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MONETARY POLICY – COPOM MINUTES

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STAYING THE COURSE…FOR NOW

- The Brazilian Central Bank (BCB) published the minutes from its May 4-5 Copom policy meeting, and we sensed a slightly more dovish tone compared to the statement.
- By affirming that a normalization path with continued Selic hikes (i.e., up to ~6.5%) would produce CPI projections considerably below the mid-target for 2022, the BCB seemed confident that inflation convergence would occur next year with still a little degree of stimulus (i.e., the policy rate below its structural level). Interestingly, that view seemed to contrast with the BCB's own sanguine views on activity developments (and reduction of slacks), as well as the perceived upside risks for inflation.
- We believe it unlikely that this scenario will materialize, both in terms of inflation conditions and the consequent policy response, amid persistent cost pressures and fiscal uncertainties. Thus, given the BCB's reaffirmed commitment to achieving the mid-point target for inflation next year (meaning flexibility to change its flight plan of "partial normalization"), we see the increased likelihood that policy will normalize (toward our neutral rate estimate of 7.00% in nominal terms) sooner rather than later.

Overview

The BCB published the minutes from its May 4-5 Copom[1] policy meeting[2], occasion when the authority once again raised the Selic policy rate by 75 bps, to 3.50%. Overall, we noted a slightly more dovish tone compared to the statement (released last week), as the BCB seemed more confident that inflation would converge to mid-target next year with a little degree of stimulus (i.e., the policy rate below its structural level), despite the BCB's own sanguine views on activity developments and views of predominantly upside risks for inflation.

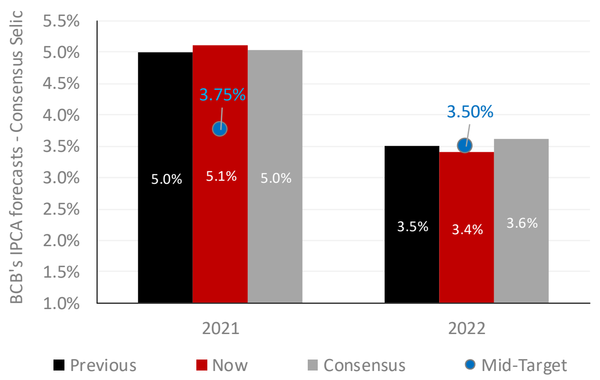
Key Policy Messages

On the one hand, the Copom justified its decision to hike interest rates by 75 bps (to 3.50%) with its perceived asymmetry in the balance of risks generated by the fiscal risks (see details below). The BCB sees the fiscal policy uncertainties affecting "the appropriate degree of monetary stimulus." **The BCB reaffirmed its guidance provided in the policy statement for another 75-bp hike (to 4.25%) for the June 15-16 policy meeting, "unless inflation determinants change".** (Paragraphs #13 and #14).

On the other hand, the authority highlights the inflation projections[3] for the baseline scenario, which point to headline IPCA slightly below the mid-target of 3.50% for 2022 (key policy horizon now). **The Copom estimates that "subsequent uninterrupted increases in the interest rate up to the level considered neutral imply projections considerably below the inflation target at the relevant horizon."** As one would naturally expect, the committee leaves the door open to alter its course of action "if there is a change in inflation projections or in the balance of risks." The board emphasizes that its steps will continue to hinge "on the evolution of economic activity, the balance of risks, and the inflation projections and expectations." (Paragraphs #13 and #14).

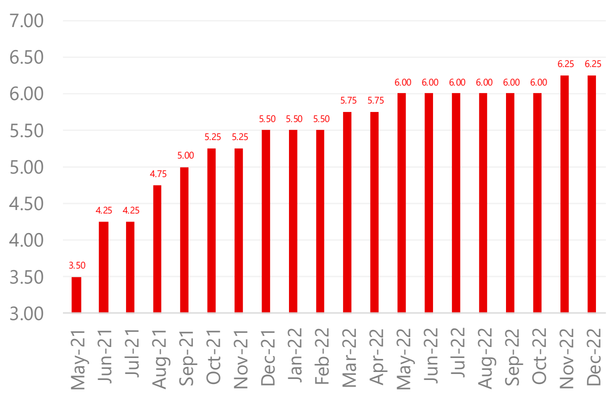
The BCB also tried to further explain the maintenance of the (increasingly controversial) **"partial normalization" language**. **According to the authority, the expression reflects the board's** "**opinions on the appropriate monetary policy for the convergence of inflation to target over the relevant horizon**.", helping increase transparency about the BCB's reaction function. This transparency is believed to improve the efficiency of monetary policy. Yet the Copom stresses that it "reevaluates its scenario at every meeting committed", reaffirming its commitment "to the convergence of inflation to the target over the relevant horizon." (Paragraph #15).

Figure 1.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 1.B. – Consensus Selic Rate Before the Copom



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

[1] The Copom is the monetary policy committee of the Brazilian Central Bank (BCB).
[2] Refer to the minutes of the 238th Copom meeting in English (https://www.bcb.gov.br/en/publications/copomminutes).
[3] According to the simulations, with FX rate starting at 5.40 and moving along with PPP afterwards, a path of Selic hikes to 5.50% for YE2021 and 6.25% for YE2022 would take inflation below the upper target for 2021 (5.1% vs. mid-target of 3.75%, with tolerance of +/- 1.5 p.p.) and just below the center target for 2022 (3.4% vs. mid-target: 3.5%).

Remarks on the Scenario Assessment, Balance of Risks

On the scenario assessment, the BCB confirms a sanguine view on economic activity. The committee notes that it was positively surprised by recent numbers despite the unexpected strength of the second wave of Covid-19 infections. **The BCB believes that "the second half of the year should bring a robust recovery, as the effects of the vaccine rollout are felt more broadly."** (Paragraph #11).

On the level of economic slacks, the Copom notes "heterogeneous effects across economic sectors," as goods-producing sectors seem to operate close to full capacity and the services sector is seen "struggling to recover." **The authority continues to believe that "the economic slack as a whole is returning to the late 2019 level in the coming quarters."** (Paragraph #12).

On inflation, just as in the statement, the BCB notes that rising commodity prices continue to impact prices of food and industrial goods. Additionally, **the Copom maintains the diagnosis that the current inflation shocks are temporary, but it will continue to "closely monitor its evolution"** (Paragraph #5).

On the global environment, the BCB continues to expect a more robust recovery in advanced economies on the heels of new fiscal stimuli and progress in immunization programs. The BCB also anticipates an expansionary policy stance by major central banks. Yet **the Brazilian authority notes that "the risk of a lasting inflation increase in the United States (…) could result in a more challenging environment for emerging economies."** (Paragraph #10).

The assessment of balance of risks for inflation was the same as in the communiqué, with the BCB seeing elements in both directions. With respect to downside risks, "economic recovery from the pandemic can be slower than estimated", possibly leading to a lower-than-expected path for inflation. And on upside risks, "further extensions of fiscal policy 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."** (Paragraphs #7, #8 and #9).

What to Expect Ahead?

Despite recent developments, the BCB seems to reaffirm its constructive views on future developments regarding the monetary policy environment, with continued Selic hikes up to 6.50% in this cycle apparently seen as too much a dose for the realization of the BCB's policy objectives (i.e., inflation at mid-target next year). Amongst key elements mentioned by the authority, we note a strong recovery of real activity in 2H21 and a subsequent reduction of economic slacks. Those are expected to materialize alongside a softening in (what is seen as "temporary") inflation pressures and a subsequent convergence of headline CPI to mid-target in 2022. Surely, despite the highlighted balance of risks for inflation, seen by the authority as skewed to the upside, the BCB's scenario and forecasts provide the basis for the maintenance of the "partial normalization" language, revealing a flight plan to hike the Selic rate to somewhere below 6.50% at the end of the ongoing adjustment.

From our side, however, we are seeing increased risks for the materialization of this scenario, both in terms of the inflation conditions and the consequent policy response. Amid persistent inflationary surprises to the upside, largely reflecting higher (and still rising) costs in BRL terms, and growing risks imparted by an increasingly cloudy fiscal outlook, we continue to see rising chances of more lasting inflation pressures, which could blur the outlook for an inflation-target achievement next year. Thus, despite our less bullish estimates for economic activity for the coming quarters, we believe the BCB's baseline scenario for inflation could be revised (to the upside) in coming months, probably leading to a more hawkish policy response, given the authority's reaffirmed will to bring inflation back to the mid-target next year. Our scenario currently projects Selic rate of 5.50% at YE2021, 6.00% for YE2022 and 7.00% for 1Q23. But we do see mounting upside risks for our estimated Selic path. In other words, despite the BCB's wording, we see the likelihood increasing that policy normalization will occur sooner (toward our neutral rate estimate of 7.00% in nominal terms).

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