Santander
Macroeconomic Research

BRAZIL MACRO

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MONETARY POLICY DECISION

STRONG WORDS TO HALT AN INTENSE CYCLE

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- The Brazilian Central Bank (BCB) maintained the Selic policy rate at 13.75%, as we (and most analysts) expected, but with a split 7-2 vote (dissenters wanted a "residual" hike of 25 bps). Overall, the Copom sought to deliver a hawkish message to halt a tightening cycle that extended for 12 meetings and brought a total interest-rate adjustment of +1,175 bps since March 2021.
- The authority pledged to "remain vigilant" and will 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 claimed 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 decision to hold interest rate at this juncture shows the BCB's confidence in its assessment, scenario and forecast. The Copom estimates that, with the current dose of monetary tightening, inflation is poised to land somewhere close to the mid-target (at 3.5%, to be precise) for 1Q24, which is still seen as the main policy horizon now.
- In the statement, the balance of risk assessment brings new elements, but apparently with no bias on a net basis. On the upside, the authority mentioned the possibility of "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 notes the possibility of "continuity of tax cuts assumed to be reversed in 2023". In the scenario assessment, the Copom remains sanguine on economic activity, looked a bit skeptical about current headline and underlying CPI trends (with no strong emphasis on the recent deflation patch), and seemed worried about the global macro conditions.
- Looking ahead, despite the message that the authority could eventually turn back to "tightening mode", we believe a change in the flight plan (of rate stability for long) would require a massive deviation from the BCB's scenario. So, we see the BCB dealing with inflation risks from now on by "autonomously" making its monetary stance more contractionary over time, with its policy steps lagging the gradual pace of decline in inflation expectations. Based on this view, our scenario anticipates that 2Q23 will see the tightest monetary policy stance in nearly 20 years.
- Regarding our scenario, we pencil in the YE2022 Selic rate at 13.75%, as we see the room for rate cuts in the short term narrowed by cyclical elements that could generate risks of resilient inflation in the medium term (namely, the absence of slack in both the economy and employment). We forecast rate cuts only in 2H23 and look for a YE2023 Selic at 12.00%.

IMPORTANT DISCLOSURES/CERTIFICATIONS ARE IN THE "IMPORTANT DISCLOSURES" SECTION OF THIS REPORT.

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POLICY DECISION AND FLIGHT PLAN

In its 249th monetary policy meeting[1], the Copom[2] maintained the Selic rate at 13.75%, an outcome that was broadly in line with most analysts (ourselves included) and the yield-curve pricing. The committee showed a split voting, as two (out of its nine members) preferred a "residual adjustment" of 25 bps (to 14.00%). Overall, the Copom sought to deliver a hawkish message to halt a tightening cycle that extended for 12 meetings and brought a total interest-rate adjustment of +1,175 bps since March 2021. This was one of the most intense hiking cycles since the start of the inflation-targeting regime in 1999. In the statement, the authority pledged to "remain vigilant" and will 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 complemented saying 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 decision to hold interest rate at this juncture reveals a good degree of BCB's confidence in its assessment, scenario and forecast. The authority estimates that, with the current dose of monetary tightening (with rate kept at this level of a while), inflation is poised to converge to a level close to the mid-target for 1Q24. The latter constitutes the "the six-quarter-ahead horizon, which reflects the relevant horizon, mitigates the primary effects from the tax changes but incorporates their second-round effects." The BCB continues to project IPCA inflation at 3.5% for that horizon in the reference scenario[3]. As per the other time windows, the BCB sees 2022 IPCA at 5.8% (previously: 6.8%; mid-target: 3.50%; upper target: 5.00%) and continues to estimate for calendar-2023 —previously seen as the main policy horizon—IPCA at 4.6% (mid-target: 3.25%; upper target: 4.75%). For 2024, the BCB slightly revised higher its forecast to 2.8% (previously: 2.7%; mid-target: 3.00%).

Interestingly, when we compare the consensus numbers with the BCB forecasts, there is still a significant gap between the estimates for free market-price inflation, especially for 2023 and 2024. Implicitly, the numbers published by the BCB today imply an inflation for competitive (or non-regulated) prices of 9.4% for 2022, 2.9% for 2023 and 2.5% for 2024. As per the last Focus survey (dating from September 16, 2022), consensus has penciled in 9.7% for 2022, 4.8% for 2023 and 3.3% for 2024.

BALANCE OF RISKS, SCENARIO ASSESSMENT

In the assessment of the balance of risks, we note a few changes but with the BCB basically maintaining a lack of bias, with elements in either direction. The BCB continues to note a (i) "greater persistence of global inflationary pressures" and (ii) the "uncertainty about the country's future fiscal framework and additional fiscal stimuli" as upside risks and (i) lower commodity prices in BRL and (ii) a disappointment with global economic activity as downside risks. New additions to the BCB's assessment: on the upside, "an output gap tighter than the currently adopted by the committee in its reference scenario, especially in the labor market"; on the downside, "the continuity of tax cuts assumed to be reversed in 2023." **The Copom minutes and the 3Q22 inflation report, with releases scheduled for next week (Tuesday, September 27, and Thursday, September 29) will likely shed more light on the BCB's assessment of economic slack and risks to its scenario.**

In the scenario assessment, the BCB maintains a sanguine view on the domestic economy, mentioning that the 2Q22 GDP "came stronger than expected, and the set of indicators released since the previous Copom meeting suggests that the economy kept growing." On inflation, the BCB continues to recognize the high level of both headline and underlying inflation (the latter still seen running above the mid-target), despite "the recent reduction in prices of more volatile items and the impacts of tax measures." In our view, the BCB sought to

[1] Refer to the statement of Copom #249 in English (https://www.bcb.gov.br/en/monetarypolicy/Copomstatements) and Portuguese (https://www.bcb.gov.br/controleinflacao/comunicadoscopom).
[2] The Copom is the monetary policy committee of the Brazilian Central Bank (BCB).
[3] The reference scenario takes as a given a Selic path as per the last Focus report (September 16, 2022), with interest rate ending 2022 at 13.75%, subsequently falling to 11.25% for YE2023 and 8.00% for YE2024. The scenario also takes FX rate departing from USD/BRL 5.20 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 -4.0% for 2022 (consensus: -4.2%), 9.3% for 2023 (consensus: 5.8%) and 3.7% for 2024 (consensus: 3.7%).

curb much of the enthusiasm about the recent one-off deflationary sequence in headline CPI. The BCB continues to see adverse and volatile global conditions, with "continued downward revisions on prospective growth in the major economies, especially in China" and as the "process of normalization of monetary policy in advanced economies continues towards contractionary rates".

WHAT TO EXPECT AHEAD?

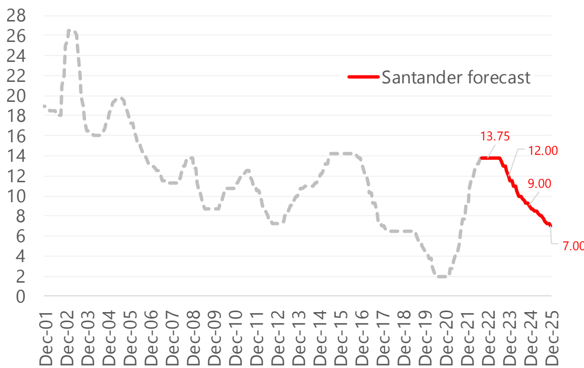
By pausing (in our view, very likely ending) the tightening cycle started in March 2021, the BCB shows confidence in its scenario of inflation convergence to around the mid-point target for the adjusted policy horizon, with annual headline inflation expected to reach 3.5% in the 1Q24, assuming the policy strategy of high rates for long. On the one hand, we believe it is natural for the BCB to use the leeway provided by the inflation-targeting framework for a little policy accommodation of the large inflation shocks of late, given the extreme difficulty of getting inflation down to the center target in 2023. On the other hand, in our view, this expected accommodation will have to be followed by a period of higher rates for longer, as we see this as necessary to bring CPI down to the mid-point inflation target (3%) further out in the future.

In our view, despite the remarks in the communiqué that the Copom could eventually continue the hiking cycle in the foreseeable future, we believe that a change in the flight plan (of rate stability for a sufficiently long period) would require a large deviation from the BCB's scenario and forecast. In fact, we see the BCB dealing with the inflation risks in the future by autonomously making its monetary stance more contractionary over time, with its policy steps lagging a bit the gradual speed of decline in inflation expectations. In fact, our scenario anticipates that 2Q23 will see the tightest monetary policy stance in more than 20 years.

Regarding our scenario, we pencil in the YE2022 Selic rate at 13.75%, as we see the room for rate cuts in the short term narrowed by cyclical elements that could generate risks of resilient inflation in the medium term, especially an apparently complete erosion of economic and job-market slack. We forecast stable interest rate until the end of 1H23 and look for gradual rate cuts to start in the 2H23, taking the Selic down to 12.00% by YE2023.

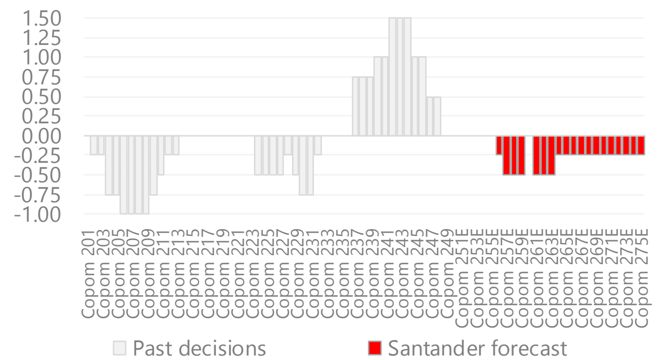
Refer to a few graphs in the next page.

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



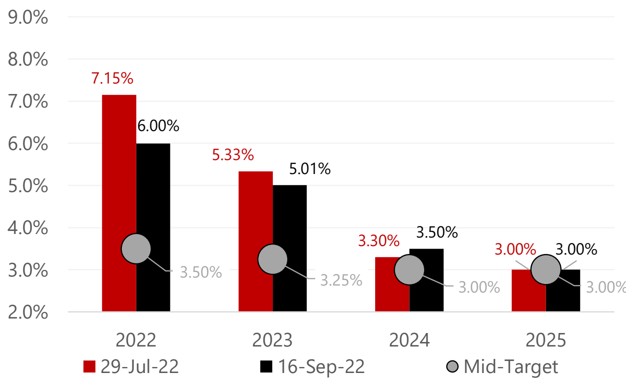
Sources: Brazilian Central Bank, Bloomberg, Santander.

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



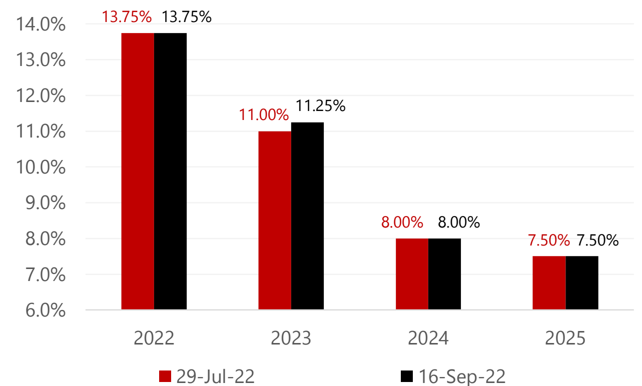
Sources: Brazilian Central Bank, Bloomberg, Santander.

Figure 3. Median Annual IPCA Forecasts (Consensus)



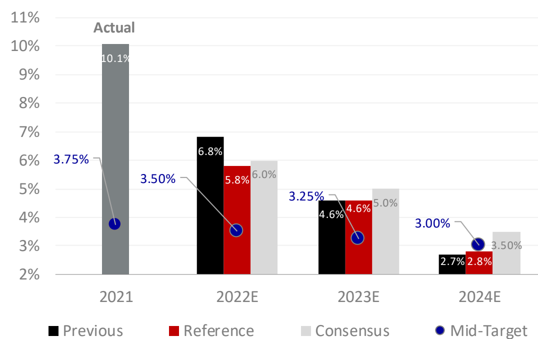
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

Figure 4. Median Annual Selic Forecasts (Consensus)



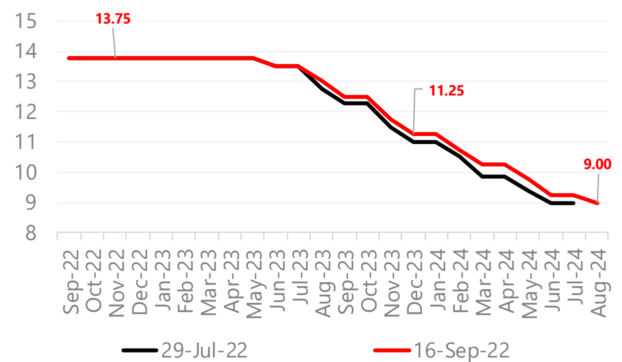
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

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



Sources: Brazilian Central Bank, Santander.
Note: IPCA simulations assume Selic rate from the Focus survey and USD/BRL starting at 5.20 and evolving according to Purchasing Power Parity (PPP). Oil prices "follow approximately the futures market curve for the following six months and then start increasing 2% per year onwards."

Figure 6. 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).

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