BRAZIL MACRO

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MONETARY POLICY – COPOM MEETING

SCANNING THE SCENE AS IT MOVES AT CRUISE SPEED

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- The COPOM has once again hiked the Selic policy rate by 100 bps, reaching 6.25%, in a decision that was broadly in line with expectations (that coalesced after the Brazil Central Bank's remarks last week, which dissuaded the markets away from expectations of an acceleration in the tightening cycle).
- In the statement, the authority indicated that "at the present stage of the tightening cycle, this pace is the most appropriate to guarantee inflation convergence to the target at the relevant horizon and, simultaneously, allow the Committee to obtain more information regarding the state of the economy and the persistence of shocks."
- In our view, the bar is high for the Brazil Central Bank (BCB) to change the speed of rate hikes ahead, as it apparently believes this is a fast-enough pace at this juncture. The adjusting variable for eventual surprises in the BCB's scenario is likely the budget of total hikes. For now, given the inflation simulations and upwardly tilted balance of risks, it is possible that the current flight plan could include a terminal Selic rate somewhere between 9.00-9.50%. This means a higher aim for the tightening cycle compared to the previous meeting, mirroring the deterioration in inflation conditions and outlook in recent weeks.
- While for now we still do not foresee the Selic rate reaching double-digit territory, we continue to perceive upside risks as per our forecast of a terminal rate at 8.5% in February 2022.

Policy decision and (brand new) guidance

The COPOM[1] has once again hiked the Selic policy rate by 100 bps[2], reaching 6.25%, in a decision that was broadly in line with macro analysts' expectations and yield curve prices. Expectations for this meeting converged to that outcome after last week's BCB speeches cooled off nascent forecasts of a bolder move.

It looks like a pace of 100 bps per meeting now might be the cruise speed in the BCB's flight plan. In the statement, the COPOM indicated that "at the present stage of the tightening cycle, this pace [100 bps] is the most appropriate to guarantee inflation convergence to the target at the relevant horizon and, simultaneously, allow the Committee to obtain more information regarding the state of the economy and the persistence of shocks."

The latter part of this phrasing signals that the total budget of rate hikes may likely be the adjusting variable should economic and inflation conditions bring surprises to the BCB's scenario. In fact, BCB officials reaffirmed the message that, at least for now, "the COPOM's baseline scenario and balance of risks indicate as appropriate to advance the process of monetary tightening further into the restrictive territory [read: interest rate going further above 6.5%]".

While the BCB's current message does not necessarily hint at a certain endpoint for the cycle (as has been the case in previous occasions), we sense the COPOM's flight plan could include a terminal Selic rate at 9% or slightly above. According to the BCB's own inflation models, with the FX rate starting at 5.25 (and moving along with PPP afterward), a path of Selic rate hikes (as projected by market economists) to 8.25% for YE2021 and 8.50% for YE2022[3] would produce disinflation from a beefy reading of 8.5% in 2021 (previously: 6.5%; upper target: 5.25%) toward a reading of 3.7% for IPCA inflation for the main policy horizon now (2022)[4]. This forecast rose 0.2 p.p. from the last meeting, and now slightly tops next year's mid-target of 3.5%[5].

It is important to note that this increase in the inflation forecast for 2022 took place even with a tighter policy stance, as expected by analysts. In the previous meeting, the BCB ran the simulations with a terminal Selic level of 7.00% (as per the Focus survey just before the August meeting). For 2023, the BCB still foresees inflation around the center target (3.2%), with the Selic rate slightly higher than in the previous meeting (6.75% vs. 6.50%). All in all, the BCB is recognizing the need for an even tighter policy stance than thought in the previous COPOM, as a reflection of the deterioration in inflation conditions and outlook in recent weeks.

Balance of risks and scenario assessment

In the analysis of the balance of risks for inflation, no changes at all were seen. The BCB continues to view elements in both directions, but still with an upward asymmetry.

To the upside, while the COPOM sees "improvement of debt sustainability indicators," it states 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." The COPOM still believes that the high fiscal risks generate "an upward asymmetry in the balance of risks, i.e., in the direction of higher-than-expected paths for inflation over the relevant horizon for monetary policy."

To the downside, the COPOM believes 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

[1] The COPOM is the monetary policy committee of the Brazilian Central Bank (BCB).
[2] Refer to the statement of COPOM #241 in English (https://www.bcb.gov.br/en/monetarypolicy/COPOMstatements).
[3] According to the Focus survey, the trajectory of the Selic rate projected by analysts include further hikes of 100bps in October and December 2021, and with a final 25-bp move in February 2022.
[4] Among the key BCB's assumptions beneath the inflation forecasts, the "energy flag is assumed to be "hydric scarcity" in December 2021 and "red level 2" in December of 2022 and 2023." This looks a more plausible assumption (given the likely temporary nature of the shock and the extraordinary policy) than the "neutral flag assumption". This methodological decision contributed for a reduction in the 2022 IPCA projection of about 0.2 p.p., vis-à-vis the "neutral flag assumption".
[5] Market analysts project IPCA inflation at 4.1% for 2022, and most of the gap from the BCB's estimate reflects differences in projections for market-free prices. In fact, consensus projects administered price inflation (~27% of the IPCA) at 4.37%, whereas the BCB pencils in 4.2% for next year.

in the baseline scenario." In our view, the BCB still hopes that a stronger BRL will help curb cost pressures that have plagued the inflation environment in recent quarters.

In the scenario assessment, the BCB reiterated that inflation concerns are warranted, highlighting that industrial goods inflation is reflecting "higher input costs, supply restrictions, and redirecting of services demands toward goods" and that these pressures have not "subsided and should remain a pressure in the short run." The BCB also recognizes that "services inflation has accelerated in recent months, reflecting the gradual normalization of the sector", which was already expected. Persistent inflation can also be seen in volatile items (food, fuel, electricity) "due to factors including the exchange rate, commodity prices, and adverse weather conditions." The BCB continues to highlight that "various measures of underlying inflation (…) above the range compatible with meeting the inflation target."

The BCB maintained a constructive tone with respect to economic activity, with the authority highlighting that "the second quarter GDP release as well as the most recent indicators continue to show a positive evolution and do not ensue relevant revisions in growth forecasts." The authority continues to envision "a robust economic recovery" for 2H21.

On the global environment, the BCB notes "two additional risk factors to the growth of emerging economies": (i) the Chinese slowdown, which the BCB sees as associated with a resurgence of the pandemic (Delta variant); and (ii) the removal of monetary policy stimulus in emerging markets, associated with higher inflation in these economies. The BCB continues to see the perception of upside risks for inflation (and expectations) in developed economies as a potential challenge for EMs. Yet the COPOM still anticipates a favorable environment for emerging economies on the back of "long-lasting monetary stimuli and the reopening of major economies."

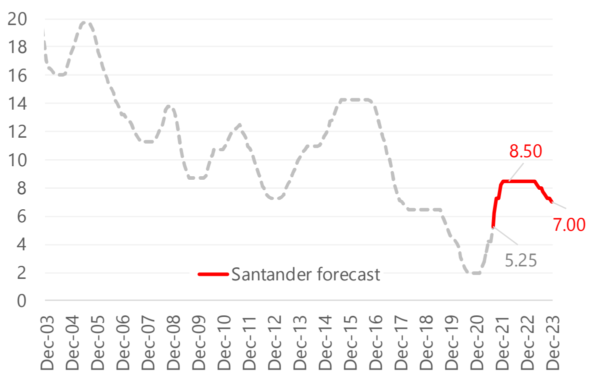
What to Expect Ahead?

In our view, the bar is high for the BCB to change the speed of rate hikes ahead, as it apparently believes this is a fast-enough pace at this juncture. The adjusting variable for surprises in the scenario is likely the budget of total hikes. For now, given the inflation simulations and upwardly tilted balance of risks, it is possible that the current flight plan could include a terminal Selic rate somewhere between 9.00-9.50%.

But this is true only if the scenario evolves in line with the BCB's expectations, and especially if inflation forecasts remain tame for 2023. That policy horizon will gain increasing relevance in the coming months, becoming equally important as 2022 as of 4Q21. While for now we still do not foresee the Selic rate reaching double-digit territory in this cycle, we continue to perceive upside risks as per our forecast of terminal rate at 8.5%.

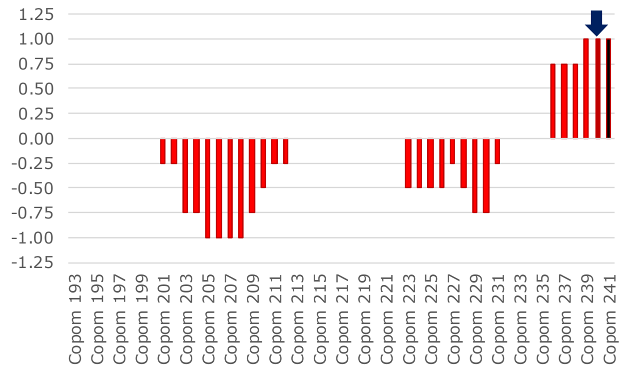
Refer to a few graphs in the next page.

Figure 1.A. – The Path for the Nominal Selic Rate (monthly average, % p.a.)



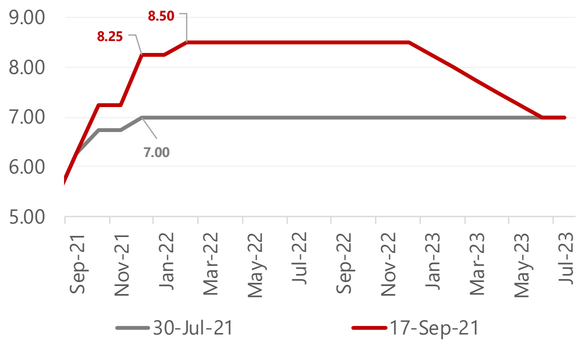
Sources: Brazilian Central Bank, Bloomberg, Santander.

Figure 1.B. – Selic Rate Moves in COPOM Meetings (in percentage points)



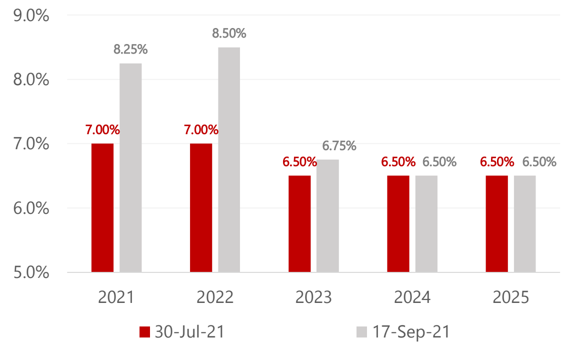
Sources: Brazilian Central Bank, Bloomberg, Santander.
Note: This graph includes the decision hinted by the BCB for COPOM #241 (October 26-27, 2021).

Figure 2.A. – Median Selic Rate Forecasts (Monthly)



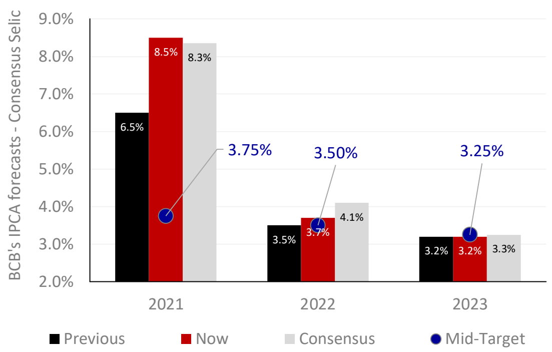
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

Figure 2.B. – Median Selic Rate Forecasts (Annually)



Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

Figure 3.A. – BCB's Inflation Simulations



Sources: Brazilian Central Bank, Santander.
Note: BCB simulations assume Selic rate from the Focus survey and USD/BRL starting at 5.25 and evolving according to purchase power parity.

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