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COPOM DECISION: Planning a Change in Plan

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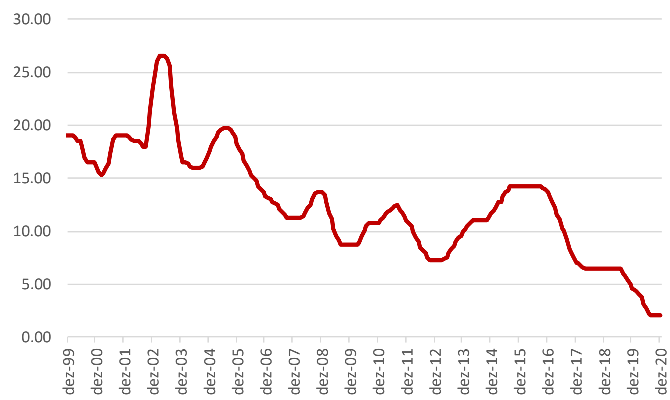
- **As widely expected, the Brazilian Central Bank (BCB) kept the Selic rate at the historical low of 2.00%.**
- **The take-on point from the statement was that the BCB signaled it may soon scrap its forward guidance, whereby the authority has been signaling a will not to "reduce the monetary stimulus as long as specified conditions are met." In our view (and probably the market's), that came a bit sooner than expected.**
- **For now, this future change in plan seems related to the switching of the policy horizon from end-2021 (when inflation is seen below the target with stable Selic next year) to end-2022 (when inflation is seen at the target, but only with Selic hikes next year). We sense the authority is still not readying for immediate rate hikes, although the stage is being set for possible moves in 2H21.**
- **While we continue to envision limited demand-led inflation next year and project IPCA below the target for 2021 and 2022, we are mindful of the BCB's new upcoming flight plan, and are about to push forward (from 1Q22 to mid-2H21) our expectation for the start of the normalization process.**

Policy decision and forward guidance

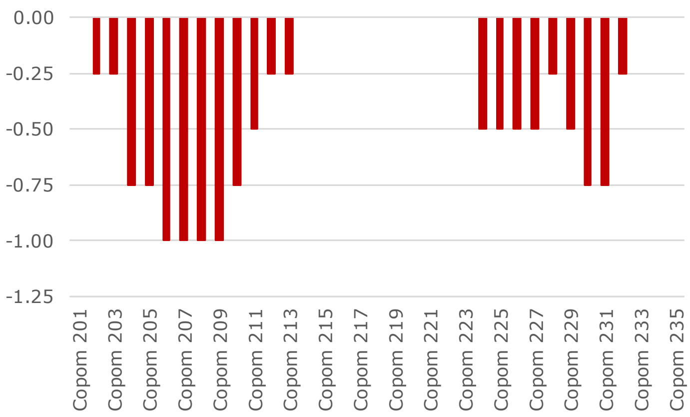
The COPOM[1] has once again kept the Selic policy rate at its historical low of 2.00% in nominal terms. This outcome was widely expected by analysts (according to forecasters' surveys) and traders (according to the local yield curve)[2].

Figure 1-A: Path of nominal Selic rate (monthly average, % p.a.)



Sources: Santander, Brazilian Central Bank.

Figure 1-B: Selic rate moves in recent Copom meetings (p.p.)



Sources: Santander, Brazilian Central Bank.

The take-on point from the statement was the signal provided about the BCB's forward guidance whereby the authority has been signaling the intention not to "reduce the monetary stimulus as long as specified conditions are met." According to the COPOM, inflation expectations by analysts and the BCB's baseline inflation projections "are still below the inflation target for the relevant horizon for monetary policy; the current fiscal regime has not been changed; and long-term inflation expectations remain well anchored," so that the conditions for the forward guidance are still there for now.

However, and maybe a bit sooner than expected, the BCB started to pave the way for the elimination of the forward guidance, owing to the fact that 1) "inflation expectations reversed their declining trend relative to the target for the relevant horizon" and 2) "over the next months, the 2021 calendar year should become less relevant than the 2022 calendar year,

[1] The COPOM is the monetary policy committee of the Brazilian Central Bank (BCB).
[2] Refer to the statement of the 235th COPOM meeting in English (https://www.bcb.gov.br/en/monetarypolicy/copomstatements).

for which projections and expected inflation are around the target." The BCB stresses that, under these circumstances (i.e., inflation expectations converging to the target) "the conditions for maintaining the forward guidance may soon no longer apply."

The BCB makes it clear that the upcoming elimination of the forward guidance "does not mechanically imply interest rates increases, since economic conditions still prescribe an extraordinarily strong monetary stimulus." According to the COPOM, without the forward guidance, "monetary policy will follow the inflation target framework, based on the analysis of prospective inflation and its balance of risks" – meaning that subsequent data dependency will define the next policy steps.

There was a yet another tightening in the policy language of the COPOM statement. As expected, the BCB dropped a previous mention that "the remaining space for monetary policy stimulus, if it exists, should be small." While we always saw this phrasing more as an optionality (or hedge) for the BCB to act in the eventuality of a massively disinflationary scenario, rather than actual guidance, the evolution of the scenario led to an inadequacy of keeping the door minimally open for further easing. And the BCB correctly adapted its tone, in our view.

Scenario assessment, inflation forecasts and balance of risks

The evolution of the official inflation projections helps us understand better the BCB's decision to hint at the elimination of the forward guidance in coming months, as the key policy horizon moves from end-2021 towards end-2022. In fact, the inflation simulations show that while BCB projects IPCA inflation below the mid-target for 2021 with stable Selic rate at 2.00%, the authority projects inflation nearly at the target for 2022 only for scenarios with Selic hikes starting sometime in 2H21.

Assuming for all simulations a USD/BRL exchange rate at 5.25 now and flat in real terms afterwards (i.e. moving along with purchasing power parity, PPP[3]), the COPOM simulates IPCA inflation at 3.5% for 2021 (previously: 3.2%) and at 4.0% for 2022 (previously: 3.8%), assuming the Selic rate flat at 2.00% all the way until year-end 2022. With the policy rate following the path expected by economists[4], 2.00% for year-end 2020, at 3.00% for year-end 2021 (with four 25-bp hikes starting in August), and at 4.50% for year-end 2022, the BCB sees IPCA inflation at 3.4% for 2021 (previously: 3.1%) and at 3.4% for 2022 (previously: 3.3%). The mid-target for next year is 3.75% and, for 2022, it is 3.50%.

Thus, the BCB is suggesting that, judging from current conditions and hypotheses, while the inflation target achievement for 2021 is within reach with the current policy stance, the delivery of the center target for 2022 might need a few 25-bp hikes in 2H21, and continuing across most meetings of 2022. While this could sound like a new flight plan of the BCB to start raising rates in August, it is possible that the markets take this "hawkish" wording in the statement as a signal of a possibly bolder action, with the yield curve possibly starting to price in even more (and sooner) hikes.

In the scenario assessment, the COPOM recognizes the upward inflation surprises of late, with a high headline CPI also expected for December. The authority "maintains the diagnosis that the current shocks are temporary, but continues to monitor closely its evolution, in particular the core inflation readings." That feels to us like a central bank that is slightly more worried about the magnitude of recent price shocks.

On activity, the BCB affirms that "recent indicators suggest the uneven recovery in economic activity continues, as expected." But the board continues to mention high uncertainty about the pace of recovery in the future, following "the expected unwinding of the emergency transfer programs." The threat of a (disinflationary) fiscal cliff still hangs on.

On the global outlook, the BCB notes the dichotomy between the short-term activity impact from the pandemic resurgence in major economies, contrasting with promising results from Covid-19 vaccine trials improving the outlook for the medium term. With monetary stimulus expected to last long in advanced economies, the BCB sees a favorable environment for emerging economies.

The COPOM once again emphasizes that the higher fiscal risks continue to feed "an upward asymmetry to the balance of risks, i.e., in the direction of higher-than-expected paths for inflation over the relevant horizon for monetary policy." Elsewhere in the balance of risks analysis, the COPOM also cites roughly the same elements as in the last meeting, some on the upside and some on the downside.

On the upside (for inflation), the authority mentions that "an extension of fiscal policy responses to the pandemic that aggravate the fiscal path or a frustration with the continuation of the reform agenda may increase the risk premium." On the downside (for inflation), the COPOM claims that "economic slack may continue to produce a lower-than-expected

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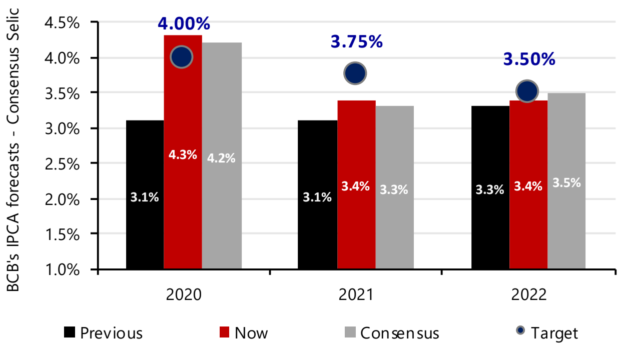
3 In this meeting, the COPOM inaugurates a new approach on the inflation simulations, as previously the BCB simulated inflation either under a nominal stability assumption or assuming the consensus path for the exchange rate, according to the weekly BCB report on market forecasts.

4 Refer to the latest weekly BCB report on market forecasts, as of December 4, 2020 (https://www.bcb.gov.br/en/publications/focusmarketreadout).

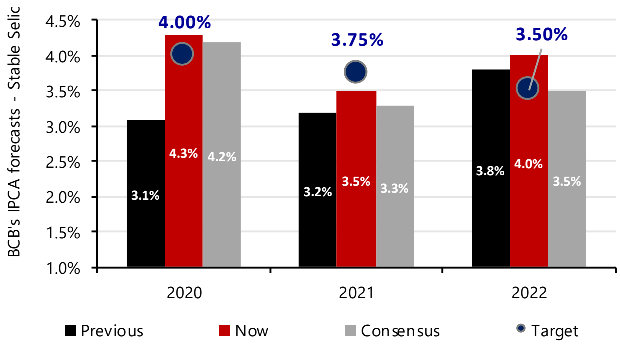
prospective inflation trajectory, especially when the slack is concentrated in the service sector.” The potential impact of the latter increases in case of precautionary savings following an eventually slower reversal of the pandemic, according to the BCB.

Figure 2-A: BCB inflation simulations – market scenario



Source: Santander, Brazilian Central Bank
Note: FX rate (USD/BRL) assumed at 5.25 and evolving according to the PPP

Figure 2-B: BCB inflation simulations – benchmark scenario



Source: Santander, Brazilian Central Bank
Note: FX rate (USD/BRL) assumed at 5.25 and evolving according to the PPP

Figure 3: Assumptions used in the BCB inflation simulations

		SELIC ASSUMPTIONS	
		Now	Previous
Consensus Selic Rate	2020	2.00%	2.00%
	2021	3.00%	2.75%
	2022	4.50%	4.50%
Stable Selic Rate	2020	2.00%	2.00%
	2021	2.00%	2.00%
	2022	2.00%	2.00%

Source: Santander, Brazilian Central Bank

What to expect ahead?

In our opinion, the BCB has set the stage for the probable elimination of the forward guidance (of stable interest rates if certain conditions are met) sometime in the next few months. For now, this future change of plan seems more related to the natural switching of the policy horizon from end-2021 (when inflation is seen below the target with stable Selic rate next year) to end-2022 (when inflation is seen at the target, with some Selic rate hikes next year). Opportunely (and possibly unintentionally), this signal also provides some space for the BCB to act in case of a market disappointment about the important upcoming fiscal decisions ahead (fiscal reforms, welfare programs, budget 2021).

While the yield curve and analysts’ forecasts may (over-)react to the hawkish tone of the BCB in coming days and weeks, we sense that the authority is still not readying to hike the Selic rate immediately. Importantly, it mentioned a couple of times the need or adequacy of an unusually strong monetary stimulus. And if we use the inflation simulations as a guide, the flight plan today would be to start raising rate sometime around mid-2H21.

We continue to envision a lack of demand-led price pressures for the relevant monetary policy horizon (i.e., in the medium term). Despite a surprisingly strong pickup in headline inflation recently, on the heels of temporary factors (food price shocks, change in consumer basket), the key fundamentals for monetary policy remain well behaved, with inflation expectations well anchored for the key policy horizons and with the economy expected to keep running below its potential for a considerable time (especially given the removal of emergency fiscal stimulus in 2021). If these conditions materialize, and assuming there is no change in the credibility of the fiscal regime, we envision inflation below the mid-target for both 2021 and 2022.

While we see room for downward revisions in the BCB’s inflation projections at some point ahead, given our view on the fundamentals, we do hear the BCB’s message and are now revising our interest-rate forecast (we had been projecting stable Selic all across 2021) to better reflect the BCB’s new plans.

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