An Earlier Start to a Partial Normalization

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- The Brazilian Central Bank (BCB) published the minutes of its January 19-20 COPOM policy meeting, which came out with a hawkish tone.

- In our view, the document signaled a growing discomfort among the policy committee members about the currently “extraordinary” level of monetary stimulus. The document also expressed an inclination to kick off a timely adjustment (seen as a “partial normalization”) in the policy stance, which could start as early as March.

- The timing, pace and magnitude of the adjustment are data dependent, and therefore will hinge especially on the evolution of the pandemic, mobility, employment, core inflation, and the upcoming fiscal decisions. Yet we have to recognize there is considerable upside risk to our previous Selic rate call (2.50%) for 2021YE.

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Key Policy Messages from a Rather Hawkish Communication

The BCB published minutes from its January 19-20 COPOM[1] policy meeting[2], when the authority kept the Selic policy rate (for a fourth meeting) at the historical low of 2.00%. **The committee apparently chose to send a hawkish message, signaling not only some discomfort about the current level of monetary stimulus but also, in our view, some sense of urgency to start hiking.**

The COPOM notes that while the baseline scenario has it that "inflation projections are around the target in the relevant horizon," the BCB considers that the "**fiscal risks** generate an upward bias in these projections, potentially justifying **an increase in policy rates earlier than that assumed** in its baseline scenario." (**Bold** emphasis is ours.)

According to the minutes, some members posed the question whether "it would still be appropriate to maintain an extraordinarily high degree of stimulus, given the **normalization** of the economic activity observed in recent months," despite the presence of the forward guidance of stable interest rate – which had been valid up to that meeting.

These members supported the start of a "process of **partial normalization**, reducing the "extraordinary" degree of monetary stimuli." The rationale is that since the BCB opted for a very large stimulus (as of May 2020), there was a reversal in the deflationary shock that affected both actual CPI and inflation expectations. These members also cite "a decline on economic slack." All of this leads to "inflation projections on the baseline scenario closer to its target in the relevant horizon," according to these BCB officials.

The conclusion of the committee as a whole, however, was more cautious: despite what is seen as "some normalization in economic activity," the COPOM still believes that the "uncertainty regarding the future dynamics of main economic variables remains above the usual." The decision then was to **wait for further information regarding "the evolution of the pandemic, economic activity, and fiscal policy**." Thus, the BCB chose to maintain "the extraordinarily high degree of monetary stimulus" "**at this time**", with this last wording, in our view, meaning there is lack of commitment to a similar decision henceforth[3].

Some remarks on the scenario assessment

The committee showed mixed remarks and a few disagreements regarding elements of the scenario assessment, mostly in the realm of economic activity.

The BCB was positively surprised by the data on economic activity for the end of last year, despite the partial reduction in government transfers. Yet the COPOM admits that "the unpredictability associated with the pandemic developments, and the necessary adjustment in government spending from 2021 on," which the BCB believes "increases the uncertainty about the economic recovery." The BCB also puts a possible downward mark on its future activity views, by stating that "the risks associated with both the **pandemic developments** and the expected **unwinding of the emergency transfer** programs may lead to a domestic scenario characterized by more **gradualism or even a temporary reversal of the economic recovery**."

On the level of economic slack, the COPOM still mentions that government transfers have reduced slack in the goods sector, but with services still struggling with lower demand (especially in the case of segments more impacted by social distancing measures). Also, the BCB still indicates that "the evolution of these sectoral gaps will depend on the pandemic developments and on the adjustment in public spending." The novelty on this topic was the fact that some members believe that "labor market data on the formal sector suggest that the overall economic slack has reduced more rapidly than expected." But that assessment is not shared by most members, who "felt that other labor market data did not support this conclusion."

[1] The COPOM is the monetary policy committee of the Brazilian Central Bank (BCB).
[2] Refer to the minutes of the 236th COPOM meeting in English (https://www.bcb.gov.br/en/publications/copomminutes).
[3] The wording "at this moment" has already been used by the BCB in the past. Historically, we calculate this expression appeared 31 times in previous Copom statements: out of those, 14 times the subsequent Copom decision was the same as the previous one. So, we conclude that this expression means just a lack of commitment to a future decision, not necessarily a signal of a pre-determined move afterwards.

What to Expect Ahead?

In our view, **the COPOM minutes signaled a growing discomfort among the policy committee about the currently "extraordinary" level of monetary stimulus**. **The document also expressed an inclination to kick off a timely adjustment in the monetary policy stance. The timing, pace and magnitude of the adjustment will be data dependent**, but is poised to largely exceed the implicit indications from the BCB's own inflation simulations, given the upwardly skewed balance of risks. For now, the COPOM still seems to plan the maintenance of a certain degree of stimulus, which we read as an indication that 6% remains a ceiling for the Selic rate up to 2022, under the assumption of no major fiscal stress.

In our view, amid wide economic slack, downside risks for activity, and inflation expectations still consistent with the target, we see a few factors that could help explain this rather hawkish BCB rationale, and the relatively fast potential U-turn (in terms of policy direction). First, the change in gears could be associated with the role of financial conditions as a channel of monetary policy transmission, maybe amid doubts about what is the effective lower bound for interest rates in Brazil (at 2.00%, has the Selic rate crossed it?). That element is directly connected with a second factor in play, which is the rising risk of a hypothetical deterioration of the fiscal outlook, amid increased pressures to extend the emergency stimulus (and with little room for accommodation within the spending cap). A third possible element is a possible concern that, amid high core inflation readings of late, inflation expectations might start to move higher and diverge from the mid-target for the relevant horizon (virtually 2022).

After examining these minutes, we see upside risk to our Selic call (2.50%) for 2021YE, with the adjustment process very possibly starting as early as March. Since we did not change our view on the cyclical position of the (below-potential) economy, an eventual fiscal policy setting that keeps the current framework in place (with limited impact on the spending cap's credibility) could reinforce our expectation for below-target inflation in 2022. We do not see the latter as a problem, especially given a falling path of the inflation target in coming years, towards the 3% level seen in some LatAm economies.

But in the final analysis, the timing, pace and magnitude of the adjustment should hinge on the evolution of the pandemic, mobility, activity (especially employment), core inflation, and the upcoming fiscal decisions.

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