BRAZIL MACRO May 10, 2022

DATA ANALYSIS – MONETARY POLICY

KEEPING ALL DEGREES OF FREEDOM

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- **In our view, the minutes of the last Copom meeting did little to clarify whether the (intended and signaled) hike at the June gathering will be the last one of the ongoing monetary tightening cycle, although some excerpts gave us the impression that this should be the case.**
- **However, in other passages, Copom members reinforced their commitment to ensure both the convergence of inflation toward the targeted level over the relevant time horizon (i.e., 2023, which is the current focus of monetary policy), as well as the anchoring of long-term inflation expectations. Such statements open room, in our opinion, for an eventual continuation of the tightening cycle in 2H22, especially given the higher level of uncertainty and volatility surrounding projections at this moment.**
- **As we expect incoming inflation readings to show less worrisome signs from now on and the lagged impacts of prior hikes to become more visible ahead, we continue to believe the Brazilian Central Bank (BCB) should refrain from increasing the base interest rate after the next Copom meeting (June 14-15). Therefore, we continue to see the Selic target rate reaching 13.25% pa and remaining at this level until early 2023.**

Overview

In our view, the minutes of the last Copom meeting did not bring a clearly answer the question of whether the next hike at the June gathering will be the last move in the ongoing tightening cycle. As per the post-decision communiqué, Copom members acknowledged that there has been marginal deterioration in both the short-term inflation dynamics and in their long-term forecasts, which justified their decision to deliver a 100-bp hike last week and to signal another move of a smaller magnitude in the next meeting (June 14-15). The Brazilian monetary authority expected this approach (to extend the cycle at a slower pace) to reflect the magnitude of hikes already delivered, to reinforce the cautious nature of the monetary policy and to underline the high uncertainty surrounding the current scenario. Additionally, it assesses that this strategy should ensure the convergence of inflation to the targeted level over the relevant time horizon for the monetary policy (the focus is 2023 for now), as well as to anchor inflation expectations over the long term.

Despite anticipating the next move, the BCB stated that it considers appropriate to extend the tightening cycle until the consolidation of a disinflation process materializes and expectations get anchored, which, in our view, opens room for an eventual extension beyond June's Copom meeting, given the many uncertainties still present. On the other hand, the BCB also calls attention to the fact that the monetary tightening carried out hitherto has been intense and timely, and that its impacts have not fully worked their way through the economy. In our opinion, it seems an indication that Copom members think the monetary policy has already reached a far point in the contractionary camp, which may make it difficult for further hikes to be implemented after June's Copom gathering.

Key Policy Messages

Regarding the international environment, Copom members saw additional deterioration with mounting inflationary pressures that may persist for a longer period of time than previously imagined, which has led central banks around the globe to tighten their monetary policies. This change in the posture of central banks has affected financial conditions for emerging markets and increased risks of a global economic slowdown (paragraphs #1 and #2). As far as the domestic environment is concerned, the BCB considers that activity indicators have come in line with its expectation, while inflation readings keep on running at high levels and showing a widespread nature (paragraphs #3 and #4).

Under the assumptions of its reference scenario[1], the BCB forecasts that the IPCA will reach 7.3% in 2022 and 3.4% in 2023, but it states that the uncertainty related to assumptions and forecasts is stronger than usual. The Copom members mulled over the reasons that may justify the divergence of their forecasts from market projections, with the influence of the current high readings of inflation being one of them (paragraph #6). Different assumptions regarding the convergence of oil prices and its byproducts have also proven to be a relevant factor, according to the BCB. Although it states there is high uncertainty regarding commodity prices in BRL, the BCB expects a partial reversal ahead (paragraph #8).

Fiscal risks were assessed once again, and the BCB's perception that they are partially incorporated in local assets prices and that longer-term inflation projections hold (paragraph #9). Moreover, the Copom members reminded us that the appropriate level of monetary tightening is conditional on the fiscal framework, whose deterioration or lack of structural reforms could imply a higher neutral interest rate (and, therefore, a higher nominal one as well).

Although it assesses that activity indicators have come in line with its expectations, the BCB underlines the risks of a stronger slowdown in the coming quarters on the heels of tighter monetary conditions that have yet to hit the economy. That is one of the downward risks to inflation forecasts, which are complemented by the potential price reversal of commodities in local currency. On the other hand, there are upward risks associated with the persistence of global inflationary pressures and the uncertainty regarding the local fiscal framework (paragraph #10 and #11).

What to Expect Ahead?

All in all, although overtly indicating that another interest rate hike is quite plausible for June's Copom meeting, the Brazilian monetary authority did not commit to any movement in 2H22, giving the many uncertainties currently present in the scenario. In our opinion, it has decided to keep itself open to either extending or ending the tightening cycle on August 2-3. However, as we expect inflation readings to start showing less worrisome outcomes from now on and the lagged impacts of prior hikes to become more visible ahead, we believe the BCB will deliver a 50-bp increase at June's Copom meeting, thus taking the Selic target rate to 13.25% pa and keeping it at this level until early 2023.

[1] Selic rate at 13.25% pa in YE2022 and 9.25% pa in YE2023; USD/BRL4.95 and following a PPP trajectory ahead, oil price at USD100/barrel at YE2022 and increasing 2% per annum from January 2023 onwards; "yellow flag" for electricity fare in Dec-22 and Dec-23; administered prices changes of 6.4% in 2022 and 5.7% in 2023.

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