BRAZIL MACRO
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MONETARY POLICY DECISION

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CONFIDENCE (VOTES) IN A GRADUAL EASING CYCLE

- At the 256th meeting of the Copom (monetary policy committee), the Brazil Central Bank (BCB) reduced the Selic policy rate by 0.50pp to 13.25%, kicking off a new easing cycle. The more-than-usual uncertainty around this meeting is well reflected in the close (5 to 4) vote within the committee, with the minority (composed of a more "technical" wing of the board) proposing a cut of 0.25pp.
- According to the statement, the Copom believes that "the improvement on the inflation scenario, reflecting in part the lagged effects of monetary policy, coupled with the reduction of longer-term inflation expectations, after the recent decision of the National Monetary Council on the inflation target, have given the necessary confidence to start a gradual cycle of monetary policy easing."
- Despite a bolder than expected action (vis-à-vis the consensus of economists), the Copom sought to send a message of caution for the continuation of this easing cycle. The BCB also tries to anchor expectations regarding the next policy steps, by unanimously signaling a possible "cruise-speed" pace of 0.50pp per meeting along this cycle. In our opinion, the BCB sought to offset the dovish surprise in the Copom decision (even if amid a well-divided vote) by signaling a gradualist strategy to cut interest rate ahead.
- The BCB's inflation projections show IPCA inflation at 3.4% for 2024 and 3.0% for 2025 in a scenario assuming the Selic path according to the Focus survey (12.00% for YE2023 and 9.25% for YE2024). The numbers seem to implicitly hint at the possibility that: i) the BCB may have opted for a more forceful action based more on the balance of risks than on the (inflation projections in the) baseline scenario or ii) amid a context of higher than usual inflation persistence, the BCB could be more willing to accept a slightly slower CPI convergence towards 3%.
- As for our scenario, our tendency will be to incorporate new cuts in the magnitude of 0.50pp over the coming months (and into 2024). Yet we are prone to keep our above-consensus view and double-digit Selic forecast for YE2024, as we foresee challenges on the fiscal side, alongside some inflationary persistence.

POLICY DECISION, GUIDANCE AND INFLATION FORECASTS

At the 256th meeting of the Copom[1] (monetary policy committee), the Brazil Central Bank (BCB) reduced the Selic policy rate by 0.50pp to 13.25%, kicking off a new easing cycle. This result was partially expected by analysts (who mostly anticipated a 0.25pp cut, as in our case) and by the interest rate market (which anticipated a greater probability of a 0.50pp cut).

The more-than-usual uncertainty around this meeting is well reflected in the close (5 to 4) vote[2] within the committee, with the minority (composed of a more "technical" wing of the board) proposing a cut of 0.25pp. The split vote was no surprise at all. Less because of the two new directors at this meeting, but mainly due to the divergence of opinions (regarding the signals of next steps) shown in the minutes of the last Copom meeting. Even so, in general, we perceive the BCB's choices (i.e., decision and communication) as more dovish than we (and possibly the consensus of analysts) expected.

According to the statement, the Copom believes that "the improvement on the inflation scenario, reflecting in part the lagged effects of monetary policy, coupled with the reduction of longer-term inflation expectations, after the recent decision of the National Monetary Council on the inflation target, have given the necessary confidence to start a gradual cycle of monetary policy easing." The BCB understands that the decision to reduce interest rate by 0.50pp "is consistent with the strategy for inflation convergence to a level around its target throughout the relevant horizon for monetary policy, which includes the year of 2024 and, to a lesser extent, 2025." The Copom evaluated the option of a more moderate reduction (-0.25pp), but opted for a more intense cut due to the "improvement in the inflation dynamics."

Despite a bolder than expected action (vis-à-vis the consensus of economists), the Copom sought to send a message of caution for the continuation of this easing cycle. In the statement, the monetary authority pledges commitment to "the firm objective of keeping a contractionary monetary policy to re-anchor expectations and bring inflation to the target in the relevant horizon." The BCB once again characterizes the current situation as "a stage in which the disinflationary process tends to be slower", with "partial re-anchoring of inflation expectation". The BCB believes the situation demands "serenity and moderation in the conduct of monetary policy."

Despite the dovish surprise at the beginning of the easing cycle, the BCB tries to anchor expectations regarding the next policy steps. The BCB signals that, if the scenario evolves in line with the committee's expectations, "the Committee members unanimously anticipate further reductions of the same magnitude in the next meetings". The signal then is that rate cuts of 0.50pp per meeting is appropriate cruise speed "to keep the necessary contractionary monetary policy for the disinflationary process". The Copom points out that the size of the cycle will depend on the evolution of data and the scenario, especially concerning "the components that are more sensitive to monetary policy and economic activity, on inflation expectations, in particular the longer-term ones, on its inflation projections, on the output gap, and on the balance of risks".

The BCB's inflation projections seem to implicitly hint at the possibility that: (i) the BCB may have opted for a more forceful action based more on the balance of risks than on the (inflation projections in the) baseline scenario or (ii) amid a context of higher than usual inflation persistence, the BCB could be more willing to accept a slightly slower CPI convergence towards 3%. The reference scenario[3] assumes the Selic trajectory according to the Focus survey: on July 28, it pointed to expectations of a drop in interest rates starting at -0.25pp in August, accelerating to -0.50pp from September, and reaching 12.00% at the end of 2023 and 9.25% at the end of 2024. Assuming this trajectory for the Selic, the models show the IPCA 2024 estimate stable at 3.4%, as compared to the 2Q23 inflation report (the last publication). For 2025, the BCB estimate fell to 3.0% from 3.1%. It is important to note that – according to the BCB's traditional rule of thumb for defining the relevant horizon (18 months or six quarters ahead) – the year of 2024 still has a much

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[1] The Copom is the monetary policy committee of the Brazilian Central Bank.
[2] Refer to the statement in English (https://www.bcb.gov.br/en/monetarypolicy/Copomstatements) or Portuguese (https://www.bcb.gov.br/controleinflacao/comunicadoscopom).
[3] The simulation assumes USD/BRL at 4.75 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, 2024 and 2025.

greater weight than calendar-year 2025 (with weights of 75% and 25%, respectively). Except for some detail to be disclosed later (maybe in the Copom minutes?), such as an eventual projection of IPCA convergence to the target for the twelve months ending in 1Q25, we can conclude **that the interest rate path seen by the consensus of economists does not lead to an IPCA inflation at the center target for the relevant policy horizon**, judging by the BCB's own calculations.

Still on BCB's inflation projections, it is interesting to note that most of the difference between the BCB's and the market's projections for headline IPCA 2024 (consensus: 3.9%) and IPCA 2025 (consensus: 3.5%) comes from market-free prices[4]. While (we implicitly calculate) that the BCB projects free-market IPCA prices to vary by 3.0% in 2024 and 2.8% in 2025, the consensus of analysts projects 3.7% and 3.5% for the same period. The BCB's incorporation of a higher neutral interest rate hypothesis (to 4.5%) – now closer to the market hypothesis (~5%) – has helped reduce a bit the difference in these estimates (from a gap ~1% in the last inflation report to a gap of 0.7% now). Yet there is still a clear wedge of estimates between the consensus and the BCB.

BALANCE OF RISKS, SCENARIO ASSESSMENT

The BCB's balance of risks analysis underwent major changes, even though the authority continues to identify risks in both directions, and without suggesting any explicit presence of a bias. Among the elements that feed upward inflationary risks, the BCB highlights "(i) a greater persistence of global inflationary pressures; and (ii) a stronger than expected resiliency on services inflation due to a tighter output gap." The BCB ripped out of the statement some considerations related to fiscal risks (amid discussions about the new framework) and a more intense or lasting unmooring of inflation expectations. Among the elements that foster lower inflationary risks, the emphasis is given to themes related to the international economy: "(i) a greater than projected deceleration of global economic activity, particularly due to adverse conditions in the global financial system; and (ii) an impact on global inflation larger than expected from synchronized monetary policy tightening." The Copom removed from the statement the downside risks from further declines in commodity prices in BRL and a more intense than expected deceleration in local credit conditions.

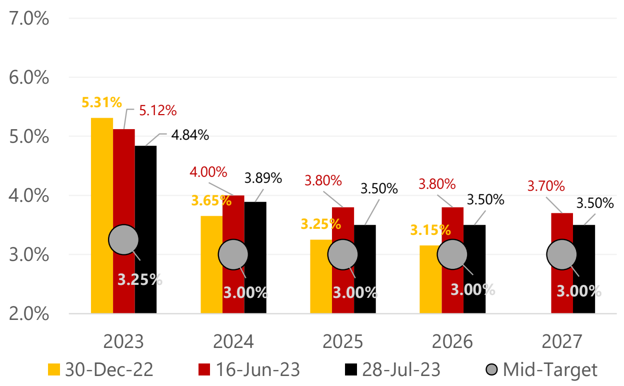
The scenario assessment was proportionally less changed. On local economic activity, the BCB reaffirms that "the recent set of indicators of activity remains consistent with the scenario of economic deceleration for the next quarters." Regarding inflation, the Copom reiterated the drop in headline inflation, and again indicated that it expects "an increase in the twelve-month headline inflation over the" 2H23. While recognizing the decline in underlying inflation trends (possibly a mention to July IPCA-15 preview), the BCB observes that underlying inflation measures still stand above the inflation target. On the international scene, the Brazilian authority highlights the resilience of inflation and labor markets in several countries and underscores the determination of the main central banks to promote inflationary convergence in their respective economies. The BCB refers now to an "uncertain" external environment, and no longer an "adverse" scenario, as in the last meeting.

In our opinion, the BCB sought to offset the dovish surprise in the Copom decision (even if amid a well-divided vote) by signaling a gradualist strategy to cut interest rate ahead. The central bank recognizes the adverse risks for the speed of inflationary convergence but seems to believe that the improved scenario (both in terms of inflation composition and expectations) already permits the achievement of the authority's objectives, and with a less contractionary monetary stance going forward. The BCB tries not to commit to the end point of this easing process, leaving the terminal rate as data dependent.

As for our scenario, our tendency will be to incorporate new cuts in the magnitude of 0.50pp over the coming months (and into 2024). Our scenario will be published on Friday (August 4th). Yet we are prone to keep our above-consensus view for interest rate for the medium term, as we continue to look for double-digit Selic rate at the end of 2024. The reason is that we do foresee challenges on the fiscal side, alongside elements that we believe will still fuel a certain inflationary persistence (e.g., strong demand for services, solid employment conditions, inflation resilience in the tertiary sector). ***Refer to a few graphs on the next page.***

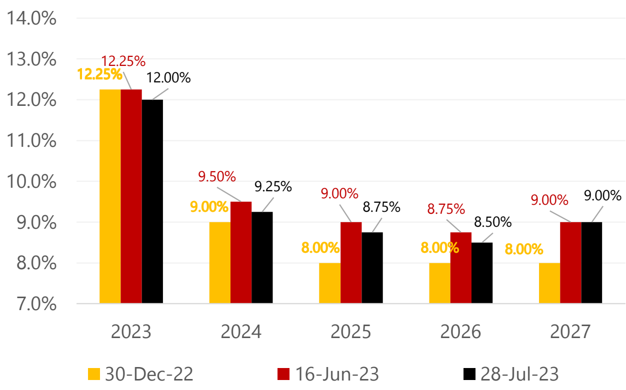
[4] The BCB projects administered prices up by 9.4%, 4.6% and 3.5% for 2023, 2024 and 2025, respectively. As of July 28, the market consensus (according to the Focus survey) for regulated prices was 8.9%, 4.4% and 3.8% for the same period.

Figure 1. Median Annual IPCA Forecasts (Consensus)



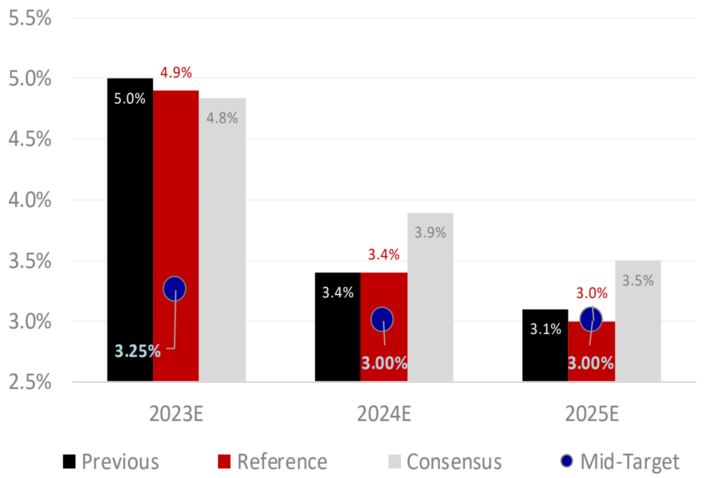
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

Figure 2. 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 3. BCB's Inflation Estimates (%, Reference)



Sources: Brazilian Central Bank, Santander.
Note: Assuming FX rate departing from USD/BRL 4.75, and then moving along with the PPP (purchasing power parity). Oil price following the futures curve for six months and stable in real terms in USD. The BCB assumes energy tariff flag "green" for both December 2023 and 2024. Consensus forecast for the future path of interest rate.

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