BRAZIL MACRO Jun 24, 2021

MONETARY POLICY – INFLATION REPORT

BCB STILL POISED TO SPEED UP HIKES; CMN KEEPS BRINGING DOWN THE TARGET

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

- The BCB published the 2Q21 inflation report, shedding more light on the authority's macroeconomic forecasts and policy discussions.
- Despite the less bullish GDP projections by the BCB, as compared to the Street, we sense the inflation report did not strike a much different tone compared to the minutes. As an upshot, we continue to see increased probability of faster hikes for the upcoming COPOM meetings, with risks tilted towards much earlier policy normalization.
- In a separate event, the CMN (National Monetary Council, in Portuguese acronym) announced the (IPCA) inflation targets for the next three years, with the novelty being the decision for 2024, as the council decided to set it at 3.0%, with the very same tolerance band of 1.5 p.p. either way. By keeping a reduction of 0.25 p.p. per year (2022 target was reaffirmed at 3.50%; for 2023, 3.25%), Brazil will now have a similar target as some EM peers, which is a welcome objective.
- While the high BCB credibility should help to consistently achieve these targets, additional fiscal reforms (on the spending side) will probably be necessary for the maintenance of such low inflation levels in the long run.

Inflation Report Highlights: Still Inclined to Go Faster

The BCB published the 2Q21 inflation report[1], shedding more light on the authority's macroeconomic forecasts and policy discussions.

Having already published its inflation estimates for the relevant policy horizon in the COPOM statement[2] and minutes[3], a point of note in the report is the key economic parameters used by the BCB in its simulations and forecasts. According to the BCB, the economy is expected to run ~2.5% below its potential in 2Q21 (for 1Q21, the output gap was previously projected at -3.2%, according to the last inflation report). The BCB still expects the output gap to fully close sometime in 2022 (consensus: 2023). Additionally, the neutral level of real interest rates is still seen by the BCB at 3.00%. On economic activity, the authority now forecasts 2021 GDP at +4.6% (previously +3.6%), which is below the consensus estimate of 5.0%.

As usual, the inflation report brought interesting policy-related studies (boxes). Despite the BCB's "downgrade" given to the downside risks (for inflation) emerging from the pace of economic recovery (i.e., risks of a slower activity recovery being downplayed), and as opposed to the explicit mention of inflation elements (e.g., services and expectations) as key drivers for the next policy steps, we noted an atypically large concentration of BCB research on real activity topics this time.

In one box, the BCB "analyzes the relationship between economic activity and pandemic intensity," concluding that there has been a reduction in the sensitivity of the former to the latter, possibly reflecting the influence of impulses from the fiscal stimulus and global growth. In another box, the BCB seeks to address the fact that "periods with large fluctuations in series make it difficult to estimate seasonal and calendar factors." So they try to filter the effects of the pandemic on the seasonal adjustment of broad activity data by removing the Covid-19 period (treated there as outliers) and comparing the results obtained with the traditional seasonal adjustment method: the conclusion is that the traditional "procedure reduces the magnitude of the fluctuation due to the second wave" of the pandemic in Brazil. The BCB therefore highlights the dangers of extrapolating atypically strong (seasonally adjusted) GDP results into 2H21; the BCB apparently believes that this distortion in seasonal filtering may explain part of the gap of their forecast with respect to the consensus.

The job market is also an object of study. In a box, the BCB reaches a (possibly preliminary) conclusion that the problems in IBGE data collection for the PNAD household survey on employment may not have distorted too much the results for unemployment rate, participation rate and employment (for other variables, the results were not so robust). Yet, elsewhere in the inflation report the BCB shows further evidence that the stronger CAGED payroll numbers might paint a more accurate picture for formal employment than the formal jobs data seen from PNAD.

In two other boxes, the BCB runs simulations stressing on risk variables that could affect the inflation outlook. In a study, they simulate the impact of a hawkish Fed reaction causing Brazil FX to weaken about 20% (similarly to what happened in the 2013 "taper tantrum"). This is a risk considered as "second-tier" (i.e., of lesser probability), not mentioned for instance in the balance of risks assessment in the COPOM statement and minutes. In the most interesting scenario of a permanent impact (i.e., FX rate does not return to previous levels, neutral real interest rate rises to 4%), the BCB estimates an upward impact of a little more than 1 p.p. on IPCA inflation for the calendar years 2021 and 2022, compared to the baseline scenario. The BCB also stresses a (downside) risk to the inflation outlook seen as more important as of now—recently upgraded to "first tier," being explicitly mentioned in the balance of risks assessment: a retracement in commodity prices in BRL. In the most interest scenario—with the FX rate back to levels seen at YE2019, adjusted by PPP and 5-year CDS; commodity prices in USD back to levels seen at YE2019, adjusted by international inflation target—IPCA inflation would be 1.0 p.p. lower for 2021 and 1.3 p.p. lower for 2022, vis-à-vis the baseline scenario.

---

[1] Refer to the Inflation Report boxes (https://www.bcb.gov.br/en/publications/inflationreportboxes) and presentation (https://www.bcb.gov.br/content/about/presentationstexts/RI_2021_2Q_EN.pdf).
[2] **Santander Brazil Monetary Policy - *"A New (Farther) Route for The Flight Plan"* –** June 16, 2021 – Available on: https://bit.ly/Std-Copom-jun21
[3] **Santander Brazil Monetary Policy - *"Whatever It Takes"* –** June 22, 2021 – Available on: https://bit.ly/Std-Copom-min-jun21

Following this morning's publication, in the press conference with Governor Roberto Campos Neto and Deputy-Governor for Economic Policy Fabio Kanczuk, the BCB reaffirmed its commitment to delivering the mid-point inflation target next year, claiming that they will use "all instruments" to achieve a 3.5% IPCA in 2022. The authority also clarified that the decision to deliver a 75-bp hike in the June meeting (instead of a bolder move, allegedly considered according to the minutes) was not due to a lack of previous communication.

All in all, despite the less bullish GDP projections by the BCB as compared to the Street, we sense the inflation report did not strike a much different tone compared to the minutes. As an upshot, we continue to see increased probability for faster hikes for the upcoming COPOM meetings, with risks tilted towards much earlier policy normalization.

CMN Announces the Inflation Target for 2024

In a separate event, the CMN (National Monetary Council, in Portuguese acronym) announced the inflation targets for the next three years, as usually done in June of each year. With the IPCA targets for 2022 and 2023 kept intact (at 3.50% and 3.25%, respectively), the novelty was the decision for 2024, as the council decided to set it at 3.0%, with the very same tolerance band of 1.5 p.p. either way. According to the note issued by the Ministry of Economy, "the 0.25-percentage-point reduction compared to the 2023 target is consistent with the high credibility of the monetary policy (...) eliminating the possible costs of reducing" it.

With this move, the Brazilian inflation target now converges to the levels seen in some key regional peers. Despite a cyclically high inflation as of late, we see this CMN decision as positive, revealing an ambition to make permanent such a low level of inflation for the long term. While the high credibility of the BCB (and especially after it was recently granted formal independence) should help the achievement of these bolder inflation targets, we believe macroeconomic reforms (especially on the fiscal side, and on the expenditure front) will be necessary in the future to facilitate a consistent achievement of this policy objective in the long term.

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	