even with inflation under control, the government still needs a greater commitment to fiscal responsibility in order to also manage expectations about future inflation. Otherwise, interest rates will remain high.

For those who are not specialists in macroeconomics and monetary policy — which is certainly our case — there is always the danger of getting lost among jargon and abstractions, making it difficult to assess the coherence of what is being discussed. Complex and abstract arguments are more likely to conceal errors. For this reason, we prefer simple and direct analyses, without embellishments or pretension.

With that preference in mind, we will discuss what is happening with Brazilian monetary policy and how we handle the situation in our investments, in the simplest way possible.

The SELIC Rate and Its Impact on the Real Economy

The basic function of a bank is to raise money in the market and lend that money at a higher rate. The difference between the interest paid on funding and the interest charged on loans is called the banking *spread*, the primary source of operating revenue for banks.

In this web of funding and lending, it is common for a bank to end the day with excess or insufficient cash, but banks are not permitted to end the day with a negative balance in their "checking account." To solve this problem, there is the Special Settlement and Custody System (SELIC), which enables banks to lend money to one another for short periods — typically just one day — so that their accounts do not go negative at daily cash close. The interest rate charged on these daily loans is the SELIC Rate, called the benchmark interest rate because it represents the return obtained from the lowest-risk credit operation in the country.

In principle, this rate could be freely determined by the supply and demand for capital in the market. However, the Central Bank operates within the SELIC system, lending (or borrowing) money at the rate set as the SELIC Target. Since the Central Bank participates in a significant portion of the total volume of these daily credit operations, the rate it practices is a strong reference for the rate across the entire market. This is how the Central Bank controls the benchmark interest rate of the national economy.

With the option of lending money to the Central Bank at the benchmark interest rate, it makes no sense to lend money to any company or individual at a lower rate. Since banks still need the banking *spread* to cover their operating costs and remunerate the invested equity capital, all loans — except subsidized ones — are made at rates higher than the SELIC. In other words, when the SELIC rises, borrowed money in Brazil becomes more expensive.

The effect of rising interest rates is quite broad. Since most companies carry some level of debt, they end up spending more on interest payments or on retiring those debts, now more expensive, leaving less capital for investment in growth or innovation. Credit for consumers also becomes more expensive, making any financed purchase more difficult, including retail installment plans advertised as "12 payments with no

interest" (which in practice means the cash price already includes the cost of financing spread over 12 months). The natural consequence is that domestic demand falls, and through the traditional mechanism whereby prices are determined by the balance between supply and demand, prices tend to fall. This is how high interest rates help control inflation, with the side effect of making economic growth more difficult.

Fiscal Responsibility, Inflation, and Interest Rates

Fiscal responsibility means, simply, the government spending less money than it takes in. The rule is so universally applicable that the strange thing is that there should be any lengthy debate over whether the government should follow it. The situation becomes more understandable when we consider the practical perversities of politics.

A government that spends recklessly during its term generates a deficit but gains popularity by delivering public works and social programs, much like a reckless consumer happily makes purchases until the credit card bill arrives. The difference is that for the politician, the "credit card bill" can be postponed until the next administration. Whoever inherits the government will face a problem: either restrict spending to rebalance public finances — always an unpopular measure — or make the problem worse by maintaining the deficit. If the decision to restrict spending falls to an opposition leader, the one responsible for the debt accumulated in the previous term will still draw comparisons claiming they delivered far more to the population during their time in office, without addressing the damage caused to public finances in the process. Political frustrations aside, let us look at what happens when the government increases its spending.

Given the large size of the State, when it spends more, total domestic demand for goods and services increases in a non-trivial way, generating upward pressure on prices through the same supply-and-demand equilibrium mechanism we already discussed. In other words, increased government spending contributes to higher inflation.

A second problem is that fiscal deficits force the government to inevitably increase public debt. If this pattern is maintained for too long, a point is reached where the government can no longer afford to pay the interest on its debt or issue additional debt, since there will no longer be buyers willing to lend even more money to a government that always closes its books in the red. In that situation, two options would remain: the government declaring a moratorium — an extreme measure in which payments related to the public debt are suspended, causing enormous damage to the country's reputation — or issuing more currency through the central bank and using it to pay the debt. Some see in this second solution a magic formula for solving the problem. However, since it is not possible to generate economic value out of nothing, simply printing more money only means that the same quantity of goods a country has is represented by a larger volume of money, and thus the value of each monetary unit decreases, causing nominal prices to rise. This is a second way to generate inflation.

There is one more negative effect. Recurring deficits cause investors to lose confidence in the sustainability of public finances. This loss of confidence reduces the inflow of foreign capital and, consequently, also reduces the volume of purchases of the local currency. Beyond the obvious problem of receiving fewer investments, the lower demand for buying reais causes our currency to depreciate and exchange rates to become less favorable for imports. In other words, the dollar rises and the price of everything that is imported increases. Since a significant portion of Brazilian consumption comes from imported products (around 20%), the rise of the dollar also increases inflation.

Meanwhile, the role of the Central Bank remains to control inflation through the only tool under its command: monetary policy. Thus, the larger the fiscal deficit, the greater the inflationary effect and the more the central bank will tend to raise (or keep high) the benchmark interest rate.

Where the Complexity Arises

If these mechanisms could be analyzed in isolation, understanding the situation and projecting likely developments would not be such a difficult task. However, all of them act simultaneously on the economy and have effects beyond those predicted by the simplified mechanics we described. For example, raising interest rates reduces inflation in the short run, but makes it harder to balance public finances, since it raises the interest the government pays on its debt and slows economic growth, thereby reducing tax revenues. Since a fiscal deficit increases inflation, the side effect of raising interest rates may actually worsen the inflation problem in the medium term — in the same way that a medicine in excessive doses harms rather than helps the patient. Calibrating the ideal interest rate is not an exact science. The Central Bank uses mathematical models to calculate what the neutral interest rate would be — the one that would neither accelerate nor decelerate the economy — and adjusts its monetary policy accordingly. However, the model is theoretical and the real effect is only known through good old trial and error. That is why the Central Bank changes the interest rate gradually: it raises it by 0.25% and waits to see what happens. It lowers it by 0.25% and waits to see what happens.

There is also the matter of expectations. Despite being a subjective element, its impact on the economy is real. When business leaders and investors believe that future inflation will be high, they incorporate that assumption into their calculations and make business decisions accordingly. They raise the selling prices of their products in anticipation of increases in their production costs, and they demand higher rates of return on their investments to compensate for the risk associated with inflation (e.g., costs rising more than can be passed on in prices). Thus, actual inflation tends to converge toward expected inflation, in a form of self-fulfilling prophecy.

In turn, inflation expectations are guided by what the market expects the Central Bank and the government to do over time, since they are the agents with real power to influence the economy in a significant way. When both act in a consistent and coordinated manner, the environment is more stable. When they act erratically and there is friction between the government and the central bank, what we are experiencing in Brazil happens. No one knows for certain what the future holds, and expectations also fluctuate erratically.

What to Do with Investments

In complex and unstable environments, we prefer to acknowledge uncertainty in its full breadth rather than overestimate our ability to predict the future. All of this discussion around fiscal responsibility, monetary policy, inflation, and interest rates makes up a complex and unstable scenario. So, rather than trying to project (or guess) what the next COPOM decision on the SELIC rate will be and its impact on inflation, we seek to position ourselves in investments that tend to generate a good rate of return regardless of the exact path that interest rates and inflation take over the years.

We repeat with some frequency in our letters what those investments are: shares of good companies with sustainable competitive advantages, a track record of high profitability, and a resilient business model. Companies like these tend to be capable of surviving and thriving because they generate real economic value. They will advance more quickly when the macroeconomic environment is favorable and will hold up as well as possible when it is not. Over long periods, they tend to generate good average returns on capital invested in the business.

We acknowledge the uncertainties of macroeconomic variables and avoid spending time trying to project what cannot be predicted with sufficient confidence to sustain an investment thesis with good return potential and controlled risk. We prefer to spend our days monitoring the companies in our portfolio, evaluating other listed companies, and studying the microeconomic cycles of sectors that draw our attention.

Our strategy has a simple essence. We seek to identify listed companies that have the characteristics mentioned, calculate a fair value for their shares assuming a very conservative scenario on the points we cannot predict with precision, and wait until there is an opportunity to buy them at a price low enough for the investment to be reasonably profitable even in that pessimistic scenario. Anything above that is profit. Literally.