Santander Macroeconomic Research

BRAZIL MACRO November 3, 2021

MONETARY POLICY – COPOM MINUTES

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ANCHOR AND HIKES

- The Brazilian Central Bank (BCB) published the minutes of the October 26-27 Copom policy meeting, when the authority accelerated the pace of hikes to 150bps, raising the Selic rate to 7.75%. Overall, our impression is that the BCB maintained a hawkish tone, but with no overreaction, in line with the statement and in proportion with the deterioration in the inflation outlook.

- The Copom is particularly worried about a possible de-anchoring of inflation expectations on the heels of recent fiscal policy signs (of an imminent change in the constitutional spending ceiling framework, the main fiscal anchor as of now). The BCB points to greater upside risks for inflation, the neutral level of interest rate and, consequently, the total budget of hikes.

- The BCB makes it clear that it has not given up achieving inflation's mid-target for 2022 – which the authority sees as necessary to avert further deterioration in expectations for longer (and increasingly important) policy horizons.

- The authority claims that "the appropriate degree of monetary tightening is significantly more contractionary than that used in the baseline scenario", as we calculate the BCB models suggest a need for a level of interest rate that reaches at least some 150bps above the scenario tested in the last BCB simulations (based on consensus forecasts in the week before the meeting).

- We recently raised our estimate for the terminal Selic rate in the cycle to 11.50%, as we look for hikes of 150bps in December 2021, and subsequent moves of 125bps in February 2022 and 100bps in March 2022. We expect the interest rate to remain around this level at least until 2Q23, conditional on the fiscal policy developments. We recognize the uncertainty about economic policy and the difficulty to make forecasts at this juncture. For now, we sense there is still upside risk as per our terminal rate call.

Overview

The BCB published the minutes of its October 26-27 Copom[1] policy meeting[2], when the authority accelerated the pace of interest rate hikes to 150bps, raising the Selic rate (for a sixth time running) to 7.75% p.a. (and signaled another similar move for December[3]). Overall, our impression is that the BCB maintained a hawkish tone with no overreaction in the minutes, about in line with the policy statement.

Key Policy Messages

The Copom highlights that since the last policy meeting "relevant questionings arose regarding the future of the current fiscal framework", raising the risk premia and the probability of de-anchoring inflation expectations. The BCB believes this leads to an even greater "asymmetry in the balance of risks for the conduct of monetary policy" and higher probability of "alternative scenarios that consider higher neutral interest rates." The authority also reminds that setbacks "in the structural reform effort and permanent changes to the fiscal consolidation process could result in an increase in the structural interest rate." (Paragraphs #11 and #12)

Clearly, as the BCB pledges a monetary tightening going "even further into the restrictive territory", a higher level for the structural level of interest rate will necessarily mean an even larger budget of rate hikes.

As per the inflation outlook[4] and budget of policy rate tightening, BCB officials indicate that the recent fiscal events led to "an increase in the upward risk to its baseline scenario projections." The authority also believes that the "upside bias is now larger than previously considered", leading the BCB to conclude that "the appropriate degree of monetary tightening is significantly more contractionary than that used in the baseline scenario." (Paragraph #13)

As per the speed of hikes, the Copom tested the "appropriate pace" by simulating "different monetary policy paths under different alternative scenarios." The Copom notes that "shocks in BRL-denominated commodity prices already impact the 2022 projections" raising the volatility of expectations and forecasts for that horizon, which remains key for the BCB. Interestingly, while the BCB's "rule of thumb" for the monetary policy window would suggest that 2022 and 2023 would be equally important policy horizons at this time of the year, the authority continues to focus on 2022 for now. The BCB seems to believe that missing the target in 2022 could have consequences for other horizons as the "Copom understands that a process of deanchoring inflation expectations may cause high economic costs in the long term". So, the committee "decided to choose a pace of interest rate hikes compatible with the convergence of inflation to the target still in 2022." (Paragraph #14)

While justifying the option for a faster movement of 150bps, the BCB made explicit that the board also considered scenarios with even faster hikes (than 150bps). However, the authority concluded that different levels of terminal rates (at this very speed of 150bps) "are consistent with inflation converging to the target in 2022, even considering the current asymmetry of the balance of risks." (Paragraph #15)

Thus, at least for now, the most likely pace ahead, according to the BCB's flight plan is 150bps, as has already been signaled for the December 7-8 Copom policy meeting. At that moment, the policy rate is expected to reach 9.25%.

Complementary Views on the Scenario Assessment

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

The BCB now sees the global environment turning "less favorable" and "more challenging" for EMs. It refers to persistent inflation pressures and the expected reaction from [major] central banks. The Copom also believes

[1] The COPOM is the monetary policy committee of the Brazilian Central Bank (BCB).
[2] Refer to the minutes of the 242nd COPOM meeting in English (https://www.bcb.gov.br/en/publications/copomminutes).
[3] **Santander Brazil - *"The Greatest Hike Since 2002, with No Overreaction"* –** October 25, 2021 – Available on: https://bit.ly/Std-COPOM-oct21
[4] In the statement, the BCB published new inflation forecasts pointing to IPCA at 4.1% for 2022 (mid-target: 3.50%) and 3.1% for 2023 (mid-target: 3.25%). This scenario assumes exchange rate starting at USD/BRL 5.60 and evolving according to the purchase power parity (PPP) and a path for the Selic rate that rises to 8.75% p.a. in 2021 and to 9.75% p.a. in 2022, ending the year at 9.50% p.a., and drops to 7.00% p.a. during 2023 (as per the consensus before the Copom meeting).

that [global GDP] growth will slow next year “with the reversal of fiscal stimuli and advance in the process of monetary policy normalization.” (Paragraph #1)

On activity, the monetary authority seems to have slightly downgraded its assessment and forecasts, as it highlights that “industrial output and trade indicators show negative and below-expected results.” The BCB refers to the contrast between goods-related sectors – impacted by “supply shortages of inputs in some productive chains, which should persist until 2022” – and services, where it sees a “robust recovery trajectory”. The BCB still projects an economic recovery in the 2H21 but it sees this process as “less intense and more concentrated in the services sector.” For 2022, the BCB notes a tug-of-war of factors, as the “rise in risk premia and the tightening of financial conditions act stifling the economic activity” and believe that “growth will be benefited by three tailwinds”. In that front, the BCB refers to i) the recovery in labor market and services, ii) “the performance of sectors less dependent on the business cycle” [read agriculture and mining] and iii) the “remaining effects of the normalization of the economy as the health crisis recedes.” (Paragraphs #2 and #3)

In the Copom minutes, the BCB also takes the opportunity for a more detailed assessment on current inflation conditions. The authority recognizes that “inflation remains high and has been more persistent than anticipated”, pointing to price gains that “are more widespread and also include items more associated with core inflation.” The BCB also mentions that industrial prices have “not slowed down and should persist in the short term, whereas services inflation accelerated due to the gradual normalization in the sector’s activity, as expected.” The committee also claims that “a substantial increase in international energy commodity prices, whose inflationary impact is amplified by the BRL depreciation” was a preponderant factor behind the increase in the BCB’s own inflation projections both for 2021 and 2022. (Paragraph #4)

What to Expect Ahead?

In our view, the minutes bring a similar tone as in the statement, with the BCB reacting in a hawkish manner, but proportionately with the deterioration in the inflation outlook. No overreaction, in our view.

The Copom is particularly worried about a possible de-anchoring of inflation expectations on the heels of recent fiscal policy signs (of an imminent change in the framework for the constitutional spending ceiling, the main fiscal anchor as of now). The BCB points to greater upside risks for inflation, the neutral level of interest rate and, consequently, the total budget of hikes.

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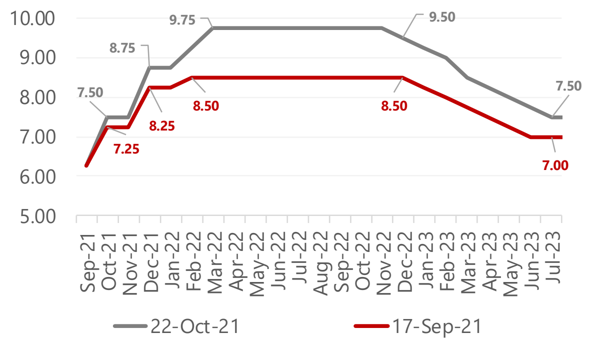
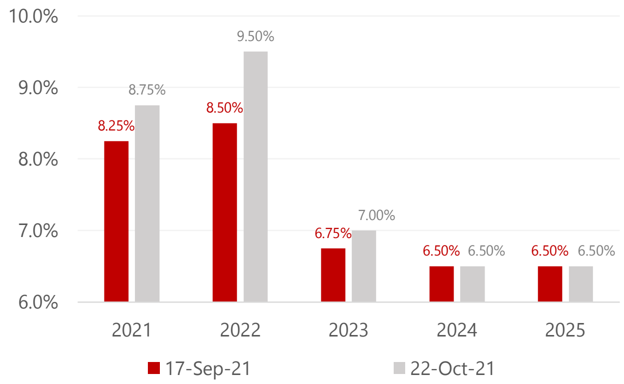
Refer to a few graphs in the next page.

Figure 1 – Median Selic Rate Forecasts (Monthly)



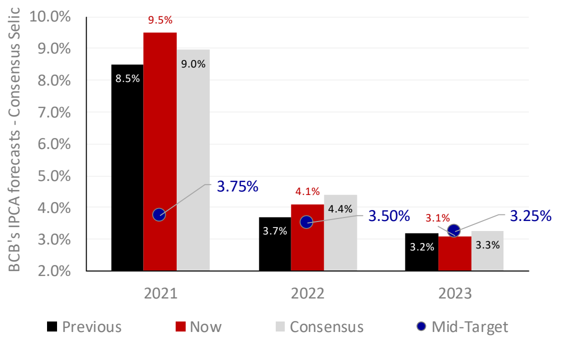
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

Figure 2 – Median Consensus Selic Forecasts



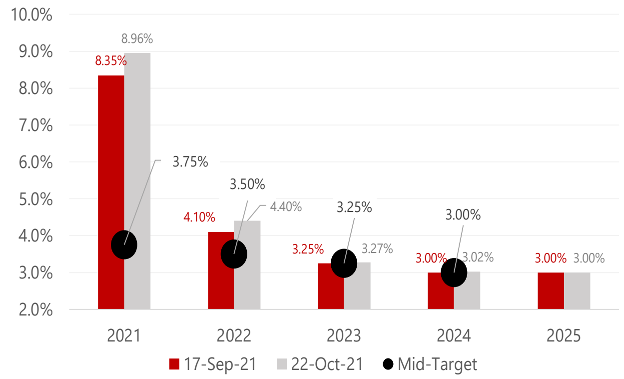
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

Figure 3 – BCB's Inflation Simulations



Sources: Brazilian Central Bank, Santander.
Note: Simulations assume Selic rate from the Focus survey and USD/BRL starting at 5.60 and evolving according to purchase power parity.

Figure 4 – Median Consensus IPCA Forecasts



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).

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