BRAZIL MACRO September 20, 2023

MONETARY POLICY DECISION

ACCELERATION OFF THE TABLE FOR NOW

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- As widely expected, the Copom announced a 50 bps reduction in the Selic rate, bringing it to 12.75%. The committee also confirmed that it continues to anticipate cuts of the same magnitude for the next few meetings and did not change the balance of risks assessment, which remained symmetrical. This outcome was in line with what we (and consensus) expected. In our view, the Copom retained a relatively neutral tone in its communication.
- In our view, the BCB's decisions today were caused by the fact that not all the conditions Copom needed to justify an acceleration in the easing cycle had been met yet. The BCB recognized that underlying measures of inflation improved, but highlighted that economic activity was still buoyant, and inflation expectations remained unanchored.
- The Copom also underscored the importance of meeting fiscal targets in order to re-anchor inflation expectations. Recent global economic developments also caused the Copom to assess, as it indicated continued concern over the high level of interest rates in the US and lower growth projected for China. Additionally, the increase of the BCB's inflation forecast due to a worsening of the model's inputs was another reason for the Copom to stick to its original monetary policy plan, in our view.
- Therefore, our own forecast remains in line with the BCB's communications, as we continue to forecast 50 bps cuts for the next two meetings, leaving the YE2023 Selic rate at 11.75%. For 2024, we continue to project 50 bps cuts for the first four meetings of the year and then a final 25 bps cut, leaving the YE2024 Selic rate at 9.5%.
- However, we continue to see an increasing risk of an acceleration in the pace of cuts, because: (i) we expect (services) inflation to continue to decelerate, and (ii) we expect economic activity to weaken more visibly from now on. As the BCB seems to be assigning a greater-than-usual weight on these factors, and if we are right in our outlook for inflation and activity, we cannot rule out sharper cuts by the end of 2023/beginning of 2024.
- Despite the possibility of an acceleration in the pace of easing, we are more skeptical about the probability for a much lower Selic in 2024. In our view, the interest rate differential against both EM and DM countries is already low. As a result, an increase of the risk of lower terminal rates is more dependent now on a change in the global rates environment towards a more dovish mood.

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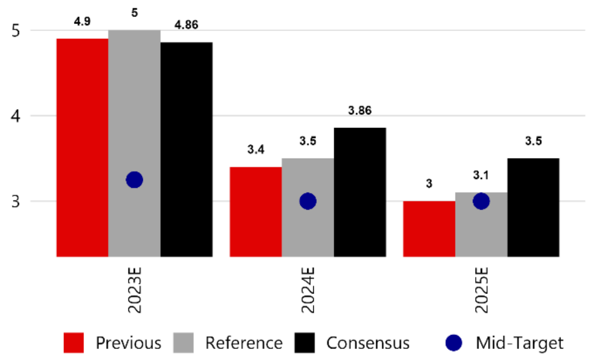
As per standard, the communiqué started with a summary of the recent global developments. The Copom indicated concern over the high level of interest rates in the US and lower growth projected for China. In our view, it was a hawkish message overall.

On the domestic front, the Copom highlighted the greater-than-expected resilience in economic activity but continued to forecast a deceleration in the coming quarters. In addition, it recognized that underlying measures of inflation have improved, but remain above the target. In discussing still unmoored inflation expectations, the Copom underscored the importance of meeting fiscal targets in the coming years. In our opinion, the Copom's reading of the domestic scenario was hawkish overall.

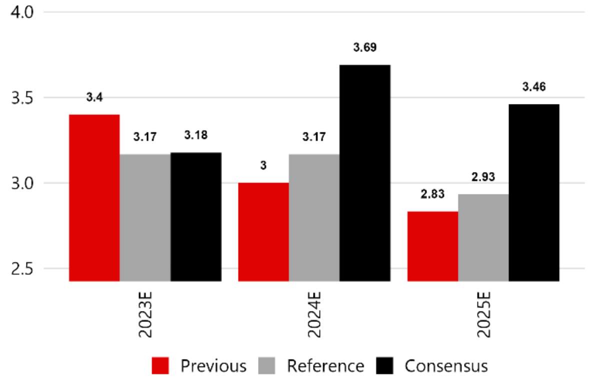
The communiqué also brought to light the BCB's updated inflation estimates for future years. There was a marginal deterioration across the board, since almost all the drivers used as inputs for the BCB's inflation forecasting model have worsened since the last meeting (oil prices are up, the BRL has depreciated, the output gap has become smaller, and Focus's expectation for the Selic rate has fallen). Surprisingly, this revision was smaller than expected by us and the market (the revised numbers for 2024 and 2025 were raised by 10 bps while we had expected a 30 and 20 bps revision respectively), which we interpret as a dovish message. It continues to be the case that the divergence between the BCB's and the economists' projections for headline IPCA 2024 (consensus: 3.9% vs BCB: 3.5%) and IPCA 2025 (consensus: 3.5% vs BCB: 3.1%) comes from free market prices.

Figure 1. BCB's Headline Inflation Estimates in August (%, Reference Scenario)



Sources: Brazilian Central Bank, Santander.
Note: Assuming FX rate departing from USD/BRL 4.90, and then moving along with the PPP (purchasing power parity). Oil price following the futures curve for six months and stable in real terms in USD. The BCB assumes energy tariff flag "green" for both December 2023 and 2024. Consensus forecast for the future path of interest rate.

Figure 2. BCB's Free Market Prices Inflation Estimates in August (%, Reference Scenario)



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Note: Assuming FX rate departing from USD/BRL 4.90, and then moving along with the PPP (purchasing power parity). Oil price following the futures curve for six months and stable in real terms in USD. The BCB assumes energy tariff flag "green" for both December 2023 and 2024. Consensus forecast for the future path of interest rate.

The BCB's balance of risks analysis underwent no changes. The authority continues to identify risks in both directions and does not see either a positive or negative bias to its inflation forecasts. Among the elements that feed upward inflationary risks, the BCB highlighted global inflation worries and potentially more resistance to lower local services inflation due to a narrower output gap. On the downward inflationary risks side, the emphasis continued to be the international economy, pointing to the risk of a stronger-than-expected deceleration in global economic activity, and to the potentially large effects of globally synchronized monetary policy tightening.

In the minutes from the previous meeting, the Copom listed the triggers that might make it consider an acceleration in the pace of its cuts, those being: (i) a sturdy re-anchoring of inflation expectations, (ii) a sharp widening in the output gap, or (iii) substantially more benign services inflation than currently expected. Looking ahead, it seems to us that the BCB is giving a greater importance to near-term inflation surprises than in the past. As a result, the recent improvement in services inflation could open room for a discussion about altering the pace of cuts sooner rather than later. In addition, deceleration in activity in the coming quarters might also support this discussion. Hence, the possibility of sharper cuts coming around the end of 2023/beginning of 2024 cannot be ruled out, in our opinion, although it is not our baseline scenario.

Based upon our expected path for inflation and the current signals conveyed by the Copom, we forecast the pace of cuts being kept at 50 bps, with the Selic rate reaching 11.75% at YE2023. We see the current monetary easing cycle leading the Selic rate to 9.50% during 2024, as we see both domestic and international factors limiting the room for much lower levels of interest rate in Brazil. Currently, we see limited room for lower terminal levels in this easing cycle, as the interest rate differential against both EM and DM countries is already low. We believe an increase of the risk of lower terminal rates is more dependent now on a change in the global rates environment towards a more dovish mood.

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