Santander
Macroeconomic Research

BRAZIL MACRO

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MONETARY POLICY DECISION

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THE STRATEGY REMAINS THE SAME

- In its 250th Copom policy meeting, the Brazilian Central Bank (BCB) maintained the Selic policy rate at 13.75%, as widely expected. This was a unanimous decision, contrasting with a split 7-2 vote (when two dissenters wanted a "residual" hike of 25 bps) in the September meeting.
- In terms of policy signals, there were no changes whatsoever: 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".
- Despite the caveats, the BCB seems confident in its assessment and forecasts for now. The Copom estimates that with the consensus path for the Selic rate (i.e., cuts starting in June 2023, reaching 11.25% for YE2023 and 8.00% for YE2024), inflation is poised to land at 3.2% for the 2Q24, which is the main policy horizon as of 4Q22 (the focus is on the six-quarter horizon).
- In the statement, the balance of risk assessment brings no new elements, and apparently continues to signal a lack of bias perceived by the BCB. In the scenario assessment, there are only a few noteworthy changes, but with no impact on the policy signaling. The Copom sounds a bit less sanguine on economic activity, noting a certain loss of steam of late, and continues to look skeptical about the ongoing decline in headline and underlying CPI. The BCB also remain worried about global macro developments, citing the tightening in global financial conditions and the market's sensitivity to changes in fiscal fundamentals as developments that need a close monitoring from emerging economies.
- The Copom minutes scheduled for next week (Tuesday, November 1) will likely shed further light on the BCB's scenario assessment – as the strategy looks quite clear so far. Judging from the tone of the statement, we believe the BCB may be trying to curb any enthusiasm about the pace of disinflation underway now. That makes perfect sense, in our view: while the numbers confirm that headline inflation and some underlying components have peaked, there is no evidence whatsoever that inflation is heading towards the mid-target for the relevant horizon. Uncertainty is very high and, at this juncture, when the cyclical position of the economy points to a possible erosion of labor and output slack, conditions seem more prone for a better pricing power by Brazilian firms. And there could still be significant costs to pass along to consumers ahead. Thus, such a conservative approach (or communication) seems warranted.
- Looking ahead, we continue to pencil in YE2022 Selic rate at 13.75%. We forecast rate cuts only in 2H23 and look for a YE2023 Selic at 12.00%.

POLICY DECISION AND FLIGHT PLAN

In its 250th monetary policy meeting, the Copom[1] kept the Selic rate at 13.75%[2]. The decision was in line with analysts' forecasts and the yield curve.

In the statement, no changes were made on the policy strategy and signaling. 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".

Despite the caveats, the BCB seems confident in its assessment and forecasts for now. The authority estimates that, with interest rate kept at this level for a while, and then falling gradually in coming years (accordingly with the path expected by economists[3], with rate cuts starting in June 2023), inflation is poised to converge to a level very close to the mid-target for 2Q24. Owing to the natural passing of time, the latter is now (at 4Q22) the new "six-quarter-ahead horizon[4]", which the BCB sees as the relevant policy horizon, which "mitigates the primary effects from the tax changes but incorporates their second-round effects."

The BCB projects IPCA inflation at 3.2% for the relevant horizon (2Q24) in the reference scenario[5,6,7]. As per the standard forecasting windows, the BCB still sees 2022 IPCA at 5.8% (mid-target: 3.50%; upper target: 5.00%) and estimates IPCA at 4.8% for calendar-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 to 2.9% (previously: 2.8%; mid-target: 3.00%).

While the BCB's headline IPCA estimate is only materially different from consensus for the horizon of end-2024 (market: 3.5%; BCB: 2.9%), there is a significant gap between estimates for free market-price inflation for calendar-2023. Implicitly, the numbers just published by the BCB imply an inflation for non-regulated prices of 9.4% for 2022, 3.1% for 2023 and 2.6% for 2024. As per the last Focus survey (dating from October 21, 2022), consensus has penciled in market-price inflation of 9.3% for 2022, 4.6% for 2023 and 3.3% for 2024.

BALANCE OF RISKS, SCENARIO ASSESSMENT

In the balance of risks analysis, there was also no change from the last statement, with the BCB maintaining an apparent lack of bias, with elements in either direction. On the upside, the BCB continues to note risks such as (i) "greater persistence of global inflationary pressures"; (ii) "uncertainty about the country's future fiscal framework and additional fiscal stimuli"; and (iii) "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; and (iii) "continuity of tax cuts assumed to be reversed in 2023."

In the scenario assessment, the BCB downplayed the tone a bit on economic activity, mentioning that "the set of indicators released since the previous Copom meeting suggests a more moderate growth rate." On

[1] The Copom is the monetary policy committee of the Brazilian Central Bank (BCB).
[2] Refer to the statement of Copom #250 in English (https://www.bcb.gov.br/en/monetarypolicy/Copomstatements) and Portuguese (https://www.bcb.gov.br/controleinflacao/comunicadoscopom).
[3] Refer to the last BCB's Focus survey among professional forecasters, as of October 21, 2022 (https://www.bcb.gov.br/en/publications/focusmarketreadout)
[4] With the turn of 3Q22 to 4Q22, the policy horizon – as denoted by the six-quarter horizon – has moved from 1Q24 to 2Q24.
[5] The reference scenario takes as a given a Selic path as per the last Focus report (October 21, 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 5.25 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 -3.9% for 2022 (consensus: -4.3%), 9.4% for 2023 (consensus: 5.5%) and 3.8% for 2024 (consensus: 3.6%).
[6] Refer to the last BCB's Focus survey among professional forecasters, as of October 21, 2022 (https://www.bcb.gov.br/en/publications/focusmarketreadout)
[7] Refer to the 3Q22 inflation report (https://www.bcb.gov.br/content/ri/inflationreport/202209/ri202209c2i.pdf). IPCA forecasts available on page 74.

inflation, the BCB continues to recognize the high level of both headline and underlying inflation, despite "the recent inflation reduction, driven by items which are more volatile and affected by tax measures". In our view, the BCB still seeks to curb the enthusiasm about the declining trend in headline CPI and some underlying measures. We agree with this conservative approach.

On the global economy, the BCB continues to see adverse and volatile conditions, with "downward revisions on prospective global growth and an increase in the volatility of financial assets". The BCB notes "a stronger market sensitivity to fiscal fundamentals, including in advanced economies" and believes that this, in conjunction with tighter global financial conditions, are developments that "require more attention from developing economies."

WHAT TO EXPECT AHEAD?

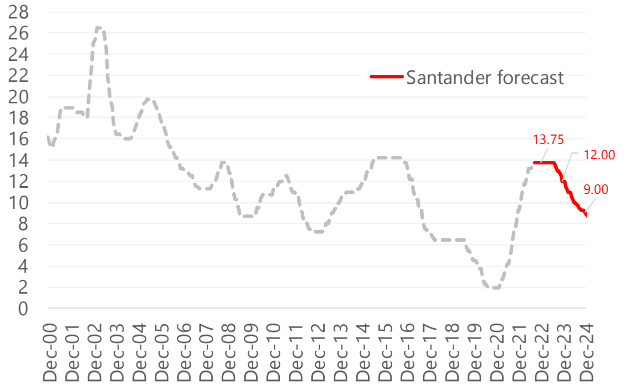
The Copom minutes scheduled for next week (Tuesday, November 1) will likely shed further light on the BCB's scenario assessment. In our view, the strategy is pretty clear so far. Judging from the tone of the statement, we believe the BCB may be trying to avoid signaling an excess optimism about the pace of disinflation now underway. That makes perfect sense, in our view: while the numbers confirm that headline inflation and some underlying components have peaked, there is no evidence whatsoever that inflation is heading for the mid-target for the relevant horizon. At this juncture, when the cyclical position of the economy points to a possible erosion of labor and output slack, conditions seem more prone for a better pricing power by Brazilian firms. And there could still be significant costs to pass along to consumers ahead (e.g., in the services sector). Thus, we believe a conservative approach and a balanced communication is warranted.

As per the BCB strategy, despite the remarks that the Copom could eventually restart 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 still 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 from 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. That seems to be a necessary condition for a center target-achievement in the medium run.

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. We forecast stable interest rates 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.

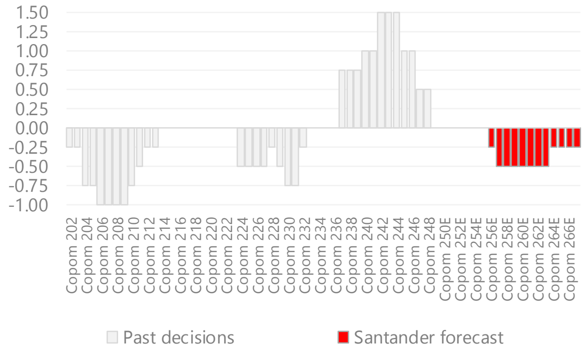
Please see graphs on the next page.

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



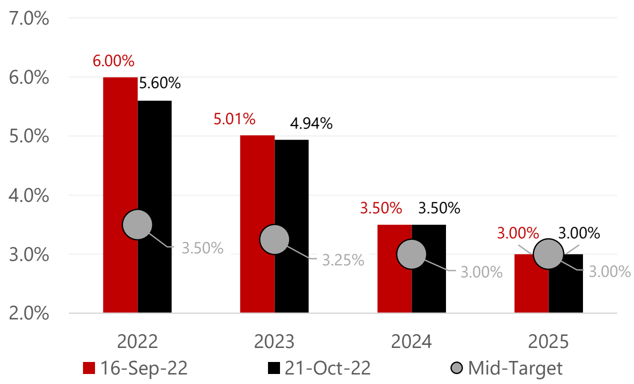
Sources: Brazilian Central Bank, Bloomberg, Santander.

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



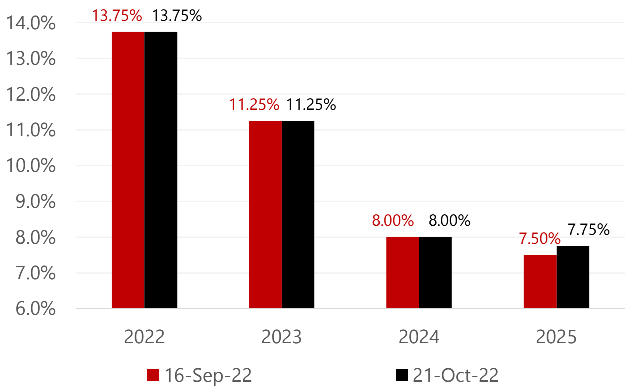
Sources: Brazilian Central Bank, Bloomberg, Santander.

Figure 3. Median Annual IPCA Forecasts (Consensus)



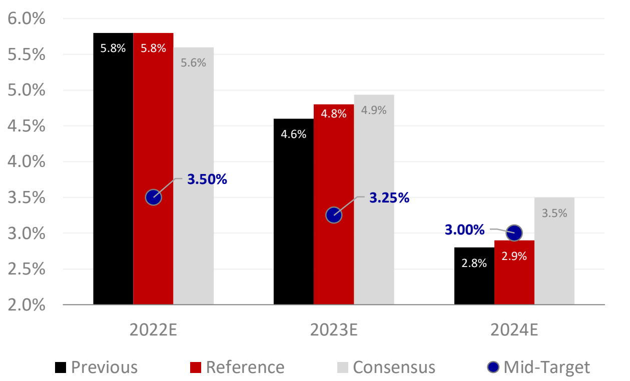
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

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 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).

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