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MONETARY POLICY – COPOM MINUTES

GOING FARTHER, NOT NECESSARILY FASTER

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- The Brazilian Central Bank (BCB) published the minutes of its September 21-22 COPOM policy meeting, when the authority again raised the Selic rate by 100 bps (for a fifth time running) to 6.25%. Our impression is that the BCB kept a moderately hawkish tone, in line with the policy statement.

- In the minutes, the BCB reaffirm some comfort with the current speed of hikes (100 bps per meeting) and confirmed (our impression following the communiqué) that the adjusting variable for the cycle is likely the budget of total hikes, as the BCB remains focused on inflation (expectations and forecasts) for 2022, while increasingly eyeing inflation forecasts for 2023.

- The BCB also took the opportunity to reaffirm a constructive outlook for the economy in 2H21 and 2022, as the BCB is continuing to see positive contributions from the economic normalization (following continued advances in the vaccinations), the reopening of services and the less cyclical commodity-related segments.

- For now, given the inflation simulations and upwardly tilted balance of risks, we continue to believe the BCB's current flight plan could include a terminal Selic rate at 9.00% or slightly above.

Overview

The BCB published the minutes of its September 21-22 COPOM[1] policy meeting[2], when the authority raised the Selic rate (for a fifth time running) by 100 bps, to 6.25% p.a. (and signaled another similar move for October[3]). Overall, our impression is that the BCB kept a moderately hawkish tone, in line with the policy statement.

Key Policy Messages

In the minutes, the BCB reaffirm some comfort with the current speed of hikes (100 bps per meeting) and confirmed (our impression following the communiqué) that the adjusting variable for the cycle is the budget of total hikes, as the BCB remains focused on inflation (expectations and forecasts) for 2022, while increasingly eyeing the inflation outlook for 2023.

According to the minutes, the BCB concludes that for now "maintaining the current pace of adjustment, coupled with the extension of the magnitude of the process of monetary tightening to a significantly restrictive level is the most appropriate strategy for assuring the convergence of inflation to the 2022 and 2023 targets" (Paragraph #15).

The BCB mentions the baseline scenario, "which uses the interest rate path extracted from the Focus survey, the exchange rate at purchasing power parity, and commodity prices in USD stable in real terms", in which "the inflation projections are slightly above the targets for 2022 and around the target for 2023" (emphasis our own). More importantly, the authority reaffirms that "the fiscal risks continue to imply an upward bias in the projections. This asymmetry in the balance of risks affects the appropriate degree of monetary stimulus thus justifying a path for monetary policy that is more restrictive than the path used in the baseline scenario" (Paragraph #13).

As the forecasts in the statement pointed to IPCA inflation at 3.7% for 2022 (mid-target: 3.50%) and 3.2% for 2023 (mid-target: 3.25%), with a terminal Selic rate at 8.50% (reached in February 2022), the upwardly skewed risks for inflation that the BCB sees (on the back of fiscal uncertainties) suggest to us that 8.50% for the terminal Selic rate in the cycle is probably a lower bound for the current flight plan: in our view, judging from the simulations and balance of risks seen by the authority, the BCB flight plan as of now likely includes a terminal rate at 9% or slightly above.

In the minutes, the BCB makes explicit the discussions about faster pace of hikes, as some analysts (including ourselves) were considering that as a real possibility for the September meeting, before some BCB remarks in the week before. The authority has three arguments to justify the maintenance of the current speed (Paragraph #14):

i) The stage of the cycle is seen as "characterized by an already effectively tightening monetary policy, which is evidenced when looking at the difference in expectations for the paths of interest rate and inflation over the relevant monetary policy horizon";
ii) "simulations with interest rate hikes that assume *different terminal rates* suggest that the current pace of adjustment is sufficient to reach a significantly restrictive level and to ensure the convergence of inflation to the target in 2022, even considering the asymmetry of the balance of risks" (emphasis our own);
iii) the BCB believes this speed buys the authority time to watch and gather more information on "the state of the economy and the persistence of the existing shocks", with the BCB referring to the "the weight of volatile items in the revisions of short-term inflation projections and the uniqueness of the post-pandemic economic readjustment process".

[1] The COPOM is the monetary policy committee of the Brazilian Central Bank (BCB).
[2] Refer to the minutes of the 241st COPOM meeting in English (https://www.bcb.gov.br/en/publications/copomminutes).
[3] **Santander Brazil Monetary Policy - *"Scanning the Scene as It Moves at Cruise Speed"* –** September 23, 2021 - Available on: https://bit.ly/Std-COPOM-sep21

Complementary Views on the Scenario Assessment

Elsewhere in the minutes, the BCB provided more details on the evolution of its scenario assessment, with a key focus on activity (and not many more additional remarks on inflation).

Copom officials reaffirm their views of a constructive outlook for the economy in 2H21 and into 2022 (Paragraph #12). According to the minutes, the BCB believes that the "slightly better-than-expected second quarter GDP result" was associated with "anticipation of the expected growth for some of the sectors hardest hit by the pandemic". But that "was followed by more negative high frequency releases, albeit evolving favorably", with the BCB associating part of that softening early in 3Q21 with "lower industrial output due to continued shortage in supply chains". Importantly, the BCB "maintained its view of a robust recovery in activity in the second half of the year, as the effects of vaccination are felt more broadly."

For next year, as the market revises down GDP forecasts (to ~1.6% in the latest survey), the BCB sees three factors supporting growth in 2022: (i) the "continued recovery of the labor market and the services sector"; (ii) a good outlook for farm and mining output, sectors seen as "less dependent on the business cycle"; and (iii) the "remaining effects of the normalization of the economy as the health crisis recedes."

The minutes also talks about the job market trends, as Copom members "debated the level of economic slack". The BCB sees good signs from the PNAD (household) survey, with the recent readings pointing to increases in "the workforce and the occupied population", which the authority takes as further evidence of a job-market recovery. Yet the BCB sees signs of remaining economic slacks, as "the [employment] levels (…) are considerably lower than those observed before the pandemic". We surely agree with this view. The Copom still sees "some difficulties in assessing the real status of the labor market", given the continued differences [in the recovery speed] between PNAD (household survey) and Caged (establishment survey) on the segment of formal jobs (Paragraph #13).

What to Expect Ahead?

Following the release of the Copom minutes, we reaffirm our view that the bar is high for the BCB to change the speed of rate hikes ahead at this juncture, as it sees its current pace as fast enough pace to achieve its targets. The minutes also confirmed our impression following last week's statement that the adjusting variable for eventual surprises in the scenario is likely the budget of total hikes. For now, given the inflation simulations and upwardly tilted balance of risks, we continue to believe the current flight plan could include a terminal Selic rate at 9.00% or slightly above, to be reached in 1Q22.

Yet we recognize that, amid great uncertainty (especially on the supply side) surrounding the cost-push component of current inflation pressures, this outlook (of single-digit terminal Selic) hinges quite a lot on an assumption of well-behaved inflation expectations for 2023, a policy horizon that will gain increasing relevance in the coming months. Importantly, comes 4Q22, the future horizon of 2023 will become equally important as the future horizon of 2022. 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%.

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