Santander
Macroeconomic Research

BRAZIL MACRO

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MONETARY POLICY – COPOM MEETING

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STEPPING UP THE PACE AND THE PLAN

- The COPOM hiked the Selic policy rate by 100 bps to 5.25%, a decision broadly in line with expectations. The tone of the statement shows the central bank is responding to the deterioration in the inflation conditions and outlook, with a view to rein in inflation expectations. But the authority is doing it in a balanced way, as warranted in our view.
- Policy-wise, the BCB has signaled that it now deems appropriate a tightening cycle to take the Selic rate to a level above the neutral, meaning another adjustment to its flight plan (which previously pointed to a neutral Selic rate at the end of the cycle). For the short term, the committee hinted at another potential move to once again raise the Selic by 100 bps (to 6.25%).
- We continue to look for another hike of 100 bps (to 6.25%) in September and a subsequent move of 75 bps in October. What we now incorporate to our baseline scenario is a final move of 50 bps in December, with our terminal rate expectation upgraded to 7.50% (from 7.00% previously).
- We expect the Selic rate to remain at this level throughout 2022, with an expected reduction towards (our hypothesis of) the neutral level of 7.00% only in 2023. That's the horizon when we finally expect IPCA inflation to converge to the mid-target (3.25%), declining from a likely reading of around 4% that we project for the IPCA next year.

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Policy decision and (a brand new) guidance

The COPOM[1] has hiked the Selic policy rate by 100 bps[2] to 5.25%, in a decision that was broadly in line with the expectations of macro analysts and the yield curve. The tone of the statement shows the central bank is responding to the deterioration in the inflation conditions and outlook. But the authority is doing it in a balanced way, as warranted in our view.

Following up on the signs given in the last policy minutes[3], the COPOM highlights that the decision "reflects the Committee's perception that the recent deterioration of inertial components of inflation, in a moment of reopening of the service sector, could result in an additional deterioration of inflation expectations." Additionally, the BCB believes that "at this moment, the strategy of a quicker monetary adjustment is the most appropriate to guarantee the anchoring of inflation expectations."

The statement also shows that, at this moment, "the COPOM's baseline scenario and balance of risk indicate as appropriate a tightening cycle of the policy rate to a level above the neutral," which means a (brand new) flight plan to take the Selic rate above the neutral level of 6.50% (estimated by the BCB). In the previous meeting, the authority hinted at a neutral Selic rate in its guidance about the total adjustment on the plan.

The COPOM's decision to abandon the previous signal of a neutral Selic is in line with the BCB's own (IPCA) inflation projections. According to the models, with the FX rate starting at 5.15 (and moving along with PPP afterwards), a path of Selic rate hikes to 7.00% for YE2021 and stable throughout 2022[4] would produce a disinflation of the IPCA exactly to the mid-target of 3.5% for the main policy horizon of 2022. This forecast was stable from the last meeting, but now incorporating a tighter policy stance (to offset the deterioration in the outlook).

For 2021, the BCB simulates a hefty IPCA inflation reading of 6.5% (previously: 5.8%), going well above the upper target of 5.25%. With market analysts projecting a number close to 6.8% for this year's IPCA inflation (and our own tracking running around 7.3%), it is possible that part of the estimate gap of the BCB vis-à-vis most analysts reflects the electricity hypothesis used in the official simulations, with a tariff flag at the "Red 1" level for the end of each year. That is probably a strategy of the BCB to avoid the "contagion" of inflation simulations with (base-)effects generated by volatile items, where monetary policy is only expected to intervene to curb the second-round effects[5].

With the BCB now including 2023 in its policy horizon, albeit "to a lesser extent," the authority started to publish the IPCA forecast for that year, when the BCB sees convergence to the center target (3.25%) with the Selic rate back to the neutral level of 6.50% (as per analysts' forecasts).

In terms of policy signals, two noteworthy points. First, the committee hints at "another adjustment of the same magnitude" for the next policy meeting (September 21-22), meaning a potential move to once again raise the Selic rate by 100 bps (to 6.25%). Second, the COPOM also continues to affirm that the "future policy steps could be adjusted to ensure the achievement of the inflation target and will depend on the evolution of economic activity, on the balance of risks, and on inflation expectations and projections for the relevant horizon for monetary policy." Thus, amid such unusual uncertainty, the BCB's flight plan could be revised further down the road.

Balance of risks and scenario assessment

In the analysis of the balance of risks for inflation, the BCB continues to view the same elements in both directions, but still with a tilt to the upside.

[1] The COPOM is the monetary policy committee of the Brazilian Central Bank (BCB).
[2] Refer to the statement of the 240th COPOM meeting in English (https://www.bcb.gov.br/en/monetarypolicy/COPOMstatements).
[3] **Santander Brazil Monetary Policy - *"Whatever It Takes"* –** June 22, 2021 – Available on: https://bit.ly/Std-COPOM-min-jun21
[4] According to the Focus survey, the trajectory of the Selic rate projected by analysts include another 100bps move in September.
[5] Among the BCB's assumptions, the "energy flag is assumed to be neutral, remaining at "red level 1" in December each year." In our view, the rising hydrological risk in Brazil indicate a high probability of a "red level 2" tariff flag for electricity costs, which would prompt roughly a 0.5 p.p. upward impact for the 2021 headline CPI estimate, and probably a downward effect for the relevant horizon of 2022 (base effects).

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 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 upgraded the tone of inflation concerns, as expected. The BCB highlights the CPI persistence and its “worse composition,” with “a surprise in the underlying services inflation and the continuing pressure on industrial goods, causing a rise in core measures.” The BCB also points to “new pressure in volatile components, as the possible additional increase in electricity fares and food prices, both due to adverse weather conditions.” The BCB still sees “various measures of underlying inflation (…) above the range compatible with meeting the inflation target.”

The BCB kept a constructive tone on economic activity, with the authority highlighting that “recent indicators continue evolving satisfactorily and do not call for relevant revisions in growth forecasts, which display a robust economic recovery” for 2H21. Recall that as per the last inflation report (published late in June[6]), the BCB projects GDP growth of 4.6% for 2021 (consensus: 5.3%).

On the global environment, the BCB notes that the “COVID-19 Delta variant adds risk to the recovery of the world economy” and believes that "there is still a relevant upward inflation risk in the central economies.” Yet, owing to “the long-lasting monetary stimuli, with the fiscal programs, and with the reopening of the major economies,” the BCB still sees favorable conditions for EMs.

What to Expect Ahead?

In our view, a more hawkish BCB response, particularly the signal of a greater total interest-rate adjustment in this cycle (i.e., reaching a contractionary territory now), was warranted. We believe this is the best response to the mounting headline inflationary pressures and spreading of inflationary shocks to underlying price trends, in a context of more prolonged budget stimulus, latent fiscal risks, and a faster cyclical activity recovery.

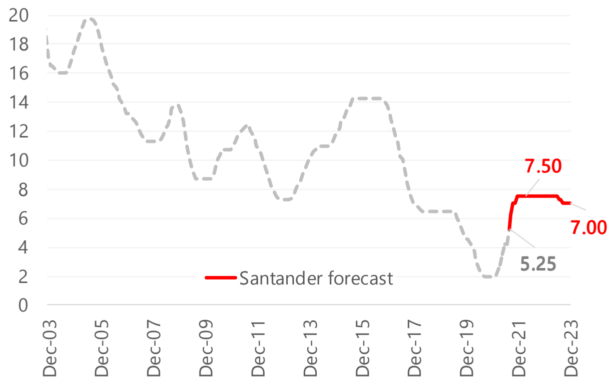
We continue to look for another Selic rate hike of 100 bps (to 6.25%) in September and a subsequent move of 75 bps in October. What we are also incorporating now is a last move of 50 bps in December into our baseline scenario, so that our terminal rate expectation for this cycle is upgraded to 7.50% (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%).

We project IPCA near 4% for 2022, after probably reaching a peak above 9% in August 2021. In our view, while the BCB will continue to do what it can for now to bring the headline CPI down to the mid-target of 3.50% for 2022 (main horizon at this stage), a larger Selic adjustment (towards no less than 8.5% for the terminal rate) may become necessary for the achievement of the mid-target in 2022. Amid a confluence of substantial supply shocks and important cost-push inflation, we believe an extension of the IPCA convergence to 2023 is possible (and maybe advisable if the shocks prove temporary). But that talk can only take place in 1Q22.

Refer to a few graphs in the next page.

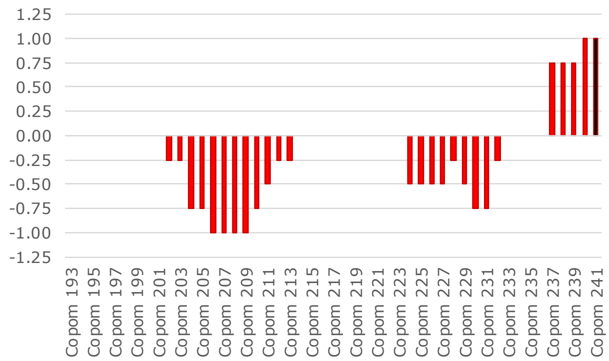
[6] **Santander Brazil Monetary Policy - *“BCB still poised to speed up hikes (…)”* –** June 24, 2021 – Available on: https://bit.ly/Std-Inflation-Rep-2q21

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



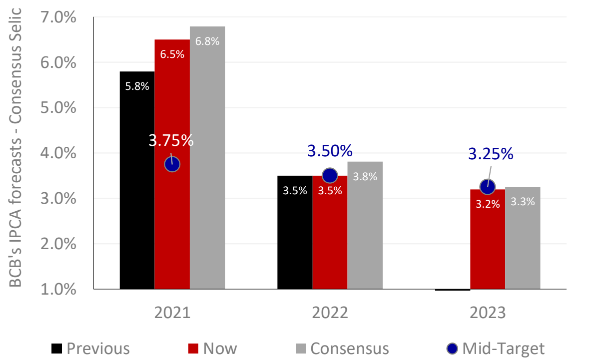
Sources: Brazilian Central Bank, Bloomberg, Santander.

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



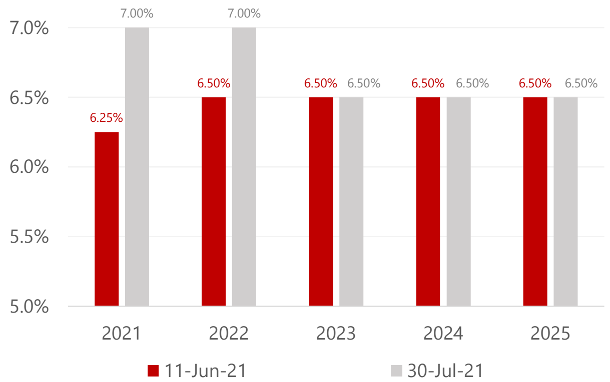
Sources: Brazilian Central Bank, Bloomberg, Santander.
Note: This graph includes the likely decision suggested by the BCB for COPOM #241 (September 21-22, 2021).

Figure 2.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 5.15 and evolving according to purchase power parity.

Figure 2.B. – Consensus Median Selic Rate 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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