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Macroeconomic Research

BRAZIL MACRO

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MONETARY POLICY – COPOM DECISION

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SLOWER BUT NOT LOWER

- Once again, the COPOM hiked the Selic rate by 150 bps, to 10.75%, in line with the consensus of macro analysts and the yield-curve pricing. This was the eighth move in the cycle, as the Selic rate reaches the highest level since the 2Q17.
- The takeaway in the statement is the change in the short-term guidance, as the BCB signaled "a reduction in the pace of adjustment" for the March 15-16 meeting, instead of pointing to a more specific outcome as in previous occasions. The authority refers to "the stage of the tightening cycle" and the policy lags language to justify this action, probably with a view to calibrate the (nearing) end of the cycle.
- While the BCB left the range of options a little broader and "lighter" than we had thought, in practical terms we believe the concerns about a de-anchoring of inflation expectations will limit the range of possibilities for the next COPOM meetings. In other words, we see the consensus Selic forecast of +100 bps for March and +25 bps for May as a lower bound for the next moves, especially given the upwardly skewed balance of risks for inflation. Judging from the BCB's inflation estimates, one can conclude that the COPOM's flight plan probably includes a terminal Selic rate close to (but no less than) 12%.
- In our view, the softer-than-expected guidance for the future speed of tightening is (at least partly) offset by other hawkish elements in the statement—such as the BCB's pledges to further advance into restrictive territory and to persist in the disinflation process and re-anchoring strategy. The continued emphasis on the risks of de-anchoring inflation expectations (led by fiscal uncertainties) adds to a cautious tone. As did the scenario assessment, downgrading the external conditions and recognizing the inflation developments.
- So, however soft the tone is perceived in this communiqué (and the minutes could further recalibrate that), we continue to see the authority committed to striving to reclaim the driver's seat in inflation expectations.
- Following today's message by the BCB, our outlook is now for a 100-bp Selic hike in March and another move of 50 bps in May (we previously expected a single 150-bp move in March). We maintain our terminal Selic rate estimate of 12.25% for this cycle and envision stability until 1Q23. This means a considerably tight monetary policy stance for the remainder of 2022.

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Policy decision and new flight plan

In its 244th monetary policy meeting, the COPOM[1] once again hiked the Selic rate by 150 bps[2], to 10.75%, in line with the consensus of macro analysts and the yield-curve pricing. This was the eighth move in the cycle, as the Selic rate reaches the highest level since the 2Q17.

As per the policy message, the takeaway is the change in the short-term guidance provided by the COPOM. For the next policy meeting (March 15-16), "the Committee foresees as adequate, at this moment, a reduction in the pace of adjustment of the interest rate." The authority refers to "the stage of the tightening cycle" and mentions that "its cumulative effects will manifest themselves over the relevant horizon." That action contrasts with previous meetings, when the authority signaled a more specific (expected) outcome. We view this as a likely preparation to calibrate the (nearing) end of the tightening cycle.

We had expected the use of the policy-lag argument at some point soon (not necessarily in this meeting), as this is the key reason justifying an imminent pause in the tightening cycle at this juncture (i.e., as year-on-year CPI still strolls in double-digit territory). Yet we note the COPOM left the range of options for March a little broader and "lighter" than we had thought. Heading into this meeting, we believed the BCB would signal the possibility of hikes for the March meeting between 100-150 bps. Not only has the BCB practically excluded a repetition of a similar (150-bp) move, but also has theoretically left open the possibility of raising rates by even less than the 100 bps widely expected by economists. But only in theory.

In the end, however, we sense that, in practical terms, moves less steep than 100 bps do not seem to be on the cards under current conditions, given that doing less than the Street thinks may not help at all the strategy to re-anchor inflation expectations—which is the key BCB concern as of now.

Still on the policy signals in the statement, the BCB kept the message that "given the increase in its inflation projections and in the risk of a de-anchoring of long-term expectations, it is appropriate to advance the process of monetary tightening significantly into the restrictive territory." The authority also reaffirmed that "it will persist in its strategy until the disinflation process and the expectation anchoring around its targets consolidate."

The inflation estimates continue to provide clues as to how deep into "restrictive territory" the BCB could be planning to reach should current economic conditions and the outlook remain unchanged. They also provide guidance on the probable range of feasible outcomes we should consider for the upcoming COPOM decisions.

According to the BCB's own inflation models, with the FX rate starting at 5.45 (and moving along with PPP afterward), IPCA inflation would stand at 5.4% for 2022 (previous estimate: 4.7%; mid target: 3.50%; upper target: 5.00%). The BCB continues to project 3.2% for 2023 (mid-target: 3.25%; upper target: 4.75%). For 2022, the upward revision in the BCB's estimate is basically led by a higher projection for administered prices[3]. Importantly, the BCB highlights that the relevant horizon[4] for monetary policy "includes 2022 and, to a larger degree, 2023." That shows the greater focus now in assuring IPCA convergence to center target next year. 2022 is "nearly over" already, from a monetary policy standpoint.

These inflation estimates point to IPCA convergence to mid-target next year assuming the following path for the Selic rate, as per the consensus of economists[5]: hikes of 100 bps (to 11.75%) for March and 25 bps (to 12.00%) for May, with rate stability afterwards. A cut of 25 bps is then expected for December 2022, with Selic rate ending this year at 11.75%. Subsequently, further rate cuts are expected, taking the Selic down to 8.00%

[1] The COPOM is the monetary policy committee of the Brazilian Central Bank (BCB).
[2] Refer to the statement of COPOM #244 in English (https://www.bcb.gov.br/en/monetarypolicy/COPOMstatements).
[3] While the BCB's inflation forecast for 2022 is now aligned with the consensus (compared to a gap of 0.3 p.p. in the previous round of estimates), there is still a difference in the IPCA composition, as the BCB sees administered prices at 6.6%, while consensus has 5.1%. For 2023, although the headline estimates are the same, the BCB projects regulated price inflation of 5.4%, whereas the consensus has 4.0%. It is possible that this difference for 2022 reflects, at least in part, the rather conservative BCB hypothesis for the electricity flag "Red 1." The latter applies both for the end of 2022 and 2023. Yet we note that items other than electricity explain the upward BCB revisions to regulated price inflation for 2022 (to 6.6% from 3.8% previously) and for 2023 (to 5.4% from 5.2%): the BCB revised now the tariff flag to "Red 1" from "Red 2" previously, which imparts a downward effect in headline CPI estimates of around 0.3 p.p. for 2022 (no effect for 2023).
[4] To be more precise, according to the rule of thumb, the relevant horizon is always six quarters ahead. Taking into account some rounding rules, this means that in 1Q22 the relevant policy horizon is a weighted average between 2022 (weight of 25%) and 2023 (weight of 75%).
[5] Refer to the BCB's weekly survey of professional forecasters for January 28, 2022 (https://www.bcb.gov.br/en/publications/focusmarketreadout)

for 2023YE. Judging from the numbers, one can conclude that the COPOM's flight plan likely includes a terminal Selic rate close to (but no less than) 12%, with moves of (at least) 100 bps in March and 25 bps in May. The upwardly skewed balance of risks for inflation is a key factor suggesting the Selic path used in the reference scenario is probably a lower bound for the BCB's planned steps.

Balance of risks and scenario assessment

The statement brings a discussion about the balance of risks for inflation and the BCB still views elements in both directions. To the downside, the COPOM believes that "a possible reversion, even if partial, of the increase in the price of international commodities measured in local currency would produce a lower-than-projected inflation in the reference scenario." No changes there.

To the upside, the COPOM sees that "fiscal policies that imply additional impulses to aggregate demand or deteriorate the future fiscal path may have a negative impact on prices of important financial assets as well as pressure the country's risk premium." Here, the BCB seems to highlight the potentially inflationary effects of additional fiscal stimulus from the standpoint of aggregate demand (and not only via asset-price selling and country-risk widening).

In sum, the BCB still believes that "uncertainties regarding the fiscal framework maintain elevated the risk of de-anchoring inflation expectations and, therefore, the upward asymmetry in the balance of risks." This leads to "a higher probability of inflation paths above the one projected under the reference scenario." We deduce this also leads to the necessity of an even tighter monetary policy than the one used in simulations (we expect this sentence to be reaffirmed in the COPOM minutes, due out on Tuesday, February 8, 2022).

In the scenario assessment, the BCB continues to recognize the adverse inflation conditions. The COPOM notes that CPI "continued to surprise negatively," both in the "more volatile components and (…) on the items associated with core inflation." The authority emphasizes again that "various measures of underlying inflation are above the range compatible with meeting the inflation target."

On activity, the BCB slightly upgraded the tone, mentioning that "growth indicators of the Q4 posted a slightly better-than-expected evolution, especially in labor market."

On the global environment, the BCB continues to see worsening conditions. The BCB cites the higher probability of a faster monetary tightening in the U.S. owing to persistent inflationary pressures in the world's largest economy. That could turn "financial conditions more challenging for emerging economies." The BCB also refers to global pandemic concerns, as the recent wave of contagion could impact activity and "delay the normalization of the global supply chains." The latter reveals that the BCB probably sees a potentially net inflationary effects from omicron. Just another element amid a sea of uncertainties and concerns.

What to Expect Ahead?

In our view, the softer-than-expected guidance for the future speed of tightening is (at least partly) offset by some other elements that we see more on the hawkish camp, such as the pledge to further advance into restrictive territory and to persist in the disinflation and re-anchoring strategy. The emphasis on the risks of de-anchoring inflation expectations (led by fiscal uncertainties) adds to a cautious tone. The scenario assessment, downgrading of external conditions and inflation developments, is also noteworthy in this context.

However "easy" the BCB tone may have been perceived in this communiqué (and the minutes could further recalibrate the message), we continue to see the authority committed to striving to reclaim the driver's seat in inflation expectations. Thus, we continue to see the Selic path used in the BCB's inflation estimate as a lower bound, considering the upwardly skewed balance of risks.

That said, following today's message by the BCB, our outlook is now for a 100-bp hike in March and another move of 50 bps in May (we previously expected a single 150-bp move in March). We continue to believe the BCB flight plan probably accounts for a terminal interest rate of no less than 12%, so that we maintain our

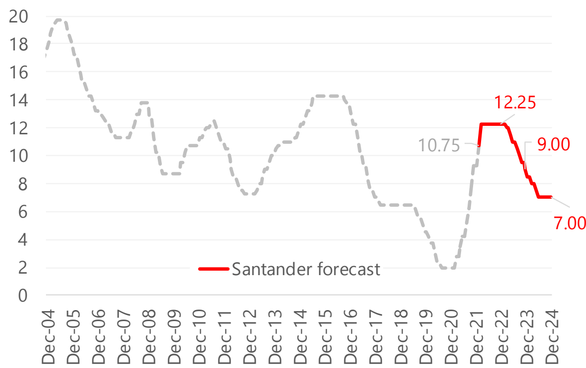
terminal Selic rate estimate of 12.25% for this cycle. We envision rate stability until 1Q23, meaning a considerably tight monetary policy stance for the remainder of 2022.

As per the next cycle (probably an easing), we see room for Selic cuts next year as long as economic policy uncertainties decline in time, following a clearer message of a renewed commitment to the fiscal consolidation process from 2023 onwards. We project cuts to start in 1Q23, with Selic rate reaching 9% for YE2023 and converging to the structural level of 7% (in nominal terms[6]) in 2024.

Refer to a few graphs in the next page.

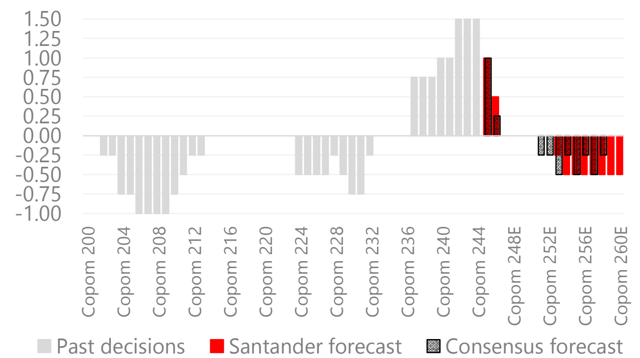
[6] Assuming a mid-point target for inflation of 3% for the long run (i.e., 2025 and beyond).

Figure 1. The Path for the Selic Policy Rate (monthly average, % p.a.)



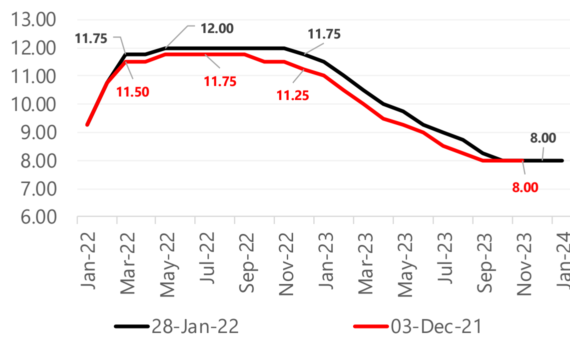
Sources: Brazilian Central Bank, Bloomberg, Santander.

Figure 2. Selic Rate Moves in COPOM Meetings: History and Forecast (in percentage points)



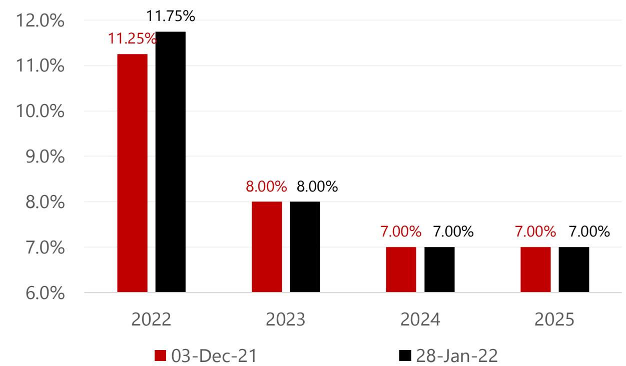
Sources: Brazilian Central Bank, Bloomberg, Santander.

Figure 3. Median Monthly Selic Forecasts (Consensus)



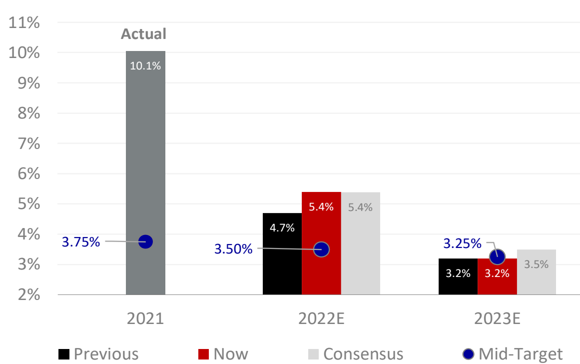
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

Figure 4. Median Annual Selic Forecasts (Consensus)



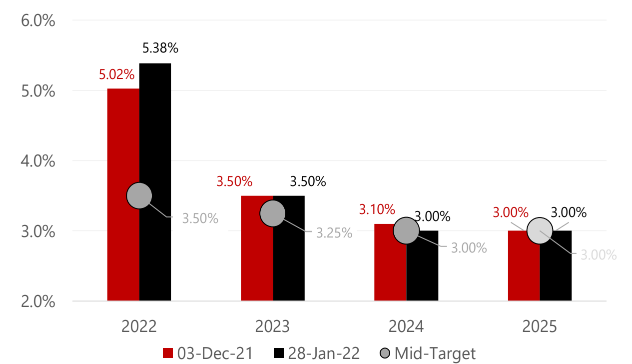
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

Figure 5. BCB's Inflation Simulations (% annual)



Sources: Brazilian Central Bank, Santander.
Note: IPCA simulations assume Selic rate from the Focus survey and USD/BRL starting at 5.45 and evolving according to purchase power parity.

Figure 6. Median Annual IPCA Forecasts (Consensus)



Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

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