Santander
Macroeconomic Research

BRAZIL MACRO

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MONETARY POLICY

CMN LEAVES CPI TARGET UNCHANGED; INFLATION REPORT REVISITS NEUTRAL RATE

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- The CMN (Monetary Council) made the widely awaited decision to keep the mid-point inflation target unchanged at 3%, with the same tolerance band of +/-1.5 pp. Brazil will now have a rule of a continuous target overtime, probably ending an old practice of annual decisions on the subject. While this is good news for inflation and the economy, helping remove further "fat-tail" (or extreme) scenarios from expectations and asset prices, the additional downward effect on inflation expectations is hard to estimate, in our view. That could be limited by fiscal uncertainties (implementation of the new framework, actual fiscal stance). Alongside the resiliency in the job market and persistency in underlying inflation, the difficulties to re-anchor CPI expectations could be a key limiting factor for the speed and depth of the monetary easing cycle expected to start in August.

- The Brazilian Central Bank (BCB) released the 2Q23 inflation report. The authority revised its GDP forecast to 2.0% (from 1.2%). While a major surprise came from agriculture, the authority pencils in better contribution from services and domestic demand. The BCB revised a bit lower its estimate for the output gap: the authority sees the economy ~1% below its potential in 1H23. Still, the BCB scenario continues to count on a slowing growth in cyclical sectors and a widening output gap toward 1.5 pp until the end of 2023.

- On short term inflation, the BCB saw a slight downside surprise owing mainly to volatile and non-core items. For the coming months, the BCB anticipates a CPI average around 0.2% m/m (slightly above our estimate), driving annual IPCA from a low of just above 3% in June toward somewhere near 5.5% by September. This is to follow a slow decline in core services inflation, and mainly the base effects from tax breaks given late last year (despite an expected help from food and industrials). The authority estimates that while the average of main core inflation gauges will likely continue a downward path, the BCB still sees this key indicator running above the inflation target. The BCB's CPI models indicate that, in a scenario assuming rate cuts expected by analysts (starting in August, reaching 12.25% for YE20223 and 9.50% for YE2024), IPCA could be nearer the 3% mid-target next year (reaching 3.4%) but only potentially reaching it in 2025. The report confirmed our suspicion that the higher neutral interest rate neutralized part of the downward contribution from markdowns in analysts' IPCA projections.

- As per the boxes of empirical work, the BCB takes a look at local credit conditions and concludes that the slowing in cyclical component of new loans seems compatible with what would be expected, given the current stage of the economic cycle and the monetary policy stance. The central bank also visited international evidence on structural interest rate, finding no definitive effect from the pandemic. Except for government debt, there was no change in main determinants (demographics, productivity, etc.). The BCB also revisits the subject of the neutral interest rate in Brazil, using different approaches and methodologies. For 1Q23, the median estimate was 4.8%, with most of the distribution of results concentrated within 4.5—5.0%.

- In the press conference, BCB Governor Roberto Campos Neto sounded confident on the disinflation process. The authority sought to clarify an apparent change of tone in the Copom minutes vis-à-vis the statement, saying that an internal disagreement about the guidance could only be communicated in a more detailed document, such as the minutes. The decision of the majority was to leave the door open for a cut, he confirmed. On the neutral rate, the authorities tried to disassociate the upward revision from upcoming policy decisions, given the already tight stance.

PART 1: DETAILS OF THE BCB'S MACRO SCENARIO IN THE INFLATION REPORT

We highlight the takeaway points from the 2Q23 inflation report[1], released on June 29, 2023 (Thursday).

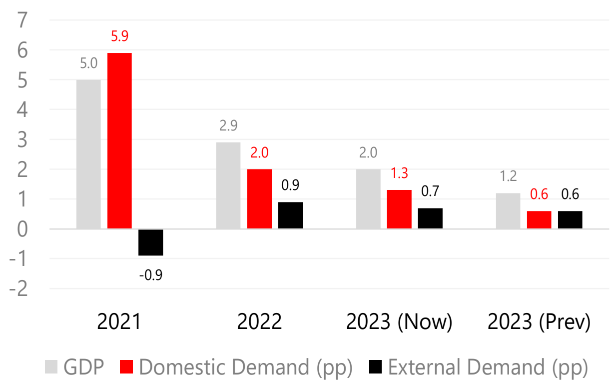
- **GDP FORECAST:** The BCB raised its 2023 GDP estimate to 2.0% (previously 1.2%). According to the BCB, there was a positive surprise in 1Q23 "mainly due to the agriculture and livestock sector". There is also a better outlook for farm output for the year. Yet most of the upward GDP revision reflects a better reading in services, accounting for half of the "delta" in the BCB's estimate (our calculation). The contribution of domestic demand was upgraded to 1.3 pp (from 0.6 pp) previously. The authority still believes in a slowing economy ahead, as a reflection of lagged effects of a tighter monetary policy. The BCB sees that "the evolution of the industrial and services sectors indicates that the economy continues to slow down" and project modest gains ahead for the cyclical components.

Figure 1. Proxy for the Copom Dataset, Part 1

	%	2021	2022	2023 (Now)	2023 (Prev)	*Δ FCST (pp)*
GDP	**100%**	**5.0**	**2.9**	**2.0**	**1.2**	***0.8***
Agriculture	4%	0.3	-1.7	10.0	7.0	*0.1*
Industry	18%	4.8	1.6	0.7	0.3	*0.1*
Services	63%	5.2	4.2	1.6	1.0	*0.4*
Net Taxes	14%	6.2	2.1	1.1	0.3	*0.1*
Consumer Spending	65%	3.7	4.3	1.6	1.5	*0.1*
Government Spending	18%	3.5	1.5	1.0	0.7	*0.1*
Investment	15%	16.5	0.9	-1.8	0.0	*-0.3*
Exports	16%	5.9	5.5	3.7	2.4	*0.2*
Imports	15%	12.0	0.8	0.0	-0.5	*0.1*
Domestic Demand (pp)	**-**	**5.9**	**2.0**	**1.3**	**0.6**	***0.7***
External Demand (pp)	**-**	**-0.9**	**0.9**	**0.7**	**0.6**	***0.1***

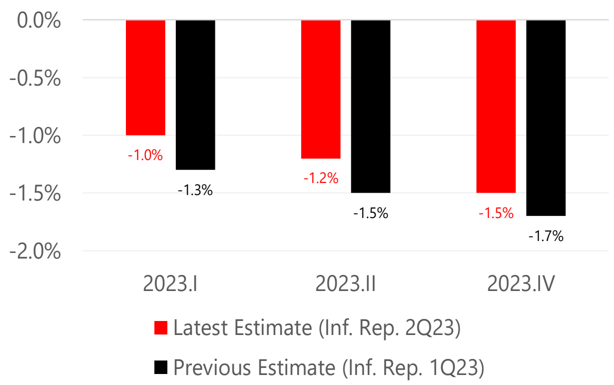
Sources: IBGE, Brazilian Central Bank, Santander.

Figure 2. BCB's GDP Expectation (and Composition)



Sources: Brazilian Central Bank, Santander.
Note: Real growth in annual percentage points. Domestic and external demand values mean contributions for the annual GDP growth. Domestic demand obtained by residual of the BCB's estimates.

Figure 3. BCB's Estimate for the Output Gap



Sources: IBGE, Santander.
Note: Negative values means economic slack, with actual GDP running below its potential.

[1] Refer to the official reports in English (https://www.bcb.gov.br/en/publications/inflationreport) and Portuguese (https://www.bcb.gov.br/publicacoes/ri).

- **OUTPUT GAP:** The BCB claims that the output gap reversed a closing trend as of 2H22, with the authority estimating that the economy was running at -1.0% and -1.2% (i.e., below its full potential) in 1Q23 and 2Q23, respectively (compared to output gap estimates of -1.3% and -1.5% in the previous inflation report). The estimate of less economic slack is due to upward revisions in short-term activity, according to the Copom. The authority continues to expect an increase in slack ahead, as a byproduct of previous Selic hikes: the authority foresees the economy running 1.5 pp below its potential as of 4Q23, which compares with an output gap estimate of -1.7 pp in the inflation report published in late March.

- **SHORT-TERM INFLATION NUMBERS AND OUTLOOK:** In the three months leading up to May, the BCB noted that IPCA inflation stood ~0.2 pp below its forecast for that period (1.8% QoQ), with year-over-year inflation ending that period at 3.9% YoY. The main contributions to the downside surprise were in food at home and in volatile (i.e., non-core) services, such as airfare tickets and communications. For the coming months, the BCB anticipates average monthly IPCA gain of 0.2% m/m for the period spanning June to September (Santander Brazil pencils in an average monthly inflation of 0.1% m/m). On one hand, the BCB's outlook considers a tame food inflation and continued disinflation in industrial goods – reflecting the decline in wholesale prices (read: commodity costs in BRL) and the effects of the tax breaks in auto sales. On other hand, the BCB assumes a full return of federal taxes on gasoline in July and counts on a slow decline in core services inflation. The authority estimates that while the average of main core inflation gauges will likely continue on a downward path, the BCB still sees this key indicator running above the inflation target. As per the annual inflation, the BCB anticipates a valley of 3.2% in June, with annual headline CPI expected to reach 5.4%, as the influence of tax exemptions given last year fade more visibly (Santander Brazil pencils in IPCA of 5.1% y/y for September).

Figure 4. Short-Term CPI Surprises in 2023 (pp)

	Total (12m)	Total (Mar-May)	Mar	Apr	May
Actual Readings	3.94	1.56	0.71	0.61	0.23
BCB Forecasts	4.17	1.79	0.87	0.63	0.28
Foreacast Error	-0.23	-0.23	-0.16	-0.02	-0.05
Mid-target	3.25	0.74	0.27	0.27	0.27

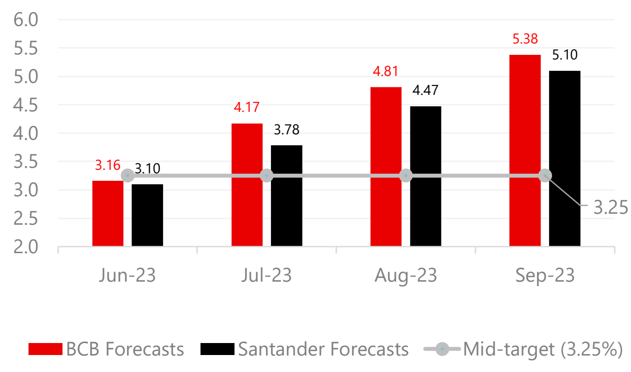
Sources: Brazilian Central Bank, Santander.

Figure 5. Short-Term CPI Forecasts in 2023 (pp)

	Jun	Jul	Aug	Sep	Total (Jun-Sep)
BCB Forecasts	-0.08	0.29	0.25	0.26	0.72
Santander FCST	-0.14	-0.02	0.30	0.31	0.45
Gap	0.06	0.31	-0.05	-0.05	0.27
Mid-target	0.27	0.27	0.27	0.27	1.07

Sources: Brazilian Central Bank, Santander.

Figure 6. Short-Term CPI Forecasts (% YoY)



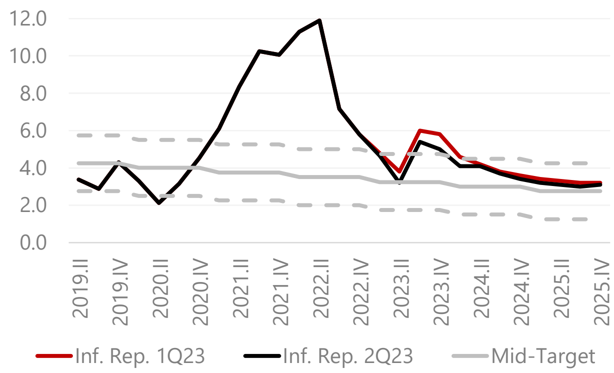
Sources: Brazilian Central Bank, Santander.

- **MEDIUM- AND LONG-TERM INFLATION FORECASTS:** As revealed in the Copom communiqué and policy minutes, in the reference scenario (assuming the Selic rate trajectory as per the BCB's Focus survey among professional forecasters), the monetary authority projects 2023 IPCA at 5.0% in the reference scenario[2], 0.8 pp lower than in the 1Q23 report. The Copom estimates IPCA at 3.4% for 2024 (vs. 3.6% in the 1Q23 inflation report) and 3.1% for 2025 (vs. 3.2% in the 1Q23 inflation report). The numbers mean that, in a scenario

[2] The reference scenario assumes the Selic trajectory according to the Focus survey (as of June 16, with rate cuts starting in August and reaching 12.25% for YE2023 and 9.50% for YE2024). The simulation assumes USD/BRL at 4.85 and then evolving with the purchasing power parity (PPP) as well as oil price following the futures curve for the next six months and then stable in real terms in USD (i.e., up 2% annually subsequently). The scenarios assume energy tariff flag "green" for both December 2023 and 2024. The BCB also assumes a 4.5% neutral real rate.

assuming the rate cuts expected by analysts, the BCB will be nearer the 3% mid-target next year (the current policy horizon) but only actually achieve it in 2025. The BCB highlights that the main factors pushing its inflation projections higher, as compared to the IPCA estimates presented in the 1Q23 inflation report: i) lower interest rate expectations; ii) stronger than expected economic activity; iii) a higher estimate for the neutral interest rate (to 4.5%, from 4.0%), which has even stronger effects for longer horizons. The factors pushing the IPCA projections of the BCB higher were: i) a stronger BRL; ii) lower than expected IPCA and monthly projections for the short term; iii) lower oil prices; iv) the green electricity tariff flag; v) lower inflation expectations; vi) improvement in the perception of economic uncertainty. Lastly, as per the BCB's fan chart – which estimates the probability distribution of IPCA outcomes for the years of 2023 to 2025 – the authority now estimates that the probability that inflation breaches the upper target in 2023 (i.e., close the year above 4.75%) is now 61%, as compared to 83% seen in the 1Q23 inflation report.

Figure 7. Short-Term CPI Surprises in 2023 (pp)



Sources: Brazilian Central Bank, Santander.

Figure 8. Short-Term CPI Forecasts in 2023 (pp)

	Inf. Rep. 1Q23	Inf. Rep. 2Q23	Mid-Target
2023.I	4.8	4.7	3.25
2023.II	3.8	3.2	3.25
2023.III	6.0	5.4	3.25
2023.IV	**5.8**	**5.0**	**3.25**
2024.I	4.6	4.1	3.00
2024.II	4.2	4.1	3.00
2024.III	3.8	3.7	3.00
2024.IV	3.6	**3.4**	**3.00**
2025.I	3.4	3.2	2.75
2025.II	3.3	3.1	2.75
2025.III	3.2	3.0	2.75
2025.IV	**3.2**	**3.1**	**2.75**

Sources: Brazilian Central Bank, Santander.

Figure 9-A. Composition of BCB's IPCA Forecast

	Inf. Rep. 2Q23			Inf. Rep. 1Q23		
	IPCA	Free-Market	Regulated	IPCA	Free-Market	Regulated
2022	5.8%	9.4%	-3.8%	5.8%	9.4%	-3.8%
2023E	5.0%	3.7%	9.0%	5.8%	4.3%	10.2%
2024E	3.4%	2.9%	4.6%	3.6%	3.1%	5.3%
2025E	3.1%	2.9%	3.4%	3.2%	3.1%	3.6%

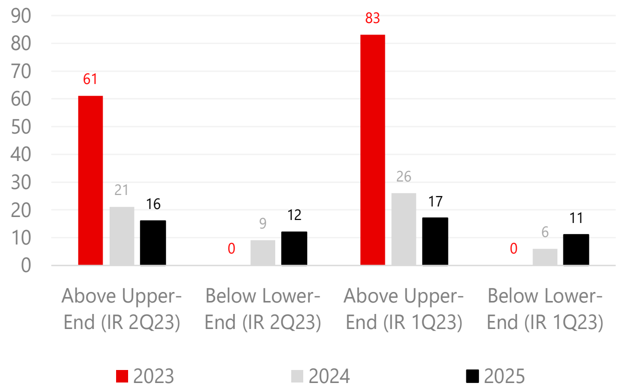
Sources: Brazilian Central Bank, Santander.

Figure 9-B. Composition of BCB's IPCA Forecast

	Inf. Rep. 2Q23			Consensus (as of June 16)		
	IPCA	Free-Market	Regulated	IPCA	Free-Market	Regulated
2022	5.8%	9.4%	-3.8%	5.8%	9.4%	-3.8%
2023E	5.0%	3.7%	9.0%	5.1%	9.1%	4.0%
2024E	3.4%	2.9%	4.6%	4.0%	4.5%	3.9%
2025E	3.1%	2.9%	3.4%	3.8%	4.0%	3.7%

Sources: Brazilian Central Bank, Santander.

Figure 10. BCB's Fan Chart's Probabilities for Headline CPI



Sources: Brazilian Central Bank, Santander.

Note: Probabilities estimated by the BCB that IPCA falls below or above the targeted zone (i.e., mid-target +/- the tolerance band).

- **METHODOLOGICAL BOXES:** There are a few noteworthy “mini” discussion papers – the so-called boxes – with works from the BCB staff to subsidize the monetary policy decisions. In one of the those, the BCB analyzes the behavior of bank lending based on the cycles of monetary policy and economic activity, “having as explanatory variables the output gap and the ex-ante real interest rate gap.” The BCB concludes that the softening in the cyclical component of new loans in recent quarters seems compatible with what would be expected, given the current stage of the economic cycle and the monetary policy stance. In another box, the BCB looks at the international evidence on the evolution of structural interest rates, and finds no definitive effect of the the pandemic on the level of natural interest rates, after decades in a falling trend. Except for government debt, there was no change in the main determinants (such as demographic changes, deceleration in the growth of productivity, rising income inequality), signaling that there may be a return to pre-pandemic levels at some point in the future.

- **NEUTRAL RATES IN BRAZIL:** The BCB also revisits the subject of the neutral interest rate in Brazil, using different approaches and methodologies to get a robust conclusion on the evolution of this unobservable (but nonetheless key) variable. While mentioning the uncertainty around the estimates, the monetary authority estimates there was a downward trend in the neutral rate, which reaches a trough early in 2020 and then starts an upward trajectory. In 1Q23, the median neutral real interest rate obtained with the different methodologies was at 4.8%, with most of the distribution of the results concentrated within a range between 4.5% and 5.0%. This study backs the BCB’s decision to assume a slightly higher estimate for the structural real interest rate (now 4.5%; previously 4.0%) in its inflation models.

- **POLICY MESSAGES:** As usual, the 2Q23 inflation report repeats the policy messages already put on display in the Copom communique and the minutes. The BCB reaffirms that the current situation is characterized by a "a stage in which the disinflationary process tends to be slower and in an environment of de-anchored inflation expectations continues to require caution and parsimony." The Copom also signaled that the future steps "will depend on the inflationary dynamics, especially the components that are more sensitive to monetary policy and economic activity, on inflation expectations, in particular the longer-term ones". The authority also emphasizes the role of its own inflation projections, the output gap, and the balance of risks in this process. In the press conference, BCB Governor Roberto Campos Neto tried to suggest that the efforts made by the BCB so far – running a considerably tight monetary policy stance – are starting to pay off. The authority sounded encouraged and more confident about the signs regarding the disinflation process, even as GDP expectations improve for 2023. In the Q&A, the authority sought to clarify an apparent change of tone in the Copom minutes, compared to the statement: According to Mr. Campos Neto, the shorter space for messages in the communiqué does not allow the BCB to reveal an internal dissent about the forward guidance within the committee. So the idea is to reflect only the consensus (not the dissent) in the communiqué. The disagreement about the message, with a majority already planning to start cutting rate in August, could only be disclosed in the minutes, according to the authority. The BCB sought to indicate that the division was only on what to communicate, and not on what to do. And the decision of the majority was to leave door open for a cut (in opposition to the other group that wanted to keep door closed). That message was clear in the statement as well, according to the BCB . On the neutral rate, the authorities tried to disassociate the upward revision in the neutral rate estimate with upcoming policy decisions, as the BCB believes the monetary policy stance is already very tight.

PART 2: CMN DECIDES ON THE INFLATION TARGET

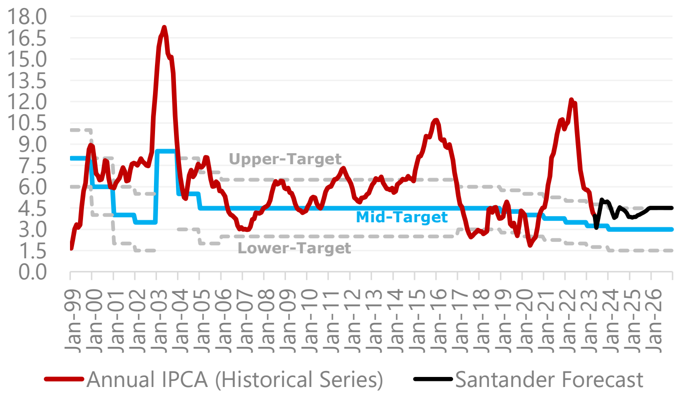
A widely awaited event for financial markets finally took place. In a press conference following the meeting of the Monetary Council[3] (CMN in Portuguese) – Finance Minister Fernando Haddad announced the adoption of a continuous inflation target of 3% to start in 2025. The tolerance band was left unchanged at +/- 1.5%. This rule holds for 2026, naturally, for which the target was set at 3% (with the same tolerance interval). There was no change from the years 2024 and 2025. Some details will still come later, such as the accountability regarding the convergence horizon – which the Finance Ministry says will be defined by the BCB. But “in practice,” he mentioned the interval of two years. The BCB may have to write annual letters to explain their actions and

[3] The council is formed by the Finance Minister, the Planning and Budget Minister (Simone Tebet) and the BCB Governor. On the inflation target, the group meets to decide on the inflation target for three years ahead (this time around the 2026 target would be debated), usually in June. More details on the CMN can be found here (https://www.gov.br/fazenda/pt-br/assuntos/cmn and https://www.bcb.gov.br/acessoinformacao/cmn).

results. The CMN decision was unanimous amongst the three members of the council. Mr. Haddad also stated that the target could theoretically undergo revisions but this is "much more rare". In practice, the old habit of annual meetings and decisions on the inflation target tends to end.

After a true zigzag in market expectations regarding the inflation target[4], we welcome the decision to leave the mid-point inflation target at 3% and with no widening in the tolerance band (which could be dangerous for the control of inflation expectations). We see no gains (in terms of potential growth) in an eventual increase of the target – in fact, it could even work perversely in the opposite way, in certain situations. The market's perception of uncertainty regarding this topic was one of the elements that drove inflation expectations higher this year. Hard to tell how much of these expectations have actually been unwound, given the decline in inflation expectations in recent weeks. While in coming weeks it is likely that the Focus survey will show a little mark down in IPCA forecasts, it is also hard to tell what the extent of these revisions will be. Especially bearing in mind that fiscal policy expectations – which also account for a good deal of the rise in inflation expectations this year – have not changed substantially. In fact, given the fiscal uncertainties still in place (regarding the implementation of the new budgetary framework, the actual swings in the fiscal policy stance), we see limited probability that expectations for the medium and long term will settle around 3% (from 3.5-4.0% nowadays). And this weak re-anchoring could be a key limiting factor for the speed and depth of the monetary easing cycle expected to start in August. This all remains to be seen.

Figure 11. Inflation Targets and Actual, Projected CPI in Brazil (% annual)



Sources: IBGE, Brazilian Central Bank, Santander.

OUR TAKE

All in all, the inflation report does not change our views after we revised our Selic scenario in the wake of the Copom minutes. And while the CMN's decision will help remove further "fat-tail" (or extreme) scenarios from economists' expectations and asset prices, the additional downward effect on inflation expectations for the key policy horizons remain uncertain, in our view.

Our impression remains that only unexpected developments could prevent a rate cut at the next Copom meeting. We look for a 25-bps cut at the August meeting, followed by a similar move in September, with an expected acceleration to 50 bps at the last two meetings of the year. Our Selic rate forecast is 12.25% for YE2023.

Looking further ahead, we still see relevant external and domestic uncertainties for the conduct of monetary policy, in a context of recurring fiscal impulses, a heated labor market and services sector, and difficulties in the process of re-anchoring expectations. These factors feed risks of inflationary persistence ahead. Therefore, we continue to foresee a slow easing cycle ahead (on a historical perspective): our forecast for YE2024 is 10.50%, implying that Brazil may still have to deal with a double-digit interest rate until the coming year.

[4] A few months ago, many were sure about a change in the target toward 4% or so; a few weeks ago, most participants already were convicted on the target's maintenance.

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