Santander
Macroeconomic Research

BRAZIL MACRO

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MONETARY POLICY DECISION

MR. DATA WILL TELL

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- In Copom meeting #255, the Brazil Central Bank (BCB) kept the benchmark Selic rate at 13.75%, a result widely anticipated by both analysts and the yield market. The tone of the statement seems to have been more hawkish than many analysts had anticipated. Overall, the Copom confirmed our expectation for guidance that their future actions will be data dependent.
- According to the BCB, "the current scenario demands patience and serenity in the conduct of monetary policy". The Copom signals that 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 BCB also highlights that the current situation is characterized by "a stage in which the disinflationary process tends to be slower", and that “an environment of de-anchored inflation expectations continues to require caution and parsimony." The authority evaluates that "the strategy of maintaining the Selic rate for a long period has been adequate to ensure the convergence of inflation" and that the Committee will "persist until the disinflationary process consolidates and inflation expectations anchor around its targets."
- The BCB's inflation projections still seem to indicate the need for some additional progress in the disinflation process. In the reference scenario, which assumes the Selic trajectory according to the Focus survey (with rate cuts starting in August, reaching 12.25% by the end of 2023, and 9.50% by the end of 2024), the estimate for IPCA 2024 fell to 3.4% (previously 3.6%). Thus, the signal is that the interest rate trajectory projected by the consensus of economists does not yet allow the achievement of the mid-target of 3%, according to the BCB's calculations.
- In our opinion, although the Copom statement reinforced the idea that an easing cycle is drawing near, the Copom did not make a "commitment" to a rate cut in August. And we sense that the bar is not low for the BCB to inaugurate an easing cycle in the next meeting. The Copom minutes, out next Tuesday (June 27) may shed more light on the BCB’s flight plan.
- With the BCB recognizing a more challenging stage of the disinflation process and a slower convergence to the target, with risks of expectations becoming un-anchored in the process, we anticipate a very gradual easing cycle ahead. We project Selic rate at 12.50% for YE2023 and 11.00% for YE2024.

POLICY DECISION, GUIDANCE AND INFLATION FORECASTS

In the 255th meeting of the Copom[1] (Monetary Policy Committee), the Brazil Central Bank (BCB) kept the benchmark Selic rate at 13.75%, a result widely anticipated by both analysts and the yield market[2]. The tone of the statement seems to have been more hawkish than many analysts had anticipated. However, overall, the Copom confirmed our expectation that the future actions will be data dependent.

According to the BCB, "the current scenario demands patience and serenity in the conduct of monetary policy". The Copom signals that 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". Thus, the eventual beginning of a rate-cutting cycle in August should be conditional upon the evolution of core inflation measures (particularly the IPCA EX3, which is more sensitive to economic cycles) and longer-term inflation expectations (i.e., from 2024 onwards). The authority also emphasizes the role of its own inflation projections, the output gap, and the balance of risks in this process.

The BCB also highlights 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 authority evaluates that " the strategy of maintaining the Selic rate for a long period has been adequate to ensure the convergence of inflation" and that the Committee will "persist until the disinflationary process consolidates and inflation expectations anchor around its targets."

The BCB's inflation projections still seem to indicate the need for some additional progress in the disinflation process. In the reference scenario[3], which assumes the Selic trajectory according to the Focus survey (with rate cuts starting in August, reaching 12.25% by the end of 2023, and 9.50% by the end of 2024), the estimate for IPCA 2024 (the relevant policy horizon now) declined to 3.4%, compared to an estimate of 3.6% in the May Copom. Thus, the signal is that the interest rate trajectory projected by the consensus of economists does not yet allow the achievement of the mid-target of 3%, according to the BCB's calculations. That could favor a rate-cutting cycle to start after the August meeting. It is important to note that the BCB did not publish projections for the alternative scenario (assuming a stable interest rate of 13.75%), as it did in the previous meeting. Combined with the dropping of the language that the BCB "will not hesitate to resume the tightening cycle if the disinflationary process does not proceed as expected" (seen in previous BCB communications), it becomes clear that the authority is convinced that the next move is a cut. The timing of this process is fundamentally dependent on the data and the evolution of the inflation outlook.

Still regarding the BCB's inflation projections, it is interesting to note that the authority's projections for administered prices in 2024 declined from 5.2% to 4.6%, converging toward analysts' projections for this group. This revision may have been the main factor behind the 0.2 pp decrease in the authority's IPCA estimate for next year (possibly reflecting the appreciation of the BRL and the decline in commodity prices). Meanwhile, the projection for free-market prices in 2024 remains well below the market consensus (3.0% vs. 3.9%), possibly reflecting, among other factors, the BCB's lower assumption for the structural interest rate (4% versus the market's 5%).

[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 simulations assume 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.

BALANCE OF RISKS, SCENARIO ASSESSMENT

The balance of risks remained practically unchanged, showing the same upside and downside elements. Only notable changes refer to i) the mention by the BCB that there is still "some residual uncertainty about the final fiscal framework to be approved by the National Congress", on the list of upside risks and ii) that a " sizeable portion" of the (expected?) decline in commodities in local currency has already been observed, on the list of downside risks. However, the BCB continues to note that, regarding the fiscal issue, the focal point for monetary policy lies in the " impacts on the expected paths of the public debt and of inflation expectations, and on risky assets." The upside of the balance of risk assessment also maintains the possibility of “a larger or more persistent de-anchoring of long-term inflation expectations.” The downside continues to acknowledge the possibility of adverse conditions in the global financial system, as well as " a slowdown in domestic credit concession larger than what would be compatible with the current stance of monetary policy." As has been the case in previous communications, the BCB does not point to an asymmetry in the balance of risks.

In the scenario assessment, no major changes, either. Regarding the scenario assessment, the BCB reaffirms that "the recent set of indicators of activity remains consistent with the scenario of economic deceleration for the next quarters." The authority reaffirms that the upward surprise in 1Q23 GDP is due to the effects of (a likely one-off) boost in agricultural production. A previous mention of labor market resilience has been removed from the statement. On the inflation front, the Copom cites the decline in headline inflation but points out that it expects " an increase in the twelve-month headline inflation" in 2H23. Despite a slight (yet widely celebrated) decline in the trend of underlying inflation in May IPCA, the BCB evaluates that " various measures of underlying inflation remain above the range compatible with meeting the inflation target." In the international scenario, the BCB notes an upward revision in global growth expectations. Despite the recent easing of banking stress in some advanced economies, the BCB continues to monitor the theme. The Brazilian authority highlights the resilience of global inflation and emphasizes the commitment of major central banks to promote inflation convergence in their respective economies.

OUR TAKE AND OUTLOOK

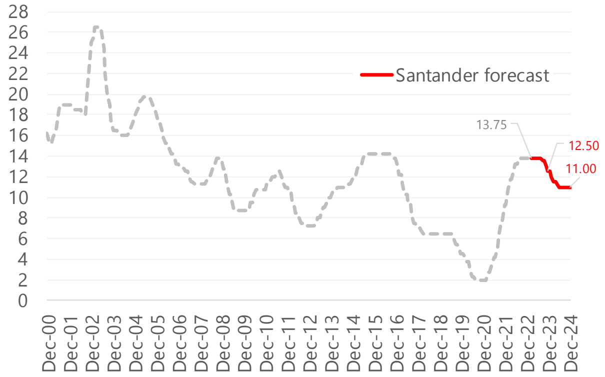
In our opinion, although the Copom statement reinforced the idea that an easing cycle is drawing near, the Copom did not make a "commitment" to a rate cut in August. Furthermore, it seems to have signaled that "the bar is not low" for such a move – in other words, we understand that the Copom indicates that a visible improvement in the inflation outlook will be necessary to initiate the easing process at the next meeting. In this regard, two key factors will play a crucial role: i) a further decline in the trend of core inflation measures, and ii) the reaction of inflation expectations (especially for the medium and long term) to the CMN's (National Monetary Council, in Portuguese) decision on the inflation target and other parameters of the inflation targeting regime. For now, we maintain our projection of the beginning of the rate cut cycle in September, but we acknowledge that the August meeting will be a live one, where the possibility of disagreement (i.e., split vote) within the committee is likely to be high, amid lingering uncertainties around both the domestic and external scenarios.

With the BCB recognizing a more challenging stage of the disinflation process and a slower convergence to the target, with risks of expectations becoming unanchored in the process, we anticipate a very gradual easing cycle ahead. In our view, the BCB will be cautious to ensure that the gains (in terms of disinflation) generated by a highly contractionary monetary policy stance are consolidated. We see this upcoming cycle starting with a 25-bp move. And unless there is a major surprise, the pace of cuts is unlikely to exceed 50 bps per meeting across 2024 (at least).

We project Selic rate at 12.50% for YE2023 and 11.00% for YE2024.

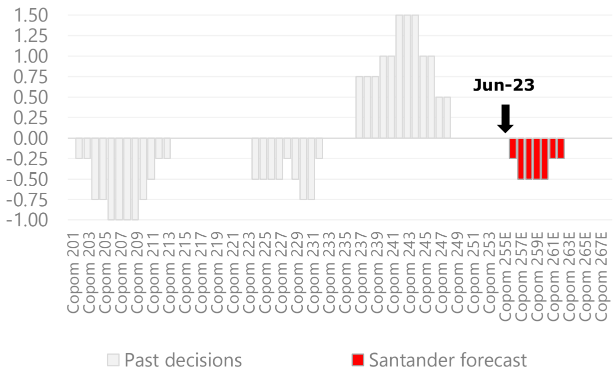
Refer to graphs on the next page.

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



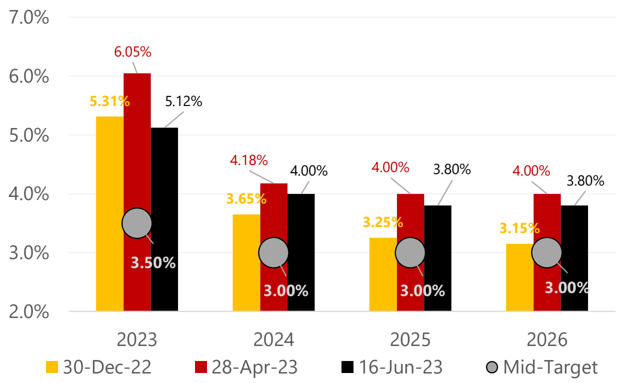
Sources: Brazilian Central Bank, Bloomberg, Santander.

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



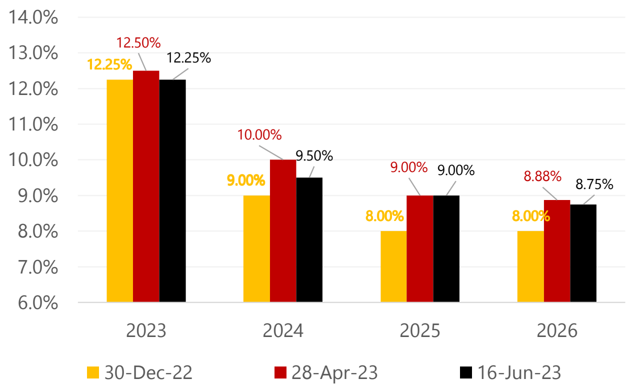
Sources: Brazilian Central Bank, Bloomberg, Santander.

Figure 3. Median Annual IPCA Forecasts (Consensus)



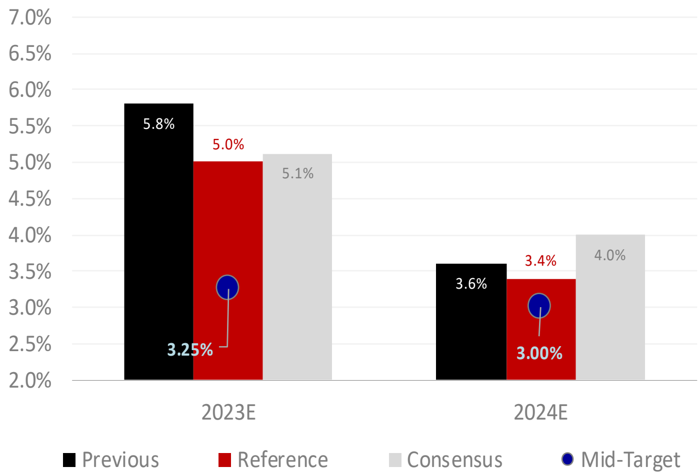
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

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 (%, Reference)



Sources: Brazilian Central Bank, Santander.
Note: Assuming FX rate departing from USD/BRL 4.85, 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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