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MONETARY POLICY – COPOM MINUTES

MORE THAN THE SIMULATIONS

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- The Brazil Central Bank (BCB) published the minutes from its August 3-4 COPOM policy meeting, when the authority raised the Selic rate by 100 bps (for a fourth time running) to 5.25% p.a. Overall, the BCB kept a hawkish tone, but in line with the policy statement, in our view.
- The committee believes that a policy path of Selic rate hikes going faster and/or farther than the projection of analysts before that meeting is appropriate. This means that a trajectory of hikes of 100 bps in September and further moves leading to a terminal Selic of 7.00% in the cycle is a lower bound for the tightening being considered ahead by the BCB (conditional on the scenario).
- We believe the BCB used the minutes to further strengthen the message that it will do what is necessary to bring inflation down to the 3.50% mid-target next year, however elusive that task may prove ahead.
- We continue to look for another Selic rate increase of 100 bps (to 6.25%) for September and a terminal rate of 7.50% (for both YE2021 and YE2022). With our inflation forecast standing around for 4% for 2022, we see the probability slightly skewed to the upside as per our own interest-rate scenario.

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Overview

The BCB has published the minutes from its August 3-4 COPOM[1] policy meeting[2], when the authority raised the Selic rate by 100 bps (for a fourth time running) to 5.25%[3] p.a. Overall, the BCB struck a hawkish tone, but about in line with the policy statement, in our view.

Key Policy Messages

In the minutes, the BCB discussed the appropriate policy path, as the authority now sees the need to take on a contractionary policy stance.

While the BCB indicated that "the inflation projections are aligned to the targets for 2022 and 2023" (assuming Selic at 7%), it kept the message that "the fiscal risks continue to imply an upward bias in the projections", which justify "a path for monetary policy that is more restrictive than the one used in the baseline scenario." The BCB also went on to say that its models indicate that "subsequent uninterrupted interest rate increases are required up to a level above the neutral rate, to obtain projections around the inflation targets in the relevant horizon" (Paragraphs #13 and #14).

The BCB reaffirmed the message in the communiqué, as it believes that "the recent worsening in inertial components of inflation, amid the reopening of the service sector, could cause a further deterioration in inflation expectations," which could increase "the costs for its future convergence", according to the BCB. The authority concluded that "a quicker adjustment of monetary policy is the most appropriate strategy at this time to assure the convergence of inflation to its targets for 2022 and 2023". The board also emphasized on "its unequivocal commitment to the pursuit of its inflation targets over the relevant horizon for monetary policy, guided by its baseline scenario as well as its assessment of the balance of risks." (Paragraphs #16 and #17).

In our view, what the BCB is basically saying is that, given the BCB's baseline scenario and the (upwardly skewed) balance of risks perceived by the authority, the committee sees as appropriate a policy path of Selic hikes going faster and/or farther than the projection of analysts before that meeting. Back then, analysts looked for a 100-bp hike (to 6.25%) for September and a terminal Selic rate at 7.00% for December (and stable at that level across 2022[4]). With most recent surveys showing analyst projections still with an upward bias for both interest rate and inflation, for both 2021 and 2022, we believe this trajectory is the least (or the lower bound for what) one can expect from the BCB in terms of subsequent policy tightening.

Thus, the BCB apparently used the minutes to further strengthen the message that it still seeks to bring IPCA inflation down to the 3.50% mid-target next year, however elusive that task may prove in the future.

Complementary Views on the Scenario Assessment

Elsewhere in the minutes, the BCB provided extra details on the evolution of its scenario assessment.

On inflation, the BCB took the opportunity to consider "potential explanations for the difference between its baseline scenario's projections and the inflation expectations extracted from the Focus survey." The COPOM believes that the gap reflects (i) different assumptions on key variables or determinants of the inflation dynamics (e.g. administered prices, economic activity); (ii) different perceptions of risk or probability for alternative scenarios; and (iii) different assumptions about the reaction function of monetary policy. The committee also highlights that "the long sequence of shocks and one-way revisions of expectations may increase the perception of inflationary inertia" (Paragraph #15).

The COPOM reaffirmed an upbeat tone on real activity, as the committee judges that "the latest available data continues to evolve positively, in line with growth forecasts." The BCB continues to anticipate a "robust recovery" for the 2H21 "as the effects of the vaccination are felt more broadly." Probably based on the

[1] The COPOM is the monetary policy committee of the Brazilian Central Bank (BCB).
[2] Refer to the minutes of the 240th COPOM meeting in English (https://www.bcb.gov.br/en/publications/copomminutes).
[3] **Santander Brazil Monetary Policy - *"Stepping Up the Pace and the Plan"* –** August 5, 2021 – Available on: https://bit.ly/Std-COPOM-aug21
[4] Refer to the Focus survey as of July 30, 2021 (https://www.bcb.gov.br/en/publications/focusmarketreadout/30072021).

conclusion from a box presented in the last inflation report[5], the BCB ponders if "the difficulties related to seasonal adjustments due to the pandemic shock would explain" the gap between analysts' median estimates and the BCB's own projections for 2021 GDP growth – with consensus currently at 5.3%[6] vs. the BCB's 4.6% (Paragraph #11).

In terms of economic slacks, the BCB affirmed that though "the economic slack as a whole is quickly returning to the late 2019 level, the Committee considered that the pandemic still produces heterogeneous effects on economic sectors and, in particular, on the labor market". The inclusion of the labor market in this context is something new in the BCB communication, as the authority previously indicated that "formal labor market data suggest that the overall slack has declined faster than anticipated, despite the increase in the unemployment rate.". This apparent recognition of remaining slack in the job market may be the only element with a slightly "dovish tilt" in this COPOM minutes (Paragraph #12).

In the balance of risks, while the market and the BCB likely saw a notable deterioration on the heels of a worse inflation composition (clearly recognized by the BCB in both the statement and the minutes), the same elements have been mentioned on both sides. On the downside, the Central Bank notes that "a possible reversion, even if partial, of the recent increase in the price of international commodities measured in local currency would produce a lower-than-projected inflation in the baseline scenario." On the upside, the authority believes that "further extensions of fiscal policy responses to the pandemic that increase aggregate demand and deteriorate the fiscal path may pressure the country's risk premium" (Paragraphs #8 and #9). The balance of risks remains tilted to the upside, as the BCB notes (and as already mentioned here in this piece).

What to Expect Ahead?

In our view, a more hawkish BCB response, particularly the signal of a faster and greater interest-rate adjustment in this cycle was warranted. We believe this is the best response to the mounting headline inflationary pressures and spreading of inflationary shocks, in a context of more prolonged budget stimulus, latent fiscal risks, and a faster cyclical recovery. If that message had already been clear in the statement, we believe the signal may have become even stronger after the minutes.

We continue to look for another Selic rate hike of 100 bps (to 6.25%) in September and a subsequent move of 75 bps in October. We also incorporated a last move of 50 bps in December into our baseline scenario, so that our terminal rate expectation for this cycle was upgraded to 7.50% (from 7.00% previously). We expect Selic rate to remain at this level throughout 2022, with an expected adjustment towards (our hypothesis of) the neutral level of 7.00% only in 2023. That's the horizon when we finally expect the IPCA inflation to converge to the mid-target (3.25%). Yet, since we project IPCA near 4% for 2022, we see the probability slightly skewed to the upside as per our own interest-rate forecast.

[5] **Santander Brazil Monetary Policy - *"BCB still poised to speed up hikes (…)"* –** June 24, 2021 – Available on: https://bit.ly/Std-Inflation-Rep-2q21

[6] Refer to the Focus survey as of August 6, 2021 (https://www.bcb.gov.br/en/publications/focusmarketreadout/06082021).

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