BRAZIL MACRO **October 27, 2021**

MONETARY POLICY – COPOM MEETING

THE GREATEST HIKE SINCE 2002, WITH NO OVERREACTION

Mauricio Oreng
mauricio.oreng@santander.com.br
+5511 3553 5404

- The BCB has sped up the pace of policy tightening, raising the Selic rate by 150 bps to 7.75%, the highest level since September 2017. The decision was in line with analysts' expectations, despite a greater than usual dispersion of estimates.
- In the statement, the authority recognized the increased doubts about the fiscal framework and its impact on the anchoring of inflation expectations, which raise "the upward asymmetry in the balance of risks", meaning a "higher probability of inflation paths above the (…) the baseline scenario."
- The Copom has signaled another hike of the same magnitude (150bps) for the next meeting and pledged tightening monetary policy "even further into the restrictive territory." Clearly, this means not only a faster speed, but also a greater budget of hikes.
- Judging from the BCB models and balance of risks analysis, we sense the flight plan today could be taking the Selic rate towards an interval of 11.0-11.5%. We keep our expectation for a 150bp move in December, but now look for hikes of 125bps and 100bps for February and March 2022, with the Selic rate at 11.5% at the end of Q1 (and staying there until mid-2023). Last week, we had penciled in a terminal rate of 10.5%, also for 1Q22.
- We recognize the high uncertainty, especially as per the terminal Selic level, which may hinge on the evolution of the fiscal policy framework and the trends in inflation expectations, particularly for 2023. The latter will become the main policy horizon as of 1Q22. In any case, for now we sense the risks are still a little skewed to the upside as per our Selic rate call.

Policy decision and new flight plan

In its 242nd meeting, the Copom[1] once again hiked the Selic policy rate (the sixth move in this cycle), but this time by 150 bps[2], to 7.75%. That is the highest Selic level since September 2017. The decision (which is an acceleration from a previous pace of 100bps) was in line with the consensus of macro analysts, despite an unusually high dispersion of forecasts. As per the yield curve, it seems like traders were bracing for a slightly bolder move by the BCB (175bps).

Make no mistake about it, this was a strong move by the BCB. The last time the authority had hiked by more than 100bps in a policy meeting was back in December 2002 (Copom #79), when the BCB raised the rate by 300bps to (a whopping) 25%. But that happened under different conditions in terms of macro fundamentals, including the level of global interest rates, the profile of Brazilian government debt, the country's external position (i.e., balance of payments, FX reserves), as well as the level of the neutral domestic interest rate (consequently). In our view, the intense policy action seen today fits quite well with the deterioration in the inflation outlook and the balance of risks, but with no immediate overreaction that could also generate (hidden) costs[3].

According to the Copom, the "recent questioning regarding the fiscal framework increased the risk of de-anchoring inflation expectations, raising 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 goes on and highlights that "given the deterioration of the balance of risks and the increase in its inflation projections, this pace is the most appropriate to guarantee inflation convergence to the targets at the relevant horizon." By relevant horizon, the BCB means 2022 and 2023 (with nearly similar weights, as suggested in the statement": this is perfectly in line with the BCB's "rule of thumb" for policy horizons, now applied to 4Q21.

The BCB also provided signals about the new flight plan, as the authority "foresees another adjustment of the same magnitude" for the next meeting (December 7-8) and sees appropriate "to advance the process of monetary tightening even further into the restrictive territory." This means a faster and greater policy adjustment than considered in the previous meeting.

The inflation simulations may provide a clue as per how deep into "restrictive territory" the BCB could be planning to reach should current economic conditions and the outlook remain unchanged. Judging from the numbers, we estimate the Copom's flight plan could include a terminal Selic rate around 11.0-11.5%, with risks tilted to the upside.

According to the BCB's own inflation models, with the FX rate starting at 5.60 (and moving along with PPP afterward), a path of Selic rate hikes (as projected by market economists) to 8.75% for YE2021 and 9.75% for most of 2022 (landing at 9.50% by YE2022), and then falling to 7.00% for YE2023,[4] would produce the following IPCA inflation path: 9.5% for 2021 (previously: 8.5%; mid target: 3.75%; upper target: 5.50%), 4.1% for 2022 (previously: 3.7%; mid target: 3.50%) and 3.1% for 2023 (previously: 3.2%; mid target: 3.25%). Based on the standard BCB model elasticities, we calculate that in order to reduce inflation (forecast) by about 0.6 pp in an interval of over a year (i.e., to bring the 2022 inflation estimate to the mid-target), would take an additional adjustment of about 150bps in comparison with the simulated scenario. That number does not account for the balance of risks.

It is important to note that the BCB has a higher expected path for inflation of regulated prices for all the forecasting horizon. For 2021, the BCB has penciled in 17.1% for regulated prices in the IPCA (consensus: 14.8%); for 2022, the official number is 5.2% (consensus: 4.2%); for 2023, the estimate is 5.1% (consensus: 3.9%). It is possible that a good deal of the gap is explained by the assumption for the electricity tariff flag, which the BCB takes as " (…) "water scarcity" in December 2021 and "red level 2" in December of 2022 and 2023." These seem to be conservative hypotheses for 2022 and 2023, which is somehow offset by a lower-

[1] The Copom is the monetary policy committee of the Brazilian Central Bank (BCB).
[2] Refer to the statement of Copom #242 in English (https://www.bcb.gov.br/en/monetarypolicy/Copomstatements).
[3] One example: from a financial stability standpoint.
[4] According to the Focus survey, the trajectory of the Selic rate projected by analysts include another hike of 125bps in December 2021, and with a couple of 50-bp moves in February and March 2022.

than-consensus BCB estimate for free-market prices. Maybe this lower estimate for non-regulated inflation follows the authority's constructive views about inflation for industrialized consumer goods going forward, as in 3Q21 inflation report[5].

Balance of risks and scenario assessment

As usual, the statement brings a discussion about the balance of risks for inflation. This time, no new elements were added, in spite of the recognized deterioration in the (upward) asymmetry. 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 fact, as per the latte, despite the efforts by the BCB, we believe it is increasingly likely that only a major downside shock in commodity prices in BRL, dampening a good deal of ongoing cost pressures, could make the IPCA converge to center target in such a short period of time (i.e., for YE2022).

In the scenario assessment, the BCB recognizes a tough inflation environment. The Copom believes that CPI is high and has surprised to the upside "led by the more volatile components, but there are also additional pressures on the items associated with core inflation." The BCB also noted that "various measures of underlying inflation are above the range compatible with meeting the inflation target."

On activity, the BCB downgraded a bit its previously constructive tone, mentioning that "growth indicators released since the last meeting show an evolution slightly below expectations."

On the global environment, the BCB sees conditions "becoming less favorable and central banks' reaction to more persistent inflation should result in a more challenging scenario for emerging markets."

What to Expect Ahead?

In our view, the BCB brought a well-suited response for an increasingly challenging environment for monetary policy. On one hand, the Copom reacted to the deterioration in the balance of risks for inflation caused by the latest fiscal policy discussions (specially the risks for the anchoring power of the constitutional spending cap framework). On other hand, the authority was careful enough not to overreact to a volatile news flow and avoided to recurring to a policy pattern that suited very well but in very different circumstances in terms of overall economic fundamentals.

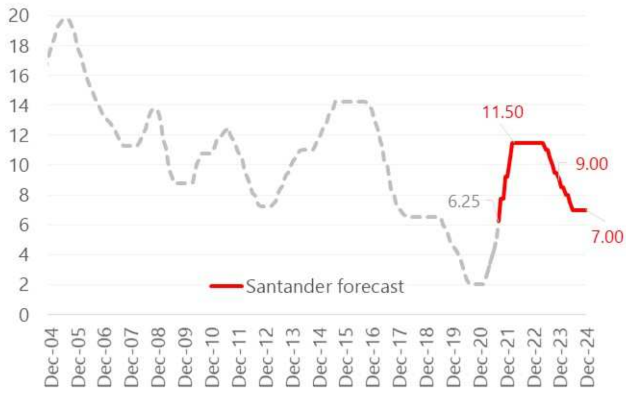
As per our scenario, we are taking the BCB's guidance about the speed of hikes and keeping our projection for a 150-bp hike (to 9.25%) for the December Copom meeting. In terms of the total budget of hikes, we are once again raising our estimate for the terminal Selic rate to 11.5%, expecting hikes of 125bps for February and 100bps for March 2022. We believe interest rate is to remain around these levels until mid-2023, conditional on the fiscal policy developments.

We recognize the tremendous uncertainty about economic policy and the difficulty to make forecasts at this juncture. For now, nonetheless, we sense there is still a little upside risk as per our interest rate forecast.

Refer to a few graphs in the next page.

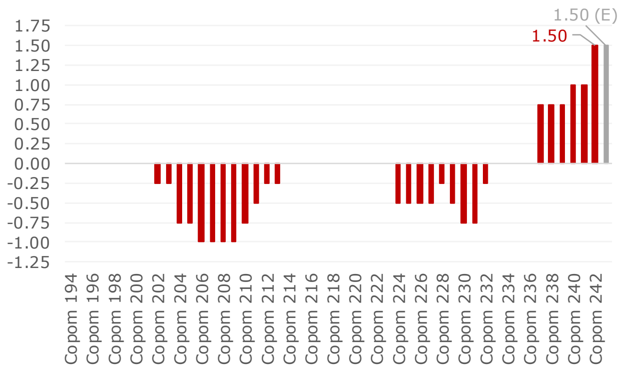
[5] **Santander Brazil Monetary Policy - *"Hindsight and Outlook"* –** September 30, 2021 - Available on: https://bit.ly/Std-InflaReport-3Q21

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



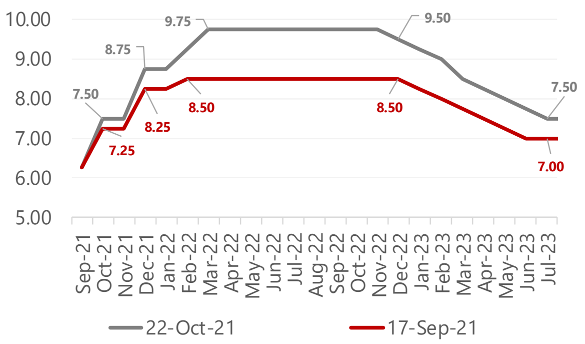
Sources: Brazilian Central Bank, Bloomberg, Santander.

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



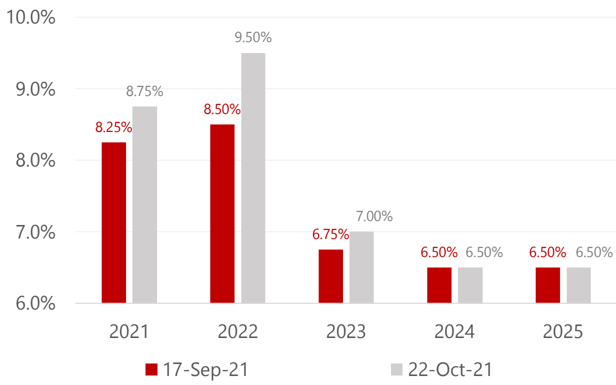
Sources: Brazilian Central Bank, Bloomberg, Santander.
Note: This graph includes the decision hinted by the BCB for Copom #243 (October 26-27, 2021).

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



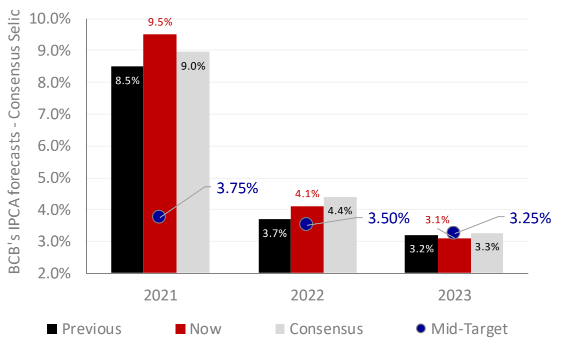
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

Figure 2.B. – Median Consensus Selic Forecasts



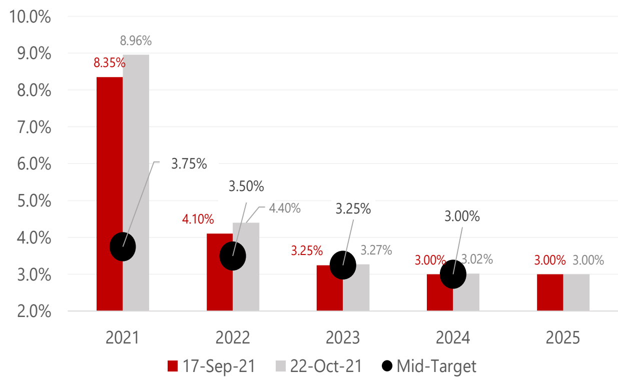
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

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 5.60 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).

CONTACTS / IMPORTANT DISCLOSURES

Brazil Macro Research			
Ana Paula Vescovi*	Chief Economist	anavescovi@santander.com.br	5511-3553-8567
Mauricio Oreng*	Head of Macro Research	mauricio.oreng@santander.com.br	5511-3553-5404
Jankiel Santos*	Economist – External Sector	jankiel.santos@santander.com.br	5511-3012-5726
Ítalo Franca*	Economist – Fiscal Policy	italo.franca@santander.com.br	5511-3553-5235
Daniel Karp*	Economist – Inflation	daniel.karp@santander.com.br	5511-3553-9828
Tomas Urani*	Economist – Global Economics	tomas.urani@santander.com.br	5511-3553-9520
Lucas Maynard*	Economist – Economic Activity	lucas.maynard.da.silva@santander.com.br	5511-3553-7495
Felipe Kotinda*	Economist – Credit	felipe.kotinda@santander.com.br	5511-3553-8071
Gabriel Couto*	Economist – Special Projects	gabriel.couto@santander.com.br	5511-3553-8487
Gilmar Lima*	Economist – Modeling	gilmar.lima@santander.com.br	5511-3553-6327
Global Macro Research			
Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@santander.pl	48-22-534-1888
Juan Cerruti *	Senior Economist – Argentina	jcerruti@santander.com.ar	54 11 4341 1272
Ana Paula Vescovi*	Economist – Brazil	anavescovi@santander.com.br	5511-3553-8567
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
Guillermo Aboumrad*	Economist – Mexico	gjaboumrad@santander.com.mx	5255-5257-8170
Piotr Bielski*	Economist – Poland	piotr.bielski@santander.pl	48-22-534-1888
Mike Moran	Head of Macro Research, US	mike.moran@santander.us	212-350-3500
Fixed Income Research			
Juan Arranz*	Chief Rates & FX Strategist – Argentina	jarranz@santanderrio.com.ar	5411-4341-1065
Mauricio Oreng*	Senior Economist/Strategist – Brazil	mauricio.oreng@santander.com.br	5511-3553-5404
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778
Equity Research			
Miguel Machado*	Head Equity Research Americas	mmachado@santander.com.mx	5255 5269 2228
Alan Alanis*	Head, Mexico	aalanis@santander.com.mx	5552-5269-2103
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Claudia Benavente*	Head, Chile	claudia.benavente@santander.cl	562-2336-3361
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Mariana Cahen Margulies*	Head, Brazil	mmargulies@santander.com.br	5511 3553 1684
Electronic			
Bloomberg		SIEQ <GO>	
Reuters		Pages SISEMA through SISEMZ	

This report has been prepared by Santander Investment Securities Inc. ("SIS"; SIS is a subsidiary of Santander Holdings USA, Inc. which is wholly owned by Banco Santander, S.A. "Santander"), on behalf of itself and its affiliates (collectively, Grupo Santander) and is provided for information purposes only. This document must not be considered as an offer to sell or a solicitation of an offer to buy any relevant securities (i.e., securities mentioned herein or of the same issuer and/or options, warrants, or rights with respect to or interests in any such securities). Any decision by the recipient to buy or to sell should be based on publicly available information on the related security and, where appropriate, should take into account the content of the related prospectus filed with and available from the entity governing the related market and the company issuing the security. This report is issued in Spain by Santander Investment Bolsa, Sociedad de Valores, S.A. ("Santander Investment Bolsa"), and in the United Kingdom by Banco Santander, S.A., London Branch. Santander London is authorized by the Bank of Spain. This report is not being issued to private customers. SIS, Santander London and Santander Investment Bolsa are members of Grupo Santander.

ANALYST CERTIFICATION: The following analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed, that their recommendations reflect solely and exclusively their personal opinions, and that such opinions were prepared in an independent and autonomous manner, including as regards the institution to which they are linked, and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report, since their compensation and the compensation system applying to Grupo Santander and any of its affiliates is not pegged to the pricing of any of the securities issued by the companies evaluated in the report, or to the income arising from the businesses and financial transactions carried out by Grupo Santander and any of its affiliates: **Mauricio Oreng***.

*Employed by a non-US affiliate of Santander Investment Securities Inc. and not registered/qualified as a research analyst under FINRA rules, and is not an associated person of the member firm, and, therefore, may not be subject to the FINRA Rule 2242 and Incorporated NYSE Rule 472 restrictions on communications with a subject company, public appearances, and trading securities held by a research analyst account.

The information contained herein has been compiled from sources believed to be reliable, but, although all reasonable care has been taken to ensure that the information contained herein is not untrue or misleading, we make no representation that it is accurate or complete and it should not be relied upon as such. All opinions and estimates included herein constitute our judgment as at the date of this report and are subject to change without notice.

Any U.S. recipient of this report (other than a registered broker-dealer or a bank acting in a broker-dealer capacity) that would like to effect any transaction in any security discussed herein should contact and place orders in the United States with SIS, which, without in any way limiting the foregoing, accepts responsibility (solely for purposes of and within the meaning of Rule 15a-6 under the U.S. Securities Exchange Act of 1934) for this report and its dissemination in the United States.

Santander