Santander
Macroeconomic Research

BRAZIL MACRO

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MONETARY POLICY – COPOM MEETING

INFLATION EXPECTATIONS, TARGET. AND (ALMOST) NOTHING ELSE MATTERS

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- The Copom once again hiked the Selic policy rate by 150 bps, reaching 9.25%. This was the seventh move in this cycle, as the Selic now stands at the highest level since 3Q17. The decision itself was in line with the consensus of macro analysts and the yield-curve pricing, even though some market participants seem to have been surprised by the more hawkish than expected tone from the BCB (which we saw as warranted).
- In a communiqué with few changes from the previous one, the Copom claims that "given the increase in its inflation projections and in the risk of a deanchoring of long-term expectations, it is appropriate to advance the process of monetary tightening significantly into the restrictive territory." Importantly, the BCB board also pledges to "persist in its strategy until the disinflation process and the expectation anchoring around its targets consolidate." The focus on expectations is quite clear.
- In our view, the Copom came up with a classical response by a central bank operating under an inflation targeting regime: as inflation expectations keep diverging from the targets for the short, medium and longer horizons, the authority suggests it will not tolerate the fading of its main policy objective, which is to put inflation expectations at the target. With the slowing activity having limited influence on expectations for now, we believe the BCB focused on the right elements. Yet, given the different (i.e., expansionary) gears seen from the fiscal levers, it will not be an easy task for the BCB to rein in inflation expectations. But they are trying, as they should.
- As per our scenario, we continue to forecast two more hikes of 150bps for the Copom meetings in 1Q22, as we interpret the BCB models signaling room for a rate tightening through 12%. Especially if one takes into account the upwardly skewed balance of risks. For now, we look for a terminal Selic of 12.25% for the cycle. But that forecast hinges on inflation expectations, especially the ones seen in the BCB's Focus survey, which takes on added relevance for the coming weeks and months.

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Policy decision and signals

In its 243rd meeting, the Copom[1] once again hiked the Selic policy rate by 150 bps, reaching 9.25%[2]. This was the seventh move in this cycle, and the Selic rate now stands at the highest level since 3Q17.

The decision itself was in line with the consensus of macro analysts and the yield-curve pricing, even though some market participants seem to have been surprised by the more hawkish than expected tone from the BCB (which we saw as warranted).

In a communiqué with few major changes from the previous one (issued in October 26-27), the Copom claims that "given the increase in its inflation projections and in the risk of a deanchoring of long-term expectations, it is appropriate to advance the process of monetary tightening significantly into the restrictive territory." Importantly, the BCB board also pledges to "persist in its strategy until the disinflation process and the expectation anchoring around its targets consolidate."

With words and actions, the Copom comes up with a classical response by a central bank operating under an inflation targeting regime. As inflation expectations keep diverging from the targets for the short, medium and longer horizons, the authority suggests it will not tolerate the deterioration of its main policy objective: putting inflation expectations (back) at the targeted path[3].

Interestingly, market expectations about the next BCB steps were apparently taking a U-turn in recent days after a batch of some weak economic activity reports. Yet the BCB mentioned in the statement that "growth indicators released since the last meeting once more posted an evolution moderately below expected."

While that sounds a much milder downgrade in the activity assessment than the markets seemed to anticipate, that should have not come as a surprise. Firstly, because the BCB has been running for long a below-consensus GDP projection for this year, ranging around 4.6-4.7% of late, according the last two inflation reports[4]. Secondly, in a study (box) presented in the Q2 inflation report, the BCB addresses the uncertainty generated by the pandemic on the seasonal adjustment and advises against extrapolating too far out the strong seasonally adjusted GDP growth seen in Q1[5].

In the Copom statement, the BCB kept the phrasing that "doubts regarding the fiscal framework increase the risk of deanchoring inflation expectations, keeping the upward asymmetry in the balance of risks. This implies a higher probability of inflation paths above the one projected under the baseline scenario." The authority also continued to focus on inflation convergence to the targets at the relevant horizon, with the latter meaning 2022 and 2023 (with similar weights, apparently). No change in the framework announced, as some had believed.

The BCB kept providing signals about the flight plan, as the authority "foresees another adjustment of the same magnitude" (i.e. 150bps, to 10.75%) for the next meeting (February 1-2). As any central bank, the BCB shows the usual disclaimers that "future policy steps could be adjusted to ensure the convergence of inflation towards its targets 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." In any case, the signal is that a slowdown in the pace of hikes is likely not on the cards for February. And maybe even for March either.

The inflation simulations provide a clue as per how deep into "restrictive territory" the BCB could be planning to reach, and for how long the pace of 150bps could remain in place. Judging from the numbers, we estimate the Copom's flight plan could include a terminal Selic rate above 12%. The BCB inflation simulations use as main inputs an FX rate starting at 5.65 (as per the rounded average of last week) and moving along with PPP afterward, as well as a path of Selic rate hikes (as projected by economists[6]) to 9.25% for YE2021 and a terminal rate of 11.75%, prevailing for most of 2022, and then landing at 11.25% by YE2022, and falling to

[1] The Copom is the monetary policy committee of the Brazilian Central Bank (BCB).
[2] Refer to the statement of Copom #243 in English (https://www.bcb.gov.br/en/monetarypolicy/Copomstatements).
[3] As Svensson (2010) puts it, an inflation targeting regime is a monetary policy strategy that "gives a major role to an inflation forecast", to the point that it can be called a "forecast targeting." Handbook of Monetary Economics, Volume 3, Chapter 22 - Inflation Targeting, Pages 1237-1302.
[4] Refer to https://www.bcb.gov.br/en/publications/inflationreportboxes.
[5] Refer to https://www.bcb.gov.br/content/ri/inflationreport/202106/ri202106b2i.pdf.
[6] Refer to the BCB's weekly survey of professional forecasters for December 3, 2021 (https://www.bcb.gov.br/en/publications/focusmarketreadout)

8.00% for YE2023[7]. According to the BCB's own models, the aforementioned monetary policy path would produce the following IPCA inflation trajectory: 10.2% for 2021 (previously: 9.5%; mid target: 3.75%; upper target: 5.25%), 4.7% for 2022 (previously: 4.1%; mid target: 3.50%; upper target: 5.00%) and 3.2% for 2023 (previously: 3.1%; mid target: 3.25%).

Based on the standard BCB model elasticities, we calculate that, in order to bring down the inflation forecast to the (adjusted) mid-target for 3Q23[8], meaning a decline of about 0.3 pp in an interval of over a year, it would take an additional Selic adjustment of about 50-75bps in comparison with the simulated scenario. That number does not take into account the upwardly skewed balance of risks, which imply a need for an even tighter policy stance, as the BCB admits.

Balance of risks and scenario assessment

No new elements were added in the balance of risks assessment. The BCB still views elements in both directions. To the upside, the Copom sees "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." 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 the scenario assessment, the BCB once again recognizes a tough inflation environment, admitting that CPI "remains high" and that price increases were "higher than expected, both in the more volatile components and on the items associated with core inflation". The Copom also sees key core inflation gauges running "above the range compatible with meeting the inflation target."

On the global environment, the BCB has also recognized a more difficult environment for emerging economies. The BCB notes that some key central banks "expressed more clearly the need for caution given the increased persistence of inflation." The authority also mentions that the risk of new waves of contagion in the pandemic "add uncertainty about the pace of recovery" in advanced economies.

What to Expect Ahead?

In our view, the BCB once again brought a well-suited response for an increasingly challenging environment for monetary policy. With the evidence of a deep contraction in future activity being scant (to say the least), and with the incoming activity number being apparently insufficient to reverse the course of inflation expectations, which remain on the rise for key horizons, the BCB's decision and policy signal in the communiqué focused on the right elements, in our view.

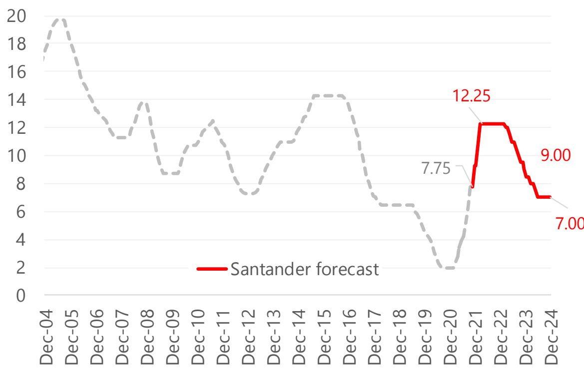
Given the different (i.e., more expansionary) gears seen from the fiscal levers, it will not be an easy task for the BCB to rein in inflation expectations. But the key signal here is that they are trying, as hard as they can.

As per our scenario, we continue to forecast two more hikes of 150bps for the Copom meetings in 1Q22. For now, we take these as the probably final moves in the cycle, leading to a terminal Selic of 12.25%. While the speed of monetary adjustment is now looking more consolidated (at least for February), the total budget of hikes may now be the moving part. And that could still increase, conditional on the trends in inflation expectations, especially the ones seen in the Focus analysts' survey. That report naturally takes on added relevance for the coming weeks and months. Uncertainty remains high, that's for sure.

Refer to a few graphs in the next page.

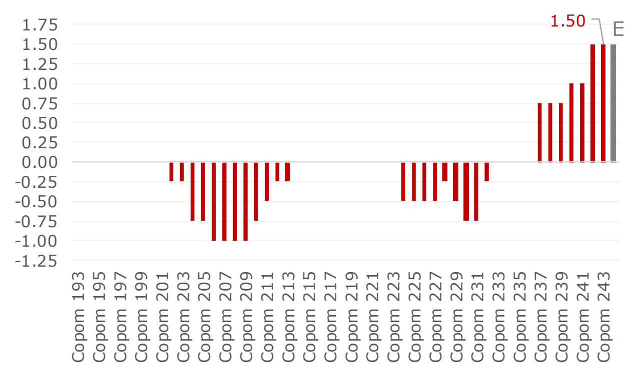
[7] According to the Focus survey, the trajectory of the Selic rate projected by analysts include another hike of 150bps in February 2022, with a 75-bp move in March 2022 and a final 25-bp hike in May 2022. Cuts projected for October and December 2022 (25bps each).
[8] This expresses the BCB's claim that "the relevant horizon for monetary policy (…) includes 2022 and 2023". In 1Q22, the BCB's own rule of thumb for the "rolling horizon" indicates that 2022 will have a weight of 25%, with 2023 prevailing with 75%. In calendar terms, this means 3Q23.

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



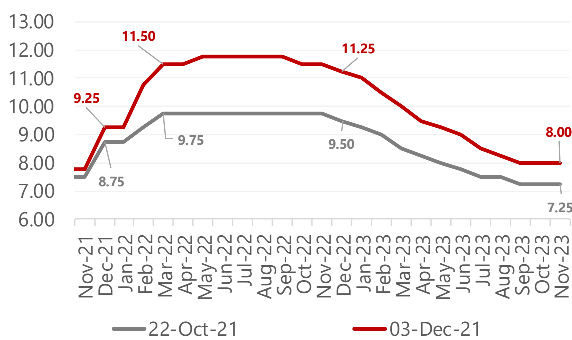
Sources: Brazilian Central Bank, Bloomberg, Santander.

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



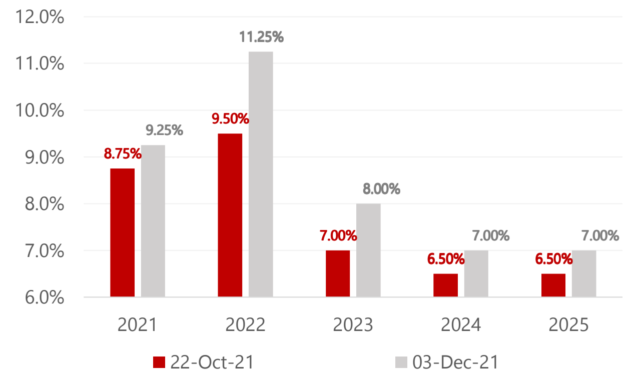
Sources: Brazilian Central Bank, Bloomberg, Santander.

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



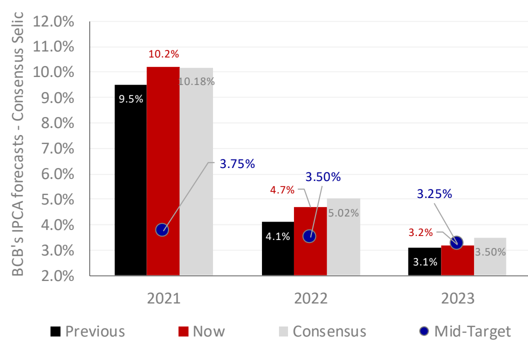
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

Figure 2.B. – Median Consensus Selic Forecasts



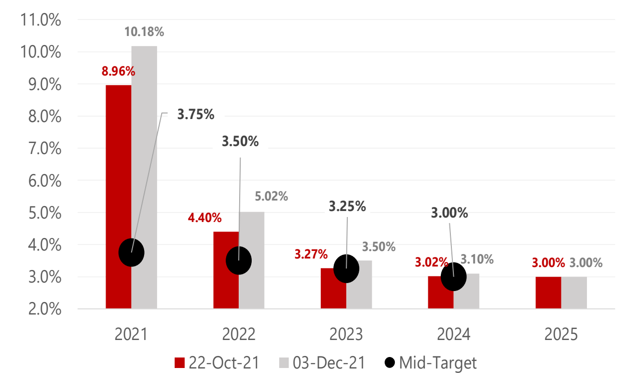
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

Figure 3.A. – BCB's Inflation Simulations



Sources: Brazilian Central Bank, Santander.
Note: Simulations assume Selic rate from the Focus survey and USD/BRL starting at 5.65 and evolving according to purchase power parity.

Figure 3.B. – 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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