BRAZIL MACRO

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MONETARY POLICY – COPOM MINUTES

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RATIFYING THE TONE

- The BCB published the minutes of its February 1-2 policy meeting, when the authority once again hiked interest rate (for an eighth time running) by 150bps to 10.75%. The overall message does not look very different from the statement and we still sense the BCB's current tone (and stance) may not be as soft as the markets had read it in the wake of last week's announcement.

- The Copom did seek to maintain the range of possibilities a little open as per the subsequent moves, especially regarding the speed of hikes going forward, amid uncertainties in the inflation scenario (namely commodities) and considering the policy lags, given the tightening already implemented.

- Yet the committee confirms that the reference scenario (with terminal Selic at 12.00%) is a lower bound for the actual paths the BCB has in mind so as to bring inflation back to the center target. In our view, this very signal also limits the speed of hike at no less than 100bps for the March meeting.

- The Copom concludes that "additional adjustments at a slower pace [than 150bps] in the next meetings, is the most appropriate strategy to achieve sufficient monetary tightening and ensure inflation convergence over the relevant horizon, as well as the anchoring of long-term inflation expectations."

- In our view, the minutes upped a bit the tone of the statement, which had been (in our view exaggeratedly) seen as soft by financial markets. In fact, despite the signal of a slower pace of hikes and the lack of a clearer pre-commitment to a certain speed in the short term, the authority continues to signal it will do no less than the consensus path. Importantly, the BCB continues to identify inflationary risks emerging from commodity prices (seen back on the rise now) but especially from the fiscal developments and its associated risks of de-anchoring inflation expectations.

- That said, we forecast a 100-bp hike in March and another move of 50 bps in May, and maintain our terminal Selic rate estimate of 12.25% for this cycle. While we interpret the BCB's language suggesting that the hiking cycle is near completion, there is little doubt that the next steps (and the total cumulative size of the adjustment) will be data dependent.

Overview

The BCB published the minutes of its February 1-2 Copom[1] policy meeting[2][3], when the authority once again hiked interest rate (for an eighth time running) by 150bps to 10.75% p.a.. The overall message is not very different from the statement, and we still sense the BCB's current tone (and stance) may not be as soft as the markets had read it in the wake of the Copom announcement last week.

Key Policy Messages

Firstly, the Copom sought to maintain the range of possibilities a little open as per the subsequent moves, especially regarding the speed of hikes going forward, amid uncertainties in the inflation scenario (e.g. commodities) and considering the policy lags, given the tightening already implemented. In the minutes, the BCB clarifies that "(...) the particularly high uncertainty surrounding important asset and commodity prices, as well as the stage of the tightening cycle, led the Committee to judge more appropriate, at this moment, not to signal the size of its future steps." (Paragraph #17)

Yet the committee confirms that the reference scenario (with terminal Selic at 12.00%) is a lower bound for the actual paths the BCB has in mind so as to bring inflation back to the center target. The document indicates that the "Copom assessed the appropriate pace of interest rate hikes. For such, it analyzed its inflation projections using simulations with monetary policy paths with different terminal rates, adjustment paces, and duration of monetary tightening. It is worth noting that the scenarios considered, consistent with the convergence of inflation to its targets, assumed a higher interest rate path than that used in the reference scenario." (Paragraph #15)

The Copom concludes that "another adjustment of 1.50 percentage points [February], followed by **additional adjustments at a slower pace in the next meetings [March onwards], is the most appropriate strategy to achieve sufficient monetary tightening and ensure inflation convergence** over the relevant horizon, as well as the anchoring of long-term inflation expectations."

Last but not least, the Copom tells us that monetary policy will take very cautiously the emergence of fiscal decisions leading to temporary price reductions (e.g. via tax breaks), and that the BCB's focus will remain on the inflation path for the relevant horizon (i.e. medium run). According to the minutes, "the Committee notes that even fiscal policies that have a downward effect on inflation in the short term can cause a deterioration in the country's risk premia, increase inflation expectations, and consequently have an upward effect on prospective inflation." (Paragraph #12)

The BCB continues to mind the uncertainties about fiscal policy and its framework, believing that this raises the probability of a higher neutral level of interest rate. Naturally, a higher level of structural interest rate means an even higher terminal Selic rate for the cycle and a higher average level for the coming months and years, for any given dose of monetary tightening needed (the latter being conditioned by the variables affecting the inflation outlook). Let alone a more challenging macroeconomic equilibrium generated by a higher structural rate. (Paragraph #12)

The BCB also reaffirms the message that given the upwardly skewed balance of risks for inflation, fed particularly by the risk of de-anchoring of inflation expectations "derived from developments in the fiscal scenario", **the BCB evaluates that its own inflation forecasts stand above the mid-target for both 2022 and 2023.** And this prompt the authority to keep the conclusion that "the monetary tightening process should be more restrictive than that used in the reference scenario throughout the relevant horizon." (Paragraph #14)

[1] The COPOM is the monetary policy committee of the Brazilian Central Bank (BCB).
[2] Refer to the minutes of the 244th COPOM meeting in English (https://www.bcb.gov.br/en/publications/copomminutes).
[3] **Santander Brazil – Monetary Policy:** ***"Copom Decision: Slower but Not Lower" –*** February 3, 2022- Available on: https://bit.ly/Std-Copom-feb22

Complementary Views on the Scenario Assessment

Elsewhere in the minutes, the BCB provided details on its scenario assessment.

On the international front, the Copom continues to see a "less favorable" outlook, amid persistent gains in commodity prices, continued inflationary pressures and the risk of even tighter global financial conditions. The BCB notes that "persistent inflation raises the chances of faster monetary tightening in the US, turning financial conditions more challenging for emerging economies." Additionally, Omicron (COVID-19) developments are seen adding uncertainty about global activity and "could delay the normalization of global supply chains." On that note, the BCB also mentions that commodity price reversed gears and started to move higher, in cases reaching "records, reinforcing the global environment of pressured prices." (Paragraph #1)

On inflation, the BCB still recognizes that CPI "remains high, with increases spread among several components, and continues to be more persistent than anticipated." The BCB continues to admit that industrial goods inflation "has not slowed down and should persist in the short term, while services inflation accelerated, still reflecting the gradual normalization in the sector's activity." The BCB notes that recent CPI reports showed readings that "were higher than expected" and that "the surprise came in both the more volatile components and particularly on the items associated with core inflation." The BCB continues to highlight that "various measures of underlying inflation are above the range compatible with meeting the inflation target." (Paragraphs #4 and #5)

In terms of the inflation forecasts, the BCB explains that the upward revision in administered prices for 2022 (to 6.6% from 3.8%) is "mainly due to the strong increase in oil prices since the previous meeting of the Committee." The Copom also mentions the influence of other "administered items whose variations will be repeated throughout the year." The authority points to a limited influence of "the change in the hypothesis of the energy flag for the end of 2022, which reflected the improved rainfall scenario." Remember that the BCB revised downwards the hypothesis of electricity flag (to Red 1 from Red 2) both for 2022 and 2023. As announced in the statement, with the FX rate starting at 5.45 (and moving along with PPP afterward), the BCB's models see IPCA inflation at 5.4% for 2022 (mid target: 3.50%; upper target: 5.00%) and at 3.2% for 2023 (mid-target: 3.25%; upper target: 4.75%). (Paragraphs #4, #5 and #6)

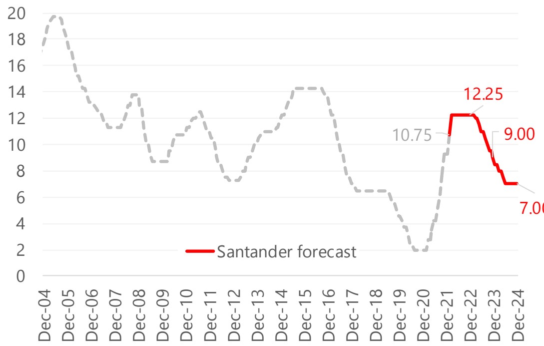
On activity, a mixed tone. On one hand, the authority mentions that "trade and services indicators showed a slightly better-than-expected evolution in November, while industry recovered in December." They also note that employment indicators "showed consistent job recovery in 2021Q4." The BCB continues to believe that the economy will be driven by the impulse from agriculture and segments benefiting from the normalization (or reopening) of economic activities, such as the labor market, even as "the rise in risk premia and the more intense tightening of financial conditions act stifling the economic activity." Yet the BCB highlights downside risks for activity, as "confidence indexes released since the previous meeting continue to deteriorate, and weather developments have affected the projections for important agricultural crops." (Paragraphs #2 and #3)

In Perspective

In our view, the BCB may have used the occasion of the Copom minutes to up a bit the tone of the statement, which had been (in our view exaggeratedly) seen as soft. In fact, despite the signal of a slower pace of hikes and the lack of commitment to a certain speed in the short term, the authority continues to signal that the Selic path used in the inflation simulations (terminal rate of 12.00%, following hikes of 100bps in March and 25bps in May) is a lower bound for the actual path the BCB estimates necessary to drive IPCA inflation down to the mid-target for the relevant policy horizon (read mainly 2023). The BCB continues to identify inflationary risks emerging from commodity prices (seen back on the rise now, and impacting the BCB's own forecast) but especially from the fiscal developments and its associated risks of de-anchoring inflation expectations.

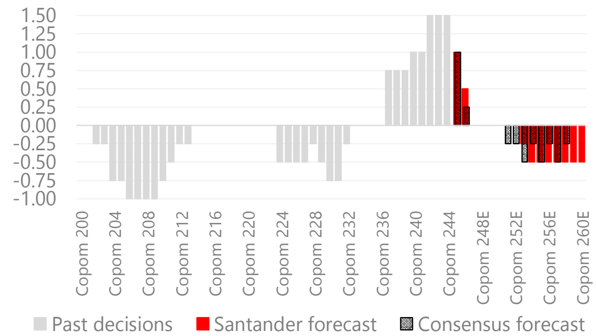
That said, we forecast a 100-bp hike in March and another move of 50 bps in May. We continue to believe the BCB flight plan probably accounts for a terminal interest rate of no less than 12%, so that we maintain our terminal Selic rate estimate of 12.25% for this cycle. While we interpret the BCB's language suggesting that the cycle is near completion, surely the next steps (and the total size of the adjustment) will be data dependent.

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



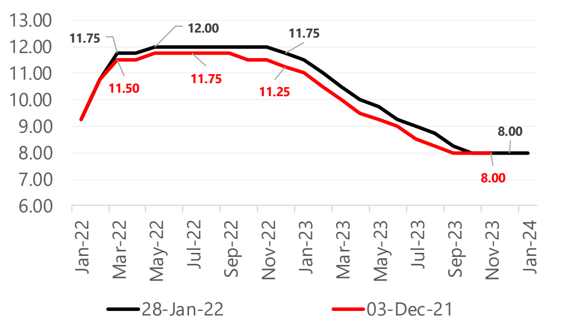
Sources: Brazilian Central Bank, Bloomberg, Santander.

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



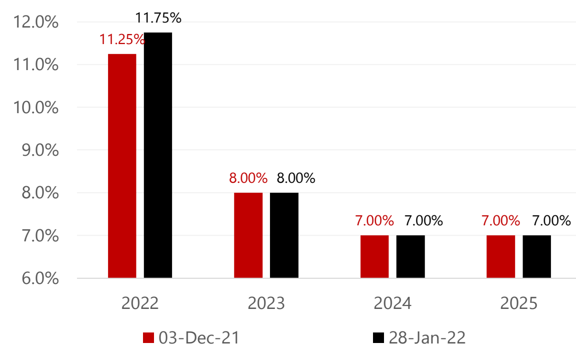
Sources: Brazilian Central Bank, Bloomberg, Santander.

Figure 3. Median Monthly Selic Forecasts (Consensus)



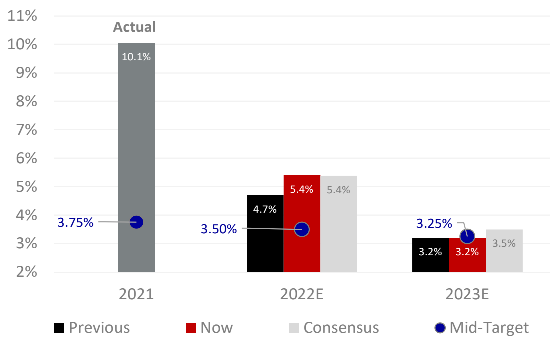
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

Figure 4. Median Annual Selic Forecasts (Consensus)



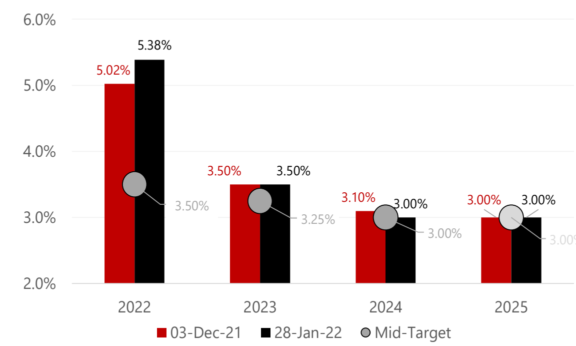
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

Figure 5. BCB's Inflation Simulations (% annual)



Sources: Brazilian Central Bank, Santander.
Note: IPCA simulations assume Selic rate from the Focus survey and USD/BRL starting at 5.45 and evolving according to purchase power parity.

Figure 6. 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).

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