Santander
Macroeconomic Research

BRAZIL MACRO

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MONETARY POLICY – COPOM MEETING

BOUND TO SAME PLACE, BUT IN A HECTIC PACE

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- The Copom has once again raised the Selic policy rate by 75bps, reaching 3.50%, in line with (nearly unanimous) expectations of market participants, in general.
- While the authority continued to signal a "partial normalization," the Brazilian Central Bank (BCB) clarified that there is no commitment to that flight plan, as the "future steps of monetary policy could be adjusted to assure the achievement of the inflation target." This reads like a current intention to hike interest rate to somewhere below 6.50%, but with this "landing site" likely being reassessed along the way.
- This path forward is reaffirmed by the inflation simulations. The BCB models suggest that, with the FX rate around 5.40, a Selic path of 5.50% for YE2021 and 6.25% for YE2022 could suffice in keeping inflation below the upper target for this year and, most importantly, bringing inflation down to just below the mid-target for next year.
- The authority projects another Selic hike of 75bps (to 4.25%) for the June 15-16 meeting, revealing a will to quickly remove (at least part of the) stimulus.
- Our scenario currently projects a Selic rate of 5.50% at YE2021 and 6.00% at YE2022. Given a worsening inflation outlook (mainly on soaring input costs and enlarging fiscal uncertainties), we see mounting upside risks to our estimates. In other words, the odds are increasing for a much sooner normalization in the policy stance (towards our neutral rate estimate of 7.00%, in nominal terms).

Policy decision and guidance

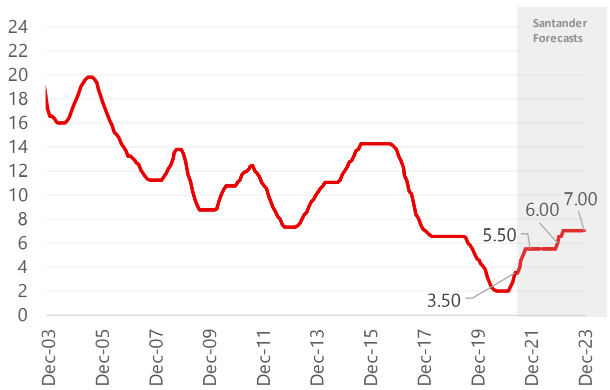
The Copom[1] has once again hiked the Selic policy rate by 75bps[2], to 3.50%, in line with expectations of most market participants in general (i.e. money managers and macro analysts). This move means another step in what the authority still considers a "partial normalization of the policy rate," meaning that the BCB still intends to "keep some degree of monetary stimulus during the economic recovery."

Amid some controversy generated by this phrasing (and the implicit flight plan to keep interest rate below 6.5%, the level assumed as neutral by the authority), the BCB clarified that "there is no commitment with this plan, and that future steps of monetary policy could be adjusted to assure the achievement of the inflation target." In our view, maintaining this message with such clarification buys flexibility for the BCB to continue pre-announcing its flight plan (favoring transparency), but at the same time reaffirming its commitment to bringing inflation back to the mid-target for the relevant policy horizon (2022).

If that part of the statement can be read as "accommodative" by some analysts, this perception is somehow diluted by the authority's apparent willingness to put in motion a faster adjustment in the policy rate (which sounds a bit "hawkish"). The authority projects for the next meeting "the continuation of the partial normalization process with another adjustment of the same magnitude", conditional on the scenario. Thus, another Selic hike of 75bps (to 4.25%) is very likely in the making for the June 15-16 meeting, revealing a will to quickly remove (at least part of the) stimulus.

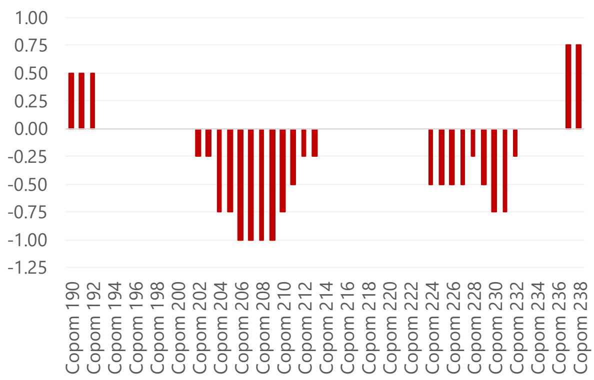
A last point about the policy decision itself is the inclusion of the expression "without compromising its fundamental objective of price stability, this decision also implies smoothing of economic fluctuations and fosters full employment." In our view, this reflects the new BCB statute—after being granted a legal autonomy from the Legislative and Executive branches—than an actual policy signal.

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.

Inflation forecasts, balance of risks, scenario assessment

The BCB's inflation simulation reinforces its message about the flight plan (to keep rate below 6.50%). With the FX rate at 5.40 for 1Q21 (and moving along with PPP afterwards), a path of Selic rate hikes to 5.50% for YE2021 and to 6.25% for YE2022 would produce an inflation decline towards 3.4% for 2022, just below the mid-target of 3.5%. That would follow a hefty print of 5.1% this year, topping the mid-target for 2021 (3.75%) but still narrowly within the tolerance band (1.5 p.p.).

In the assessment of the balance of risks for inflation, the BCB continues to view elements in both directions. With respect to the downside, "economic recovery from the pandemic can be slower than estimated", this could lead to a possibly lower-than-expected path for inflation. And on the upside, "further extensions of fiscal policy

[1] The Copom is the monetary policy committee of the Brazilian Central Bank (BCB).
[2] Refer to the statement of the 238th Copom meeting in English (https://www.bcb.gov.br/en/monetarypolicy/copomstatements).

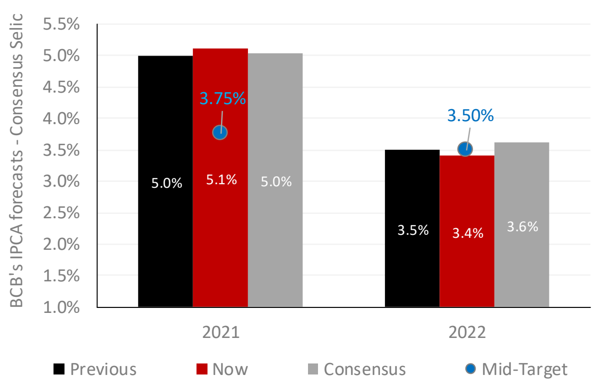
responses to the pandemic that aggravate the fiscal path, or a frustration with the continuation of the reform agenda, may add pressure to the country's risk premium.” According to the Copom, the high fiscal risks continue to “imply an upward asymmetry to the balance of risks, i.e., in the direction of higher-than-expected paths for inflation over the relevant horizon for monetary policy.”

In the scenario assessment, the BCB continues to expect a more robust recovery in advanced economies on the heels of new fiscal stimuli and progress with the immunization programs. The BCB also anticipates an expansionary policy stance by major central banks. Yet the Brazilian authority continues to fear that “market discussion regarding inflationary risks” could prompt more challenging conditions for EMs.

As per the local activity conditions, the BCB upgraded its view, stating that “recent indicators are evolving better than expected in spite of the second wave of the pandemic being more intense than anticipated.” The authority believes that “uncertainty about economic growth still remains larger than usual but should gradually return to its normal level.”

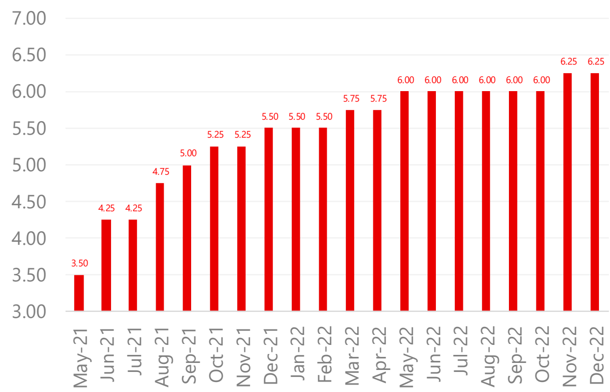
On inflation, the BCB notes that rising commodity prices continue to impact prices of food and industrial goods. Additionally, the BCB sees underlying inflation “at the top of the range compatible with meeting the inflation target.” However, the Copom keeps the diagnosis that “the current shocks are temporary.”

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 5.40 and evolving according to purchase power parity.

Figure 2.B. – Path of Consensus Selic Rate Forecasts



Sources: Brazilian Central Bank, Santander.
Note: Based on the BCB’s weekly Focus survey as of April 30, 2021 (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

What to Expect Ahead?

Amid persistent inflationary surprises to the upside, largely reflecting higher (and still rising) costs in BRL terms, and increasing risks imparted by an increasingly cloudy fiscal outlook, we continue to see higher chances of a more hawkish than expected response by the BCB.

The maintenance of the “partial normalization” language has not changed our perception. Our scenario currently projects a Selic rate of 5.50% at the end of this year and 6.00% the end of 2022. We see mounting upside risks for our estimated Selic rate path, with rising chances of a much sooner policy normalization (towards our neutral rate estimate of 7.00% in nominal terms).

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