BRAZIL MACRO

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MONETARY POLICY – COPOM MEETING

KEEPING OPTIONS OPEN, FOR NOW

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- As widely expected, the Copom hiked the Selic policy rate by 50 bps, taking it to 13.25%, the highest level since mid-2017. While the authority has signaled another hike "of the same or lower magnitude" (read 25 or 50 bps) for the August 2-3 Copom meeting, there has been no signal about the plan afterward, which we think could reflect the increased macro uncertainty perceived by the Brazilian Central Bank (BCB).
- On the one hand, the statement carried virtually no additional emphasis that the cycle is coming to an end. Moreover, with the simulations still not assuming the effects of the recently approved tax breaks on inflation, the models show an increase of 0.6 p.p. to 4.0% for the IPCA estimate for 2023 (key policy horizon), assuming the Selic rate at 13.25% for YE2022 and 10.00% for YE2023. We calculate that these numbers would imply a necessity for additional (and almost immediate) hikes of no less than 200 bps (i.e., terminal Selic rate north of 15%) to bring the IPCA estimate down toward the mid-target (3.25%).
- On the other hand, the BCB is acknowledging the possibility of slowing the pace of tightening (to 25 bps) at the next meeting. Furthermore, the committee is now referring to a "strategy for inflation convergence to a level around its target throughout the relevant horizon [read 2023]." At the previous meeting, the Copom mentioned "convergence …to its target." Our current interpretation (subject to changes pending future BCB communications) is that this could pave the way for a possible extension of the convergence horizon, explicitly or not. This remains to be seen.
- In the statement, the Copom mentioned that "the uncertainty in its assumptions and projections is higher than usual and has increased since the previous meeting." In our view, this could be an additional reason for the committee to seek somewhat greater degree of freedom at this juncture, as the BCB duly avoided providing more signals about its policy steps after August. It makes sense to gather more information until then, in our view.
- In this context, we believe that the upcoming BCB events — such as release of the Copom minutes on Tuesday (June 21), the press conference with members of the board on Thursday (June 23), and the inflation report in the following week (June 30) — will take on added relevance, as the markets will look for more clues on whether the central bank is more willing to eventually boost the monetary policy dose in this cycle or to eventually opt for a smoothing interest rate strategy.
- Since we are more inclined to assume the latter in our scenario, we continue to forecast a terminal rate of 13.50% in the cycle (i.e., with a final move of 25 bps in August) and project the Selic rate at 10.50% for YE2023. But we do see a slight upward bias for our 2022 call and reasonable upside for our 2023 estimate. The latter is based on what we see as deteriorating conditions for the disinflation process in the coming months (and years).

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Policy Decision and Flight Plan

At its 247th monetary policy meeting, the Copom[1] once again hiked the Selic rate. This time the increase was of a magnitude of 50 bps[2], taking the policy rate to 13.25%, the highest level since mid-2017. The decision was in line with most analysts' forecasts and the likeliest scenario implicit in the yield curve. This is the tenth move in this tightening cycle — which started off in late 1Q21 with the Selic at 2.00%.

The policy message is roughly the same, as the BCB sees it as "appropriate to continue advancing in the process of monetary tightening significantly into even more restrictive territory", given "its inflation projections and the risk of a deanchoring of long-term expectations." The Copom pledged to "persist in its strategy until the disinflation process consolidates and anchors expectations around its targets." The authority also continued to signal the necessity for "caution" in its actions, given the growing uncertainty in the scenario (including for its own assumptions and forecasts) and "the advanced stage of the current monetary policy cycle," whose impacts the BCB believes are yet to be observed.

For the next policy meeting (August 2-3), the BCB signaled "a new adjustment, of the same or lower magnitude", meaning either another 50-bp hike or a 25-bp move. The committee referred to a "strategy for inflation convergence <u>to a level around its target</u> throughout the relevant horizon for monetary policy, which includes 2023." In the previous meeting, the Copom mentioned "convergence of inflation <u>to its target</u>." The Copom minutes (out on Tuesday, June 21) will probably clarify whether this subtle change has any meaning.

The possibility of further slowing the process of tightening (to a minimum speed) contrasts with a substantial deterioration in the BCB's own inflation forecast for the relevant policy horizon. The models now show that, with the FX rate starting at 4.90 (and moving along with PPP afterward), IPCA inflation would stand at: 8.8% for 2022 (previously: 7.3%; mid-target: 3.50%; upper target: 5.00%); 4.0% for 2023 (previously: 3.4%; mid-target: 3.25%; upper target: 4.75%); and 2.7% for 2024 (mid-target: 3.00%; upper target: 4.50%). These results assume[3] the Selic rate at 13.25% for YE2022, 10.00% for YE2023, and 7.50% for YE2024, as well as oil prices "ending the year [2022] at USD110/barrel, and then start increasing 2% per year in January 2023." Previously, the BCB expected oil prices at USD100/barrel for the end of this year.

The sharp increase in the official IPCA forecast for 2023 — the key policy horizon now — is largely explained by the deterioration in inflation expectations as per the BCB's Focus survey of professional forecasters. With the interruption in these weekly publications due to the strike of federal workers, the Copom statement provided an update of estimates from last week (ended June 10), showing that analysts now expect IPCA inflation at 8.5% for 2022 (previous week[4]: 8.9%; before May Copom: 7.9%), at 4.7% for 2023 (previous week: 4.4%; before May Copom: 4.1%), and at 3.25% for 2023 (previous week: N.A.; before May Copom: 3.20%).

While in their scenario, BCB officials "do not incorporate the tax measures on energy and telecom prices", market expectations already look a bit influenced by the discussions in Congress (even before approval of the tax measures, which took place earlier this week). This can be seen in last week's decline in median IPCA forecasts for 2022 (-0.4 p.p. to 8.5%) and in the increase in median IPCA estimates for 2023 (+0.3 p.p. to 4.7%). This movement is roughly in line with the BCB's views on the impact of the new tax breaks, as the authority believes that "the tax measures under the approval process imply a <u>sizable reduction in inflation in the current year</u>, although it <u>raises by a smaller magnitude inflation in the relevant horizon</u> for monetary policy."

The BCB estimates administered price inflation at 7.0% for 2022, 6.3% for 2023, and 3.3% for 2024, which means a big gap vs. our number for 2022 (Santander Brasil had 9.6% before the incorporation of the new tax breaks) and a similar number for 2023 (our team had 6.3% before the measures). With our last published inflation forecast standing at 9.5% for 2022 and 5.3% for 2023, before Congress's approval of the tax measures, one notes that the gap between our inflation numbers and the BCB's estimates is mostly led by administered prices for 2022 and by market-free prices for 2023. In our view, this could mean upside for the BCB estimates

[1] The Copom is the monetary policy committee of the Brazilian Central Bank (BCB).
[2] Refer to the statement of Copom #247 in English (https://www.bcb.gov.br/en/monetarypolicy/Copomstatements).
[3] These results also assume a "Yellow" electricity tariff flag for YE2022, YE2023 and YE2024.
[4] On June 6, 2022, the BCB published an extraordinary and partial update on some forecasts of the Focus survey, with those dating from June 3, 2022. Refer to https://www.bcb.gov.br/detalhenoticia/17680/nota.

for the relevant horizon, especially in the absence of a major factor dragging down the level of commodity prices and other costs for this period.

Based on the standard BCB model elasticities, we calculate that reducing the inflation forecast by about 0.8 p.p. in an interval of ~18 months (i.e., bringing the 2023 IPCA inflation estimate to the mid-target of 3.25%) would require additional Selic hikes of no less than 200 bps, in comparison with the simulated scenario — which assumed a terminal Selic of 13.25%. In other words, the BCB models could be suggesting the necessity of a terminal rate north of 15% to take the expected IPCA path down to the mid-target for the relevant horizon.

In our view, the numbers suggest that the BCB will soon have to make a tough decision to resolve the following dilemma: whether to extend much further the process of tightening or smooth the path of interest rates and extend the IPCA convergence horizon for 2024. Given the BCB's forward guidance implying the possibility of further slowing the pace of hikes to a minimum speed in August, we believe that it is more likely that the BCB will take the second path mentioned above. But the upcoming BCB communications could shed more light on this discussion.

Balance of Risks and Scenario Assessment

Given the ongoing fiscal policy initiatives that could contribute to further increases in inflation estimates for the main policy horizon (read 2023), the discussion about the balance of risks for inflation turned out to be more neutral than we thought. In addition to the aforementioned BCB considerations about the effects of tax breaks on the inflation path, the most important change in this part of the statement was the introduction of a new element — "fiscal policies that support aggregate demand" — to the factors generating upside risk for inflation and expectations.

Other than that, the BCB still sees risks in both directions. To the upside, the Copom mentioned "a greater persistence of global inflationary pressures" and "an increase in the risk premium due to the uncertainty about the country's future fiscal framework". To the downside, the Copom cited "a possible reversion, even if partial, of the increase in the price of international commodities measured in local currency" and "a greater deceleration of economic activity than projected". The Copom reaffirmed the message that "the uncertain and volatile current scenario requires serenity when evaluating the risks."

In the scenario assessment, the BCB continues to recognize a tough inflation environment. The Copom noted that CPI has "continued to surprise negatively, both in volatile components and items associated with core inflation". The BCB also pointed out (as in previous communications) that "various measures of underlying inflation are above the range compatible with meeting the inflation target."

On activity, the BCB upgraded the tone, mentioning that "the set of indicators released since the previous Copom meeting suggests a rate of growth above the Committee's expectations."

On the global environment, the BCB sees it deteriorating further, given downward revisions in global growth expectations as well as "strong and persistent inflationary pressures." The BCB referred to greater uncertainty and volatility for emerging economies, on the heels of tighter "financial conditions due to the repricing of monetary policy in advanced countries, as well as the rise in risk aversion."

What to Expect Ahead?

In our view, the Copom statement was much less emphatic than we expected regarding whether the tightening cycle is nearing its end. Additionally, the revised IPCA forecasts indicate the need for a good deal of further tightening to bring expected inflation down to the center target for the relevant horizon. Yet these facts contrast with the option that the BCB has left open for further slowing the process of rate hikes (maybe to a minimum pace) in August. The lack of clarity on the BCB's possible actions after the next policy meeting is natural, and in our view could reflect the high (and rising) uncertainty that the BCB currently faces.

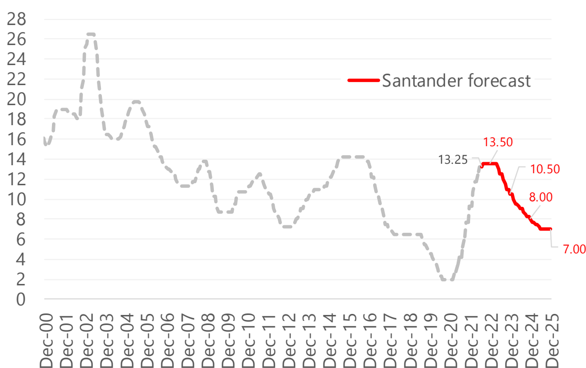
Moreover, with the persistence of adverse shocks amid extremely difficult conditions for inflation, despite what is likely to become the tightest policy stance in more than a decade, we believe the BCB may have limited

options other than smoothing out the Selic rate path and extending the IPCA convergence horizon for 2024. However, to promote this convergence (even in 2024), we believe the authority would probably have to run a still notably tight monetary policy for most of 2023, meaning that the next cycle (rate cuts) could take longer and be slower than we may think at this juncture. Importantly, the size of the challenge will also hinge on the eventual help that the BCB may or may not get from fiscal policy next year.

As per our last scenario review[5], we see the cycle ending at 13.50% in 3Q22 (following a final hike of 25 bps in August). Looking ahead, while in 1H23 monetary policy will reach its tightest stance since 2009, the persistence of inflation pressures leads us to think this will not be enough to allow inflation to reach the mid-target next year. Thus, we believe this will lead to an even more cautious approach by the BCB in the ensuing easing cycle expected to start in 2023: our YE2023 Selic forecast is 10.50%, and our YE2024 estimate is 8.00%.

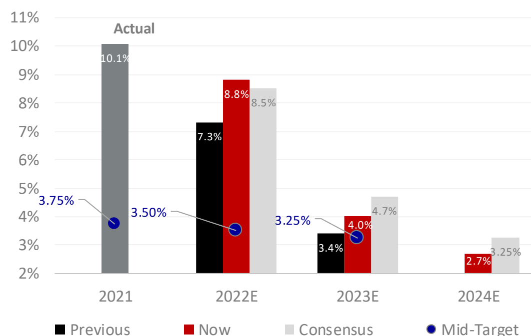
Given the (growing) challenges ahead for the disinflation process, and the uncertainties regarding local policymaking and global interest rates (for both the shorter and longer term), **we continue to see risks skewed to the upside for our interest rate scenario, which applies both to 2022 (with a greater likelihood of a 50-bp move in August) and to 2023-2024 (with a greater likelihood that rate cuts may take longer and be slower than the market expects).**

Figure 1. Selic Rate (monthly average, % p.a.)



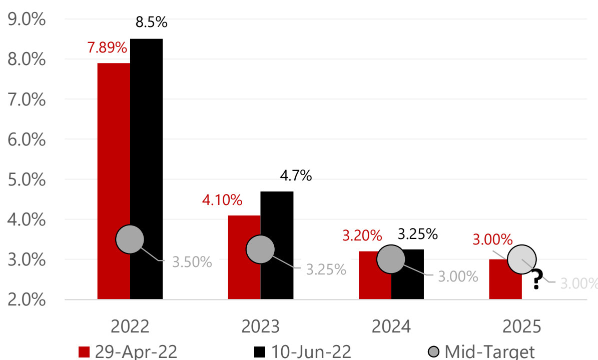
Sources: Brazilian Central Bank, Bloomberg, Santander.

Figure 2. BCB's Inflation Forecast (% annual)



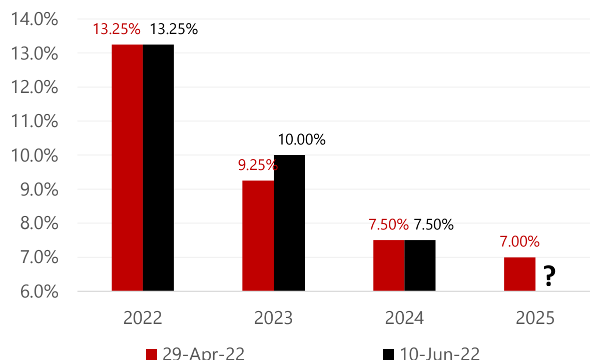
Sources: Brazilian Central Bank, Bloomberg, Santander.
Note: IPCA simulations assume Selic rate from the Focus survey and USD/BRL starting at 4.90 and evolving according to purchase power parity. Assumes oil price at USD 110 and (as per the week before the Copom meeting) and a 2% change per year afterwards.

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).

[5] **Santander Brazil – Scenario Review: *"A Bittersweet Scenario"* –** June 02, 2022- Available on: https://bit.ly/Std-scenreview-jun22.

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