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MONETARY POLICY – COPOM MINUTES

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A HIGH BAR FOR SPEEDING UP?

- In our view, the Copom minutes bring a relatively neutral tone and no major news from the communiqué, at least when it comes to (the expectations for) the next monetary policy steps. The fact that the BCB did not strike either an accommodative (dovish) nor a contractionary (hawkish) bias in the tone should not be surprising, in our view. On the one hand, there is a need for the BCB to maintain coherence with a rate cut that turned out to be more aggressive than most analysts were looking for; on the other hand, the BCB is trying to anchor expectations on the maintenance of the same pace of easing at 0.50 p.p. per meeting ahead, amid uncertainties and risks regarding the speed of the disinflation process and convergence to the mid-target.
- Judging by the minutes, the dissent in last week's decision (with a 5-4 vote in favor of a Selic rate reduction of 0.50 p.p. to 13.25%) seemed focused on each group's conviction in the recurrence of factors evolving favorably since the last meeting, such as the drop in underlying inflation, and the degree of (over-)heating of the labor market. The prevailing majority was also keen to avoid an unintended (and undesired) monetary contraction, following the recent drop in inflation expectations.
- Disagreements aside, the minutes in general reinforce the BCB's signaling of a flight plan with cuts of 0.50 p.p. for the upcoming meetings: such a speed is likely seen as opportune by the BCB's board, due to the committee's perception that a contractionary policy stance over the projection horizon (in other words, Selic above 8.5% for the next 18 months) is quite necessary to bring inflation down to the target. We believe the Copom minutes portray the BCB willing to "keep the bar high" for an eventual acceleration in the pace of easing. However, the authority also buys flexibility to eventually change the flight plan to fit the scenario's evolution.
- If the BCB wants to reinforce the flight-plan signal and curb expectations of an even faster normalization in the policy stance (which could be harmful for a full re-anchoring of CPI expectations), it will be essential that the Copom's next steps fortify the conditioning role of inflation expectations, BCB's inflation projections and the balance of risk assessment.
- As for our scenario, we continue to anticipate rate cuts of 0.50 p.p. over the coming months, as we estimate the Selic rate at 11.75% for YE2023 and 10.00% for YE2024. Our Selic rate projection stands above the consensus for next year, mirroring the challenges we foresee on the fiscal side and elements that we believe still feeds some inflationary persistence (e.g., strong demand for services, solid employment conditions). But we recognize that the risks for our Selic call are skewed to the downside, given the greater uncertainty about the BCB's reaction function going forward.

THE FLIGHT PLAN

The minutes indicate that the committee unanimously agreed that the evolution of the scenario – as inflation expectations dropped after the CMN’s decision to keep the CPI target unchanged and following some improvement in both headline and underlying inflation – “has given the necessary confidence to start a gradual cycle of monetary easing” [Paragraph #15].

There was also a consensus within the committee on the need to signal “a more conservative stance throughout the cycle of monetary policy easing”, given the partial re-anchoring of inflation expectations, core (and services inflation) running above target and the resilient economic activity [Paragraph #16]. As already anticipated in last week's communiqué, the BCB board unanimously agrees with “cuts of 0.50 percentage point in the next meetings ", with the committee evaluating that "this pace is appropriate to keep the necessary contractionary monetary policy for the disinflationary process” [Paragraph #18].

A contractionary monetary stance over the relevant horizon is seen as a necessity “to consolidate the inflation convergence to the target and the anchoring of expectations” [Paragraph #19]. The BCB reinforces the message that the size of the adjustment (that is, the level of the terminal rate in this easing cycle) 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, on its inflation projections, on the output gap, and on the balance of risks”. The authority signals that “the extension of the cycle will reflect the BCB’s legal mandate”, which is another formula for the BCB to signal commitment with the inflation target ahead.

THE RATIONALE FOR THE DECISION AND POINTS OF DISAGREEMENT

According to the minutes, the debate at the last Copom meeting focused on the choice of the two options put on the table: (i) a cut of 0.25 p.p., probably supported by Copom members who “emphasized that the underlying fundamentals for the dynamics of services inflation do not allow yet to convincingly extrapolate the recent benign behavior” or (ii) a cut of 0.50 p.p. probably supported by Copom members who “emphasized the recent dynamics” [Paragraph #15].

According to the BCB, “both options, depending on the cycle undertaken, would be consistent with the convergence of inflation to the target in the Copom’s reference scenario and in other scenarios discussed in the meeting” [Paragraph #16]. For the more conservative group (which counted on 4 out of the 9 members), “no relevant changes had been observed either in the scenario or in Copom's projections that justified the re-evaluation” of the signaling given at the previous meeting that “the caution and parsimony inherent to this scenario.”

The predominant group (which had the five remaining votes, including the governor), argues that “the monetary policy stance at a significantly contractionary degree allows the start of the cycle already at the moderate pace considered for the next meetings, without compromising the commitment to achieve the target and the credibility of monetary policy” [Paragraph #17].

The latter also identified “the adequacy of recalibrating the real interest rate in view of the inflation expectations movements”, perhaps to avoid an unwanted degree of monetary tightening, especially amid a probable inflection in the inflationary cycle. In this sense, the minutes indicate there was agreement that "there is no evidence of an ongoing monetary tightening beyond that necessary for the inflation convergence to the target". Furthermore, the Copom believes that the scenario “still calls for caution, reinforcing the view of serenity and moderation that Copom has expressed” [Paragraph #18].

The minutes indicate that the Copom understands that “there is low probability of an additional intensification in the pace of adjustment”. For that, the BCB judges that this would require “substantial positive surprises that would raise even further the confidence in the prospective disinflationary dynamics”. Among the main factors behind this confidence, the Copom highlights “significant change in the fundamentals of inflation dynamics, such as a much more solid reanchoring of expectations, a sharp widening of the output gap, or a services inflation dynamics substantially more benign than the expected".

PARTIAL REANCHORING OF EXPECTATIONS

The Copom believes that there was a "credibility gain produced by the June meeting of the National Monetary Council (CMN), which established the inflation target for 2026, as well as its tolerance range, at the same values as those for 2024 and 2025 [i.e., 3%]". The Copom also notes that "the announcement of a change to continuous target system, with rules yet to be set out, has reduced uncertainty about the targets for subsequent years, also contributing to further reanchoring" [Paragraph #10]. But the Copom recognizes that this reanchoring is still "partial", given that CPI expectations (as measured by the median of analysts for the IPCA in the Focus survey) stands around 3.9% for 2024 and at the level of 3.5% for 2025 to 2027.

In Paragraph #11, the Copom lists possible factors behind the residual unmooring of expectations, such as: (i) the fiscal issue: despite having removed the discussion on approval of the new fiscal framework from the balance of risk analysis, the fiscal dynamics remains relevant in the baseline scenario of the BCB; (ii) global inflation: with the authority identifying the possibility of international CPI at higher levels for a prolonged period as an element that makes it difficult to fully re-anchor expected inflation in Brazil; (iii) doubts about the BCB's policy steps: the Copom highlights "the hypothesis of the agents' perception that, over time, the Banco Central do Brasil (BCB) would become more lenient in fighting inflation".

In this subject, the BCB reinforces the signal that "regardless of the BCB's board composition, the Institution's credibility and reputation should be ensured". On the fiscal topic, some Copom members highlighted "some uncertainty persists among agents about overcoming fiscal challenges, evidenced in primary balance expectations that diverge from the targets set by the government, and that this may also be reflected in unanchored inflation expectations for longer maturities".

The Committee understands that "the maintenance of the fiscal commitment in addition to a reduction in uncertainties about the tax measures that underpin the implementation of this objective, would contribute to a faster disinflationary process". The BCB also points out that an eventual "lack of commitment with structural reforms, the increase of earmarked credit granting, and the uncertainties about the stabilization of the public debt have the potential to raise the neutral interest rate of the economy, with harmful impacts on the monetary policy power and, consequently, on its cost to the economy" [Paragraph #12].

SCENARIO ASSESSMENT – INFLATION

The Copom struck a milder tone regarding the inflation conditions assessment, pointing out that "inflation continues to show more benign current dynamics, particularly in industrial goods and food components". Additionally, the committee interprets that "components more sensitive to the economic cycle and the monetary policy, which have greater inflationary inertia, declined, they remain above the inflation target" [Paragraph #3].

The Committee also maintained its distinction of a two-stage disinflation dynamics, in line with previous communications. In the August minutes, the institution extends this discussion, indicating that the first stage was "deeper than expected, given the more benign dynamics of food and industrial prices and the behavior of wholesale price." The Copom understands that "the recent dynamics of the exchange rate and international commodity prices, although with greater volatility, has contributed to slow down international pressures on inflation in Brazil". That factor is seen improving "the dynamics of the second stage of disinflation, with lower inertia on core inflation and services inflation."

But the Copom still sees reason for caution, given the more inherent volatility in industrial goods and food prices, whose trends are seen as susceptible to the possibility of abrupt reversals. Factors seen as potential upward shocks, such as El Niño and oil prices were discussed and partially incorporated into the baseline scenario as usual [Paragraph #8].

Still regarding the current stage of the disinflationary process, Copom officials understand that services inflation data "point to continuity in the trajectory of disinflation in the recent period, despite some oscillation at levels still above the value compatible with the target." The BCB points out that "it is more relevant to focus on its underlying fundamentals" – such as possible changes in the labor market and real activity dynamics – rather "than punctual movements in services inflation, relative to some component or some period" [Paragraph #9]. In Paragraph #15, the BCB informs that the stability in the inflation projection (especially for 2024 – the main policy horizon now – and for which the BCB's IPCA estimate remained flat at 3.4%), the effects of a drop in inflation expectations was offset by a revision in the path of the output gap and the update of some variables with weight in the BCB's models.

SCENARIO EVALUATION – ACTIVITY

The Copom reaffirms the communiqué's indication that "the recent set of indicators suggests a scenario of gradual deceleration of activity", in line with the BCB's expectations. The board notes that "there is some retraction in the trade sector, stability in industry and some accommodation in the services sector, after a stronger growth pace in previous quarters". Regarding the labor market, it is seen "resilient but with some moderation at the margin" [Paragraph #2].

The minutes emphasize the uncertainties associated with assessing the degree of slack in the Brazilian economy in the current situation, with the BCB seeking a robust estimate based on various measures (and calculation methodologies) of the output gap. The Copom notes that "the speed with which the gap is assumed to close over the projection horizon is as important as the initial level assumed for the gap".

The BCB identifies "the risk that the output gap is tighter than assumed in the reference scenario, in particular in the labor market", which, in the Committee's assessment, could generate possible impacts on the inflation perspectives. The institution pointed that its output gap revisions balanced the downward effects brought by the partial reanchoring of expectations on its inflation forecasts [Paragraph #7].

There are diverging opinions on labor market trends, with some in the Committee noting a "recent moderation in the labor market, which points to the slowdown in the pace of hirings in the formal market and the decline in the participation rate". Meanwhile, other members emphasize "the drop in the unemployment rate and the still high pace of hirings in formal employment".

According to the BCB, however, there is consensus with regards to a lack of "evidence of high wage pressures in labor negotiations". Some members see a movement of partial recomposition of previous losses in real wages from the pandemic, which does not seem to worry the Committee, given the slowdown seen in nominal earnings. The Copom also highlights an "accommodation" in the services section, even amid a continuity in what is seen as a "process of rebalancing the consumption basket, and, consequently, relative prices, between goods and services" [Paragraph #6].

SCENARIO EVALUATION – GLOBAL ECONOMY

Regarding the global economy, the Copom sees an "uncertain" environment, in midst of "some disinflation at the margin but with still high core inflation, gradual slowdown in economic activity, and resilience in the labor market of many countries". The BCB also highlights that "the central banks of major economies remain committed to bringing inflation back to its targets", be it through further tightening or through singling a prolonged period of high interest rates. The authority keeps pointing that the picture calls for requires "greater caution in the conduct of economic policies, particularly by emerging countries" [Paragraph #1].

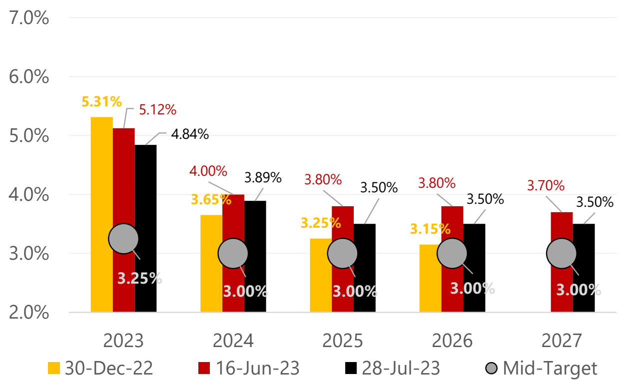
The Copom understands that the external environment is marked by "resilience of activity and the labor market in advanced economies, even if some moderation is observed at the margin, as well as lower growth projection for the Chinese economy". Regarding the global growth scenario, "some members see a mild moderation in activity in major economies as more likely, although a sharper slowdown is not ruled out". With regards to the "disinflation process at the margin is observed, reflecting the slowdown of commodity pressures after the initial impacts of the war in Ukraine and the normalization of productive sectors", the Copom caveats that "uncertainties remain about the global inflation dynamics", given a slow retreat in core inflation, amid a "resilience of the labor market and tight output gap in advanced economies" [Paragraph #5].

The BCB believes that a “synchronization of contractionary monetary policy may have a larger-than-expected impact on the global output gap and on the” global disinflation process. Thus, even if it may exert an “impact upon domestic asset prices in the short term, coupled with a credit slowdown in major economies”, the central banks’ stance “contributes to a more credible and lasting global disinflationary process” [Paragraph #5].

BALANCE OF RISKS

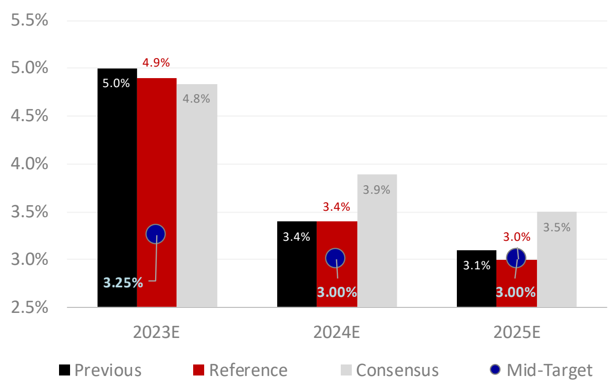
The balance of risks remained unaltered with respect to last week’s communiqué, highlighting upside risks “(i) a greater persistence of global inflationary pressures; and (ii) a stronger than expected resiliency on services inflation due to a tighter output gap” and downside risks as “(i) a greater than projected deceleration of global economic activity, particularly due to adverse conditions in the global financial system; and (ii) an impact on global disinflation larger than expected from synchronized monetary policy tightening” [Paragraph #13].

Figure 1. Median Annual IPCA Forecasts (Consensus)



Sources: Brazilian Central Bank, Santander.
Note: Based on the last edition of the BCB’s weekly Focus survey with professional forecasters before the Copom meeting (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

Figure 2. BCB’s IPCA Inflation Estimates (% annual, Reference Scenario, August Copom)



Sources: Brazilian Central Bank, Santander.
Note: Assuming FX rate departing from USD/BRL 4.75, 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: 12.00% for YE2023; 9.25% for YE2024 and 8.75% for YE2025.

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