BRAZIL MACRO

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MONETARY POLICY – COPOM MINUTES

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POISED TO PAUSE, UNLESS…

- The Brazilian Central Bank (BCB) has published the minutes of its August 2-3 Copom policy meeting, when the authority once again hiked interest rate (for the 12th time in this cycle) by 50 bps, to 13.75% p.a.— the highest level in more than five years.

- Overall, we believe that the minutes reaffirm the BCB's flight plan to pause the tightening cycle in the next (September 20-21) meeting, with the Selic rate at 13.75%. Our impression from the recent Copom communications (statement and minutes) clearly contradicts our call for a final 25-bp hike in September (to 14.00%). Our current call is based on the assumption that inflation expectations can rise a bit further in coming weeks and that activity may see a little boost from the fiscal stimuli early in 3Q21.

- In the August Copom minutes, the BCB justifies its decision to hike the Selic rate by 50 bps (to 13.75%) based on the committee´s assessment that "the strategy required to bring the projected inflation to around the target for the relevant horizon required (…) an additional adjustment at this meeting and the maintenance of the interest rate in significantly contractionary territory for a sufficiently extended period" (PARAGRAPH #18).

- Repeating the statement, the authority also reaffirmed that "it will assess the need for a smaller residual adjustment at the next meeting, with the aim of bringing inflation to around the target in the relevant horizon." The Copom pledges to "remain vigilant and will assess whether the prospect of maintaining the Selic rate by itself for a sufficiently long period will ensure such a convergence." The BCB says it will "ensure the convergence of inflation over the relevant horizon, as well as the anchoring of longer-term inflation expectations", taking into account the tightening already implemented – which the BCB believes "should affect the economy more strongly" in the 2H22 – and the uncertainty of the scenario (PARAGRAPHS #19 and #20).

- The Copom also discussed on the deployment of a policy horizon not based on calendar years (as stipulated in its statutory mandate). The BCB at this meeting "noted that inflation projections for the years of 2022 and 2023 were heavily impacted by temporary tax measures across calendar years." That is the rationale for focusing on year-on-year IPCA inflation projections for 1Q24, which the authority believes to reflect the relevant policy horizon. The Copom also believes it "smoothens out the primary effects from tax changes, but incorporates their second-round effects on the relevant inflation projections for monetary policy decisions." According to the minutes, this horizon [1Q24] "is consistent with the strategy of inflation convergence to around the target over the relevant horizon." The BCB highlights that its IPCA inflation projection for 2024 is also around the target (PARAGRAPHS #14 and #15).

- The numbers explain the BCB's rationale. In the reference scenario, the inflation estimate for calendar-year 2023 stands at 4.6% (previously: 4.0%; mid-target: 3.25%; upper target: 4.75%). For 1Q24 – now seen as the relevant policy horizon – the BCB's year-on-year IPCA projection stands at 3.5%, in compliance with the BCB's strategy to bring the IPCA "around the target". The number for the 2024 horizon is 2.7% (mid-target: 3.00%).

- As in the previous Copom minutes, the monetary authority highlights that "the current monetary tightening cycle was quite intense and timely and that, due to the long and variable monetary policy lags, much of the expected contractionary effect and its impact on current inflation are still to be seen." Yet the Copom notes that "measures to sustain aggregate demand, which will be implemented in the short term, may make it difficult a more precise evaluation about the stage of the economic cycle and the impacts of monetary policy" (PARAGRAPH #16). As per this claim, a key doubt here is whether or not the new demand impulse should have led to an additional monetary policy reaction. The answer will only be known several months ahead.

- The BCB recognizes that "the short-term inflationary dynamics remains challenging, with increasing core inflation measures in an environment of surprises in current activity, and that its projections continued to deteriorate". Yet the authority sees a mitigating factor in the recent rise in inflation expectations and projections for the medium run, mentioning that these developments were "concentrated in the inflation of administered prices, due to the temporary nature of some tax measures." (PARAGRAPH #17).

- As per the scenario assessment, the BCB notes that temporary income-supporting measures mean further stimulus to aggregate demand, whose extension "might increase the country's risk premia and inflation expectations as they pressure aggregate demand and worsen the fiscal trajectory." According to the minutes, fiscal policy can impact inflation via activity, asset prices and expectations (PARAGRAPH #10).

- The heating up job market did not go unnoticed. The BCB mentions that the upside surprises in the "the pace of job openings and the unemployment rate (…) indicate a faster-than-anticipated narrowing of the estimate of the output gap." While pointing to the uncertainty related to the assessment of the output gap, and especially its labor-market component, the "Committee evaluates that economic slackness persists." The BCB pledges to keep "monitoring and evaluating the output gap in the next releases" but keeps the view that "activity should decelerate in the coming quarters when the lagged impacts of monetary policy will be more strongly felt." (PARAGRAPH #11).

- Elsewhere, the BCB dedicates several paragraphs analyzing the global economic environment, and its consequences for the inflation and monetary outlook in Brazil. The BCB basically highlights the "adverse and volatile" global conditions but emphasizes on the "an incipient normalization in the supply chains and accommodation in the prices of leading commodities". As per the global inflation outlook, the Brazilian monetary authority sees a probable "moderation of inflationary pressures related to goods" but also believes "that inflationary pressures in the sector of services might take long to dissipate." The BCB notes that "the change in the growth outlook have impacted financial conditions in both advanced and emerging economies". The BCB say it "continues monitoring the risks involving a global deceleration in a highly pressured inflationary environment."

- All in all, our impression from the minutes does not differ from our reading of the statement. The BCB is heading for a pause in the tightening cycle, given the extension of its planned convergence horizon and under the belief that the additional inflationary risks posed by the further fiscal stimulus and narrower economic slack (given a stronger than expected job market and a more closed output gap) will be dealt with the lagged effects of the ("intense and timely") monetary tightening cycle, as well as the global economic slowdown, and the softening in commodity prices. Vis-à-vis our "ex-ante" expectations (i.e., before the August Copom meeting) what we thought would be an adjustment of the BCB's strategy with a little more tightening than previously hinted has actually materialized as an adjustment in the policy horizon (from YE2023 to 1Q24, with the latter horizon seen less contaminated by tax-driven distortions). While the "higher than usual" uncertainty keeps the BCB from pre-announcing a pause now, we recognize that the bar looks high (for changes in the scenario, mainly inflation expectations and real activity) to trigger a change in the BCB's plan to pause at 13.75% in September. Of course, this means a significant downside risk as per our call of terminal Selic rate of 14.00% in this cycle.

- Since we see considerable risks of greater inflationary persistence for the medium term, we continue to see a limited room for rate cuts next year. Our scenario pencils in Selic cuts starting in June 2023, taking interest rates to 12.00% by YE2023. Risks also are tilted to the upside.

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