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MONETARY POLICY – COPOM DECISON

The Last Chapter(s)

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- As widely expected by market participants in general, the Copom hiked the Selic policy rate by 50 bps, taking it to 13.75%, the highest level since 2017.
- In the statement, the authority signals that it "will evaluate the need for a residual adjustment, of lower magnitude, in its next meeting", leaving open the possibility either to pause the cycle or to implement another hike of 25 bps (to 14.00%) in the September 20-21 policy meeting. The Brazil Central Bank (BCB) mentions that "future policy steps could be adjusted to ensure the convergence of inflation towards its target", but stresses on the global and local uncertainties, the "advanced stage of the current monetary policy cycle" and the lagged expected reaction of the economy as reasons to take "additional caution in its actions". In other words, despite (what we saw as) a recent deterioration in the inflation outlook, the BCB seems to believe the dose of total tightening that was already in the plan at the June meeting is likely enough for the authority to achieve its objectives (i.e., of inflation convergence). As an upshot, the BCB is paving the way for a pause.
- In our view, the key element for the BCB to proceed with its plan to soon end the hiking cycle was a mild twist in its policy horizon. In the June policy communications, the BCB referred to its strategy of bringing the IPCA 2023 projection around the target (or below 4%, as indicated in the press conference of the 2Q22 inflation report). At the August meeting, the BCB "decided at this moment to emphasize the projections for 12-month inflation in the first quarter of 2024, which reflects the relevant horizon, smooths out the primary effects from tax changes, but incorporates their second-round effects on the relevant inflation projections for monetary policy decisions".
- The numbers explain the BCB's rationale. In the reference scenario, the BCB now sees the 2022 IPCA at 6.8% (previously: 8.8%), with the decline in the official forecast mainly owing to the recently approved tax reductions on energy prices. The inflation estimates for calendar-year 2023 — which was previously seen as the main policy horizon — has increased to 4.6% (previously: 4.0%; mid-target: 3.25%; upper target: 4.75%). The hefty forecast change for 2023 likely follows the anticipated effects of a likely (partial) reversal of fuel tax policies next year, as well as the hefty increase (63 bps) in inflation expectations for that horizon since the last policy meeting. The number for the "junior" horizon of 2024 was unchanged, at 2.7% (target: 3.00%).
- In an unusual publication of numbers in a Copom statement, the Copom revealed that for 1Q24 (i.e., "the six-quarter-ahead horizon") — which the BCB believes "mitigates the calendar-year impact but incorporates the second-round effects of the tax measures that occur in 2022 and the first quarter of 2023"— the YoY IPCA projection stands at 3.5%. That number is probably seen as close enough to the center target for the policy horizons (3.25% for 2023, 3.00% for 2024), as the Copom sought to soften a bit the calendar-year restrictions in its mandate. Just for the sake of comparison, in the 2Q22 inflation report (published late in June), the forecast for that horizon of 1Q24 stood at 3.6%.

- The reference scenario takes as a given a Selic rate path as per the last Focus report (July 29), with interest rate ending the (tightening cycle and this) year at 13.75%, and subsequently falling to 11.00% for YE2023 and 8.00% for YE2024. In the June Copom, the BCB assumed interest rate at 13.25% for YE2022, and then falling to 10.00% for YE2023 and 7.50% for YE2024 (as per the Focus report of June 10, 2022).
- In the assessment of the balance of risks, the BCB basically kept the same elements in either direction, apparently hinting on the maintenance of a lack of bias in general. This contradicts our expectation that the recent bout of fiscal stimulus would lead to an upward tilt in the balance of risks. The BCB argues that while on the one hand "the possibility that fiscal policies that support aggregate demand become permanent heightens the upside risks of the inflationary scenario", on other hand "the rising risk of a greater global deceleration increases the downside risks to inflation".
- In the scenario assessment, the BCB's current view on the domestic economy is sanguine, which contrasts with a perception of future downside risks owing to a drag from external demand. According to the authority "the set of indicators released since the previous Copom meeting continues to suggest that the economy grew throughout the second quarter, with the labor market recovery stronger than expected by the Committee." Elsewhere, the BCB continues to recognize the high level of underlying inflation, which keeps running above the target. The BCB also continues to see adverse and volatile global conditions, as the "process of normalization of monetary policy in advanced economies has accelerated, affecting the prospective scenario and increasing the volatility of assets".
- All in all, the BCB has apparently decided not to react as intensely as we had anticipated to (what we saw as) additional inflationary risks, given the new round of fiscal stimulus, the signs of a likely overheating job market, and increased inflation expectations. This may reflect the BCB's belief that what turned out to be one of the most intense and swift tightening cycles in recent decades could suggest that a sufficient dose of medicine has been administered, with no need to prescribe a stronger dosage at this stage. Amid what the BCB recognizes as "higher than usual" uncertainties, the difference in scenarios and forecasts seem quite normal at this stage. Thus, the BCB looks confident to proceed with its plan to end the cycle soon, so as to observe the effects of past tightening on the economy. In our view, that is part of a smoothing interest-rate strategy amid a confluence of shocks and facing tremendous difficulties in promote a very fast inflation convergence.
- As far as our 2022 Selic forecast goes, we had been expecting another hike of 50 bps in September, which is out of the cards now. While the BCB has not necessarily shut door on a final move of 25 bps for the next Copom, this is highly data-dependent, especially conditional on the signs of economic activity (any cooling at all? what sigs of reaction from the stimulus?) and, of course, the evolution of inflation expectations. To keep coherence with our own scenario, we now pencil in another 25-bp move in September, reducing out terminal Selic expectation to 14.00% (from 14.25% previously). But the recent signs of a tentative accommodation in inflation expectations, likely reflecting ups and downs in short-term CPI numbers (temporarily under the influence of tax cuts in volatile prices) are possible leading indicators of a pause likely to happen in next month's policy meeting.
- For the medium run, we believe the story could be a bit different. Conditional on the speed of (what looks poised to be a quite difficult) disinflation process, the IPCA expectations for 2024 could be well affected if the economy takes longer to soften and/or if cyclical prices (such as the slow-moving core services) show greater persistence that thought. Thus, the risk here is that the Selic rate may remain at contractionary levels for longer, so that we remain comfortable with our call for a Selic

rate at 12.00% for the end of 2023 (meaning a later exiting of such extraordinary monetary tightening).

Note 1: In the reference scenario, the BCB assumes FX rate departing from USD/BRL 5.30 and moving with PPP (purchasing power parity) afterwards and oil price following the futures curve for the next six months (and stable in real terms afterwards). In the June Copom the BCB took as assumptions the FX rate starting at USD/BRL 4.90 and oil price at USD 110 bbl for YE2022.

Note 2: Refer to the links for the Copom statement in English (https://www.bcb.gov.br/en/monetarypolicy/copomstatements) and Portuguese (https://www.bcb.gov.br/controleinflacao/comunicadoscopom).

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