Santander
Macroeconomic Research

BRAZIL MACRO

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MONETARY POLICY – INFLATION REPORT

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HINDSIGHT AND OUTLOOK

- The Brazil Central Bank (BCB) has published the 3Q21 inflation report, disclosing further information on the authority's macroeconomic analyses, forecasts and policy discussions.
- In our view, the BCB took the opportunity to explain points of divergence vis-à-vis market analyses and estimates, as well as its recent position on policy actions, the consequences, and the impact of recent shocks that dramatically altered current inflation conditions and the outlook.
- In a nutshell, the BCB sees most of this year's inflation surprise largely associated with energy price shocks and believes an eventual persistence in inflation of industrial consumer goods will hinge more on the future evolution of costs and shocks, rather than on the lagged CPI pass through of a repressed upstream inflation. The BCB also sees well anchored inflation expectations for the long run and a small deviation for the shorter policy horizon.
- The BCB also reaffirmed its strategy to bring the Selic rate to significantly tighter levels, justifying its choice to use the total budget of hikes (instead of the speed of tightening) as the adjusting variable. The authority believes this strategy helps the BCB buy time to watch how the economy (and inflation outlook) will evolve amid considerable uncertainty.
- Given the inflation simulations and the upwardly tilted balance of risks, we continue to believe the current flight plan includes a terminal Selic rate at 9.00% or slightly above, likely to be reached in February 2022. That said, we see clear upside risk to our terminal rate forecast (8.5% as per our last scenario review, published on September 16, 2021).

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The BCB's macroeconomic parameters and forecasts details

Having already published its inflation estimates for the relevant policy horizons and the balance of risks 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 1.7% below its potential in 3Q21 (for 2Q21, the output gap was previously projected at -2.5%, according to the previous inflation report). The BCB also expects the output gap to stand at -1.2% for 4Q22 (in the last report, the BCB projected the gap to be fully close sometime in 2022). The neutral level of real interest rates is still seen at 3.00%.

On economic activity, the authority forecasts 2021 GDP at +4.7% (previously +4.6%), which is below the consensus estimate of 5.0%[4]. For 2021, the BCB projects real GDP growth of +2.1% (consensus: 1.6%). The upgrade for this year follows a better-than-expected headline GDP in 2Q21 as well as an advance in the COVID-19 vaccination campaign. For the next year, the BCB sees a lesser contribution from base effects (at this later stage of the economic cycle) and the lagged effects of a tighter monetary policy. Those are mitigated by a constructive outlook for agriculture (greater area of planting, weather conditions) and for mining (iron ore, oil).

On inflation, the BCB points to a cumulative, upside inflationary surprise of 1.18% from June to August, in comparison to the authority's forecast in the 2Q21 inflation report. For the short term, the BCB expects an IPCA change of 1.98% from September to November, with YoY inflation reaching 9.22% in November. It is no wonder that the BCB estimates 100% probability of breaching the upper end of the inflation target band (5.25%) this year. For 2022, the central bank estimates a probability of 17% that the IPCA could stand above the upper target (5.00%). Interestingly, this is not very different from the likelihood associated for a scenario of breaching below the lower bound of the target (i.e. IPCA below 2.00%): 11%.

Studies (or boxes): discussions about activity

As usual, the inflation report brought interesting policy-related studies (boxes). Three of those cover topics related to economic activity. In one of those, the BCB calculates a high-frequency proxy for overall consumption of goods and services based on IBGE monthly reports (PMC, PMS), and their respective weights in the official GDP. The BCB numbers point to a solid cyclical recovery – held back a little by the pandemic relapse started in late Q1 – with a return to the pre-COVID level (as of February 2020) in July 2021. The BCB sees the (still-incomplete) catching up in services supply as a possible growth driver in 2H21, yet the authority recognizes this could come at the expense of lesser consumption of goods.

In another study, the BCB investigates the scarcity of industrial inputs and inventories in manufacturing, which is aggravating earlier this year. The BCB also points to a widespread reduction of inventories across industrial segments. Capacity utilization is showing asymmetries, as some categories (such as capital goods) are going strong and other categories are running below the recent historical average (e.g., cars, electronics). This is seen as a reflection of recent shocks in demand (e.g. greater investment appetite supporting capex) and supply (shortage of key inputs, such as semiconductors).

The job market is also an object of study. In a box, the BCB highlights the relative resiliency in average income, a variable that is seen to have suffered less than other employment indicators. The BCB associates this with a composition effect, with a decline in the participation rate for lower-income cohorts of workers that have been

[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_3Q_EN.pdf)
[2] **Santander Brazil Monetary Policy - *"Copom Meeting: Scanning the Scene as It Moves at Cruise Speed"* –** September 23, 2021 – Available on: https://bit.ly/Std-Copom-sep21
[3] **Santander Brazil Monetary Policy - *"Copom Minutes: Going Farther, Not Necessarily Faster"* –** September 28, 2021 – Available on: https://bit.ly/Std-Copom-min-set21
[4] Refer to the BCB's Focus weekly survey among professional forecasters (https://www.bcb.gov.br/en/publications/focusmarketreadout)

more intensely impacted by the pandemic. The BCB already notes a reversal in this trend, likely reflecting the recovery in the job market participation amid as the economic reopening unfolds.

More policy studies: inflation shocks and anchoring

The BCB updates previously published boxes touching base on the relationship between PPI and CPI and the pass-through of industrial costs. The BCB concludes that the persistence of the industrial cost group in the IPCA has to do with continued pressure in factory-gate prices. The authority does not see signs of repressed inflation (following the big recent mismatch between PPI and CPI gauges) and believes the outlook will hinge more on the emergence of new shocks than on time lags to pass cost pressures along to consumers. The BCB estimates that the cost pass-through was more intense than usual within companies but less intense than usual in the way from wholesale to retail.

In another study, the BCB runs a counter-factual exercise revisiting the 2021 IPCA forecast presented in the 4Q20 inflation report, but now using newly updated assumptions. Back then, the BCB estimated the 2021 inflation at 3.4%, which today is estimated by the BCB at 8.5%. The exercise "recomposes" the IPCA projection up to 7.8%, with the 0.7 p.p. residual associated with supply chain disruptions. The costs shocks in fuel (+2.3 p.p.), electricity (+1.0 p.p.) and commodities (+0.6 p.p.) explain the bulk of the (rather strong) upside surprise.

Another box shows that long-term inflation projections have moved with the announcement of the target of late, and the median estimates remain consistent with the path of the center target set by the CMN (Monetary Council). In the study, the BCB seeks to show that, while many believe there is an "inertia" for long-term projection horizons in analysts' surveys, the current anchoring does not happen all the time: the BCB cites episodes between 2012 and 2016, when inflation expectations for 3-5 years moved very often (most of the times, crossing or distancing further above the target).

In other words, the authority does see an anchoring in long-term expectations, even though that contrasts with a sequence of upside inflation surprises and a high level of inflation. The BCB also concludes that their actions during these "challenging times" was about in line with what one could expect as a standard response under an inflation targeting regime, with the data suggesting that Copom decisions were in large scale predictable and close to what as seen as adequate by the market, according to this box. The BCB also points to small deviations of inflation projections (from the target) for the closest policy horizon.

Policy signals

In a press conference following this morning's publication, Governor Roberto Campos Neto reaffirmed the BCB's will to implement a monetary tightening that takes the policy rate to a "significantly restrictive" level. The authority clarified that this expression, used in the last formal communications, refer to the terminal Selic level. In fact, the BCB governor reinforced the idea that the total budget of hikes is more important than the speed of adjustment for the achievement of the BCB's objective to put inflation at the center target for the relevant horizons (mainly 2022, but increasingly 2023).

So, the BCB's strategy is likely to remain with (cruise-speed) moves of 100bps per meeting until the BCB envisions (the place to "land" at) a terminal Selic level. The authority believes this strategy helps the BCB buy time to watch how the economy (and inflation outlook) will evolve amid considerable uncertainty.

Final impressions

All in all, the BCB took the opportunity of the inflation report to explain points of divergence vis-à-vis market estimates (e.g., headline GDP, free-market IPCA), as well as its recent position on policy actions, the consequences, and the impact of recent shocks that dramatically altered current inflation conditions and the outlook. The BCB reaffirmed its strategy to bring the Selic rate to significantly tighter levels, justifying its current choice to use the total budget of hikes (instead of the speed of tightening) as the adjusting variable.

Given the inflation simulations and upwardly tilted balance of risks, we continue to believe the current flight plan could include a terminal Selic rate at 9.00% or slightly above, likely to be reached in February 2022. That said, we continue to see clear upside risk to our terminal rate forecast (8.5% as per our last scenario review, as of September 16, 2021[5]).

[5] **Santander Brazil - Macroeconomic Scenario:** ***"The Inflation Factor…Again"* –** Set 16, 2021- Available on: https://bit.ly/Std-scenreview-set21

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