Santander
Macroeconomic Research

BRAZIL MACRO

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MONETARY POLICY – COPOM MINUTES

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GOING FOR THE SMOOTHING STRATEGY?

- The Brazilian Central Bank (BCB) published the minutes of its June 14-15 Copom policy meeting, when the authority once again hiked interest rate (for the eleventh time running) by 50 bps, to 13.25% p.a.— the highest level in more than five years. Overall, the minutes shed more light on the BCB's flight plan, reinforcing our belief that the BCB will seek a smoothing strategy to bring inflation close to the target for the relevant policy horizon.

- The takeaway is the BCB's discussion on the strategy to bring IPCA inflation to around the target, as authority forecasts IPCA at 4.0% for 2023, way above the mid-target (3.25%) for the relevant horizon. According to the minutes, this strategy includes: (i) a terminal Selic rate above the level of 13.25% used in the reference scenario; and (ii) "the maintenance of the interest rate in significantly contractionary territory for a longer period than that used in the reference scenario." Thus, the BCB claims that it needs a more contractionary policy stance than the path implied in its inflation forecast, which assumes a Selic rate at 10.00% for YE2023.

- Given the persistence of inflationary shocks, the Copom admitted in the June 14-15 meeting that the sole "perspective of maintaining the Selic rate for a sufficiently long period would not assure, at this moment, the convergence of inflation around the target in the relevant horizon." According to the Copom minutes, this is the reason for signaling of another hike of 25 or 50 basis points for the August 2-3 meeting.

- All in all, we believe the Copom minutes gave us further hints that the BCB may be more inclined to take the smoothing policy rate strategy ahead. This means avoiding a very steep peak for interest rate in this cycle but keeping rate at a much higher level for much longer (vis-à-vis the consensus forecasts used as inputs in the BCB's inflation estimates). Naturally, this planned strategy may be under scrutiny for the coming weeks and could eventually be reconsidered (or recalibrated) depending on the size of future additional deviations in key variables, mainly inflation expectations for 2023.

- As per our scenario, we continue to see upside risks in our baseline scenario for interest rates in Brazil. The latter still has a terminal rate of 13.50% for the cycle (with a final move of 25 bps in August) and Selic at 10.50% for YE2023 (with cuts starting in May 2023). We do see a slight upward bias in our call for the terminal rate this year (in other words, we recognize the high probability for a 50-bp move in August) and identify a particularly hefty upside risk for our Selic call for YE2023. This upside risk in the medium run comes from what we see as deteriorating conditions for the disinflation process in coming months (and years).

OVERVIEW

The BCB published the minutes of its June 14-15 Copom[1] policy meeting[2], when the authority once again hiked interest rate (for the eleventh time running[3]) by 50bps to 13.25% p.a. — the highest level in more than five years. Overall, the minutes sheds more light on the BCB's flight plan, reinforcing our belief that the BCB will seek a smoothing strategy to bring inflation close to the target for the relevant policy horizon. This strategy means just a little more tightening in this cycle, combined with a path of higher interest rate for longer.

THE KEY POLICY MESSAGES

In the minutes, the BCB justifies the decision for a 50-bp hike at the June meeting, as that was seen as appropriate given "an environment of high uncertainty and the significantly contractionary stage of monetary policy, which, considering its lags, should affect the economy more strongly" in the 2H22. (Paragraph #17)

The takeaway from the minutes is the BCB's discussion on the strategy to bring IPCA inflation to around the target, as the authority forecasts IPCA at 4.0% for 2023, way above the mid-target of 3.25% for the relevant policy horizon. According to the minutes, this strategy includes: (i) a terminal Selic rate above the level of 13.25% used in the reference scenario; and (ii) "the maintenance of the interest rate in significantly contractionary territory for a longer period than that used in the reference scenario." Thus, the BCB claims that it needs a more contractionary policy stance than the path implied in its inflation forecast, which assumes a Selic rate at 10.00% for YE2023. (Paragraph #16)

Given the persistence of inflationary shocks, the Copom admitted that the sole "perspective of maintaining the Selic rate for a sufficiently long period would not assure, at this moment, the convergence of inflation around the target in the relevant horizon." According to the Copom minutes, this is the reason for signaling of another hike of 25 or 50 basis points for the August 2-3 meeting. The authority views this strategy as "more appropriate to ensure the convergence of inflation over the relevant horizon, as well as the anchoring of longer-term inflation expectations" and at the same time "reflecting the already implemented monetary tightening, reinforcing the cautious monetary policy stance, and emphasizing the uncertainty of the scenario." (Paragraph #18)

The authority kept the previous message that the "current monetary tightening cycle was quite intense and timely and that, due to monetary policy lags, much of the expected contractionary effect and its impact on current inflation are still to be seen." At the same time, the BCB also recognizes the "deterioration in both the short-term inflationary dynamics and the longer-term projections", as the BCB points out that "the scenario is surrounded by higher than usual uncertainty and volatility." (Paragraphs #14, #15)

COMPLEMENTARY VIEWS ON THE SCENARIO ASSESSMENT

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

On economic activity, the BCB sounded constructive for the short term but more cautious about the medium run. On one hand, the authority mentions the upside surprises with economic activity released of late. According to the minutes, the labor market continues to recover and "the release of the [1Q22] GDP pointed to a higher-than-expected pace of activity, raising the statistical carry-over for this year." The BCB highlights the particularly positive contributions from consumer spending and the negative contribution from capital spending in the last quarter. But the monetary authority believes that the stronger-than-expected data may also have followed some temporary drivers, still reflecting "for the most part, the post-pandemic normalization process of the economy, both in the higher consumption of services and in the utilization of the excess savings observed over historical records". The BCB also refers to the role played by fiscal stimulus in 1H22. The BCB continues

[1] The Copom is the monetary policy committee of the Brazilian Central Bank (BCB).
[2] Refer to the minutes of the 247th Copom meeting in English (https://www.bcb.gov.br/en/publications/copomminutes).
[3] **Santander Brazil Monetary Policy: "*COPOM DECISION: Keeping Options Open, For Now*"** – June 16, 2022 – Available on: https://bit.ly/Std-COPOM-jun22

to believe that "activity should decelerate in the coming quarters when the lagged impacts of monetary policy will be more strongly felt." (Paragraphs #4, #11)

On inflation, the Committee kept a cautious tone both on the recent readings and CPI composition. The BCB continues to emphasize that "inflation remains high, with increases spread among several components, and continues to be more persistent than anticipated." And the Copom still clarifies that "the surprise came in both the more volatile components and on items associated with core inflation." The BCB continues to note a deterioration in current inflation conditions as "the [CPI] components most sensitive to the economic cycle and the monetary policy continues elevated, and the various measures of underlying inflation accelerated, standing above the range compatible with meeting the inflation target." (Paragraph #5)

On the fiscal side, the minutes point to a discussion about the upside risks for the inflation outlook generated by difficulties with the fiscal framework and the discussions about new budgetary stimulus. The Copom "reinforces that uncertainty about the future of the country's fiscal framework and fiscal policies that support aggregate demand may bring an upside risk to the inflationary scenario and to inflation expectations." (Paragraph #10)

The minutes also bring a thorough discussion on global factors affecting the conduct of monetary policy in Brazil. Overall, we sense BCB officials hope to see a more favorable contribution from global factors for the disinflation process soon, despite a still shaky environment. The minutes refer to downward revisions for growth projections both for 2022 and 2023 "due to the expected reversal of the stimuli implemented during the long pandemic period, in particular by monetary policy action." (Paragraph #2) The Copom also stresses that "the global inflationary scenario continues to be marked by inflationary pressures stemming from both persistently high demand for goods and supply shocks linked to the war in Ukraine and China's Covid-19 policy" and cites that "recent policies restricting trade in agricultural products in commodity-producing countries, coupled with the effects of the war in Ukraine, bring additional risk to global inflationary pressures." (Paragraph #7) At last, the BCB describes the global conditions that it expects to navigate in coming months. According to the minutes, the Copom "anticipates a slowdown in global activity in the coming quarters, due to geopolitical tensions and monetary policy tightening, as well as financial conditions underway in several central economies". The committee also believes that "the global synchrony in the process of stimulus withdrawal introduces additional risks to markets and may boost its impact on the prospective scenario." (Paragraph #8)

OUR TAKE

In our post-Copom comment[4], we mentioned what we saw as the **BCB's dilemma**, running an already very tight monetary policy and having to do even more, as it continues to see signs of inflation persistence and an increasing difficulty to bring (expected) annual IPCA down to 3.25% at the end of 2023 – the policy horizon. The options at hand seems to be the (**i) an overkill strategy**, meaning taking the Selic rate north of 15% in the BCB's scenario (or way much higher if we take Santander's own IPCA forecasts for 2023) or (**ii) the policy smoothing strategy**, meaning to avoid a very steep peak for interest rate in this cycle but keeping rate at a much higher level for much longer (vis-à-vis the consensus forecasts used as inputs in the BCB's inflation estimates).

We believe the Copom minutes gave us further hints that the BCB may be more inclined to take the second alternative – the smoothing strategy. In the minutes, let alone the signaling of higher rate for longer given on Paragraph #16, we also perceived a greater emphasis by the BCB on the late stage of the cycle and the already tight monetary policy stance today. Thus, the Copom minutes contributed to strengthen our ex-ante assessment that the BCB would choose to hike less (than in the overkill) in this cycle but at the expense of probably cutting rate later and more slowly in the subsequent easing cycle.

[4] **Santander Brazil Monetary Policy: "*COPOM DECISION: Keeping Options Open, For Now*"** – June 16, 2022 – Available on: https://bit.ly/Std-COPOM-jun22

Importantly, the smoothing strategy does not imply tolerance with inflation overtime. This strategy is a policy choice that finds backing in the monetary policy literature[5], as some authors highlight the non-optimality of policies seeking an immediate inflation convergence under the strong influence of cost push inflation (and, at a secondary tier — according to the BCB's formal independence framework — concerns about output deviations). Of course, for the BCB to retain credibility in this process, the smoothed peak of interest rate will have to come at the expense of sacrifices in the future, translated into a rate-cutting process that will have to be much less timely (time-wise) and much less aggressive (speed-wise). And there is little doubt that this whole process will also hinge on the behavior of future cost shocks, expected fiscal policy decisions, and how those will influence inflation expectations. Naturally, this planned strategy may be under scrutiny for the coming weeks and could eventually be reconsidered (or recalibrated) depending on the size of future additional deviations in key variables, mainly inflation expectations for 2023.

All in all, we continue to see upside risks in our baseline scenario for interest rates in Brazil. The latter still has terminal rate of 13.50% for the cycle (with a final move of 25 bps in August) and Selic at 10.50% for YE2023 (with cuts starting in May 2023). We do see a slight upward bias in our call for the terminal rate this year (in other words, we recognize the high probability for a 50-bp move in August) and identify a particularly hefty upside risk for our Selic call for YE2023. This upside risk for the medium run is based on what we see as deteriorating conditions for the disinflation process in coming months (and years).

[55] Clarida, Gali and Gertler (1999) is a great example: refer to https://www.nber.org/system/files/working_papers/w7147/w7147.pdf

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