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MONETARY POLICY DECISION

SERENELY WAITING AND SEEING FISCAL EVENTS

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- In its 251st Copom meeting, the Brazilian Central Bank (BCB) maintained the Selic policy rate at 13.75%, as widely expected.
- In terms of policy signals, virtually no changes seen: the authority continues to pledge to "remain vigilant" and to assess "if the strategy of maintaining the Selic rate for a sufficiently long period will be enough to ensure the convergence of inflation". The BCB still claims that "future monetary policy steps can be adjusted" and that it "will not hesitate to resume the tightening cycle if the disinflationary process does not proceed as expected".
- The BCB has chosen to take a mild, cautious approach on the fiscal risks for now. The authority stated that it will "closely monitor future developments in fiscal policy", particularly focusing on "its effects on asset prices and inflation expectations, with potential impacts on the dynamics of future inflation." No hikes in the pipeline for now, amid limited visibility of the scenario.
- The BCB made slight changes in its inflation forecasts. It projects IPCA inflation at 3.3% for 2Q24 (the key horizon now), up from 3.2% in the October Copom. The Copom also estimates IPCA at 5.0% for 2023, +0.2 pp from the previous publication. For 2024, the BCB slightly revised higher its forecast again to 3.0% (previously: 2.9%; mid-target: 3.00%). We continue to see the authority projecting inflation for free-market items much below the consensus for 2023 and 2024.
- In the scenario assessment, the BCB downgraded a bit the tone on economic activity, kept the hawkish wording on inflation, and remains alert about the global risks and developments.
- Next week's communications (Tuesday's Copom minutes and Thursday's inflation report) will likely shed further light on the BCB's scenario assessment, perceived risks, and policy strategy. Judging from the tone of the statement, we believe the BCB is waiting for the upcoming fiscal decisions to either ratify or change its strategy of holding interest rates steady for long. Uncertainty remains very high at this juncture, in our view.
- Despite the stronger cyclical position of the Brazilian economy and introduction of permanent fiscal stimulus, we still believe that a change in the flight plan (rate stability for an extended period) would require scenarios and hypotheses much different from the current ones held by the BCB.
- We continue to pencil in rate cuts only in 2H23, taking the Selic down to 12% for YE2023 and 9% for YE2024. Given the tone of current fiscal discussions, however, we see risks for the Selic path potentially skewed to the upside.

POLICY DECISION AND FLIGHT PLAN

In its 251st monetary policy meeting, the Copom[1] kept the Selic rate at 13.75%[2]. The decision was in line with analysts' forecasts[3] and the yield curve, as the latter priced in roughly a 90% probability for this outcome.

In the statement, no changes made on the policy strategy and signaling. The authority continues to pledge to "remain vigilant" and assess "if the strategy of maintaining the Selic rate for a sufficiently long period will be enough to ensure the convergence of inflation." The BCB still claims that "future monetary policy steps can be adjusted" and that it "will not hesitate to resume the tightening cycle if the disinflationary process does not proceed as expected".

The BCB has chosen to take a mild, cautious approach on the fiscal risks for now, given the increased perception of fiscal risks amid ongoing discussions related to the fiscal waiver for 2023 and beyond, as well as its possible links with a new framework to be debated and implemented next year. The authority stated that it will "closely monitor future developments in fiscal policy", particularly focusing on "its effects on asset prices and inflation expectations, with potential impacts on the dynamics of future inflation." No hikes in the pipeline for now, albeit this could be a possibility conditional on the evolution of the budgetary outlook.

The BCB has basically kept unchanged its assessment and scenario, with very slight changes in its inflation forecasts. The authority estimates that, with interest rates kept at this level for a while, and then falling gradually in coming years (accordingly with the path expected by economists[4], with gradual cuts starting in August 2023), inflation is poised to converge towards the mid-target for 2Q24. The latter is the six-quarter-ahead horizon, which the BCB sees as the relevant one, which "mitigates the primary effects from the tax changes but incorporates their second-round effects." The BCB projects IPCA inflation at 3.3% for that horizon in the reference scenario[5,6] (up from 3.2% in the October Copom). As per the standard forecasting windows, the BCB sees 2022 IPCA stable at 6.0% (previous estimate: 5.8%; mid-target: 3.50%; upper target: 5.00%) and estimates IPCA at 5.0% for 2023, +0.2 pp from the previous publication (mid-target: 3.25%; upper target: 4.75%). For 2024, the BCB slightly revised higher its forecast again to 3.0% (previously: 2.9%; mid-target: 3.00%). If the slight increase in BCB's inflation forecasts has had upward contributions from a narrower output gap – following the recent upward revisions in the GDP series, as seen in the 3Q22 report – we will only know next week, with the release of the 4Q22 inflation report.

The BCB's IPCA estimates assume an FX rate starting at USD/BRL 5.25 and evolving with the purchasing power parity (PPP), as well as a Selic path (as per the Focus report among economists for the end of last week) with interest rate on-hold at 13.75% until August 2023, then falling to 11.75% for YE2023 and 8.50% for YE2024.

While the BCB's headline IPCA estimate is more materially different from consensus for 2024 (market: 3.5%; BCB: 3.0%), there is still a significant gap between estimates for free market-price inflation for both 2023 and 2024. Implicitly, the numbers published by the BCB today imply an inflation for competitive (or non-regulated) prices of 9.6% for 2022, 3.5% for 2023, and 2.6% for 2024. As per the last Focus survey (dating

[1] The Copom is the monetary policy committee of the Brazilian Central Bank (BCB).
[2] Refer to the statement of Copom #251 in English (https://www.bcb.gov.br/en/monetarypolicy/Copomstatements) and Portuguese (https://www.bcb.gov.br/controleinflacao/comunicadoscopom).
[3] **Santander Brazil Monetary Policy: "*Copom Preview: Holding Interest Rate Steady With An Eye On Fiscal Decisions*"** – December 1, 2022 – Available on: https://bit.ly/Std-COPOM-p-dec22
[4] Refer to the last BCB's Focus survey among professional forecasters, as of December 2, 2022 (https://www.bcb.gov.br/en/publications/focusmarketreadout)
[5] The reference scenario takes as a given a Selic path as per the last Focus report (December 2, 2022), with interest rate ending 2022 at 13.75%, subsequently falling to 11.75% for YE2023 and 8.50% for YE2024. The scenario also takes FX rate departing from USD/BRL 5.25 and moving with PPP (Purchasing Power Parity) afterwards, as well as oil price following the futures curve for the next six months (and stable in real terms in USD afterwards). The BCB also assumes a "Green" electricity tariff flag for the end of 2022 and a "Yellow" flag for the end of 2023 and 2024. The authority projects the inflation for regulated prices at -3.6% for 2022 (consensus: -3.6%), 9.1% for 2023 (consensus: 6.1%) and 4.2% for 2024 (consensus: 4.0%).
[6] Refer to the last BCB's Focus survey among professional forecasters, as of December 2, 2022 (https://www.bcb.gov.br/en/publications/focusmarketreadout)

from December 2, 2022), consensus has penciled in free-market price inflation of 9.5% for 2022, 4.8% for 2023, and 3.5% for 2024.

BALANCE OF RISKS, SCENARIO ASSESSMENT

In the assessment of the balance of risks, a key area for a potentially more thorough discussion of fiscal risks, there was almost no change from the last statement, with the BCB maintaining a lack of bias and citing elements in either direction. On the upside, the BCB continues to note a (i) "greater persistence of global inflationary pressures"; (ii) the "HEIGHTENED[7] uncertainty about the country's future fiscal framework and additional fiscal stimuli"; and (iii) and "an output gap tighter than the currently adopted by the committee in its reference scenario, especially in the labor market". On the downside, the Copom refers to (i) lower commodity prices in BRL; (ii) a disappointment with global economic activity as downside risks; and (iii) "the continuity of tax cuts assumed to be reversed in 2023."

In the scenario assessment, the BCB downgraded a bit the tone on economic activity, kept the tough wording on inflation, and remains alert about the global developments and risks. Again, the BCB sounds less sanguine on economic activity, citing a more moderate GDP growth in 3Q22 and noting that the "recent set of indicators is in line with the scenario of deceleration expected by Copom". On inflation, a similar assessment as in October: despite the recent IPCA decline – which the BCB sees associated with volatile items and tax cuts – headline CPI remains high. And "various measures of underlying inflation are above the range compatible with meeting the inflation target", says the authority. The BCB also remains worried about global macro developments, citing a picture of "below-potential global growth", "high volatility of financial assets", in an "inflationary environment". According to the BCB, the tightening in global financial conditions and the market's sensitivity to changes in fiscal fundamentals still "require more caution" from emerging economies.

WHAT TO EXPECT AHEAD?

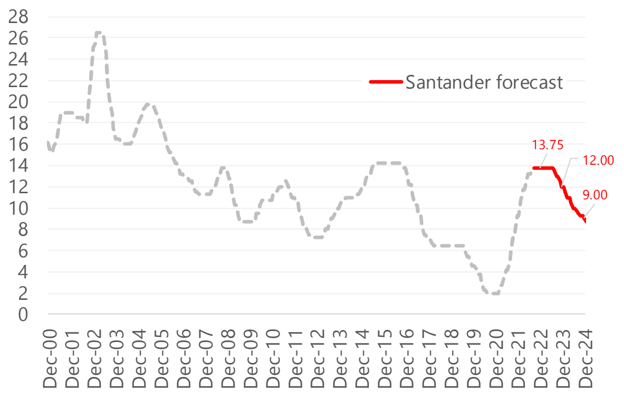
Next week's communications by the Copom (Tuesday's Copom minutes and Thursday's inflation report) will likely shed further light on the BCB's scenario assessment, perceived risks, and policy strategy. Judging from the tone of the statement, we believe the BCB is waiting for the upcoming fiscal decisions to either ratify or change its strategy of holding interest rate steady for long. Uncertainty remains very high at this juncture, in our view.

Despite the solid cyclical position of the Brazilian economy and the introduction of permanent fiscal stimulus, we still believe that a change in the flight plan (of rate stability for an extended period) would require scenarios and hypotheses much different from the current ones held by the BCB. We continue to pencil in rate cuts only in 2H23, taking the Selic down to 12% for YE2023 and 9% for YE2024. Given the tone of current fiscal discussions, however, we see risks for the Selic path potentially skewed to the upside.

Refer to graphs on the next page.

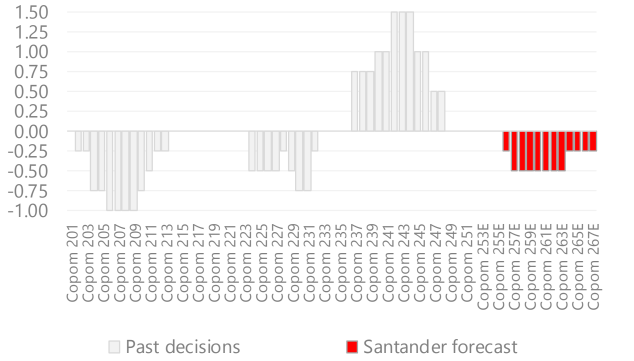
[7] The mention of "**heightened** uncertainty" [about the country's future fiscal framework], is the only addition to the statement in this section, which means the BCB is upping just a bit the tone in the balance of risks.

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



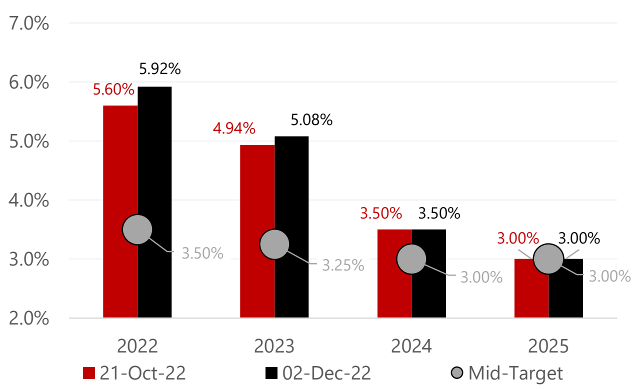
Sources: Brazilian Central Bank, Bloomberg, Santander.

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



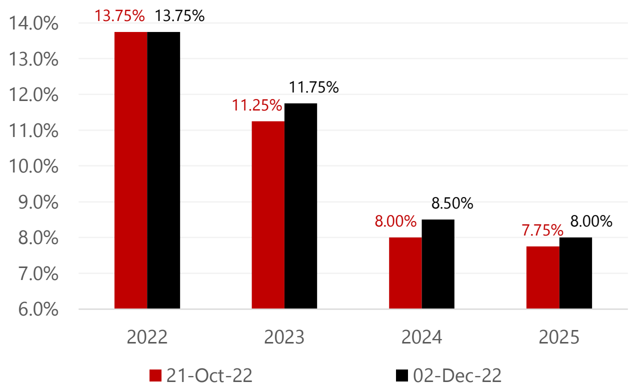
Sources: Brazilian Central Bank, Bloomberg, Santander.

Figure 3. Median Annual IPCA Forecasts (Consensus)



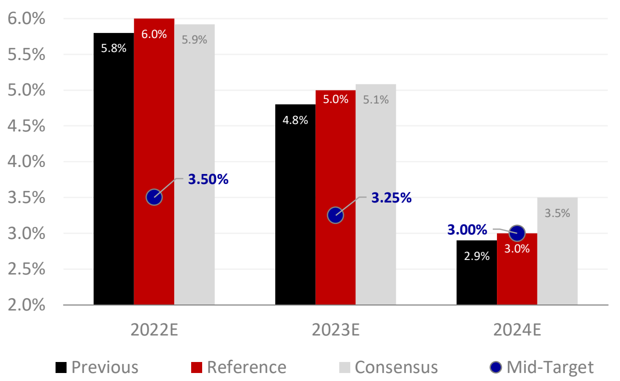
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

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 Estimates (% Annual IPCA)



Sources: Brazilian Central Bank, Santander.
Note: Assuming FX rate departing from USD/BRL 5.25, and then moving along with the PPP (purchasing power parity). Also assumes oil prices following the futures market curve for six months and then increasing 2% per year afterwards. The BCB uses the consensus forecasts (as per the Focus reports) for the Selic policy rate as an assumption for interest rate.

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