Santander
Macroeconomic Research

BRAZIL MACRO January 21, 2021

DATA ANALYSIS – MONETARY POLICY

Making a U-Turn Soon, but Slowly

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- As widely expected, the Brazilian Central Bank (BCB) kept the Selic policy rate at the historical low of 2.00%. In the statement, the takeaway point was the abandonment of the forward guidance, whereby the authority had been signaling a will not to "reduce the monetary stimulus as long as specified conditions are met."
- The BCB estimates the forward guidance meant an easing of monetary conditions equivalent to a Selic cut of 25 bps. Thus, the decision to scrap it means a small tightening in the policy stance. Increases in inflation expectations and projections as well as high underlying CPI numbers explain such a fast tightening (for now, still in the realm) of communication.
- The committee made it clear that dropping the forward guidance does not imply mechanical rate hikes subsequently, with upcoming COPOM moves being data dependent. Based on the BCB's inflation simulations, we think a good candidate for a flight plan is to start hiking rates in August.
- While we continue to envision wide economic slacks in coming quarters, and still forecast headline IPCA below the mid-target for 2021 and 2022, we are mindful of the upside inflation risks generated by rising input costs. Moreover, a hypothetical situation of rising COVID-19 hospitalizations (leading to mobility restrictions) and further budget stimulus (maybe outside the constitutional spending cap), seen as net inflationary, adds to the picture and elevates chances of propagation of current shocks.
- All in all, the accumulation of upside risks to inflation is making us increasingly uncomfortable about our baseline call for a later-than-consensus start to the BCB's rate normalization process.

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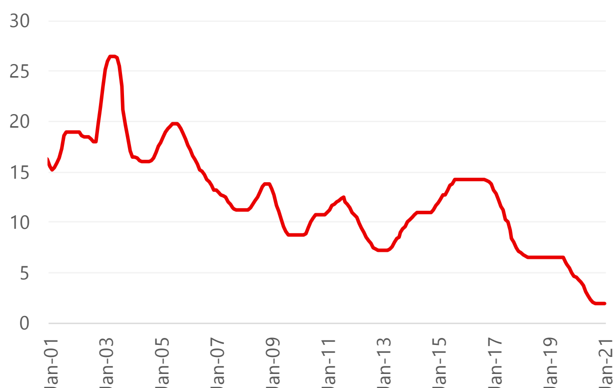
Policy Decision, Forward Guidance

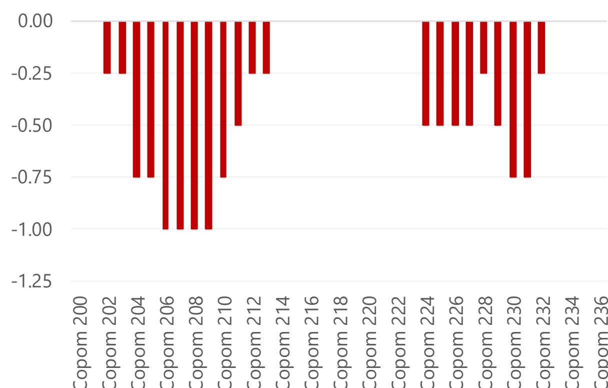
The COPOM[1] has once again kept the Selic policy rate at its historical low of 2.00% in nominal terms. This outcome was widely expected by analysts (according to forecasters' surveys) and investors (according to the local yield curve)[2].

Figure 1.A. – Nominal Selic Rate (monthly average, % p.a.)



Sources: Brazilian Central Bank, Bloomberg, Santander.

Figure 1.B. – Selic Changes in Copom Meetings (in percentage points)



Sources: Brazilian Central Bank, Bloomberg, Santander.

The take-on point from the statement was the abandonment of the BCB's forward guidance, whereby the authority had been signaling intention not to "reduce the monetary stimulus as long as specified conditions are met." The BCB no longer sees the conditions holding for keeping this pledge, as "inflation expectations, as well as inflation projections for its baseline scenario, are sufficiently close to the inflation target over the relevant horizon for monetary policy."

The authority reiterated that "the removal of the forward guidance does not mechanically imply interest rates increases, since, at this moment[3], uncertainties regarding the evolution of growth still prescribe an extraordinarily strong monetary stimulus." The BCB also reinforced the message that "monetary policy will follow the usual analysis of the balance of risks for the prospective inflation."

In our view, this indicates the BCB is not making commitment to a pre-determined policy path, and the timing for hikes will depend on how the macro scenario and risk factors will evolve.

Inflation Forecasts, Scenario Assessment, Balance of Risks

The evolution of the official inflation projections shows (at least part of) the rationale for the BCB's decision to scrap the forward guidance now, with BCB inflation estimates now standing "close enough" to the mid-target.

Assuming for USD/BRL exchange rate at 5.35 now and flat in real terms afterwards (i.e. moving along with purchasing power parity, PPP), the COPOM simulates IPCA inflation at 3.6% for 2021 (up 0.2 p.p. from previous publication) and at 3.4% for 2022 (unchanged from previous publication). These simulations assume the policy rate path expected by economists[4]: 3.25% for year-end 2021 (with hikes starting in August), and 4.75% for year-end 2022. The mid-target for this year is 3.75% and, for 2022, it is 3.50%.

The numbers suggest that, judging from the current conditions and hypotheses, inflation would stand around the targeted path for the relevant horizons with Selic rate hikes starting in August 2021 (mostly in steps of

[1] The COPOM is the monetary policy committee of the Brazilian Central Bank (BCB).
[2] Refer to the statement of the 236th COPOM meeting in English (https://www.bcb.gov.br/en/monetarypolicy/copomstatements).
[3] Some observers note that the wording "at this moment" had already been used in the past. Historically, we calculate this expression appeared 31 times in previous Copom statements: out of those, 14 times the subsequent Copom decision was the same as the previous one. So, we conclude that this expression means just a lack of commitment to a future decision, not necessarily a signal of a pre-determined move afterwards.
[4] For more on consensus forecasts, refer to the BCB's Focus report in English (https://www.bcb.gov.br/en/publications/focusmarketreadout)

25bps along the way). In our view, if no big changes take place in key variables or in the balance of risks, this Selic path is a good candidate for a flight plan by the BCB at this juncture.

The **scenario assessment** also provides a background to better understand the tightening of communication. On **inflation**, the authority elevates the tone of concerns, by recognizing that the "various measures of underlying inflation are in levels above the range compatible with meeting the inflation target." In our view, this mirrors the hefty sequential trends in some key core measures, such as the seasonally adjusted annualized three-month moving averages for a few core gauges. But that contrast with the fact that year-on-year changes for these indicators continue to stand below 3%.

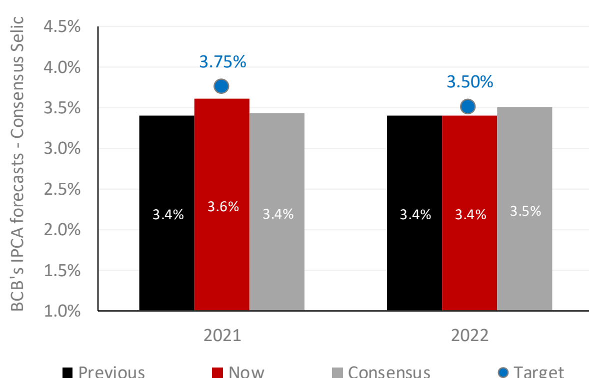
The BCB is also bracing for further price pressure from volatile items, as the COPOM sees that "recent increase in commodities prices and its effects on food and fuel prices imply an increase in inflation forecasts for the next months." Yet the committee keeps the assessment that "the current shocks are temporary, although more persistent than expected."

On **activity**, while the BCB states that "growth at the end of last year have been better than expected", the BCB hints at downside risks from the recent spike in COVID-19 infections. The authority also continues to see "larger than usual" uncertainty for economic activity, especially for 1Q20, given "the expected unwinding of the emergency transfer programs." Thus, while activity is seen better, the BCB does not seem to be so sure on whether the good pace will continue.

On the **global outlook**, the worsening of the pandemic and subsequent loss in mobility (weighing in the short term) are seen compensated by new fiscal stimulus and rollout of vaccines (for the medium term). According to the BCB, activity "slack and central bank communication from major economies suggest monetary stimuli will last long, resulting in a favorable environment for emerging economies."

The COPOM brought no changes in the balance of risks, where the authority still sees an upward (i.e., inflationary) asymmetry. The COPOM cites 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 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. – Inflation Simulations – Focus Selic



Sources: Brazilian Central Bank, Santander.

Figure 2.B. – Assumptions in BCB Simulations

SELIC ASSUMPTIONS		
	Now	Previous
2021	3.25%	3.00%
2022	4.75%	4.50%

Sources: Brazilian Central Bank, Santander.
Note: FX at 5.35 initially and moving along with PPP afterwards

What to Expect Ahead?

In our view, by facing an inflationary shock that is proving greater and more resilient than expected, with risks of generating second-round effects, and amid a still constructive (though not conclusive) signs from economic activity, the COPOM used a bit of its discretion in the interpretation of clauses to end this (rather controversial) forward guidance.

At this stage, the end of the forward guidance is very convenient for the BCB strategy. On one hand, it starts to set the direction of monetary policy in tightening mode, as the BCB sees the forward guidance equivalent to a 25-bp Selic hike (according to estimates presented in the last inflation report). That helps the authority "close the flank" (or seek "protection" against potential pressures) on inflation expectations for the relevant horizons. On the other hand, the lack of a commitment to a pre-determined schedule of removal of interest-rate stimulus (by indicating data dependency) buys the BCB an important amount of time to watch some hard-predicting developments that mean risks to the scenario, such as the evolution of the pandemic and rollout of vaccines at local level, as well as Congressional discussions on the budget 2021, macro reforms and fiscal stimulus.

We have not changed our assessment about the cycle and still see the economic recovery as highly driven by temporary factors, notably a gigantic (and unrepeatable) fiscal impulse. Consequently, we continue to envision limited demand-led inflation next year, given the high levels of unemployment and below-potential economy across 2021. Alongside expectations of a fading food shock, this explains why we still project IPCA below the target for 2021 and 2022.

However, we are mindful of the rising inflation risks from a production cost standpoint, given the rising commodity prices in local currency. Additionally, a combination of worsening pandemic developments (high hospitalizations, slow immunization) with additional budgetary stimulus (outside the spending cap) is likely seen as net inflationary by the BCB, according to simulations presented in the last quarterly inflation report. This combination is a risk on the rise. In other words, the fiscal risk is another factor that could expedite the start of a Selic tightening cycle.

All in all, amid an accumulation of upside risks to inflation, we are growing uncomfortable about our call for a later-than-consensus start to the normalization process of the BCB's monetary policy stance. For now, based on the economic cycle and under the hypothesis of no big shocks, we project hikes starting in October, with our Selic rate forecast at 2.50% for end-2021 and 4.50% for end-2022.

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