Santander Macroeconomic Research

BRAZIL MACRO

December 13, 2022

MONETARY POLICY – COPOM MINUTES

RATIFYING THE STRATEGY AND MONITORING THE RISKS

Mauricio Oreng
mauricio.oreng@santander.com.br
+5511 3553 5404

- The Brazilian Central Bank (BCB) published the minutes of its December 6-7 Copom policy meeting, when the authority kept the Selic policy rate at 13.75% for a third time running. In our view, the minutes maintain the same tone as the statement, bringing just a few new elements to the policy discussion and risk assessment. The strategy is still "maintaining the Selic rate for a sufficiently long period will be enough to ensure the convergence of inflation", with the committee still signaling it "will not hesitate to resume the tightening cycle if the disinflationary process does not proceed as expected."

- While coming to no conclusions amid substantial perceived uncertainty, the Copom debated (in theory) the impact of fiscal scenarios (and variables that have influence) on the inflation outlook. The Committee sees "different channels through which fiscal policy can affect inflation not only via the primary effects of <u>aggregated demand</u> but also via <u>asset prices</u>, the degree of <u>economic uncertainty</u>, <u>inflation expectations</u>, and <u>neutral interest rate</u>." The board believes that "changes in parafiscal policies or the reversal of structural reforms that lead to a less efficient allocation of resources might reduce the power of monetary policy." Moreover, the BCB simulations led to the conclusion that "the final effect, either on inflation or on activity, will depend on both the combination and the magnitude of the fiscal and parafiscal policies."

- On activity, the BCB sees the latest data still indicating a more moderate pace of growth and reinforcing "the Committee's expectation of a slowdown in the pace of economic activity, which should worsen over the coming quarters." Moreover, while the Committee estimates "a reduction in the degree of economic slack" in 3Q22, the Copom still "believes that the [output] gap should widen over the relevant horizon."

- The BCB continues to attempt to tone down the potential market optimism on the inflation assessment, with all Copom members agreeing that "current inflation did not surprise significantly in relation to expectations or substantially changed the understanding about future inflation dynamics." The BCB also shows concerns about "a rise in the average expectations" for 2024. The BCB believes that the "disinflation in services and core inflation — components with greater inertia — will require increased attention and perseverance in the conduct of monetary policy." However, the Committee believes that "the disinflation process of this component will become clearer over time."

- The minutes include an extensive discussion on the global scenario, still seen as "adverse and volatile", as the BCB anticipates "below-potential 2023 global growth", a slower than usual disinflation process, and a tighter monetary policy for a longer period. The BCB also points to factors seen as potentially hampering the financial conditions facing emerging economies.

- All in all, we believe the Copom minutes reinforce the "wait and see" mode of the BCB currently. We still believe that a change in the flight plan would require scenarios and hypotheses much different from the current ones. We continue to pencil in rate cuts only in 2H23 (taking the Selic down to 12.00% for YE2023), with risks for our expected interest-rate path skewed to the upside.

OVERVIEW

The BCB published the minutes of its December 6-7 Copom[1] policy meeting[2,3], when the authority kept the Selic policy rate at 13.75% for a third time running. In our view, the minutes basically keep the same tone of the statement, bringing just a few new elements to the BCB's scenario and risk assessment. The BCB's strategy continues to be "maintaining the Selic rate for a sufficiently long period will be enough to ensure the convergence of inflation", with the committee still signaling it "will not hesitate to resume the tightening cycle if the disinflationary process does not proceed as expected."

DETAILS OF THE POLICY DISCUSSION

While showing no final conclusions for the current cycle, amid a perception of great uncertainty, the Copom debated, in theoretical terms, the impact of fiscal policy scenarios (and key variables that bear influence) on the inflation outlook. Firstly, the Committee highlights "the different channels through which fiscal policy can affect inflation not only via the primary effects of aggregated demand but also via asset prices, the degree of economic uncertainty, inflation expectations, and neutral interest rate." The BCB's board believes that "changes in parafiscal policies or the reversal of structural reforms that lead to a less efficient allocation of resources might reduce the power of monetary policy." Moreover, BCB simulations[4] led to the conclusion that "the final effect, either on inflation or on activity, will depend on both the combination and the magnitude of the fiscal and parafiscal policies." The authority also highlights the role of the output gap estimates and debt sustainability expectations on determining the inflationary effects of fiscal policies, stressing that in "an environment of a narrow output gap, the impact of significant fiscal stimulus on the path of inflation tends to outweigh the aimed impacts on economic activity." The BCB sees "a lot of uncertainty about the prospective fiscal scenario" and believes that "the moment requires caution in risk assessment." The Committee pledges to keep monitoring "future fiscal policy developments and their potential impacts on prospective inflation dynamics." (Paragraphs #12 and #13)

The BCB also apparently continues to seek to tone down the potential market optimism on the inflation assessment, with all Copom members agreeing that "current inflation did not surprise significantly in relation to expectations or substantially changed the understanding about future inflation dynamics." The BCB also believes that the "disinflation in services and core inflation – components with greater inertia – will require increased attention and perseverance in the conduct of monetary policy." The internal discussions published in the minutes also reveal a slight divide in the Committee as per the possible contribution from commodity prices to the inflation outlook. While some members "noted the benign movement of commodities in BRL, highlighting additional downside risks ahead", other members "emphasized the volatile nature of these prices in an environment of pressured inventories." (Paragraph #11)

The Copom minutes reinforced the message that, according to the BCB estimates, the "12-month inflation projection for the second quarter of 2024 [at 3.3%], in the scenario using the interest rate trajectory extracted from the Focus survey [i.e., 13.75% for YE2022; 11.75% for YE2023; 8.50% for YE2024], remains consistent with the strategy of inflation convergence to around the target over the relevant horizon[5]". The minutes also highlight the BCB estimates that "inflation projection for 2024 is also around the target." Yet the authority still points to a "lower-than-normal visibility of the forward-looking scenario," which the BCB believes "increases the uncertainty of the point projections communicated by the Committee over longer horizons." (Paragraph #16)

While the minutes kept virtually unchanged the Copom's analysis on the balance of risks (just as in the statement), the BCB discussed "the evolution of the broad array of data monitored, the projections, inflation expectations, output gap, and the balance of risks." The BCB justifies a "slight increase" in its inflation forecasts for the relevant policy horizon "due to both an increase in the projection for the inflation of

---

1 The Copom is the monetary policy committee of the Brazilian Central Bank (BCB).
2 Refer to the minutes of the 251st Copom meeting in English (https://www.bcb.gov.br/en/publications/copomminutes).
3 Our analysis on the statement: **Santander Brazil Monetary Policy: "*COPOM DECISION: Serenely Waiting and Seeing Fiscal Events*"** – December 7, 2022 – Available on: https://bit.ly/Std-COPOM-dec22
4 More details on these simulations might be presented on the 4Q22 inflation report, due out on Thursday December 15, 2022).
5 The mid-point inflation target is 3.25% for 2023 and 3.00% for 2024 (these are the main policy horizons, with equal weights, as per 4Q22).

market prices in shorter terms and a revision of the projection for the inflation of administered prices over longer terms." The Copom sees that services inflation "showed some moderation but remains at high levels", with the Committee still believing that "the disinflation process of this component will become clearer over time." Moreover, while the Committee estimates "a reduction in the degree of economic slack" in the 3Q22, the Copom still "believes that the [output] gap should widen over the relevant horizon." (Paragraphs #14, #16 and #18)

The Copom also continues to indicate the "neutrality" of fuel tax policies on the conduct of monetary policy. In the minutes, the BCB continued to say that "if the alternative scenario of maintaining tax exemption on fuels in 2023 materializes, it will again emphasize usual horizons that include the" 1Q23. The authority again claims such a decision would bear "no relevant impacts on the conduct of monetary policy since the primary effects of such measures are already being disregarded." (Paragraph #17)

OTHER VIEWS ON THE SCENARIO ASSESSMENT

Elsewhere in the minutes, one finds details on the authority's scenario assessment, both regarding the domestic and global economies.

On activity, the BCB sees the latest data still indicating "a more moderate pace of marginal growth" and reinforcing "the Committee's expectation of a slowdown in the pace of economic activity, which should worsen over the coming quarters." The BCB notes that the 3Q22 GDP figures indicate "a reduction in the pace of growth, especially in some of the more cyclical components" [although the authority notes the growth in all demand components]". The BCB also points to: i) "a reduction in the pace of job openings" [although the authority highlights the still positive net hirings of late]", ii) a "drop in confidence indicators" and iii) a "reduction in credit granting". The BCB expects further loss of steam in the economy given "the lagged effects of monetary policy". (Paragraphs #4 and #10)

On inflation, the authority maintains a skeptical tone on current inflation trends and remains wary of developments on core inflation and inflation expectations. The BCB sees the recent annual CPI decline associated with "items which are more volatile and affected by tax measures". While noting the deceleration in industrial goods "reflecting the more intense decrease in producer prices and the reduction of pressures in global value chains", the BCB still believes that "components more sensitive to the economic cycle and the monetary policy, which present greater inflationary inertia, remain above the range compatible with meeting the inflation target". The BCB also highlights concerns of "a rise in the average expectations" for 2024, in the context of increased perception of fiscal risks. (Paragraphs #5 and #18)

The minutes keep an extensive discussion on the global scenario, still seen as "adverse and volatile", as the BCB anticipates a "below-potential 2023 global growth", a slower than usual disinflation process, and a tighter monetary policy for longer. The BCB cites "tightening of financial conditions in major economies, difficulties in energy supply to Europe, and a challenging scenario for growth in China". The BCB discusses the speed of the global disinflation process, given the ambiguity between expectations of a slowdown in flexible prices ("industrial goods, energy, and food segments", given the normalization of global production chains and falling commodity prices) and the persistence and spreading of sticky and services inflation (given the "environment of tight labor markets in several countries"). The BCB concludes that "the [global] disinflation process should be non-linear and slower than that observed in recent episodes." The authority also notes the "determination of central banks to reduce inflationary pressures and anchor expectations", which the BCB believes points to a "scenario of longer tightening of financial conditions, with interest rates at the end of the tightening cycle maintained for a sufficiently long period at contractionary levels". the authority sees this element "raising the risk of a more pronounced global deceleration." (Paragraphs #1, #2, #3, #7 and #8)

The BCB also discusses market themes that could further hamper financial conditions for emerging economies. The Copom continues to see greater market sensitivity "to developments that affect fiscal fundamentals, due to the combination of higher interest rates and sovereign debt at historically high levels." The authority also highlights the lower liquidity in sovereign bond markets, which the BCB associated with "greater uncertainty in the interest rate dynamics, the reversal of long-term asset purchase policies and regulatory changes." (Paragraph #9).

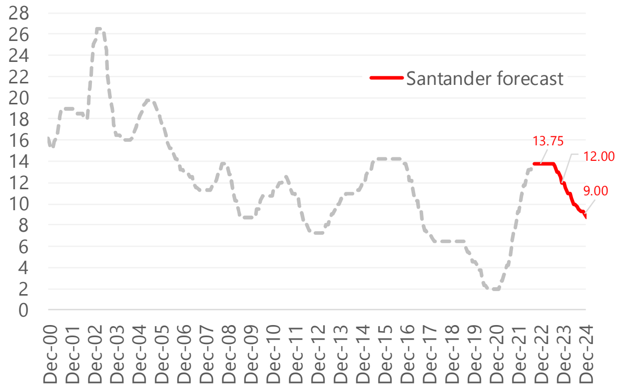
WHAT TO EXPECT AHEAD?

All in all, we believe the Copom minutes reinforce the current wait-and-see mode by the BCB. For now, the Copom continues to see its strategy of lower rates for long consistent with achieving the mid-point inflation target (3%) over the medium term. Judging from the tone of the statement and the minutes, we believe the BCB is waiting for the upcoming fiscal decisions to either ratify or change its strategy of holding interest rate steady for long. Uncertainty remains very high at this juncture, in our view.

Despite the solid cyclical position of the Brazilian economy and the introduction of permanent fiscal stimulus, we still believe that a change in the flight plan would require scenarios and hypotheses much different from the current ones held by the BCB. We continue to pencil in rate cuts only in 2H23, taking the Selic down to 12% for YE2023 and 9% for YE2024. Given the tone of current fiscal discussions, however, we see risks for the Selic path potentially skewed to the upside.

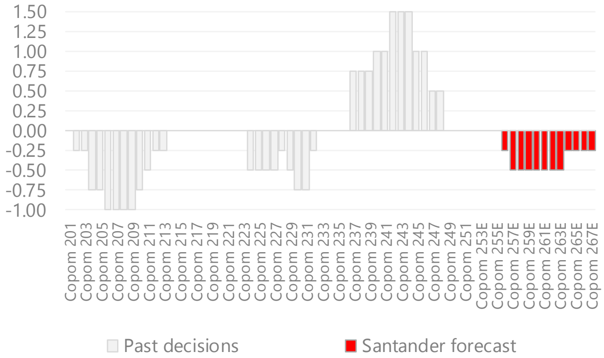
Please see graphs on the next page.

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



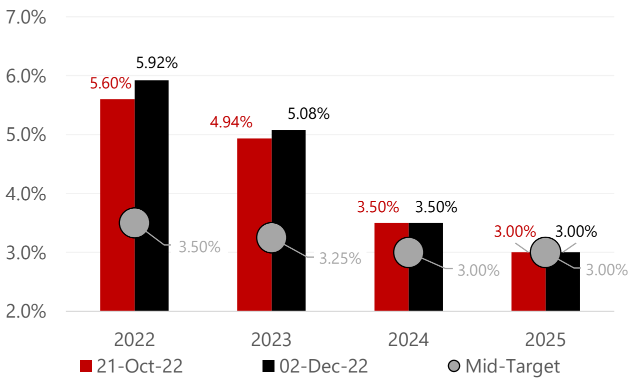
Sources: Brazilian Central Bank, Bloomberg, Santander.

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



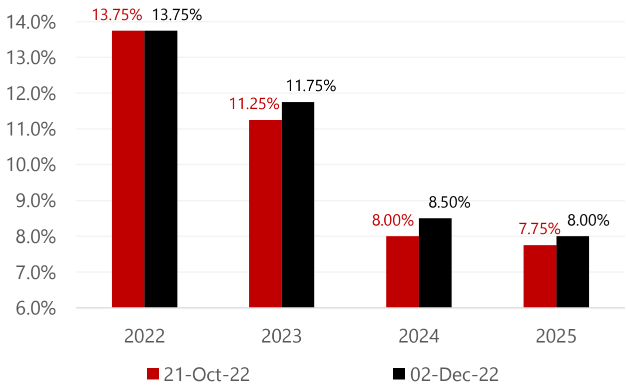
Sources: Brazilian Central Bank, Bloomberg, Santander.

Figure 3. Median Annual IPCA Forecasts (Consensus)



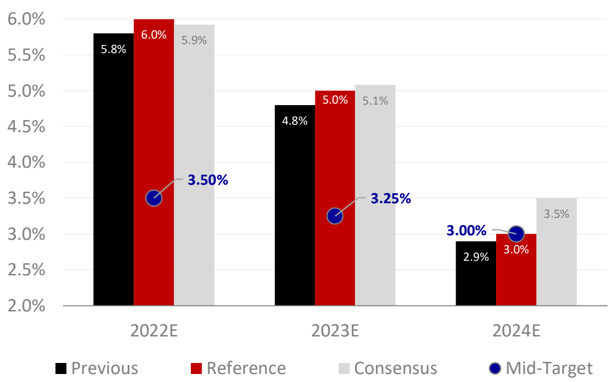
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout). As of the week before the Copom meeting.

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). As of the week before the Copom meeting.

Figure 5. BCB's Inflation Estimates (% Annual IPCA)



Sources: Brazilian Central Bank, Santander.
Note: Assuming FX rate departing from USD/BRL 5.25, and then moving along with the PPP (purchasing power parity). Also assumes oil prices following the futures market curve for six months and then increasing 2% per year afterwards. The BCB uses the consensus forecasts (as per the Focus reports) for the Selic policy rate as an assumption for interest rate.

CONTACTS / IMPORTANT DISCLOSURES

Brazil Macro Research			
Ana Paula Vescovi*	Chief Economist	anavescovi@santander.com.br	5511-3553-8567
Mauricio Oreng*	Head of Macro Research	mauricio.oreng@santander.com.br	5511-3553-5404
Jankiel Santos*	Economist – External Sector	jankiel.santos@santander.com.br	5511-3012-5726
Ítalo Franca*	Economist – Fiscal Policy	italo.franca@santander.com.br	5511-3553-5235
Daniel Karp Vasquez*	Economist – Inflation	daniel.karp@santander.com.br	5511-3553-9828
Tomas Urani*	Economist – Global Economics	tomas.urani@santander.com.br	5511-3553-9520
Lucas Maynard*	Economist – Economic Activity	lucas.maynard.da.silva@santander.com.br	5511-3553-7495
Felipe Kotinda*	Economist – Commodities	felipe.kotinda@santander.com.br	5511-3553-8071
Gabriel Couto*	Economist – Special Projects	gabriel.couto@santander.com.br	5511-3553-8487
Fabiana Moreira*	Economist – Credit	fabiana.de.oliveira@santander.com.br	5511-3553-6120
Gilmar Lima*	Economist – Modeling	gilmar.lima@santander.com.br	5511-3553-6327
Global Macro Research			
Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@santander.pl	48-22-534-1888
Rodrigo Park *	Economist – Argentina	rpark@santander.com.ar	54-11-4341-1272
Ana Paula Vescovi*	Economist – Brazil	anavescovi@santander.com.br	5511-3553-8567
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
Guillermo Aboumrad*	Economist – Mexico	gjaboumrad@santander.com.mx	5255-5257-8170
Piotr Bielski*	Economist – Poland	piotr.bielski@santander.pl	48-22-534-1888
Mike Moran	Head of Macro Research, US	mike.moran@santander.us	212-350-3500
Fixed Income Research			
Juan Arranz*	Chief Rates & FX Strategist – Argentina	jarranz@santanderrio.com.ar	5411-4341-1065
Mauricio Oreng*	Senior Economist/Strategist – Brazil	mauricio.oreng@santander.com.br	5511-3553-5404
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778
Equity Research			
Miguel Machado*	Head Equity Research Americas	mmachado@santander.com.mx	5255 5269 2228
Alan Alanis*	Head, Mexico	aalanis@santander.com.mx	5552-5269-2103
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Mariana Cahen Margulies*	Head, Brazil	mmargulies@santander.com.br	5511-3553-1684
Electronic			
Bloomberg		SIEQ <GO>	
Reuters		Pages SISEMA through SISEMZ	

Hong Kong (HK): This report is distributed in Hong Kong by Banco Santander, S.A. (a public limited liability company incorporated in Spain) which has a branch in Hong Kong. Banco Santander, S.A., Hong Kong Branch is regulated as a Registered Institution by the Hong Kong Monetary Authority for the conduct of Advising and Dealing in Securities (Regulated Activity Type 4 and 1 respectively) under the Securities and Futures Ordinance. This report is not intended for distribution to any persons other than professional investors. Banco Santander, S.A. or its affiliates may have a holding in any of the securities discussed in this report; for securities where the holding is greater than 1%, the specific holding is disclosed in the Important Disclosures section above. The recipient of this report must not distribute it to any person without the prior written consent of Banco Santander, S.A. **Singapore (SG):** This report is distributed in Singapore by Banco Santander, S.A. which has a branch in Singapore. It is not intended for distribution to any persons other than institutional investors, accredited investors and expert investors (each as defined in the Securities and Futures Act 2001 of Singapore). Recipients of this report should contact Banco Santander, S.A., Singapore Branch at researchsingapore@gruposantander.com for matters arising from, or in connection with, this report. **Mainland China (CN):** This report is being distributed in Mainland China by Banco Santander, S.A. which has two branches in Mainland China, being Shanghai Branch and Beijing Branch ("Santander China"). Santander China is regulated by China Banking and Insurance Regulatory Commission. Banco Santander, S.A., Shanghai Branch is licensed for foreign currency business, RMB business and derivative business. Banco Santander, S.A., Beijing Branch is licensed with foreign currency business. The recipient of this report must not distribute it to any person without the prior written consent of Banco Santander, S.A..

Santander