BRAZIL MACRO

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MONETARY POLICY – COPOM MINUTES

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KEEPING THE (HAWKISH) TONE

- The Brazilian Central Bank (BCB) published the minutes of its March 16-17 COPOM policy meeting. We sense the committee chose to keep a hawkish message, in line with its latest decision and its associated flight plan.

- While the authority continues to refer to a "partial normalization," the COPOM believes that the asymmetry in the balance of risks justified faster moves in the policy rate than implied by the baseline scenario.

- The committee presents sanguine views of the economy, in our view, seeing strong activity in recent months, a reduction in job-market slacks, and a quick economic rebound when the effects of the vaccination process start to show. On inflation, despite the assessment that cost pressures are temporary, the BCB sees the influence of positive demand shocks. Several members of the COPOM saw risks of second-round effects (via inflation expectations for 2022, the key policy horizon).

- All in all, we believe the COPOM minutes gave credence to our recently revised Selic rate estimates. We project YE2021 Selic rate at 5.50%, with an additional hike of 75 bps in May and four subsequent moves of 50 bps afterwards. We continue to anticipate a two-stage normalization process, with a pause in 4Q21, before reaching a higher neutral level in 1Q23.

Overview

The BCB published the minutes from its March 16-17 COPOM[1] policy meeting[2], when the authority raised the Selic policy rate (for the first time since 2015) to 2.75%, from (a historical low of) 2.00%. At the time, most analysts (including ourselves) expected a 50-bp hike. We sense the committee chose to keep a hawkish tone, in line with their decision and the apparent flight plan.

Key Policy Messages

The main policy messages were unchanged from the statement. According to the minutes, the COPOM believes that "the current conditions ceased to prescribe an extraordinary stimulus," as the BCB views strong activity and inflation expectations above the target for the relevant horizon and projections topping the upper target for 2021 (Paragraph #20).

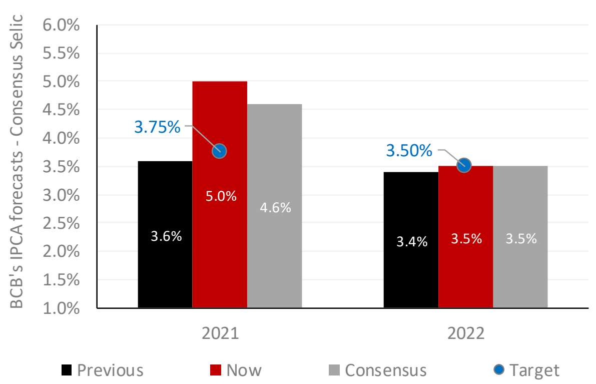
The authority continues to refer to a "partial normalization" – meaning a reduction in the "extraordinary degree of monetary stimulus." The Brazilian Central Bank (BCB) justifies the pace of 75 bps in the kick-off with a belief that "a swifter adjustment has the benefit of reducing the probability of not meeting the inflation target in 2021, as well as of keeping longer horizon expectations well anchored." This strategy is seen by the authority as consistent with achieving the center of the target range for next year (Paragraph #21).

The authority continues to project "the continuation of the partial normalization process with another adjustment, of the same magnitude" for the next meeting, but that strategy is conditional "on the evolution of economic activity, the balance of risks, and inflation projections and expectations." The authority affirms that "its views for the next meeting may be altered if there is a significant change" in these elements (Paragraphs #17 and #22).

Remarks on the scenario assessment, balance of risks

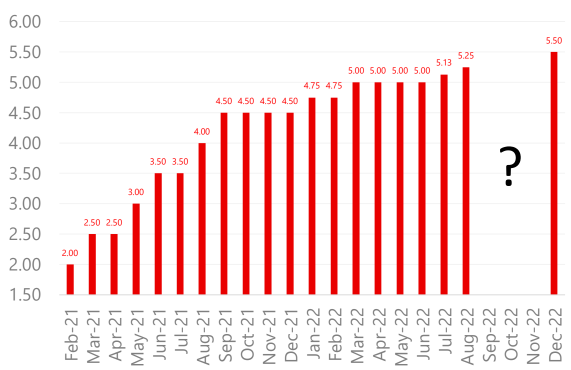
Elsewhere in the minutes, the COPOM remarks also felt hawkish to us, as the BCB highlights the upside risks for inflation and apparently downplays the downside risks. According to the BCB, despite recent reforms (read the "*PEC Emergencial*"), "the fiscal risks remain high in the short term due to the worsening of the pandemic," and that implies an upward bias to the inflation simulations[3] presented in the statement. The COPOM believes that "this asymmetry in the balance of risks affects the appropriate degree of monetary stimulus," and justifies a "larger initial increase in the policy rate than that implied by the baseline scenario." (Paragraph #14)

Figure 1.A. – BCB's Inflation Simulations (COPOM)



Sources: Brazilian Central Bank, Santander.

Figure 1.B. – Consensus Selic Before the COPOM



Sources: Brazilian Central Bank, Santander.
Note: Based on the weekly Focus report as of March 15, 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 237th COPOM meeting in English (https://www.bcb.gov.br/en/publications/copomminutes).
[3] According to the simulations, with FX rate at 5.70 for 1Q21 (and moving along with PPP afterwards), a path of Selic hikes to 4.50% for YE2021 and 5.50% for YE2022 would take inflation below the upper target for 2021 (5.0% vs. mid-target of 3.75%, with tolerance of +/- 1.5 p.p.) and to the mid-target for 2022 (3.5%).

While the BCB recognizes the uncertainties generated by the pandemic on the expected pace of economic recovery for the 1H21, "the Committee assessed that a possible economic recovery setback due to the worsening of the pandemic would be less extreme than the one observed last year and would probably be followed by another fast recovery." Expecting broader effects of the vaccination process, the BCB keeps a sanguine view on activity for the 2H21 (Paragraph #11).

Other optimistic assessments of real activity can be found in other parts of the minutes. The BCB has a view that "recent indicators, particularly the GDP growth in the fourth quarter of 2020, continued to suggest a consistent economic recovery in spite of the reduction in the emergency income transfers." The BCB board also "judges that economic activity and formal labor market data suggest that the overall slack has declined faster than anticipated, despite the increase in the unemployment rate." (Paragraphs #2 and #12)

On inflation, the BCB sees "a positive demand shock at work" amid pressures in production costs and sector-based prices related to the "delay in the normalization of the production chains." The BCB also seeks to make it clear, in our view that "despite the diagnosis that the current shocks are temporary, the Brazilian inflation targeting regime aims at headline inflation in the calendar year," leading to "a more assertive stance in the conduct of monetary policy." Several members saw risks that inflation pressures in 2021 could derail inflation expectations for 2022, potentially causing a de-anchoring process for the relevant policy horizon.

Our interpretations and expectations

While we have a less sanguine outlook for economic activity for 2021, we agree with the authority's decision not to accommodate the mounting cost driven inflationary pressures, as the BCB seeks to avert secondary effects from these shocks. Those could potentially make inflation more persistent ahead, if the expectations channel is contaminated. We do not fully discard an alternative explanation for the faster initial hikes, as a faster Selic rebound towards its effective lower bound might help make the FX rate channel work in the Committee's direction (that is, a stronger currency, to attenuate the impact of commodity shocks).

By reinforcing the signals sent in the statement, and, importantly, by hinting that that Selic path shown in the simulations may be just a lower bound for the actual flight plan (given the upwardly skewed balance of risks), we believe the COPOM minutes gave credence to our recently-revised Selic rate estimates. We project the YE2021 Selic rate at 5.50%, with an additional hike of 75 bps in May and four subsequent moves of 50 bps afterwards. We continue to anticipate a two-stage normalization process, with a pause in 4Q21, before reaching a higher neutral level in 1Q23.

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